NZSUPERFUND
Te Kaitiaki Tahua Penihana Kaumātua o Aotearoa

5 March 2019

Michael Wood, Chair
C/- Siobhan Coffey, Clerk
Finance and Expenditure Select Committee
Parliament Buildings
WELLINGTON
By email: finance.expenditure@parliament.govt.nz

Dear Michael,

SUPPLEMENTARY QUESTIONS – GUARDIANS OF NEW ZEALAND SUPERANNUATION

Thank you for the hearing we had in front of the Finance and Expenditure Committee on 20 February 2019. We appreciated the strong engagement of the members of the Committee in the approach and activities of the Guardians of New Zealand Superannuation ("**Guardians**") as the manager of the New Zealand Superannuation Fund ("**Fund**").

We would like to take this opportunity to correct one point with the Select Committee. We were asked by the MP from New Lynn about whether exempting the Fund from domestic income tax would result in lower Government contributions to the Fund.

As you are aware, the Government is not currently contributing to the Fund at the level set out in the New Zealand Superannuation and Retirement Income Act. Consequently, should the Fund be exempted from domestic income tax, there would be no impact on Government contributions to the Fund for the fiscal years until June 2022.

Government contributions to the Fund for 2023 and following fiscal years are determined by a model set out in the New Zealand Superannuation and Retirement Income Act and available at: https://treasury.govt.nz/publications/information-release/new-zealand-superannuation-fund-contribution-rate-model.

This model relies on a forecast rate of return for the Fund on a net of tax basis. Implementing a zero tax rate would have an immediate impact on the model, with the result that the required contributions would be lower. The lower contributions would (approximately) be offset by tax no longer received from the Fund. The Government's books would neither win nor lose through this change in approach; the advantages of the tax exemption are that the Fund:

- no longer has to bear the deadweight losses of tax compliance costs;
- can potentially obtain some sovereign tax immunity benefits offshore; and
- as a long-term savings vehicle, does not suffer 'withdrawals' in the form of NZ tax should contributions be suspended by the Government again.

Please find our responses to the Committee's Supplementary Questions attached.

Yours sincerely

Matt Whineray
Chief Executive Officer

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GUARDIANS OF NEW ZEALAND SUPERANNUATION
Level 12, Zurich House, 21 Queen Street, Auckland 1010
PO Box 106 607, Auckland 1143, New Zealand. Phone: +64 9 300 6980 Fax: +64 9 300 6981
www.nzsuperfund.co.nz

Guardians of NZ Superannuation and NZ Superannuation Fund - Responses to Supplementary Questions

113. The Committee notes the Fund made good returns in 2018 with it achieving an overall return of 12.43%.
a. What were the main reasons for the strong returns?
b. Which sectors had the greatest returns?

There are two components to Fund returns:

- the performance of global listed markets, to which the Fund has passive exposure through its Reference Portfolio;
- the performance of the Fund's active investments.

Of the total return of 12.43% (which is reported after costs, before NZ tax), the Fund's exposure to global markets contributed 10.42%, as set out below:

Reference Portfolio benchmark	Weighting	2017/18 Return (NZ$)
Global equities – developed markets	65%	13.03%
Global equities – emerging markets	10%	9.05%
New Zealand equities	5%	17.63%
Global fixed income	20%	2.20%
TOTAL	100%	10.42%

The remaining 2.02%[1] represents the Guardians' active investment activities, which added value of $703 million to the Fund over the market return achieved by the Reference Portfolio. The main drivers of these active returns were the Guardians' strategic tilting programme, a positive performance by the Fund's single largest investment, Kaingaroa Timberlands, and the active collateral mandate. For further information on the sources of active return please refer to page 40 of our 2017/18 Annual Report.

It is important for Committee members to understand that the Guardians is deliberately pursuing long-term investment strategies that are designed to play out over many years – not a twelve month period. There will be years when the Fund performs well and years when it does not. Long-term performance is a more useful and important metric of the Fund's success than an annual figure. Up-to-date information on Fund performance, since inception in 2003, is available at https://www.nzsuperfund.nz/performance/investment.

114. There are future investment risks including a downturn in global growth and international trade tensions.
a. What strategies do the Guardians have in place to mitigate future investment risks?

For the Fund to meet a significant portion of the future cost of New Zealand Superannuation, the ability to take market risk to earn investment returns over long periods of time is crucial. But market risk means the Fund will experience mark-to-market losses from time to time when financial markets fall in value.

[1] NB: rounding means figures don't sum.

In addition to taking market risk, the Fund's endowments (long-term horizon, known cash flow profile, operational independence and sovereign status) enable it to embrace active, contrarian investment strategies in order to further enhance returns.

In keeping with the Fund's long investment horizon (no sustained withdrawals are projected until the 2050s), and in order to meet its mandate of "maximising return without undue risk", we have deliberately weighted the Fund towards growth assets (80% equities, 20% fixed income). This is a similar approach to the "growth" mandates offered by typical KiwiSaver funds.

In the short-term, growth assets can be volatile, moving up and down in price. The Fund has the ability to ride out and potentially benefit from these short-term movements.

By taking on the market risk associated with growth assets, the Guardians accepts the risk that markets may experience sharp drops in value, be they driven by financial or political shocks, large commodity price movements, natural disasters or war. It is largely unavoidable that a growth-oriented portfolio such as the Fund will fall in these periods. The Fund is well-placed to withstand such losses, as there is no immediate need to withdraw capital from it. These fluctuations can be treated as unrealised losses with little long-term ramifications for the Fund's ability to fulfil its purpose.

In the long-term, the Fund's exposure to market risk from growth assets such as shares is expected to pay off in the form of higher returns than the cost to the Government of contributing to the Fund.

The Fund uses active investments to diversify away from equity markets (for example, into timber and rural land). It also employs active investment strategies that take advantage of its long-term horizon and known cash flow profile, such as investing in illiquid, privately held assets.

The Fund has the ability to act as a contrarian investor, buying when other investors are selling (and vice-versa). This is the purpose of the Fund's strategic tilting programme, which uses derivatives to take positions across a number of investment markets (equity, bond and currency). This programme relies on a belief in mean reversion in asset prices towards fair value and is a buyer of "risky" assets during financial market downturns. In summary, financial market downturns are seen by the Guardians as an opportunity.

The major risk to the Fund is not that it will experience significant volatility in its returns - we know that will happen. The major risk to the Fund is that we lose our nerve, close down our investment positions and lock in the losses experienced in the crisis. This would significantly impair the ability of the Fund to fulfil its long-term purpose.

As the Fund becomes bigger in dollar terms, and grows as a share of the economy, its gains and losses from short-term market volatility will also increase in size. We encourage Committee Members to understand that the main challenge in persisting as a long-horizon investor is in looking through short-term shifts in value and focusing instead on more appropriate and long-term metrics of success.

Even considering the risk of market crises, the Guardians' view is that the Fund's market risk and active strategies are appropriate and compensated risk exposures for a long-term investor.

115. The Government restarted contributing to the Fund in 2017/18.

a. How, if at all, does the resumption of Government contributions to the Fund affect the Fund's investment approach?

The Fund is projected to grow more strongly following the resumption and scaling up of Government contributions to the level required by our legislation, which is projected to occur in 2021/22. With this in mind, we are continuing to work on long-term organisational target state with a focus on identifying where internal capabilities and capacity should be developed further and where resources could be re-focused for better longer-term effect. This work involves a consideration of which of our current investment activities are easily scalable and which are not; and which investment opportunities are suitable for in-house management, and which are better out-sourced to external investment managers. This work is continuing. Over the next year we anticipate recruiting more staff, both in the investment and investment support teams, and continuing the significant investments we have made in information technology and operational systems over recent years.

116. The Guardians established its Investment Hub to facilitate direct investing into New Zealand businesses.

a. How has the Investment Hub helped the Guardians increase its New Zealand investments?

The role of the Investment Hub is to research and shape new investment opportunities of scale that would otherwise be unachievable in the New Zealand market, and added more staff to our New Zealand direct investment team. The formation of the Hub has resulted in increased domestic market engagement by the Guardians across a range of sectors. During the 2017/18 year the Investment Hub team considered a number of investment opportunities, developed the Public-Public Investment model as a mechanism for investment (e.g. in large-scale infrastructure) and submitted an unsolicited proposal to invest in Auckland Light Rail to the Government. We added new investment opportunities to our investment pipeline and developed a deeper understanding of how to execute on Investment Hub opportunities [for example, in respect of the Te Pūia Tāpapa fund. Please see our response to Q117 for more information].

b. Have any issues arisen with its direct investment strategy? If so, what were these?

Section 59 of the NZ Superannuation and Retirement Income Act prohibits the Fund from owning a controlling stake in an operating company. This constraint means the Fund is necessarily always a minority shareholder and must work in partnership with other investors. As a result, we devote significant resource to establishing strong partnerships with like-minded and compatible co-investors, both domestically and offshore.

With respect to individual investments (for example, where we may have a seat on the Board) we focus our influence on delivering our investment thesis through working to ensure Boards and companies have a long-term growth focus in making decisions about strategy and capital expenditure, and take a best-practice approach to risk management, including in respect of environmental and social risks.

The cost-effectiveness of direct investment (i.e. investments managed by our in-house team) as a way of accessing investment opportunities is also a consideration. For this reason (in combination with the constraint on control, explained above) we target direct transactions of NZ$100m plus, for a 20%-50% stake. This necessarily limits our direct participation in domestic transactions to those at the larger end of the market and where we have partners of similar financial scale.

117. In March 2018, the Guardians signed a Memorandum of Understanding with Te Pūia Tāpapa Fund, establishing a preferred partnership agreement.

a. How does the partnership work in practice?

Under the MoU, Te Pūia Tāpapa and the Fund have committed to a preferred partnership relationship to be conducted in a spirit of mahi tahi (working together), transparency and good faith. This involves the formal sharing of ideas and collaboration in areas of mutual interest and potential commercial benefit. We are meeting on at least a monthly basis with Te Pūia Tāpapa representatives, and have reviewed a number of potential co-investment opportunities in a diverse range of sectors.

b. What are the advantages of the partnership? Are there any disadvantages? If so, what are these?

The MoU is intended to help both Te Pūia Tāpapa and the NZ Super Fund stimulate investment opportunities that would not otherwise have existed. For Iwi/Māori participants the fund facilitates more diversification in investment portfolios, it enables participants to work (and commit to invest) together with one another in a commercial setting, it provides for more cost-effective access to direct investments, and it catalyses access to larger scale direct investment opportunities than they could ordinarily achieve on an individual basis. For the Guardians, Te Pūia Tāpapa represents a like-minded, inter-generational investor of scale in the New Zealand context.

As well as presenting suitable investment opportunities under consideration by the Guardians to Te Pūia Tāpapa, we look forward to Te Pūia Tāpapa presenting investment opportunities, such as those relating to Maori-owned land, to us.

The Guardians and Te Pūia Tāpapa will raise awareness amongst each of other of unique investment practices and expectations, along with networks, as we continue to work together.

We do not see any disadvantages in the arrangement.

c. Have any joint investments been made? If so, what are they?

Not to date. We understand that Te Pūia Tāpapa only formally closed its fundraising in August 2018 (meaning has only been in a position to invest since then). If a joint investment is made by the Fund and Te Pūia Tāpapa, it will be publicly announced, consistent with our commitment to transparency. Select Committee members should note that it is typical for large scale direct investment transactions to take many months – indeed, sometimes years – to progress from origination to completion. One opportunity that we have been investigating together with multiple land owners has been curated over a period of nearly two years.

118. The Committee notes the Guardians introduced a climate change investment strategy in 2016 to improve investment resilience to climate change over the long- term horizon of the Fund.

a. How do the Guardians factor climate change considerations into investment decisions?

Climate change considerations are factored into the Guardians' valuation investment decision-making processes and governance structures on an ongoing basis. This entails managing and monitoring the Fund's carbon exposure, managing climate-related risks, and seeking to take advantage of the investment opportunities arising from climate change action. The strategy is being implemented via four work-streams:

- Reduce – implement rules and activities to reduce climate change risk in the passive listed equities portfolio and other relevant portfolios;
- Analyse – implement framework to assist investment professionals in integrating climate change into valuations for active and prospective investments;
- Engage – implement an engagement programme and voting policy on climate change;
- Search – progress implementation of climate change opportunities identified.

For more information please refer to: https://www.nzsuperfund.nz/how-we-invest-balancing-risk-and-return/climate-change.

b. What initiatives, if any, did the Guardians introduce in 2017/18 to manage the Fund's exposure to climate change?

Initiatives under each of the four work-streams noted above are outlined below;

<u>Reduce</u>

After initially focusing on the Fund's passive equity holdings, 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. We will continue to work on reducing carbon exposure across other active mandates, focusing next on our factors mandates. We are also focusing on how emissions can be reduced across the Fund's unlisted assets.

<u>Analyse</u>

We completed a framework for investment professionals to incorporate climate change considerations into valuations. The objective is to ensure climate change risk for new and existing investments is assessed in a consistent and systematic manner by our investment professionals. This framework was approved by the Investment Committee and introduced to the wider investments team. It will be refined on an ongoing basis.

Engage
The Responsible Investment (RI) and External Investments and Partnerships (EIP) teams together reviewed the engagement work conducted by our listed equity investment managers on climate change. In addition, as part of our ongoing responsible investment monitoring, all managers were asked about their climate change activities through Environmental Social and Governance (ESG) due diligence questions sent out in April 2018.

This year, we also brought our global voting activity in-house (previously, our external managers voted the shares they managed on our behalf). The change will help ensure we vote consistently on climate change related resolutions for the same company and in line with our voting guidelines on climate change.

We also:

- made submissions to the NZ Productivity Commission Inquiry into the transition to a low emissions economy;
- provided feedback on Business NZ's submission to the Ministry of Business, Innovation and Entrepreneurship's Climate Change Adaptation Options Report
- joined the Climate Action 100+'s five year initiative to engage with the world's largest corporate greenhouse gas emitters to improve governance on climate change, curb emissions and strengthen climate-related financial disclosures; and
- played a leading role in the formation of the One Planet Sovereign Wealth Fund Working Group. See our response to question 119, below.

Search
The Guardians' investment research clearing house, the New Opportunities Assessment Hub (NOAH), reviewed a number of climate-related opportunities. We continue to search for investments within our alternative energy opportunity set. This year, we invested in Rubicon Global, a waste management and technology platform, which aims to reduce emissions from waste by increasing recycling rates.

Progress towards targets
We use carbon footprinting to measure carbon exposure across the whole of the Fund and to track our progress towards our 2020 carbon reduction targets. Our 2018 carbon footprint assessment reported that the total Fund's carbon emissions intensity is 18.7% lower than our baseline level (vs a target of 20% lower), and its exposure to potential emissions from reserves is 32.1% lower (vs a target of 40% lower).

119. The Guardians are a founding member of the One Planet Sovereign Wealth Fund Group, which launched a Climate Change Framework in July 2018.

a. What does the new framework cover, and what does it intend to achieve?
Given both their influence and long-term investment horizons, Sovereign Wealth Funds ("SWFs") are in a unique position to promote long-term value creation and sustainable market outcomes. Accordingly, the One Planet Sovereign Wealth Fund Working Group was established in December 2017 in order to accelerate efforts to integrate financial risks and opportunities related to climate change into the management of large, long term and diversified asset pools.

The Guardians is a founding member of the One Planet SWF Working Group, alongside the Abu Dhabi Investment Authority, Kuwait Investment Authority, Norges Bank Investment Management, the Public Fund of the Kingdom of Saudi Arabia and the Qatar Investment Authority.

Together, the founding members collectively manage over USD3t in assets. The initiative is championed by President Macron of France.

The Group's Climate Change Framework was launched in July 2018, with the Guardians contributing in particular on policy and technical leadership. Building on current industry best practice, the framework aims to foster a shared understanding among long-term asset owners with regard to the key principles, methodologies and indicators related to climate issues. It also aims to identify climate-related risks and opportunities in members' investments, while enhancing their investment decision-making frameworks to better inform SWFs' priorities as investors and participants in financial markets. In particular, knowledge transfer through the initiative has built leadership on climate change amongst frontier and emerging market SWF members. As a result, the One Planet Framework aims to have an impact amongst other SWFs where engagement on the issues of climate change is currently low.

The framework's three guiding principles are:

- Alignment: build climate change considerations, which are aligned with the SWFs' investment horizons, into decision making.
- Ownership: encourage companies to address material climate change issues in their governance, business strategy and planning, risk management and public reporting to promote value creation.
- Integration: integrate the consideration of climate-related risks and opportunities into investment management to improve the resilience of long-term investment portfolios.

A copy of the framework is available at: https://oneplanetswfs.org/.

b. How, if at all, does it complement the Guardians' climate change strategy?
The Guardians' involvement in the initiative fits under the 'Engage' work stream outlined in our response to question 118. The Fund's climate change strategy is already consistent with the One Planet Framework – we do not need to take further steps to comply with it. Our involvement has been instrumental in forming the Working Group, attracting other members and in developing the Framework itself. As such it is a contribution to systemic change in the financial markets and consistent with our obligations as a responsible investor.

120. The Board appointed Matt Whineray as its new CEO with his appointment commencing in July 2018.

a. Will the appointment result in any change to the Fund's investment strategy?
The Fund's investment strategy, while well-established, will inevitably change over time, in order to remain competitive and in line with global best practice. This will continue to happen regardless of CEO appointments. As noted in our answer to Q115a, we are also undertaking a piece of work on the Guardians' long-term organisational state. This work, which commenced prior to the appointment of Mr Whineray, is continuing.

121. The Committee notes that the number of Guardians' staff that identify as Māori in 2017/18 is four, which is the same as for the previous year.

a. How are the Guardians trying to improve Māori representation among staff?
People identifying as Māori, Pasifika or both together constitute 6% of our staff compared to 22% of the NZ population, and we are committed to doing more to attract Māori and Pasifika people to the investment industry and to the Guardians.

Our current focus is on building a pipeline of talent, and to that end we have been strong supporter of the TupuToa programme, which seeks to provide corporate and professional internship opportunities for Māori and Pasifika students during their university studies. We have had six interns work with us via the TupuToa programme, which has led on to one permanent employee and two others who continued to work with us post their internships, as they continued their studies.

We are continuing to invest significantly in our engagements with Māori groups with a view to investment partnerships and co-investment, including the development of a preferred partnership agreement with Te

Pūia Tāpapa Fund. We have existing investment partnerships with a number of iwi, investing in local assets such as Kaingaroa Forest.