



# How We Invest

NEW ZEALAND  
SUPERANNUATION  
FUND 

The balance of risk and return is the key decision for structuring the Fund.





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# Executive Summary

1. The New Zealand Superannuation Fund (Fund) exists as a part of the response to the fiscal pressure posed by New Zealand's ageing population. The Fund's structure, its overall level of risk and the investment activity it comprises all address this long-term purpose.
2. The Guardians (Guardians, we) of New Zealand Superannuation exist to manage the Fund. The Act which established the Guardians and the Fund made the Guardians operationally autonomous from the Crown. This means that the Government does not decide who can be nominated for the Guardians' Board, nor does it have any role in the Guardians' investment decisions
3. The balance of risk and return is the key decision for structuring the Fund. We have decided that a weighting toward growth assets is required by the Fund's long-term purpose. This weighting tends to produce short-term volatility but the Fund's performance must be judged over a long period.
4. We have considerable freedom to invest how we see fit. We are limited only by our Act and by the investment policies, strategies and controls imposed by our Board.
5. We believe we can produce better returns by pursuing investments which can be riskier, more complex and more expensive than simpler options. We test that belief by publicly measuring the Fund's returns against the returns of the Reference Portfolio – our blueprint for a simple, low-cost portfolio which could achieve the Fund's purpose
6. We believe that paying attention to Environmental, Social and Governance factors is good practice for investors and for investee companies

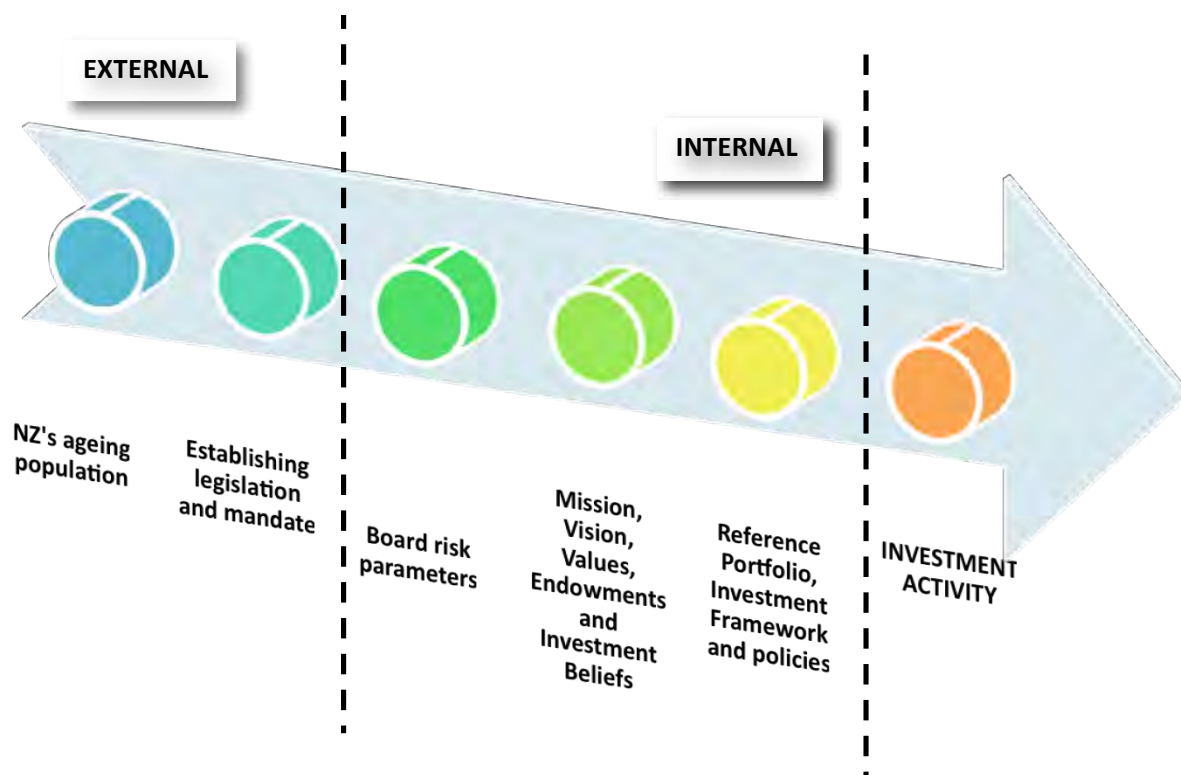
## ABOUT THIS DOCUMENT

In this document 'we' refers to the Board and management of the Guardians of New Zealand Superannuation, the Crown agency that manages the New Zealand Superannuation Fund (the Fund). Both terms are explained further on page 7.

The document explains how we invest the Fund (which, for quick reference, is summarised in Figure 1 below). The document assumes readers have some knowledge about financial investment and is intended for:

- new (and potential) employees or Board members of the Guardians of New Zealand Superannuation
- people who work with us, or who would like to work with us, such as external investment managers
- managers of other investment funds, particularly other Sovereign Wealth Funds
- any other keen observers of our activities who wish to deepen their understanding of how we work.

**Figure 1 – the Road to Investment**





## STRUCTURE OF THE DOCUMENT

This document has two parts:

- Part 1: Influences on how we invest
- Part 2: How we plan and execute investments

Part 1 describes what influences the way we invest the Fund. The purpose of Part 1 is to give readers a context for our investment decisions by explaining the public policy settings and decisions behind the way we structure the Fund. We discuss:

- why we exist – spreading the tax burden of the future cost of New Zealand Superannuation
- our organisational structure
- how we balance risk and return

Part 2 describes how we make a decision to invest and, when that decision is made, how we carry it out. The purpose of Part 2 is to give readers a greater depth of technical detail on key parts of the investment process, including:

- how we select our investments
- when and how we invest through or with third parties
- how we invest responsibly
- how we manage risk
- how we report our performance

Both Part 1 and Part 2 are divided into sections (from A to C in Part 1 and from A to G in Part 2) to assist cross-referencing with our Statement of Investment Policies, Standards and Procedures. We refer more to the relationship between the two documents on page 5.

### Where to go to for more general information about the Guardians and the Fund

Our work and the success of the Fund is important to all New Zealanders. All New Zealanders – not only those with some investment knowledge – need to understand why the Fund exists, how we manage it and how it is performing.

That general information is on our website, [www.nzsuperfund.co.nz](http://www.nzsuperfund.co.nz). We have tried to present and explain it in a way that needs no technical knowledge about investment. We suggest you start with our [Introduction to the Guardians and Fund](#).



## HOW DOES THIS DOCUMENT RELATE TO OUR OTHER INVESTMENT DOCUMENTS?

This document fits under our [Statement of Investment Policies, Standards and Procedures \(SIPSP\)](#) which is on our website. It provides all the supporting information for the Procedures part of the SIPSP (and its sections are numbered consistently with the SIPSP). Together, these documents meet the requirements of section 61 of the New Zealand Superannuation and Retirement Income Act 2001.

On the website you can also find material that builds on what we discuss in this document, including:

- [monthly updates that set out the Fund's performance](#) and a snapshot of the asset classes it comprises
- [Responsible Investment Reports](#)
- [Statements of Intent and Annual Reports](#) which set out, and report on, the investment plans and portfolio activity governed by the procedures covered in this document





# PART 1: INFLUENCES ON HOW WE INVEST

## Section A - Why do we exist?

### Main points in this section

**New Zealand's ageing population sets the public policy context for our legislation**

**Our legislation establishes our purpose, which requires us to invest for the long-term and bestows endowments giving us an advantage over many other investors**

**Our mandate helps us to frame our organisational Mission and to decide what nature of organisation, and individual, is appropriate to that Mission**

**Our endowments help us to develop the investment beliefs which form our investment philosophy**

### What is the effect of New Zealand's ageing population?

Statistics New Zealand data projects that, between 2005 and 2050, the number of New Zealanders eligible to retire (aged 65+) will double. The associated cost of providing their retirement income, New Zealand Superannuation (NZS), will more than double.

This means New Zealand will have:

- more people of retirement age, as a proportion of the population, than ever before
- fewer 'working-age' people whose productivity can be tapped, through taxation, to fund the greater cost of retirement income

These projections have significant implications for future Governments' ability to fund other vital areas such as health, welfare, education and law enforcement. This information is therefore relevant for all New Zealanders, now and in the future.



## How do we and the Fund respond to New Zealand's ageing population?

The NZ Superannuation and Retirement Income Act 2001 (the Act) established two entities:

- the Fund, as a pool of assets on the Government's balance sheet
- the Guardians, as a Crown agency charged with managing the Fund

Together, the two entities respond to New Zealand's ageing population by 'smoothing' the tax burden between generations of New Zealanders arising from the higher future cost of NZS.

We smooth by investing Government contributions to the Fund and the returns on those investments. Over decades of investing this grows the Fund. At a future date - currently from 2031 - the Government begins to withdraw money from the Fund to help to meet the cost, at that time, of NZS.

Saving now for this future cost is called 'pre-funding' NZS. Pre-funding means that future Governments do not have to seek as much from future New Zealand taxpayers (or from other sources, such as by raising debt) to meet the cost of NZS when it is increasing most sharply.

This is reflected in our Mission Statement:

'Maximise the Fund's return over the long term, without undue risk, so as to reduce future New Zealanders' tax burden'

We believe this statement frames the purpose of the Fund and Guardians in a way meaningful to all New Zealanders.

## How does the purpose of the Fund affect how we invest?

The main impact of the Fund's purpose is that it gives us a firm idea of what matters.

Smoothing the tax burden of NZS over generations of New Zealanders is a long-term job. So, the Fund must be invested to grow and produce suitable returns over a long period.

Many factors will affect the tax burden associated with NZS, including:

- the Government's policies for retirement and superannuation (most importantly, how much the Government pays in NZS and who gets it)
- the state of the New Zealand and global economies

We cannot influence either of these factors.

But we can influence the return on the Fund and, therefore, its size when withdrawals begin and beyond that date.

So what really matters, is the long-term return on the Fund after meeting all costs and paying foreign taxes (as New Zealand tax is a transfer to the Crown we are indifferent to it and express our returns before New Zealand tax is paid).



## Endowments

The Fund's purpose gives it, and therefore gives us as the Fund's managers, important characteristics that we call 'endowments'. They are:

### ***Sovereign status***

The Fund is a pool of financial assets wholly owned by the Government and the Fund obtains sovereign tax status as result. Having sovereign tax status is beneficial as foreign countries can have a different taxation approach to entities with sovereign status. The effect of this is a reduction in foreign tax leakage, which improves Fund returns. Sovereign status can also be regarded favourably by counterparties and it can position the Fund well as a potential co-investor of choice within New Zealand.

### ***Independent investment responsibility***

The legislation which created ourselves and the Fund also established our investment independence from the Government. Our investments are made for a specific purpose and the investment mandate contained within the legislation requires that they be made on a purely commercial basis. The Government may only direct us about its expectations of the Fund's overall risk and return. This investment independence gives us confidence to enter into investment arrangements that best suit the Fund's purpose, with minimum agency risk. The legislated investment mandate also requires us to manage the Fund in a transparent manner, and to have regard to environmental, social and governance standards. We believe this assists in positioning us to be an investor, or co-investor, of choice in many regions.

### ***Certain liquidity profile***

The flow of cash into and out of the Fund is governed by a funding formula, which is public. This provides us with certainty, and transparency, of cash flow timing. Such certainty provides us the confidence to invest the Fund in assets where other investors may be more constrained by their own liquidity demands. We can buy assets when other market participants are constrained or have been forced to sell to meet their own liquidity demands.

### ***Long Fund horizon***

The investment structure of the Fund is designed to exist for many decades. The longevity of the Fund thus allows us additional flexibility to undertake investments with longer-term return characteristics, such as private equity. In addition it means that the Fund is more tolerant than other investors to market volatility, enhancing its ability to endure market cycles.



## How do we reflect our view of ‘what matters’, and our endowments, in our work?

First, they are reflected in our mission statement:

‘Maximise the Fund’s return over the long term, without undue risk, so as to reduce future New Zealanders’ tax burden’

Second, they are reflected in the values we bring to the office and to our investment activities:

**Inclusiveness:** We combine diverse skills, and seek relevant views and rigorous analysis, in a supportive environment.

**Innovative:** We encourage initiative taking and continuous learning, and drive timely decisions

**Integrity:** We behave consistently in a transparent and commercial manner for the long-term benefit of the Fund

Finally, they are reflected in the investment beliefs that are the foundation for all our investment decisions.

Other investors may have different investment beliefs. But our beliefs are well suited to the Fund’s purpose and the way that we have chosen to serve that purpose.



**Table 2 – Our Investment Beliefs**

INVESTMENT DECISION	INVESTMENT BELIEFS	INVESTMENT FACTS
<b>Governance and investment objectives</b>	1. Clear governance and decision-making structures that promote decisiveness, efficiency and accountability are effective and add value to the Fund.	It is important to be clear about investment objectives for the Fund, risk tolerance, and the timeframe over which results are measured.
<b>Asset allocation</b>	2. Asset Allocation is the key investment decision. 3. Investors with a long-term horizon can outperform more short-term focused investors over the long-run.	Risk and return are strongly related. There are varied investment risks that carry premiums/compensations. Illiquidity risk is one such premium. Investment diversification improves the risk to return (Sharpe) ratio of the Fund.
<b>Asset class strategy and portfolio structure</b>	4. Expected returns are partly predictable within asset classes and returns can revert toward a mean over time.	Investment markets are competitive and dynamic, with excess returns very difficult to find and constantly changing source. Market volatility tends to cluster over short horizons but mean-reverts over longer horizons. Investment risks can be unbundled to make the Fund more efficient. This includes the separation of market (beta) and investment specific investment manager skills (active returns).
<b>Manager and investment selection</b>	5. True skill in generating excess returns versus a manager's benchmark (i.e. pure alpha) is very rare. This makes it hard to identify and capture consistently. 6. Some markets or strategies have characteristics that are conducive to a manager's ability to generate excess return. These characteristics tend to evolve slowly over time, although the shorter term opportunity set available in any market/strategy can vary through the cycle. 7. Identifying the life cycle of an investment is important to assessing the expected return. 8. Responsible asset owners who exercise best-practice portfolio management should have concern for environmental, social, and governance (ESG) issues of companies. 9. Improving ESG factors can improve the long term financial performance of a company.	Each investment should be made on the basis of its expected value-add to the Fund as a whole. Principal/agent conflicts exist with outsourced investment managers. The more efficient a market is, the more difficult it is for a manager to generate an excess return (versus their benchmark). Most excess return is driven by a combination of the research signals the manager is using, the conduciveness of their market to generating active returns, beta factors and luck. Research signals and methods used by managers tend to commoditise over time through market forces. In some cases, synthetic exposure to a market or factor can provide a guaranteed additional return to the Fund, and represents an additional hurdle that an active manager must surpass.
<b>Execution</b>		Managing fees and ensuring efficient implementation can prevent unnecessary costs.



### FOR MORE INFORMATION

The Treasury website has more information on New Zealand's ageing population and the role that the New Zealand Superannuation Fund pays in partially pre-funding the associated costs.

Particularly useful are the [series of tables produced by the Treasury on the Fund's contribution model](#). These tables illustrate, among other things, the intergenerational tax-smoothing effect noted earlier of the Fund.

We have also provided some information – and links to the above- on our website [www.nzsuperfund.co.nz](http://www.nzsuperfund.co.nz)





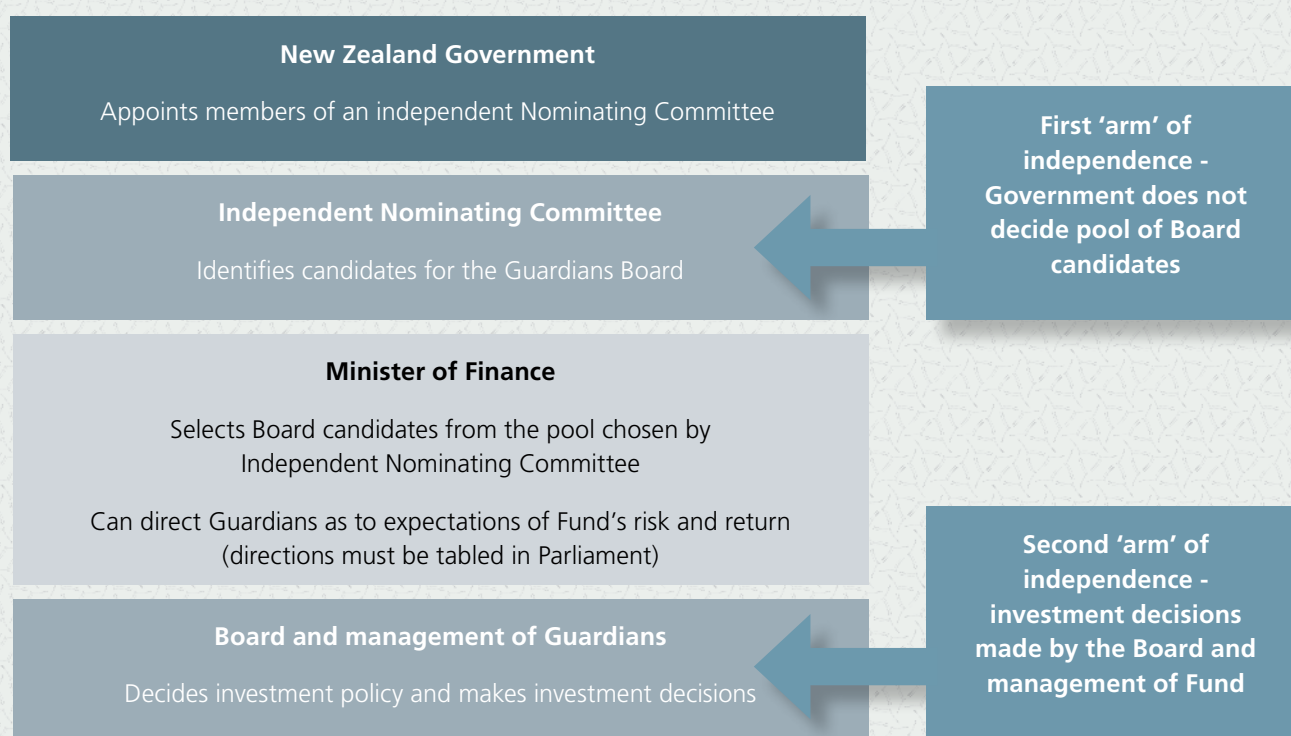
## Section B - What is our organisational structure?

The Act made us operationally autonomous from the Crown. The autonomy is achieved in two ways:

- While the Minister of Finance is responsible for appointing our Board members, the Minister must choose from a pool of candidates selected by an Independent Nominating Committee
- the Guardians is solely responsible for deciding how and where to invest the Fund

The figure below shows how our governance is 'double-arm's length' from the Crown.

**Figure 2 – 'Double-arm's length' autonomy**



### FOR MORE INFORMATION

The website of the Parliamentary Counsel Office has a copy of our Act.

We have put information about our independence from the Government, the responsibilities of the Guardians and how our Board is appointed on our website.



## Section C - How do we structure the Fund?

### Main points in this section

How we structure the Fund is guided by:

- our Act
- a Directive from the Minister of Finance
- investment constraints established by our Board
- our Responsible Investment approach

**Investment policies, strategies and constraints are set by our Board and implemented by our management, directly or through third parties such as investment managers.**

### What restrictions are placed on how we invest?

As we said in the first chapter, we have considerable freedom to invest how we see fit. However, there are some important restrictions.

The Act includes an investment mandate which states that we must invest the Fund on a prudent, commercial basis and 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

The legislation does not provide any guidance as to what these three terms mean - that is left to us to decide.

Other, narrower restrictions also apply.

- The legislation prevents the Fund from controlling any other entity, or from borrowing or placing a contingent liability on ourselves, the Fund or the Crown
- We have a New Zealand investment directive from the Minister of Finance which is subject to our mandated requirement that we invest on a prudent, commercial basis. The directive also states:

It is the Government's expectation, in relation to the Fund's performance, that opportunities that would enable the Guardians to increase the allocation of New Zealand assets in the Fund should be appropriately identified and considered by the Guardians.

- Our Board has established within our investment policies a number of controls for our investments. They include restrictions on
  - o concentration on a single asset (e.g. one company)
  - o concentration on a single asset class (e.g. infrastructure)
  - o concentration with one investment manager.
- We have excluded certain companies from our portfolio because of the nature of their business activities, consistent with our Responsible Investment approach



## Who can make investment decisions?

Who	What decisions
The Board	<ul style="list-style-type: none"> <li>• sets investment policy for the Fund</li> <li>• decides on an appropriate level of risk for the Fund</li> <li>• approves and monitors investment strategies</li> <li>• appoints the Custodian<sup>1</sup> of the Fund</li> <li>• approves new investment managers<sup>2</sup></li> </ul>
Management	<ul style="list-style-type: none"> <li>• provides investment policy advice to the Board</li> <li>• implements agreed investment strategies</li> <li>• monitors and reports on the performance of investment strategies and of the Fund as a whole</li> <li>• monitors the ongoing suitability of appointed investment managers</li> </ul>
External investment managers (only where an external manager has been appointed)	<ul style="list-style-type: none"> <li>• make investment choices on our behalf, subject to an Investment Management Agreement (for further detail, see ‘When and how do we invest through third parties?’ on page 25)</li> </ul>

### FOR MORE INFORMATION

On [www.nzsuperfund.co.nz](http://www.nzsuperfund.co.nz) you can find out more about our:

- Board
- management
- investment policies

1. A custodian holds all of the Fund's listed assets and provides investment administration services, including some performance reporting, accounting and tax reporting.

2. The Board approves new investment managers where there is an Investment Management Agreement (IMA). Where there is not an IMA, the appointment is approved by management.



# PART 2: HOW WE PLAN AND EXECUTE INVESTMENTS

Part 1 discussed why we exist, our investment beliefs, our organisational structure, and restrictions on how we invest to give a context for how we invest.

Part 2 discusses in more detail how we make a decision to invest and how we carry out our investment decisions.

## Main points of this section

**The key decision for our portfolio is the appropriate balance of risk and return. This establishes the ratio of growth to income assets in our portfolio.**

**The long-term purpose and mandate of the Fund mean that it should be weighted toward growth assets in order to have the best chance of achieving its performance goals.**

**The structural blueprint for the Fund is the Reference Portfolio. The Reference Portfolio is our assessment of a Fund structure which represents an appropriate balance of risk and return and which can be accessed at low cost.**

**Because we believe we can produce better returns by deviating from the Reference Portfolio blueprint, we undertake value-adding investment activity. Such activity is often more expensive and complex to execute. So we expect a higher return for the greater risk and cost that we are taking on.**

**Our belief that we can add value is tested by comparing the returns we get from the Actual Portfolio (including value-adding activities), with the return of the Reference Portfolio.**

## Section A - What influences our decision about how much risk is appropriate for the Fund?

Our Act requires the Fund to be invested in a manner consistent with “maximising return without undue risk to the Fund as a whole”.

This requirement is vital to our decisions about how much risk is appropriate for the Fund. Also important is that the Fund’s purpose and our investment perspective must be long term. This means we must decide what the overall mix must be of growth assets and income assets.

### GROWTH ASSETS

The expected financial benefit of growth assets such as equities derives from their value increasing over time and is primarily realised when we sell. There is greater risk in such assets as their value can increase and decrease – sometimes markedly – depending on what happens in investment markets. To accept that higher level of risk, we require a greater return.

### INCOME ASSETS

The expected financial benefit of income assets such as bonds derives from gaining a share of stable and predictable cash flows and is realised the entire time we hold the investment. Such assets have less risk as the income stream is agreed in advance (as it is in, say, a term deposit). The returns we expect are therefore lower.



## **DECIDING THE MIX BETWEEN GROWTH AND INCOME ASSETS**

More growth assets means more risk and more likelihood of variations in the value of the portfolio in the short-term. However, over the longer term, when the pattern of volatility tends to even out, growth assets are expected to produce a higher return.

Choosing a mix between growth and income assets is therefore essentially deciding:

- the returns you want
- the certainty you need

This decision involves important trade-offs. Broadly, if you require absolute certainty of a return, that return is likely to be low – typically it will be the lowest available in the market as it is regarded as ‘risk-free’.

So the growth/income balance – the ‘asset allocation’ – is not a simple decision. For us, the starting point is the Fund’s Reference Portfolio.

## **What is the Reference Portfolio?**

The Reference Portfolio is:

- low-cost, simple (i.e. listed asset classes) and passive
- representative of the investable market
- appropriate to the risk profile of the Fund
- relevant to a New Zealand investor.

The Reference Portfolio is weighted 80:20 toward growth assets (primarily global equities with fixed income securities such as bonds comprising the income portion) as we regard that as:

- a balance best suiting the long-term purpose of the Fund
- consistent with ‘maximising return without undue risk’

You can find the composition of our Reference Portfolio on our website.

## **What is the importance of the Reference Portfolio?**

The Reference Portfolio is important because it is our best effort at a blueprint for an investment portfolio that will meet the Fund’s purpose, as simply and inexpensively as possible. This means it is both a structuring guide and an important standard for measuring whether we are adding value to the Fund.



## How does the Reference Portfolio measure whether we are adding value?

We have the ability to pursue some types of investments which deviate from the simple, passive investments within the Reference Portfolio. We do this only when we believe such investments will produce higher returns than are possible from the Reference Portfolio. Because of this assumption, we call these additional investments ‘added-value activities’.

Typically, ‘added-value’ investments are more complex and are more expensive to access than what is in the Reference Portfolio (and we discuss them further in the following section on the Actual Portfolio). They can also be harder to sell quickly. This is why we expect a higher return from them.

This expectation – and therefore the value of this type of investment – must be tested by comparing their performance (taking cost into account) against the simpler, less expensive Reference Portfolio investments.

We publicly disclose the performance comparison in our Annual Report. We believe this represents a useful, and robust, test of our belief that we can add value by diverging from the Reference Portfolio.

## What is the Actual Portfolio?

The real-life composition of the Fund at any one time is called the Actual Portfolio. It is the sum of all the investments we have made which reflect the Reference Portfolio, plus any added-value investments. Investment opportunities come and go. So the Actual Portfolio can – and usually does – deviate from the Reference Portfolio, based on what additional activities are both possible and, in our view, will add value.

The role of the Actual Portfolio is therefore to represent the best portfolio possible that:

- reflects the Fund’s purpose and investment beliefs
- makes appropriate use of the Fund’s endowments and our own organisational capacity to make them happen.

The composition of the Actual Portfolio is disclosed in each Annual Report.



## Improving the Sharpe Ratio of the Fund

All of our added-value investment aims to improve what is known as the Sharpe Ratio of the Fund.

The Sharpe Ratio of the Fund is:

$$\frac{\text{Total Return (- cash)}}{\text{Risk}}$$

**‘Total Return’ is a combination of Excess Return and Active Return**

**Excess Return** = the return premium earned on financial assets such as equities and property over and above what would be possible to earn investing in cash (a ‘risk-free’ investment). This is the contribution of the Reference Portfolio (see page 16) and is why cash is netted off.

**Active Return** = the additional return earned by investing outside of the Reference Portfolio. This is the contribution of our value-adding strategies and is, collectively, the difference between the Reference Portfolio and the Actual Portfolio.

**Risk** = the level of risk collectively brought into the Fund by the sum of all investment activity in the Actual Portfolio. Risk is measured by the volatility (standard deviation) of returns.

**The formula above makes clear that if the risk denominator is high, the Returns must be higher. So each active investment we undertake must raise the sum of the top line, reduce the sum of the bottom line, or both.**

## When do we decide to pursue added-value activities?

This is a particularly important question. We undertake added-value investment activity only when we believe it will either reduce the risk in the Fund, improve the returns of the Fund, or both (this is improving the ‘Sharpe Ratio’ of the Fund – see the sidebar).

Getting to the point where we believe an added-value investment proposal will have a positive impact on the Fund’s Sharpe Ratio requires a thorough assessment. We use the Investment Framework for all of these assessments, to ensure that each proposal is considered from a common perspective.

## The Investment Framework

The Investment Framework establishes a common investment language so that when our team members are discussing concepts such as risk, opportunity and value-add, they are talking about the same thing.

More important, the common internal understanding of key concepts and definitions drives a common approach to how they are applied to each investment proposal regardless of the asset class, geographical location or how it is accessed (for example, directly or through an investment manager).

This common approach is tuned to take account of the characteristics particular to the Fund, such as our Endowments (see page 8). The framework requires us to assess:

- what risk we are bringing into the Fund with each investment proposal
- the returns we expect for the risks – the ‘Sharpe Ratio’ assessment
- our level of confidence in the expected returns, a judgement based on some or all of whether:
  - i. the proposal assists with the diversification of the Fund
  - ii. the proposal is built around a genuine investment opportunity. Opportunities generally involve mispricing and examples include vendor distress, market failure, the impact of regulatory reform and exclusivity (which may arise because of the Fund’s sovereign status)
  - iii. the proposal is built around a genuine skill, either our own skill or that of an external investment manager
  - iv. whether we are accessing the opportunity in the ideal way



## What is an added-value activity?

Our added-value activities fall into three broad categories. Each is anchored to one or more of our investment beliefs (set out on page 10). The sum of all activity falling into one or more of these categories is the difference between the Reference and Actual Portfolios at any one point in time.

### STRATEGIC TILTING

We have the ability to temporarily adjust – ‘tilt’ – the Fund’s balance of growth and income assets. We will make this adjustment when we believe that the market’s expectation of returns (as reflected in pricing at the time) is significantly different to our own expectations of what returns should be in the longer-term. The pay-off of this strategy is when the Fund captures the benefit of the movement of the market away from its short-term position, back toward a more ‘normal’ long-term position. (The relevant investment beliefs are 1, 3, 4 and 7);

### CAPTURE ACTIVE RETURNS

This refers to the broad class of activities undertaken because we believe that, over the long-term, they will produce better returns than what is possible from the Reference Portfolio. This can involve investing in asset classes not in the Reference Portfolio (such as timber); or investing in asset classes that are in the Reference Portfolio, but doing so actively (such as through an investment manager) rather than passively. (The relevant investment beliefs are 1, 3, 5, 6, 8 and 9).

### PORTFOLIO COMPLETION

This refers to investment activities related to the most cost-effective means of gaining access to investments and of managing them when we have made them. An example of this includes how we time an investment in equities: a sizeable investment in a small market can be quickly noticed by other players and prices can increase rapidly, involving extra cost if you are a buyer. Executing the trade skilfully can minimise or avoid this extra cost. (This activity links to the investment fact relating to execution – ‘managing fees and ensuring efficient implementation can prevent unnecessary costs.’

### For more information

On our website you can find:

- in-depth information about how we structure the Reference Portfolio
- further detail about our added-value activities and investment strategies relevant to each
- the composition of the Reference Portfolio (our Annual Report: go to page 17)
- the performance of our added-value activities compared to the performance of the Reference Portfolio (our Annual Report: go to page 23)



## Section B - What asset classes can we hold?

### Main points of this section

**We have freedom to invest in any asset classes we choose, subject to restrictions imposed by our legislation, our Board and our Responsible Investment programme.**

**We can hold assets physically or synthetically, according to which represents the best balance of risk and return and value for money.**

The investments we make for the Fund are driven by our investment strategies and by our Investment Framework (page 18). A particular strategy may involve investments in more than one asset class and often a single investment can be categorised in more than one asset class.

We have freedom to invest in whatever asset classes we choose to, subject (as is detailed on page 13) to:

- our mandate
- our Act
- Board-imposed restrictions
- our exclusions on Responsible Investment grounds

The Fund can hold exposure to the following assets:

Asset	Explanation
Global equities	<p>‘Shares’ in companies which are listed or are shortly to be listed – when the investment can be made as part of an Initial Public Offering (IPO) of equities before listing – on any recognised stock exchange.</p> <p>This category also enables investments in companies listed on stock exchanges other than Australia or New Zealand but for which New Zealand is their primary source of business.</p>
New Zealand equities	<p>‘Shares’ in companies which are listed or are shortly to be listed on the New Zealand or Australian stock exchanges. We have included Australia – on a limited basis – in recognition of the close economic relationship with Australia.</p>
Fixed interest	<p>Investments that do not represent ownership, as do investments in equities. Rather, the ‘investor’ has given another party the use of their money and expects interest as payment for that use. This asset class includes bonds, deposits and debentures but there are many different ways to structure a fixed interest investment.</p>
Property	<p>Land and premises built on land. Can be held directly by the Fund or jointly with other investors in investment pools such as through listed property trusts (investments can also be held privately).</p>



Asset	Explanation
Infrastructure	The basic physical systems and networks underpinning a country or community and its population. Infrastructure includes roads, water supply and gas and electricity distribution. These investments can be held directly by the Fund or jointly with other investors in investment pools and can be listed or held privately.
‘Private markets’ assets	<p>Defined as those unlisted assets with claims on equity, where returns have varying degrees of correlation with listed asset classes. This varies the degree to which their values are impacted by the performance of the equity markets at any point in time.</p> <p>Typically, private markets assets cannot be sold quickly or easily (they are ‘illiquid’) and the investor expects higher returns to compensate them for this. We discuss how we assess whether private markets’ assets are adding value to the Fund in the box on this page.</p>
Cash	A collective term for assets which include bank account balances and short-term fixed interest investments such as term deposits. We note that cash is not only an asset class, it is also held as collateral within the Fund to ensure we can meet our responsibilities and make new investments (we still seek a return on this cash).

## How do we hold our investments in asset classes?

The investments can be held:

- physically (through holding the actual asset class)
- synthetically (typically, through derivatives as explained in the box in this section)

The decision whether to invest directly or through derivatives is made case-by-case, depending upon the assessed costs and risks in each instance.

### How do we assess whether unlisted ‘private markets’ assets are adding value?

As a general principle, we require all investments to be valued at fair value. In the case of listed assets, fair value is readily determined by reference to traded prices on recognised exchanges. For unlisted ‘private markets’ assets, where quoted market prices are not available, fair value will be determined on the basis of independent valuations, where practical.

Where it is not practical to obtain an independent valuation, an investment manager’s valuation will be used. If we are not satisfied that an investment manager’s valuation is sufficiently reliable, we will value the investment at cost less any impairment.

We ensure that any independent valuations are conducted at least annually by qualified independent professional advisors.

Before valuations are booked, the valuation methods used by the advisors are tested by an internal Valuation Working Group, comprising senior members of the Investments and Finance teams.



## When and how do we use derivatives?

Derivatives are financial instruments that replicate the behaviour and performance of certain types of investments. Typically, they are linked to:

- individual securities such as equities
- indexes on bonds and equities, such as New Zealand's NZX50, which aggregate the performance of a group of securities
- reference rates (such as an exchange rates or interest rates)

There are many types of derivatives and many reasons to use them, including:

- to manage risk and liquidity
- to lower transaction costs
- as added-value investments in their own right

## Using derivatives to manage risk and liquidity

The Reference Portfolio is generally 100% hedged back to New Zealand dollars. (We do this to get the benefits of New Zealand interest rates being higher than offshore interest rates. We are indifferent to fluctuations in the NZD relative to other currencies.) This reduces our risk exposure to fluctuations in foreign currencies versus the New Zealand dollar. Currency derivatives, such as forward contracts, allow us to manage this foreign currency risk in an efficient manner.

In addition, the actual portfolio tends to "drift" away from its target exposures through time due to differential performance of the various asset classes we own and also due to changes in exchange rates. In other words, the portfolio's actual risk can drift away from the desired risk. Derivatives are a convenient way of re-balancing the portfolio back to its targeted risk level.

Derivatives can also help us to manage our liquidity. When we enter into a derivative contract, we often are not required to make any deposit on this exposure. Where we are required to set aside a deposit, it is often a relatively small percentage of the underlying exposure. This means we hold a pool of collateral within the Fund, while maintaining the desired market exposures through the derivative. In instances where we require liquidity at short notice, closing the derivative position allows us to access an immediate source of cash.

### Using derivatives to lower transaction costs

Derivatives can lower transaction costs in at least two ways:

- index derivatives are often cheaper to buy than the individual physical securities making up the index
- commissions are generally negligible.

### Using derivatives to add value to investment

Derivatives allow us to add value to the Fund in some instances. For example, derivative counterparties, such as investment banks, may offer attractive terms to the Fund for entering into certain types of derivative contracts. Total return swaps on global equities, for example, involves us contracting to receive the total return on the global equity



index and to pay an interest rate back to the counterparty. The interest rate we pay, is to compensate the counterparty for the cost of funding the equity position.

In some cases, the counterparty may quote us an interest rate below the market standard interest rate. In turn, we can generally earn a return on the cash collateral that we hold that is above the standard interest rate. The net effect of the swap transaction is for the Fund to receive the return on global equities plus an additional margin reflecting the difference between the relatively high interest rate we earn on our collateral and the relatively low interest rate we pay to the counterparty. The alternative way of obtaining global equity exposure, through physical purchase of the equities, generally involves the Fund generating the same return on the index but having to pay all the associated expenses of buying and managing the securities.

## **Are there any restrictions on the use of derivatives?**

Our Act states that the Minister of Finance must approve us holding “any financial instrument that places or may place a contingent liability on the Guardians, the Fund or the Crown”.

A derivative is a contract which at some stage must be paid out. So a contingent liability is implicit in derivatives. Our Board has therefore sought and received the Minister’s approval to use derivatives, subject to conditions including that they are used only as part of an investment strategy and are consistent with the objectives of that strategy.

For more information

On [www.nzsuperfund.co.nz](http://www.nzsuperfund.co.nz) we provide a monthly update of the asset classes to which the Fund is exposed.





## Section C - How do we choose how to access investments?

### Main points of this section

**We can manage an investment ourselves or we can contract a third party to manage it for us.**

**We only use a third party when we are convinced we could not ourselves produce the returns we expect the third party to produce.**

**Even if we believe a third party could produce returns otherwise unavailable to us, they must meet a number of tests relating to their track record, organisation capabilities and values before we will employ them.**

We have already set out the main factors guiding our investment choices:

- the Fund's purpose
- restrictions
- our desired risk and return
- our Investment Framework and investment strategies
- we are free to invest across asset classes

With those guiding factors in mind, our investment staff identify and analyse potential investment opportunities. If we decide to pursue an investment, it can be either:

- managed internally and according to an investment strategy (including a passive investment and including using derivatives); or
- managed externally by an investment manager and according to an agreement specific to the investment. The agreement will specify how risk is to be managed, what can be invested in and other matters (such as use of derivatives, as discussed on page 22).

Key to this decision will be our judgement as to which option is most likely to produce the best returns ('effective') after all costs ('efficient').



## When and how do we invest through third parties?

We only invest through third parties when we firmly believe that doing so is the most effective and efficient way to access an investment. We look for third parties:

- who are operating in an environment where we believe it is possible to generate active returns (i.e. returns over and above the passive alternative, after costs) who, because of a good investment strategy, are themselves capable of generating such returns
- who also satisfy a set of demanding due diligence hurdles

We have used the umbrella term ‘third parties’ because we use three types of external assistance to help us manage the Fund:

Type of third party	How it works	How they are appointed
Investment managers	Typically, the manager runs a portfolio of assets specific to the Fund, under guidelines we specify.	New managers are approved by the Board.  Decisions to use approved investment managers are made by our Investment Committee (a management committee)
Investment pools provided by external managers	We invest alongside other investors according to guidelines specified by the manager (although we might be able to negotiate additional terms specific to our investment).	The Investment Committee makes decisions about investing in pools.
Portfolio completion agent	Portfolio completion agents help us achieve desired exposures in the Fund. A good example is where we decide to transition assets from one manager to another. To do so we must maintain the market exposure held by the first manager while simultaneously buying and selling assets (often, equities) to effect the transition. This is complex and we may choose to use a specialist transition manager to assist us.  Portfolio completion agents do not have the discretion granted to investment managers and the transaction is typically a one-off so they have no ongoing mandate.	Appointing new portfolio completion agents and the decision to use an approved agent are made by the Investment Committee.



## What must a third party do to manage Fund assets?

We have discussed the foundation factors which must be present for us to decide to invest through, or alongside, a third party. Once we have made that decision, we conduct due diligence before entering an investment relationship with any third party (in particular, an investment manager).

A conviction framework governs this process. It has two levels. First, there is a series of gates a manager must pass through to even be considered. The gates are specific to the type of manager being accessed (see 'Differences in application' below) and include:

- a capacity to manage the asset class for which we are seeking managers
- the trust we have in the manager
- the alignment of interest between the manager and ourselves (primarily, we want the manager to have a meaningful co-investment alongside us in – and therefore a personal stake in the success of – the investment they are managing for us.
- our confidence in the viability of the manager's business
- no conflicts of interest.

They are called gates because if the manager fails to meet any of them, they cannot be appointed. Once a manager has passed through these gates, conviction focuses on their investment capability. This is the second level of the process, a range of important factors including:

- ownership structure
- the experience and depth of their team
- their key person risk and how they are managing it
- their investment philosophy
- how they construct portfolios
- their risk management

We apply a weighted score to each factor (weighting varies depending on the job we expect the manager to do). A poor total score, or a very poor score in a single important factor, could constitute a gate and the manager not being appointed. We believe this process assists us to select managers who will be in the top quartile of performance relative to other managers.

### DIFFERENCES IN APPLICATION

There are subtle differences in the way that we apply this framework for managers being considered for listed asset mandates, and those being considered for unlisted asset mandates.

Also, the framework as we have described it describes the general approach used for appointing active managers. Where we are appointing a manager solely to provide a market exposure included in the Reference Portfolio, a briefer evaluation process applies. This is because it typically will be a simple, low-cost exposure.

On [www.nzsuperfund.co.nz](http://www.nzsuperfund.co.nz) you can find more information about how we select third parties



## Section D - How do we invest responsibly?

### The key points of this section

**We believe paying attention to Environmental, Social and Governance factors is good investment practice**

**We use external benchmarks for what is accepted good corporate practice**

**If we believe an investee company is breaching accepted good practice we try to improve its behaviours via engagement. In some circumstances we will block, or remove, a company from our portfolio.**

## What is Responsible Investment?

Like many institutional investors, we invest with a long-term focus. We recognise that environmental, social, and governance (ESG) issues are long-term factors that can be highly relevant to investment performance.

ESG issues present regulatory, market, reputational, and operational risks and opportunities which shareholders should consider to fully understand what they are taking on when they choose to invest in companies.

Responsible investment (RI) is, therefore, the 'integration of ESG considerations into investment management practices in the belief that these factors can have an impact on financial performance'.

## How do we benchmark our Responsible Investment programme?

We have adopted the [UN Global Compact principles](#) as a benchmark for expected standards of corporate behaviour.

We have adopted the [UN Principles for Responsible Investment \(UNPRI\)](#) as an internationally accepted framework for investors to manage ESG issues in a manner consistent with improving long-term investment returns.

These ESG standards and beliefs form the basis of our RI framework.



## What is our framework for incorporating Responsible Investment?

### Table 3 – How we have incorporated Responsible Investment across our investment activity.

We have published the full version of our Responsible Investment Framework to our website. In summary, the framework covers the following areas:

Our RI workstream	Relevant UNPRI principle(s)	Typical activities covered
<b>Integration</b> Developing guidelines to integrate ESG considerations across different types of investments Effective engagement with the external investment managers, the manager selection advisers we use and the companies we invest in Considering investments which provide positive social returns in addition to the required financial return	<b>Principle 1</b> We will incorporate ESG issues into investment analysis and decision-making processes	Integrate RI guidelines across asset classes Apply exclusions Positive Investment and social rating Investment manager due diligence; monitoring and conviction
<b>Ownership</b> Being an active owner of securities in which we invest by exercising our voting rights Maintaining a robust analytical and decision making process in responding to investee companies breaching our Responsible Investment standards	<b>Principle 2</b> We will be active owners and incorporate ESG issues into our ownership policies and practices	Direct and collaborative engagements with companies Voting - reducing agency risk NZ Corporate Governance Governance guidelines for other asset classes
<b>Disclosure (by investee companies)</b> Raising investee companies awareness of good practice reporting standards and encouraging their own efforts in this regard	<b>Principle 3</b> We will seek appropriate disclosure on ESG issues by the entities in which we invest.	ESG Reporting standards for companies Carbon Disclosure Project Encourage good practice reporting by NZ companies
<b>Best practice and collaboration</b> Benchmarking our performance against the Responsible Investment standards to which we aspire	<b>Principle 4</b> We will promote acceptance and implementation of the Principles within the investment industry. <b>Principle 5</b> We will work together to enhance our effectiveness in implementing the Principles.	Participation in Forums and working groups (e.g. UNPRI) Engagement with regulators and advisors Collaboration with Crown Financial Institutions and global peers Asset and co-investment guidelines
<b>Communication</b> Reporting on our activities across all workstreams including the benchmarking of those activities	<b>Principle 6</b> We will each report on our activities and progress towards implementing the Principles.	Public reporting of RI activity and benchmarking Internal reporting Stakeholder engagement



## **What do we do when we believe there is an ESG issue with an investee company?**

We communicate with companies, either directly or collaboratively with other investors, to encourage them to address environmental, social or governance (ESG) performance. We call this 'engagement' and it can happen proactively, when we identify issues we believe companies should be aware of; or reactively when we believe a company already has a problem.

Reactive engagement begins with screening the Fund to identify companies that have breached – or are reported to have breached – internationally recognised ESG standards. Our key source of information on potential or actual breaches is our external research provider. Our research provider analyses company performance in these areas, and investigates broader sources of information about the company's activities (such as reports from media or Non Government Organisations like the World Wildlife Fund for Nature).

Where there is evidence that companies have breached international standards, or where there is a high risk of them doing so, our research provider adds the company to a "red list". We prioritise engagement with companies on the red list by seeking to understand if the breach is:

- long-term or short-term
- historic or ongoing
- isolated or endemic

We assess how successful we might be at getting the company to change the behaviour underlying the breach. We also assess how much time, effort and money will be required to achieve that success.

## **What happens if engagement is not appropriate or does not change company behaviour?**

Sometimes we decide we cannot invest in a company (we call this 'exclusion') or, if we have already invested, that we should remove them from the Fund (we call this 'divestment'). We have excluded and/or divested from companies that are directly involved in:

- the manufacture of cluster munitions
- the manufacture or testing of nuclear explosive devices
- the manufacture of anti-personnel mines
- the manufacture of tobacco
- the processing of whale meat

### **HOW DO WE ENFORCE EXCLUSIONS?**

We use specialist screening agencies to identify companies involved in cluster munitions, nuclear explosive devices and tobacco manufacturing. These screening agencies give us annually updated lists which we then compare with our list of investment holdings. Where there is a match, we sell the company. The Fund is also monitored by our Custodian for compliance with our exclusions.

We may also receive relevant information from other organisations with expertise in this field or from the companies themselves. Our screening agencies review their research on a regular basis. We update our exclusion lists as required and inform our third-party managers.



## FOR MORE INFORMATION

On [www.nzsuperfund.co.nz](http://www.nzsuperfund.co.nz) you can find a range of information about our Responsible Investment approach, including:

- [a chart setting out how we engage](#)
- [a full list of our exclusions](#)

We report on our Responsible Investment activity on pages 36, 37 and from page 132 of our [2010 Annual Report](#)

## Section E - How do we manage risk?

### The key points of this section

**We regard risk as anything which threatens the likelihood of the Fund meeting its objectives.**

**Risk management is everybody's responsibility, however we have a formal framework which establishes requirements, processes and reporting lines.**

Failing to appropriately identify, assess and manage risk has potentially significant financial, operational and reputational consequences. Our risk management framework therefore covers each of these risk-management activities.

### OUR DEFINITION OF RISK

We define risk as any internal or external factor that poses an actual or potential threat to our ability to fulfill our, and/or the Fund's, purpose. Risk is characterised by uncertainty and is measured in terms of the impact of an event and likelihood of its occurrence.

The objective of our Risk Management framework is to ensure that:

- we have effective and efficient continuity of our operations
- our assets are safeguarded
- our reputation is preserved and enhanced
- our internal and external reporting is reliable
- we comply with applicable laws and regulations

Creating and maintaining a culture consistent with our risk tolerance is an important element of operational risk, as are our selection and recruitment processes.

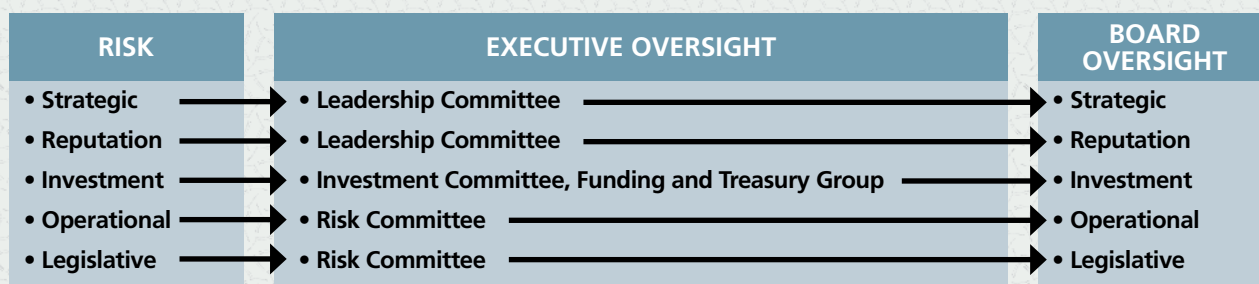
## Who has oversight of our risk management?

The Board has overall responsibility for oversight of risk management. All managers must integrate risk management into the decisions they make every day. Our risk oversight is based on three levels of control as shown in the figure below.

### Figure 3 – Responsibility for risk oversight

LEVEL 1	• Managers, who are primarily responsible for managing risks associated with their operations.
LEVEL 2	• Our Risk Committee (RC) has oversight of all risks. The RC reports through to our Investment Committee or to the Leadership Team as appropriate.
LEVEL 3	• Our Board and the Audit Committee, supported by internal audit.



**Figure 4 – How we assign specific areas of risk oversight**

### Our risk management process

Our risk-management process has four stages.

#### IDENTIFYING RISK

We list events that could negatively impact the achievement of the business objectives we have set out in our strategic and business plans.

#### ANALYSING RISK

We rate how likely it is that the events on the list will happen and the severity of their impact on business plans. Each risk is assigned an Initial Risk rating, which is our initial assessment of how serious the risk is without any controls.

#### RATING EFFECTIVENESS OF CONTROLS

We analyse the effectiveness of our existing controls in addressing the risks we've identified. Our controls include policies, procedures, standards, processes and codes of practice. We do this analysis annually, using findings from external and internal audits, case studies of reported incidents and any other relevant and useful information. We then assign a Current Risk rating to each instance where we've concluded that a risk still presents a threat even after taking account of all available controls.

#### ANALYSING RESIDUAL RISK

Finally, we decide how to deal with Current Risks. Typically, this involves developing management plans specific to that risk to ensure the threat it presents remains within acceptable limits. These plans then feed back into the strategic and business planning.

## What are our risks?

Our five major risk categories are listed below:

- *Investment risk*: The risk inherent in achieving investment goals and objectives (that is, the risk of not achieving them), including market, credit, counterparty, manager and liquidity risk
- *Strategic risk*: The risk that we make inappropriate strategic choices or that we are unable to successfully implement selected strategies
- *Legislative and regulatory risk*: The risk of financial loss or reputational damage due to non-compliance with actual or proposed laws, rules and regulations and prescribed industry practices
- *Operational risk*: The risk of financial loss from inadequate or failed internal processes, people or systems, or from external factors
- *Reputation risk*: Risk of loss of reputation or credibility due to internal or external factors



## Managing currency risk through hedging

Investing overseas means our investments are affected when currencies rise and fall. The main effect of this is to amplify the short-term variances of the Fund. However, over the longer term currency fluctuations can also affect the returns on overseas investments. This introduces uncertainty, which is undesirable, and is what we manage through 'hedging'.

Hedging is a financial strategy that involves making an agreement now on the exchange rate for future transactions, so that returns on foreign investments, when received, are in New Zealand dollars at a rate that we have agreed. The return may be smaller than if we had not hedged, because of favourable currency movements. The favourable movement was not predictable, but the value lies in the certainty of an acceptable return.

Our base position is to hedge 100% of major foreign currency investments. The Reference Portfolio is 100% hedged. If the New Zealand dollar becomes less attractive, we can reduce the hedging from 100% to something more suitable through Strategic Tilting (see page 19).

We hedge the whole fund, regardless of what it includes (equities, bonds, private market investments and so on) and we hedge each major currency involved.

Along with reducing currency risk, hedging in New Zealand dollars also provides other benefits:

- the New Zealand dollar typically gives better returns due to higher interest rates, on average, than other major currencies
- the New Zealand dollar is relatively stable

Finally, we can also make independent investment decisions based on foreign currency movements. If the New Zealand dollar or a foreign currency has moved substantially away from what, in our view, is its appropriate value, we have the ability to 'tilt' toward or away from that currency (see page 19).

### FOR MORE INFORMATION

On [www.nzsuperfund.co.nz](http://www.nzsuperfund.co.nz) we provide further information on our [risk management approach](#)



## Section F - How do we measure the performance of the Fund?

### The main points of the section

**There are two main benchmarks for the Fund's performance.**

**If the Fund outperforms Treasury Bills, it is adding value to the Government's financial position.**

**If the Fund outperforms the Reference Portfolio, we are adding value to the Fund with our investment approach.**

The Fund's two key performance measures are:

- Treasury Bills
- the Reference Portfolio

## What is the significance of Treasury Bills?

We believe that the Fund's investment horizon, risk profile, weighting to growth assets and purpose make it logical and realistic for it to exceed, before New Zealand tax, the return on Treasury bills over rolling 20-year periods.

The Fund is a pool of financial assets held by the Crown. As such, contributions to the Fund make no difference to net Crown assets/liabilities. However, contributions can impact the level of the Crown's gross debt.

Accordingly, Treasury Bills proxy the 'opportunity cost' to the Government of contributing capital to the Fund, instead of using the money to retire debt. This is because Treasury Bills represent the marginal interest cost to the Government of raising debt.

Over time, the Fund is expected to earn more for the Government in investment returns than it would save in debt servicing. In other words, it is expected to add to Crown wealth, putting future governments in a better position to meet increased Superannuation commitments.

## What is the significance of the Reference Portfolio?

As we discuss on page 16, the Reference Portfolio is our best estimate of a simple, low-cost, passive portfolio we could invest in to achieve our mandate. It therefore represents a benchmark for our ability to add value with the strategies we have described in the section 'What is an added-value activity?' See page 19.

## How do we measure the performance of external investment managers?

We monitor the investment performance and investment risk of each manager relative to our expectations for the investment or mandate they manage on our behalf.

Performance is monitored on a monthly basis but we give most emphasis to longer-term measures. The appropriate timeframe over which to measure the performance of a particular manager, and the appropriate benchmark for each manager, depends on the strategy being managed. We appoint managers using an Investment Management Agreement (IMA). Each IMA contains specific reporting requirements.

### FOR MORE INFORMATION

On [www.nzsuperfund](http://www.nzsuperfund) we provide:

- monthly updates of the Fund's performance relative to Treasury Bills
- annual assessments of the value we have added relative to the Reference Portfolio (see page 23 of the 2010 Annual Report)



## Section G - Who do we report to?

### Main points of this section

**The Fund is subject to a high degree of transparency. We have numerous public reporting requirements and have adopted a proactive approach to disclosure.**

**Public reporting is supported by internal reporting from management to the Board and from investment managers and our Custodian to management.**

#### WE REPORT PUBLICLY

We have adopted a high degree of transparency around our management of the Fund and its performance.

We report publicly on our asset allocation, key investment activities and on the Fund's performance in the following ways:

- a monthly portfolio update and Fund returns through the website
- an annual list of all of our equity holdings
- an Annual Report
- an annual Statement of Intent
- our Statement of Investment Policies, Standards and Procedures
- our How We Invest document
- regular reporting through our website on our responsible investment activities

#### WE REPORT TO THE MINISTER OF FINANCE

We report to the Minister of Finance each quarter on:

- the performance of the Fund
- any important investments
- any other important activity – such as employing new senior staff or new investment managers – undertaken during the quarter.

We also report to the Treasury each quarter, which contributes to Treasury's production of the Government's accounts, and of economic data.

#### MANAGEMENT REPORTS TO THE BOARD

We report to the Board as follows.

- progress reporting on Strategic Plan change initiatives
- progress on implementing value add investment activities
- Fund performance including Value Add contribution
- financials
- communications updates
- reporting on HR: staff, recruitment, wellness
- compliance and counterparty reporting.



## INVESTMENT MANAGERS REPORT TO US

After partnering with an investment manager, we monitor them on an ongoing basis, as follows.

- Through Investment Monitoring, we evaluate both investment returns and the manager's investment competency. For this we assess performance and, annually, test whether the manager continues to meet the hurdles set out in the table on page 26.
- Through Compliance Monitoring, we ensure that managers appointed by us are keeping to the Investment Guidelines for each investment. To make sure of this, our Custodian monitors each manager for compliance with the investment guidelines prescribed in the IMA. The Custodian reports on active and passive breaches of those guidelines to us and the manager.
- Through Operational Monitoring, we review a manager's operational competency and effectiveness. For this we typically require managers to provide us with a selection of documents including:
  - o their external audit report (if completed)
  - o any licence they are required to hold (when renewed or changed)
  - o their insurance certificates
  - o their Anti Money Laundering policy

All of these are further detailed in the Externally Managed Investments Policy on our website.

## OUR CUSTODIAN REPORTS TO US

Our Custodian reports to us on:

- the Fund's Performance including the contribution of added-value activities
- Investment manager compliance with their investment mandates
- Responsible Investment screening
- the size of our exposures to counterparties and the total value of all of our derivatives
- daily Net Asset Value

## FOR MORE INFORMATION

On [www.nzsuperfund.co.nz](http://www.nzsuperfund.co.nz) you can find:

- Annual Reports and Statements of Intent
- Monthly performance reports
- News announcements and presentations
- Responsible Investment Reports



## GLOSSARY

### A

<b>Access point:</b>	the means by which the Fund obtains exposure to a desired risk or, in the world of active investing, the access point is the way we get exposure to the desired active return stream. Access points are our way of exploiting opportunities, themes, stress test outcomes and manager skill. The access point can be passive, active, <a href="#">synthetic</a> or <a href="#">funded, directly</a> (internally) or <a href="#">externally</a> managed.
<b>Active management:</b>	The management of active risk positions.
<b>Active returns:</b>	Any <a href="#">return</a> differential between the <a href="#">actual portfolio</a> and the <a href="#">reference portfolio</a> . In the context of an <a href="#">investment</a> , the positive return we hope to earn for taking on <a href="#">active risk</a> . Same as <a href="#">value add</a> .
<b>Active risk:</b>	Any deviation in risk in the <a href="#">actual portfolio</a> relative to the <a href="#">reference portfolio</a> . Active risk is a relative risk concept. The active risk in the portfolio is dominated by activities in our <a href="#">value adding strategies</a> . Note that the actual portfolio can have the same total or absolute risk as the reference portfolio but still have active risk. Technically active risk is expressed as the expected standard deviation of the <a href="#">active returns</a> .
<b>Active strategies:</b>	<a href="#">value add strategies</a>
<b>Actual portfolio:</b>	the Fund's portfolio at any point in time reflecting all the positions arising from the Fund's <a href="#">value adding strategies</a> as well as <a href="#">drift</a> . Conceptually, the actual portfolio equals the <a href="#">reference portfolio</a> ( <a href="#">cash</a> plus <a href="#">risk premiums</a> ) plus drift plus <a href="#">active risk</a> .
<b>Asset Class:</b>	an asset class is well-diversified exposure to a group of securities or assets that share common characteristics.

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### B

<b>Belief:</b>	the Fund's stated view on some aspect of financial markets and investing
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## C

<b>Capability:</b>	management's ability to execute a <a href="#">value add strategy</a> . Incorporates depth and breath of experience, risk management abilities etc.
<b>Cash:</b>	generally taken to mean a very short term investment earning interest from a highly-rated bank or an equivalent bank bill.
<b>Compensation:</b>	return for taking on risk. Often, the compensation is the <a href="#">risk premium</a> , or <a href="#">excess return</a> over cash, that the <a href="#">investment</a> offers.
<b>Conviction:</b>	a measure of the degree of confidence we have in an active manager's investment <a href="#">skill</a> . The Fund's approach to rating an <a href="#">active</a> manager. Applicable to both public and private market managers. The conviction rating is a quantitative overall score based on the scores of a number of individual, largely qualitative, factors.
<b>Credit risk:</b>	the risk associated with the variability in the perceived credit quality of a fixed income instrument.
<b>Direct:</b>	a direct activity is a <a href="#">financial market transaction</a> undertaken by the Fund's management.

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## D

<b>Diversification:</b>	the potential improvement in a portfolio's <a href="#">Sharpe Ratio</a> that arises from introducing assets into the portfolio that behave differently to the assets in the Reference Portfolio. Introducing any new asset or asset class into the portfolio will have a diversification benefit. The more diversified a portfolio, the more difficult it is to achieve further diversification gains.
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## E

<b>Economic risk exposures:</b>	the handful of basic economic drivers that determine the risk and return of all securities, investments and asset classes. Generally unavoidable and undiversifiable. These economic drivers are real growth, inflation, agency risks and “other”.
<b>Endowment:</b>	a characteristic of the Fund that provides the Fund with a natural advantage or edge over the typical investor.
<b>Excess return:</b>	see <a href="#">risk premium</a> .
<b>Equilibrium:</b>	the long term or steady state. Generally expressed in the context of long term average expected risks and returns.
<b>External:</b>	an investment managed by an appointed manager. An investment not managed directly by management. Externally managed.

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## F

<b>Financial market transaction:</b>	is a public market transaction relating to individual securities, foreign exchange and derivatives.
<b>Fixed income:</b>	assets providing income to investors via a fixed coupon payment. In the context of the reference portfolio, fixed income is a very well diversified set of exposures including sovereign bonds, investment grade credit, agency debt, high yield bonds and emerging market debt. Inflation-linked securities are also included though an element of the income is variable because it is linked to future inflation outturns.
<b>Foreign exchange:</b>	The Fund’s exposure to non-NZD cash rates. In our reference portfolio there is no foreign exchange exposure as all non-NZD denominated assets (ie foreign funded assets) are hedged back to NZD. Hedging back to NZD essentially replaces foreign cash returns with NZD cash returns. Foreign exchange in the Fund’s context refers to a basket of the major foreign currencies.
<b>Funded:</b>	A funded investment uses cash to buy the underlying physical securities. In contrast, a synthetic or derivative investment does not generally require full funding, or at least not full funding.

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## G

<b>Gate:</b>	a minimum level of integrity or commercial viability that a manager must demonstrate to be even considered as a manager for the Fund. Used explicitly in public markets but implicit in private markets as well. The public market gates are asset capacity, trust, alignment of interest, business viability and conflicts of interest. After passing through the gates a <a href="#">conviction</a> analysis of the manager can be undertaken.
<b>Gross return:</b>	the return on an investment before distributions to the manager and the tax authorities. The gross return has already deducted direct costs related to the investment, for example interest on borrowings, transaction costs and, in the case of private investments, acquisition and disposal costs associated with entering and exiting investments.
<b>Growth:</b>	growth assets load heavily onto the economic growth risk exposure. In the <a href="#">reference portfolio</a> , growth comprises equities and REITs. Some private market assets are also growth assets, eg private equity.

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## H

<b>Hurdle:</b>	the inability to buy or sell an investment in a timely manner with minimal transaction costs. Usually inherent in private market investments but can also be evident in public market investments. Illiquidity is a risk and like all risks the investor must be compensated for taking the risk on. In the case of illiquidity, the compensation is a higher expected return from an illiquid investment compared to a comparable liquid investment.
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	Internal Investment Mandate (IIM):

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## I

<b>Illiquidity:</b>	the inability to buy or sell an investment in a timely manner with minimal transaction costs. Usually inherent in private market investments but can also be evident in public market investments. Illiquidity is a risk and like all risks the investor must be compensated for taking the risk on. In the case of illiquidity, the compensation is a higher expected return from an illiquid investment compared to a comparable liquid investment.
<b>Internal Investment Mandate (IIM):</b>	IIM. The policy governing the management of an internal mandate falling under an active strategy.
<b>Investment:</b>	an allocation of risk capital to a specific manager or activity. Could include an individual investment undertaken by the Fund's internal management under an <a href="#">Internal Investment Mandate</a> (IIM).
<b>Investment theme:</b>	see <a href="#">Theme</a> .

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## L

<b>Leverage:</b>	For the purposes of this document, leverage is borrowing and is defined as debt divided by enterprise value (EV) (where EV= debt plus equity). In a broader context, this is too narrow a definition. Leverage is the amount of risk generated per dollar of invested capital. Leverage does not require borrowing. Investing \$100 in equities is more risky and contains more leverage than investing \$100 in government bonds.
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## M

<b>Market risk:</b>	is the non-diversifiable risk associated with exposure to a broad mix of asset classes. The risk in the <a href="#">market portfolio</a> . In the context of the Fund, this also refers to the risk in an investment that is correlated with the reference portfolio or some investable public market benchmark or asset class. <a href="#">Systematic risk</a> .
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## N

<b>Net return:</b>	The return the Fund actually receives after all manager fees and taxes. Equal to the gross return minus manager fees and taxes.
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## O

<b>Opportunity:</b>	a feature of the investment environment that is conducive to generating positive risk-adjusted <a href="#">active returns</a> .
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P

<b>Passive:</b>	passive exposure to an <a href="#">asset class</a> or benchmark. Replication of the risk and return of an asset class or benchmark. Can be done <a href="#">physically</a> or <a href="#">synthetically</a> .
<b>Passive fees:</b>	the cost, in manager fees or derivative pricing, of obtaining public market asset class benchmark replication. Generally very low cost.
<b>Physical:</b>	an investment that is funded with cash to the full notional amount of the investment. <a href="#">Funded</a> .
<b>Portfolio Construction:</b>	the allocation of risk in a portfolio. Generally applied to <a href="#">active</a> management, portfolio construction embraces the broad allocation of risk capital to various <a href="#">value add strategies</a> as well as the specific allocations of risk capital to individual investments.
<b>Private markets active strategies:</b>	Private market <a href="#">value adding strategies</a> .
<b>Public market:</b>	public market investments comprise: 1) exchange listed securities or 2) Over the counter financial contracts linked to listed securities and/or widely-followed indices or benchmarks. Public market investments are generally (but not always) liquid and generally (but not always) have regular and transparent pricing. We prefer to use the term “listed” rather than “public market” although OTC instruments are, by definition, not listed.
<b>Public market active return strategy:</b>	Generating active returns through a strategy that focuses on listed securities. This used to be a separate business unit but now comes under the Investments group. An increasingly artificial distinction between the private markets active strategy. Abbreviated to PMAR.

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## R

<b>Reference Portfolio:</b>	a low cost, passively managed and well diversified portfolio of listed asset classes that is consistent with the Fund achieving its return objectives without undue risk, ie fit for purpose. Conceptually, the reference portfolio comprises a 100% <a href="#">cash</a> position (NZD) plus a set of <a href="#">risk premiums</a> or <a href="#">excess returns</a> that also sum to 100%.
<b>Return:</b>	the return on an <a href="#">investment</a> after manager fees and taxes. Generally when we use the term return, it is a net return concept. The net return is the return the Fund actually receives.
<b>Risk:</b>	The standard deviation of expected returns. The Fund's risk model uses equilibrium risk (and return) assumptions.
<b>Risk Premium:</b>	the return in excess of cash earned by investors as compensation for taking passive exposure to the market or an asset class. Risk premium and <a href="#">excess return</a> can be used interchangeably.

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## S

<b>Sharpe Ratio (SR):</b>	Portfolio total return minus cash divided by total risk. Usually applied at the portfolio level, in which case it is the total portfolio return over cash (which is the sum of excess returns and active returns) divided by total risk. Can also be applied to individual investments and strategies. Abbreviated to SR.
<b>Skill:</b>	active investment expertise. The ability to provide <a href="#">active returns</a> .
<b>Strategies:</b>	abbreviation of <a href="#">value adding strategies</a> or <a href="#">active strategies</a> .
<b>Synthetic:</b>	obtaining exposures using derivatives. Generally does not require to be <a href="#">funded</a> .

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## T

<b>Theme:</b>	Long term influences on the economy and capital markets that are expected to be relatively immune to business cycle and other short-term influences. An enduring characteristic or feature of the global economic or financial environment.
<b>Tilt:</b>	changes in the mix of the Fund's market or currency exposures relative to the reference portfolio (other than through drift or the proxies). Note that while we generally exclude the differences between market exposures inherent in private market assets (after proxy adjustment) from our definition of a tilt, in effect these private market positions may have elements of a tilt to them. Tilting is a <a href="#">value add strategy</a> .
<b>Total risk:</b>	Generally referring to the Fund's total or absolute risk.

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## V

<b>Value add:</b>	see <a href="#">active return</a> . In performance reporting, the difference between the actual return and the reference portfolio return net of the costs of obtaining passive exposures.
<b>Value adding strategies:</b>	Board approved strategies that define the objectives and parameters for taking on active risk. Also referred to as <a href="#">active strategies</a> or just strategies.

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