**BRIEFING TO**

**HON BILL ENGLISH**
**MINISTER OF FINANCE**

**Prepared by**

**GUARDIANS OF NEW ZEALAND SUPERANNUATION**

**December 2008**

## 1 Purpose

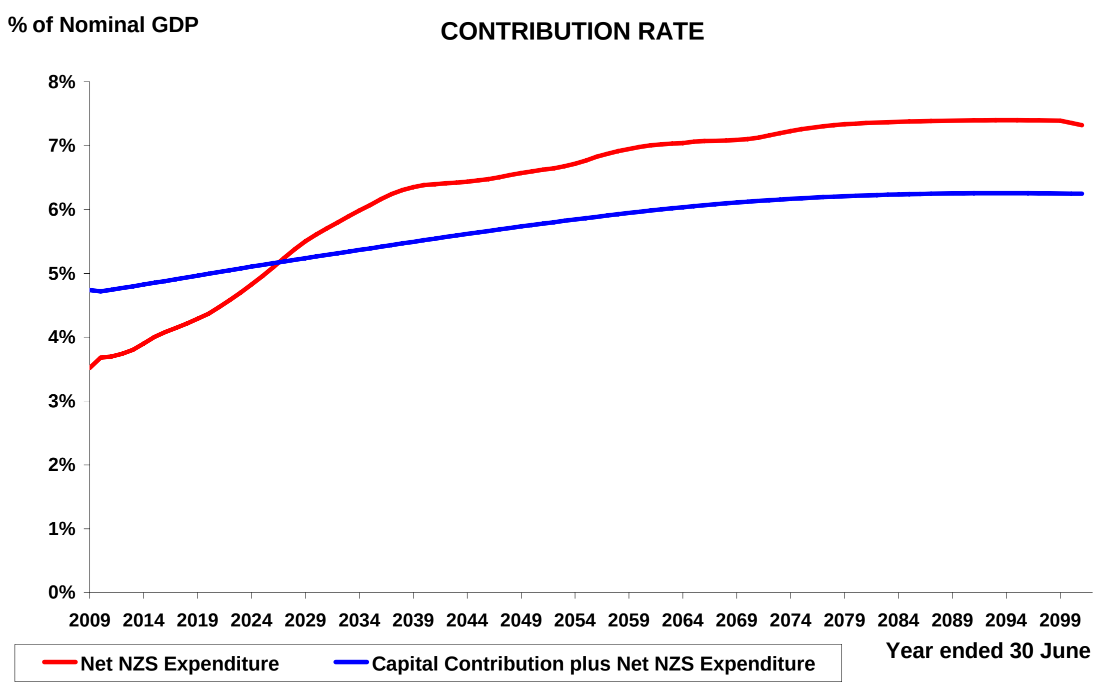
1.1 The purpose of this document is to provide the incoming Minister of Finance with a brief overview of:

- the Guardians of New Zealand Superannuation (Guardians);
- the New Zealand Superannuation Fund (Fund); and
- an introduction to the key issues that the Minister will be asked to consider in the next several months.

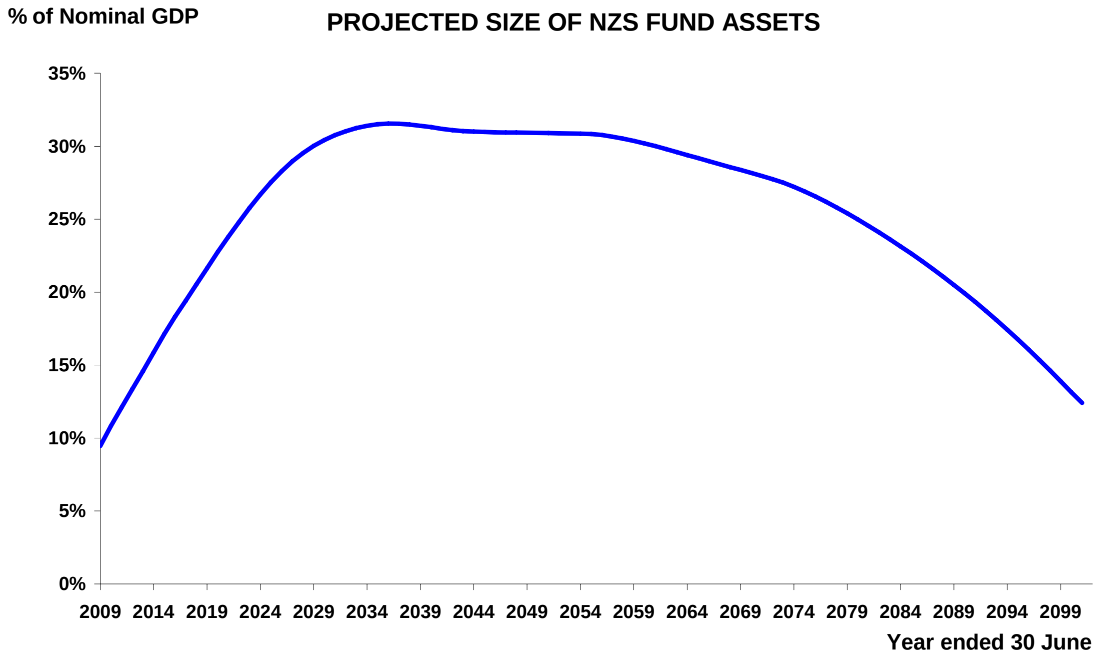
## 2 Background

2.1 The Guardians is an autonomous Crown entity established under the New Zealand Superannuation and Retirement Income Act 2001 (Act). The Guardians manage, administer, and invest the Fund. The Fund was also established under the Act, and is a pool of financial assets that form part of the Government's core balance sheet.

2.2 The Fund is designed to act as a 'buffer' to help future Governments make retirement income payments (New Zealand Superannuation) to New Zealanders. The following graph shows the projected net cost of New Zealand Superannuation with (blue line) and without (red line) Fund capital contributions.




2.3 Under current funding assumptions, capital contributions continue until 2026 (by law withdrawals are not permitted before 2020). After that the Fund is progressively drawn on to meet the higher costs of NZS: however, the withdrawals are always less than projected Fund income so the Fund continues to grow in nominal terms. In real terms the Fund peaks (at just over 30% of GDP) in the mid 2030s.




## 3 Our Legislation

3.1 As stated the Guardians and the Fund are set up under the Act. Among other things the Act:

- establishes the Board of the Guardians and criteria and process for Board member selection;
- sets out our investment mandate;
- prevents the Fund from holding a controlling interest in another entity;
- establishes requirement to prepare and publish a Statement of Investment Policies Standards and Procedures;
- places constraints on the Fund's use of borrowing and derivative instruments;
- provides a limited power of Ministerial direction; and,
- provides for public accountability and independent performance reviews.

3.2 Two key features of our legislation are that it provides a clear purpose (to help meet future New Zealand Superannuation costs) and operational independence to ensure the time consistency necessary to achieve an intergenerational transfer of wealth. The clear purpose and operational independence aspects of the Act are seen as global best practice as are the public accountability requirements.

## 4 Our Legislated Mandate

4.1 Our mandate is set out clearly in the Act:

*The Guardians must invest the Fund on a prudent, commercial basis and, in doing so, must manage and administer the Fund in a manner consistent with—*

*(a) best-practice portfolio management; and*

*(b) maximising return without undue risk to the Fund as a whole; and*

(c) *avoiding prejudice to New Zealand's reputation as a responsible member of the world community.*

4.2 Interpretation of the terms 'best-practice'; 'undue risk'; and, 'avoiding prejudice' is left to the Guardians to determine.

4.3 The specified mandate provides us the necessary flexibility to achieve the task given and remain consistent with relevant funds management practices. *Best practice* involves a constant evaluation of the organisational and investing practices of our global peers. *Maximising returns without undue risk* means assessing the appropriate balance between the level of risk and the expected return intended to generate a positive impact on the Crown's balance sheet over the long term (see chart in 7.3). We have integrated *avoiding prejudice* into our Responsible Investment policy.

## 5 Our Organisation

5.1 The Guardians is overseen by a Board appointed by the Governor-General on the Minister of Finance's recommendation. The Minister must draw his recommendations from candidates put forward by a Nominating Committee appointed by the Minister. This double-arms length process is seen as very important globally for our reputation as a Fund removed from political control and for our ability to attract necessary expertise.

5.2 The Board must comprise no less than five and no more than seven members. Members are appointed for terms of up to five years and those terms may be renewed. Current Board members, their original date of appointment and the expiry of their current term are:

- David May (Chairman), August 2002, September 2012
- Sir Douglas Graham, August 2002, September 2008[1]
- Bridget Liddell, August 2002, June 2010
- David Newman, September 2004, September 2009
- Glen Saunders, September 2004, September 2009
- Mark Tume, April 2006, April 2011
- John Evans, December 2006, December 2011

5.3 The Board has certain powers reserved to it including the power to appoint investment managers and custodians.

5.4 Our business model is largely one of internally determining (with appropriate external advice) the optimal long term asset allocation for the Fund together with outsourcing the selection of individual securities within that asset allocation to specialist investment managers. Safekeeping of the assets of the Fund is undertaken by a specialist custodian.

5.5 While day to day management of the various sub-portfolios (or mandates) that make up the Fund is largely outsourced to external managers, there remains a wide variety of complex specialist functions that occur in-house. Those functions include:

- Formulating investment strategy at the whole of Fund level (the Strategic Asset Allocation) including researching ideas for enhancing the efficiency of the Fund (e.g. evaluating more closely linking asset allocation decisions with the drivers of future levels of New Zealand Superannuation payments);

[1] Sir Douglas has been asked to stay on until you have had a chance to consider a new appointment.

- Researching, evaluating, selecting and monitoring investment managers, advisors and counterparties;
- Legal contracting and legislative compliance;
- Managing the Fund's liquidity requirements through capital contribution cashflows; tax, profit and loss and collateral payments on derivatives and capital calls on private markets commitments;
- Tax management;
- Accounting and reporting and associated financial analysis;
- Overlaying our Responsible Investment policy;

5.6 In addition to these functions are the usual administrative and technological support functions required.

5.7 As of 10 December we employed 43 fulltime equivalent staff. We are actively recruiting to bolster our organisational capabilities in a number of areas. Our current organisation chart is attached as Appendix 1.

5.8 As of 21 November we have management relationships with 28 external investment managers covering 38 investment mandates. Those managers between them manage over 3,000 securities. In addition to those relationships we have relationships with a number of financial institutions as derivative counterparties and we have a number of specialist (e.g. tax, legal) advisory relationships.

5.9 It is important to note that the Guardians and the Fund are still at a relatively young stage of their life. We are, however, investing in organisational growth ahead of Fund growth to stay ahead of the demands associated with managing a larger Fund. In a later section we discuss some of the challenges involved in engineering the Guardians for future growth in the Fund.

5.10 As the Guardians has matured we have placed increasing focus on organisational risk management by, for example, ensuring that we have comprehensive policies and procedures, clearly delegated authorities and business continuity plans.

5.11 Since our inception we have been subject to two major external reviews. The first by independent reviewer Jonathan Eriksen was in 2004. The second was last year and was undertaken by Ernst & Young on behalf of the Office of the Auditor General. Both reviews were overwhelming positive in the conclusions and where recommendations for improvements were made we have moved on those.

## 6 The Fund in the Context of Sovereign Wealth Funds

6.1 The Fund is one of a group of so called 'Sovereign Wealth Funds' (SWFs). While SWFs have been around in one form or another for some decades it is really only in the last decade that they have emerged as a common tool of sovereign balance sheet management. The purpose of SWFs varies from managing commodity wealth (e.g. UAE, Russia), foreign exchange reserves (e.g. China), and pre-funding future pension obligations (e.g. Canada, New Zealand).

6.2 With huge current account surpluses developed in emerging economies in recent years and the significant inflows to the commodity producing nations, the size of SWFs in aggregate has grown markedly over the past decade. Though they control only a small percentage of global financial assets, they are large as an investor class. In aggregate SWFs rival the global hedge fund and private equity industry combined. The largest SWFs manage portfolios in excess of USD100bn.

6.3 As SWFs have grown and (the larger ones in particular) diversified their investment portfolios they have attracted greater scrutiny from nations who are recipients of their investment capital[2]. That heightened attention lead to the formation of an International Working Group (IWG) on SWFs established under the auspices of the IMF. New Zealand, represented by both the CEO of the Guardians and the Treasury, was an active participant in the IWG.

6.4 In October this year the IWG released a set of Generally Agreed Principles and Practices (GAPP) – the so called Santiago Principles – on the management and governance of SWFs. The GAPP, which are voluntary, number 24 principles covering, among other things, the need for sound legal frameworks; good governance; accountability and transparency; sound investment policies based on economic objectives; and sound risk management.

6.5 We are confident that the Guardians measures up well on each of the Santiago Principles. An earlier independent analysis of SWFs by the Peterson Institute for International Economics ("A scoreboard for sovereign wealth funds") compared 32 sovereign wealth funds on four categories: structure, governance, transparency and accountability, and behaviour. The study concluded that the Fund ranked first amongst those measured.

6.6 The Petersen Institute findings reflect in one part the sound footings on which the Guardians and the Fund were established: a clear mandate, operational independence, appropriate governance structures and the need for public accountability. In another part, because the findings were based on systematically available public information, they reflect the conscious decision by the Guardians to be as transparent as commercial sensitivities allow.

6.7 That same transparency, while earning us the kudos of our peers and independent reviewers, occasionally creates a rod for our own backs. An example of this would be our decision to publish the monthly returns for the Fund. That is almost unprecedented amongst our peer funds and potentially creates somewhat of a distraction given the long term nature of the Fund. On the other hand it reinforces understanding that in seeking higher returns over a long timeframe there are inevitably bumps along the way (and as recent events have shown, these can at times be severe).

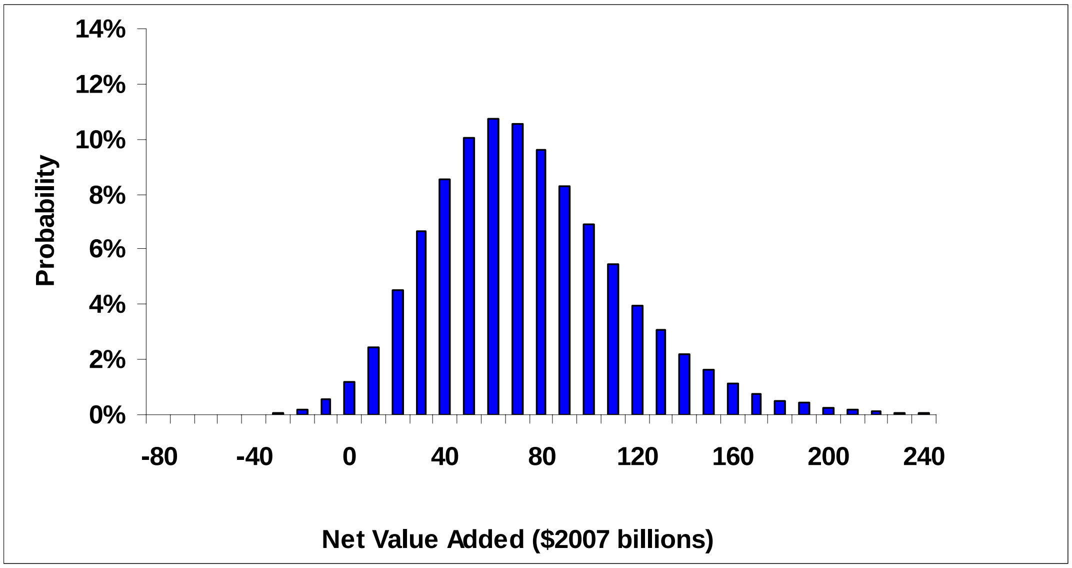
## 7 Our Investment Strategy

7.1 Our investment strategy is designed to exploit our inherent investment strengths. These strengths include our long investment horizon, limited need for liquidity, and the wide range of investment assets and strategies acceptable to us.

7.2 The cornerstone of our investment strategy is our Strategic Asset Allocation (SAA), which specifies the proportions of the Fund invested in various broad asset classes, and consequently the Fund's exposure to the underlying markets. In considering the SAA we make a number of assumptions (using a well accepted methodology) about the long term risk and return characteristics of individual asset classes and the correlations between them. Using those assumptions we are able to model a range of outcomes for the Fund assuming different combinations of asset classes. A key outcome we look at is the long term impact of our expected returns for the Fund on the Crown's balance sheet.

[2] New Zealand has its own experience with SWFs through the 2007 activity around Auckland International Airport.

7.3 The graph below from our 2007 SAA review shows the distribution of the projected 'net value added', relative to investment in Treasury bills, over 30 years. The distribution has been calculated from 60,000 random trials. The vertical axis represents the proportion of the total number of trials falling within the range of outcomes shown for each bar. The horizontal axis shows 'net value added' in inflation adjusted terms (i.e. in 2007 dollars).




7.4 This graph highlights the high probability of adding value relative to Treasury bills (as a proxy for the Crown cost of debt) over long time horizons.

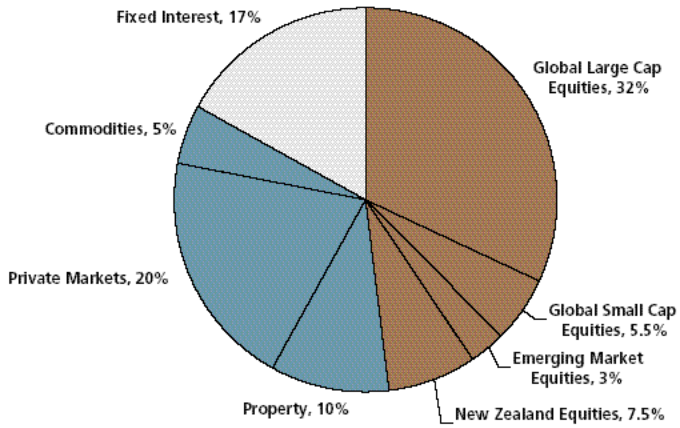
7.5 The other major component of our investment strategy relates to the manner in which these exposures are obtained. In some cases we acquire representative market exposures at relatively low cost, by 'passively' tracking a market index. We also seek to add gains from active management by engaging a variety of external investment managers.

7.6 The overall risk profile of the Fund is mainly determined by market exposures specified in the SAA, especially from the split between 'income' assets (bonds) and the various 'growth' assets (including equities). Growth assets tend to be more volatile than bonds, but offer higher expected returns over the long run.

7.7 We review the SAA periodically. Our third revision came into effect on 1 November 2007. The revised SAA introduced a more flexible mechanism for taking advantage of private market opportunities (including those in private equity, infrastructure and timber). We may vary private market exposures over time, but in a fashion that maintains the risk profile of the Fund as a whole. As a result the Fund's actual weights at a given point of time will differ from the target weights in the SAA.

7.8 The Fund's target SAA weights are as follows:

Strategic Asset Allocation




## 8 Our Performance and Benchmarks

8.1 We have recently provided you an update on the Fund's performance through the current extraordinarily difficult market conditions. In this section we provide a high level overview of how we think about performance measurement.

8.2 One of the key investment objectives in our mandate is to maximise returns without undue risk to the Fund as a whole. To measure achievement against this objective we look at two metrics:

- The Fund's excess return over the risk free rate (defined as the NZ Treasury bill return). This measure tells us how well the Fund is being rewarded in compensation for the risk it takes. The risk free rate can be thought of as the Crown's opportunity cost of investing.
- Our value add. The idea behind this measure is that we could build a portfolio that closely mimics the one envisioned in the Fund's SAA but that invests only in asset classes that can be purchased in low cost 'passive' form. To do so would be relatively cheap – we estimate it would cost no more than 30 basis points per annum (0.3%). This measure tells us whether we are adding value to the Fund through engaging in active management and private markets strategies.

8.3 Our expectation is that the Fund will over the very long term (rolling 20 year periods) exceed the risk-free rate of return by an average of at least 2.5% p.a. We think that 20 years is an appropriate horizon for a genuinely long term investor like the Fund. Our SAA review in 2007 indicated there was around a 50% probability of meeting that excess return over a given 20 year period.

8.4 We recognize that the public will look to shorter periods to gauge our progress. While we report on annual (indeed monthly) performance we do not consider those particularly useful measurement periods. In any one year we would expect considerable variability around our long term expectation. That variability diminishes as we consider returns over longer periods. We consider rolling 5 year periods as important milestones towards the longer term objective.

8.5 We haven't invested the Fund using the low cost approach because we think we can add value in a number of ways:

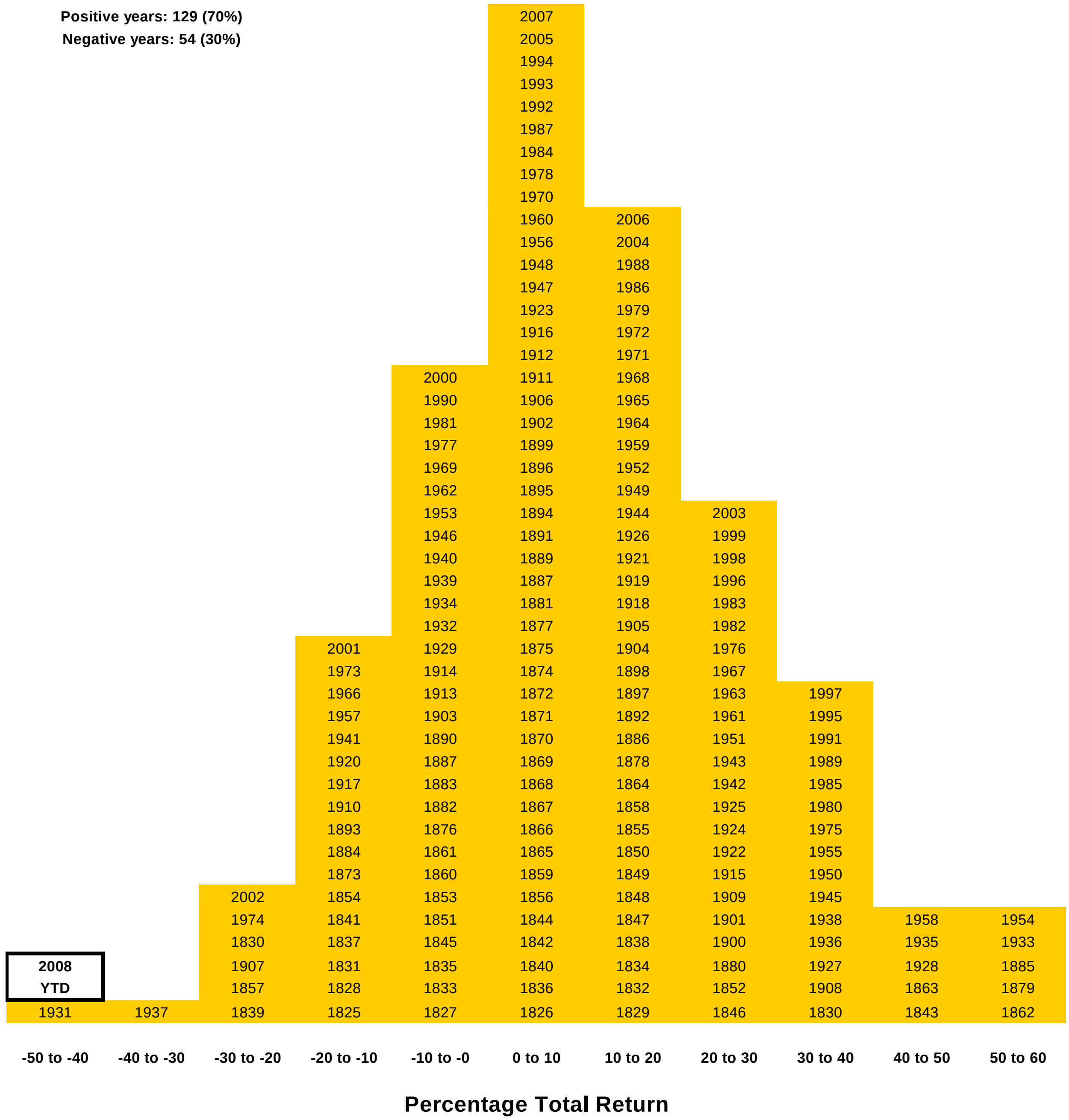
- by investing in more complex strategies such as are involved with private markets investing (e.g. timber or infrastructure);
- by identifying managers, in both public and private markets who can add value through security selection skill;
- by adjusting the asset allocation over time to reflect the gradual evolution of expected returns ('strategic tilting'), which is an approach the Guardians have been developing and will soon implement; and
- through operational efficiencies.

8.6 Our investment activities are anchored by a set of investment beliefs that we publish along with our Statement of Investment Policies, Standards and Procedures. A strongly held set of beliefs is an important characteristic of successful long-term investors. Having said that we recognize the need to avoid becoming dogmatic and therefore periodically retest them. A set of beliefs is most useful, and most tested, in times of financial market stress.

8.7 In the first few years of its existence the Fund's returns tracked well above our long term median expectations. The recent, perhaps 1 in a 100 year, experience has dragged the cumulative return since inception (a period of slightly more than 5 years) below our median expectations although it remains within our initial confidence range. As earlier reported to you, returns over the financial year to date, however, are well outside our confidence range.

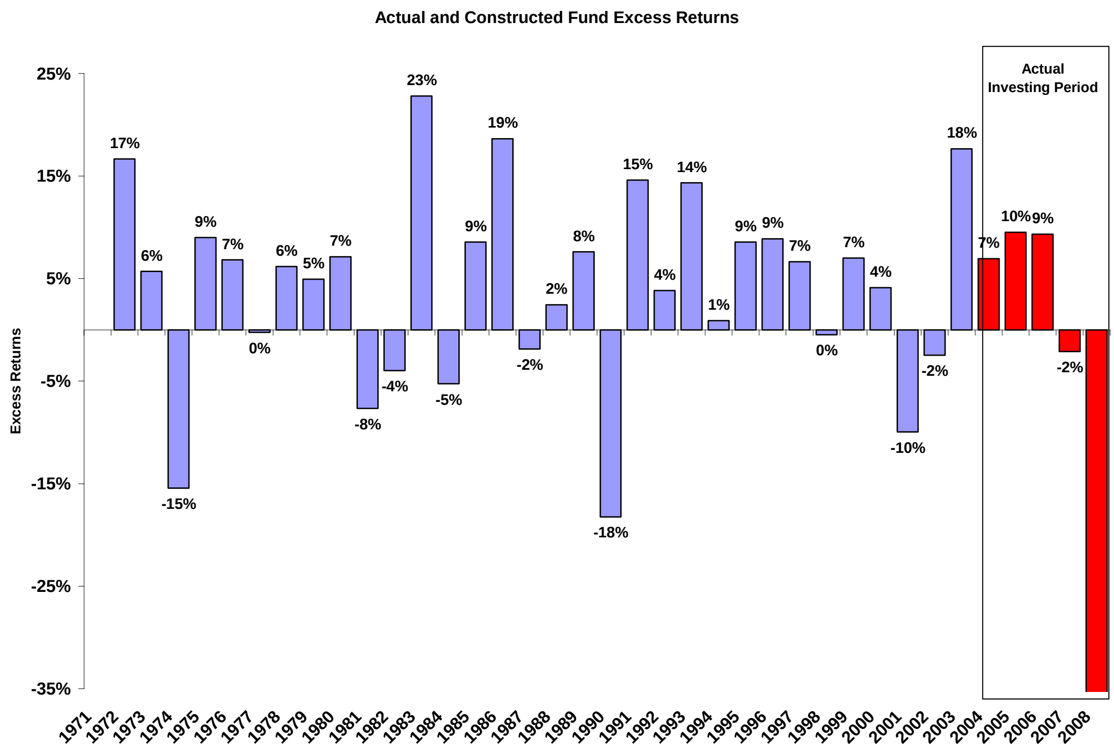
8.8 Using the US stock market as a proxy, the following chart puts recent returns in a historical perspective:

## US Stock Market returns from 1825 to 2008




Source: Value Square Asset Management & Yale University.

8.9 Another way to get a historical perspective of recent returns is to look at an indication of what the Fund's returns might have been had it started investing in 1970 (the earliest date from which we have reliable data over multiple assets classes). The following chart updates one we provided in our most recent Annual Report:




8.10 Disappointing as recent results have been it is important to bear in mind that most of the contributions to the Fund still lay ahead of it. According to the most recent Treasury projections, the Fund will receive an average $1.7bn p.a. for the next 17 years. In some part the recent sharp falls in asset prices reflect a re-estimation by investors of future earnings. In some large part though the falls reflect that at this point investors require a higher rate of return on their risk capital in the future.

## 9 Our Current Organisational Focus

9.1 In our most recent Statement of Intent (SOI) we set out two outcomes we strive for:

- Ensure a cost effective fit for purpose portfolio; and
- Maintain public and Government confidence in our capabilities and integrity

9.2 To help us achieve those outcomes we outlined in the SOI a series of activities that we would undertake over the following three years. For the first outcome the activities focus particularly on how we shape and implement investment strategy and include:

- Exploring the benefits of linking strategy more explicitly to the characteristics that drive future New Zealand Superannuation payments;
- Evaluating a framework that would allow us to tilt the SAA at times of extreme market pricing; and

- Improving cost efficiency by accessing more efficiently priced forms of market exposure and raising the hurdle for excess return that we expect from potential active managers.

9.3 For the second outcome the activities focus on strengthening the institutional base from which we operate and include:

- Developing and maintaining the competencies we have as a sophisticated investor;
- Developing and protecting the intellectual property and networks that we build; and
- Further embedding Responsible Investment practices into our organisation and investment activities.

9.4 To achieve those outcomes we have been building the organisation so that we are adequately resourced to identify, research and implement the opportunities open to the Fund. As mentioned above, that has, to some degree, meant investing ahead of future growth in the Fund. We have been fortunate to be in the position where the future size of the Fund is reasonably predictable given established government policy.

9.5 While there has been significant growth of the organisation over the past couple of years and some more growth is ahead of us, we have in mind an organisational structure that is lean compared to the organisational models that some of our peer funds have developed. Many of those funds now employ staff numbering in the hundreds. Whilst they might have a larger starting asset base the complexity of their funds is often no greater and the Fund is forecast to grow significantly.

9.6 We can maintain our organisational leanness by focusing on those competencies from which we believe we can exploit a competitive edge in the execution of strategy. The complexity of the Fund and a constant focus on cost efficiency will almost inevitably see us manage more internally. A greater focus on New Zealand assets would possibly require more staff due to limited depth of external talent and greater conflicts of interest issues associated with investing in the local market.

9.7 We use an international benchmarking service (CEM) to compare our cost structure against relevant peers. Those comparisons show that relative to a group of our peers (those with similar outsourcing models and of similar size) our cost structure is about right. As the Fund grows the significant economies of scale associated with managing financial assets mean that the ratio of costs to Fund size will fall.

9.8 Responsible investment (RI) has been an area of considerable focus for us over the past year and we feel satisfied that, despite the complexities of the issues involved we have made substantial progress.

9.9 We have a new RI framework which outlines how we integrate RI into the business of the Fund. We are guided by United Nations (UN) standards, the UN Principles for Responsible Investment (UNPRI), to which we are founding signatories. The UNPRI is considered the leading international authority on responsible investment and provides a benchmark for best practice.

## 10 Managing Though the Credit Crisis

10.1 The current financial markets and economic crisis has thrown up a series of challenges for our management team. Quite apart from the sharp falls in asset values we have had to devise strategies for a world in which liquidity is at a premium and the strength of once trusted counterparties is under constant threat. As the scale of the crisis first became apparent a few months ago we set up a cross-team group that could evaluate rapidly changing conditions as they unfolded and put in place appropriate response mechanisms.

10.2 We are already 'institutionalising' lessons learned in this crisis. Those include: the need to ensure appropriate cash buffers to deal with unanticipated liquidity shocks; using a wider suite of creditworthiness evaluation tools to assess and monitor our counterparties; and, greater stress-testing of the Fund to assess how the portfolio behaves during period of extreme outcomes. We have no doubt that as we stand back and reflect of how events unfolded we will forge new ways of thinking about the challenges we face. The lessons generated by this crisis reinforce the motivations behind us building an organisation capable of steering the Fund through all weathers.

## 11 Potential Limits to Growth

11.1 As the Guardians and the Fund grow we gain a better understanding about what is achievable given the environment within which we operate. We also have a good sense of the limitations of the rules under which we operate and how those could be modified to enable the Guardians to fulfil their mandate.

11.2 As the Fund has grown we have come up against the limits of the New Zealand capital markets. We observe this in a number of ways. Examples include the greater impact on market prices we are having (due to our large size in relation to the market) when we transact in the debt and equity markets. In some asset classes, for example infrastructure and bonds, there is a real paucity of opportunities suitable for a Fund of our (current and projected) size.

11.3 We are conscious of your stated policy of wanting to see the Fund invest a greater proportion of its assets within New Zealand. We would be eager to enter into a dialogue with you and the Treasury about the purposes for, and practicalities of, that policy. We will provide you with a separate paper on our initial thoughts on this subject.

## 12 Changing our Legislation

12.1 Through practical experience, we have identified a number of weaknesses in our governing legislation that limit our ability to fulfill our mandate. Those weaknesses include limitations on our ability to effectively structure private markets transactions so as to minimise potential liabilities for the Crown. There are also prescribed practices in the legislation that fall short of best-practice governance standards. Early in the New Year we will provide you with a separate paper addressing those issues together with suggestions as to how the Act can be improved.

12.2 In the short-term we have a practical issue around the Ministerial authority we have to enter into borrowing arrangements (which we use to facilitate short term cashflow management). We will shortly forward you a letter addressing this issue.

## Appendix 1: Current Organisation Chart