NZSUPERFUND
Te Kaitiaki Tahua Penihana Kaumātua o Aotearoa

5 April 2018

Hon Grant Robertson
Minister of Finance
Parliament Buildings
Private Bag 18888
WELLINGTON

Dear Minister

ANNUAL LETTER OF EXPECTATION

We write in response to your letter of 9 February 2018 setting out expectations of the Guardians of New Zealand Superannuation ("Guardians") and of our 2018/19 Statement of Performance Expectations and Statement of Intent.

Long-Term Performance
We note the Minister's focus on the importance of the New Zealand Superannuation Fund ("Fund") achieving its long-term performance objectives.

The Fund has returned 10.5% p.a.[1] since inception in 2003 (after costs, before NZ tax, as at 28 February 2018). It is significantly ahead of its key performance benchmarks, having:

- exceeded the passive Reference Portfolio benchmark by an estimated $7 billion (representing the value added by active investment); and
- exceeded the Treasury Bill return, a measure of the Government's cost of debt, by $22 billion.

It is important to take a long-term view of Fund performance. Monthly and annual returns will reflect varying and often volatile market conditions. The Fund is fortunate in being able to look through and profit from short-term market movements.

Investment Management Expenses
We note the expectation that costs incurred in implementing our investment strategy are, in the context of managing Crown assets, fully transparent and appropriate.

While, costs and their impact on Fund performance are a key consideration, the Guardians' primary focus is on adding value to the Fund net of all costs. We may and do choose to pursue more expensive active investment strategies over passive ones, if we believe they will deliver superior risk-adjusted returns over time, after all costs are deducted. Nevertheless, we remain very conscious of the fact that costs (especially management fees) are generally known in advance while returns are not.

Internal and external cost transparency has been a focus for the Guardians for some time, and will continue to be a priority. All investment management expenses incurred *directly* by the Fund, both internal and external, are disclosed in our Annual Reports and on our website. The detail of Costs incurred *indirectly,* however (i.e. those incurred by investment vehicles in which the Fund holds an interest and which are netted off against the investment returns from those

[1] Performance return figures are unaudited and provided after costs, before NZ tax.

vehicles) are not always readily accessible by us. This accessibility depends on the timing and extent of reporting provided by those investment vehicles and the extent of the Guardians' influence over them). Work to improve our access to this information is currently underway; we aim to present an estimate of these costs in our 2018 Annual Report.

We also benchmark the Fund's costs against other pension and sovereign wealth funds in an annual global cost-effectiveness survey by CEM Benchmarking. The Fund continues to perform very well in these surveys; the 2016 survey of 252 funds (the most recent available) found that the Fund's five-year net total return of 15.5% was among the highest in its peer group and that the Fund delivered an average cost saving of 2.0 basis points (compared to the benchmark cost) over the same period. The CEM survey results are summarised in our Annual Reports and are available in more detail at: https://www.nzsuperfund.co.nz/performance/cost.

Internal Performance Incentives
A key component of managing investments is alignment of incentives to reduce principal/agency risk. This applies to both internal and external investment management.

We are confident that our internal incentive scheme, which is described in detail in our Annual Report, is well-aligned with the Guardians' and Fund's objectives, and allows us to remain competitive in attracting top talent. We note that the 2014 Independent Review by Promontory Financial Group, which was commissioned by the then Minister of Finance, endorsed our general incentive programme approach (whole-of-Fund, longer time frame) and described it as consistent with industry best practice. Specifically, Promontory said that our approach minimised conflicts of interest and contributed to the building of a collaborative team where all relevant business units must perform well in order to maximise potential bonus allocations (page 126). Promontory also said that senior remuneration packages were "modest" and that maximum bonus levels for the CEO and management were low by industry standards, suggesting that the differential be reviewed at regular intervals to ensure the Guardians remained competitive (page 127). Bonus participation levels for the CEO and non-investment members of the Leadership Team were increased to match the front office, following the Promontory Report. We will continue to analyse and review our incentive programme regularly to ensure it is appropriate and meets our commercial needs.

Risk Profile
The Fund has a stable risk appetite and strong weighting towards growth assets (80% growth, 20% fixed income), in keeping with its long-term purpose.

We are confident that risk management processes, both in terms of investment risk and enterprise risk, are in line with global best practice investment management.

In response to stakeholder interest in risk-adjusted performance we have introduced reporting on the Fund's Sharpe Ratio in our Annual Reports, starting with the 2017 Annual Report. The Sharpe Ratio is a commonly-used metric for measuring risk-adjusted performance. It compares the portfolio's returns above cash returns as a ratio to the volatility of returns. The higher the Sharpe Ratio, the greater the returns earned for the risk taken, and vice-versa.

Complex Products and Activities
We note your comment, in the "Complex Products and Activities" section of your letter, that there has been, within the CFI portfolio, an increase in the use of derivative instruments, and your expectation that the CFIs should use derivatives judiciously.

For your information, since 2012 the Fund's derivative exposure has decreased, as a proportion of the Fund, on both a gross and net basis. The Fund's gross derivative exposure in absolute notional terms has remained flat since 2015, while the Fund net asset value has grown substantially.

The derivatives we use are standard market products, and are used for hedging, liquidity management, efficient implementation, to manage risk and for active mandates.

We may choose to increase our use of derivatives again in the future, if we believe it will achieve the best commercial outcomes for the Fund.

The Ministerial expectation that we use derivatives judiciously has been in place since the 2013/14 year. We have considered what 'judicious' means in the context of the management of the Fund. We define the judicious use of derivatives as demonstrating good judgement in their use, by:

- demonstrating through measurement and reporting, the economic benefit from derivative use versus using cash equity or cash fixed income products (where relevant);
- only using derivatives where we are confident that we have well managed processes to mitigate Market, Liquidity, Counterparty, Valuation, Operational, Complexity and Legal/Regulatory Risk (our processes to manage these are detailed in Schedule 4A of our Derivatives Policy, available at www.nzsuperfund.co.nz/publications/policies); and
- ensuring our use of derivatives is subordinate to the investment strategy to which they are used (i.e. the use of derivatives for hedging or taking active risk is captured and reported within the Fund's relevant investment strategy, opportunity or risk basket.)

We discharge our obligation for the judicious use of derivatives through a number of frameworks: Risk Management, Investment Risk Allocation Process, Liquidity Management and Counterparty Management. The Chief Investment Officer and General Manager Portfolio Completion attest quarterly to the Board to the judicious and efficient use of derivatives as evidenced by these frameworks. These attestations are backed by reporting against the frameworks.

We provide comprehensive reporting on the Fund's derivative exposures in our Annual Report in note 4(e) to the Fund's financial statements. The Board and management also receive regular and extensive reporting on derivatives use and the impact on risk, liquidity and counterparties. In November 2017 the Board received an education refresher session on leverage, risk and the use of derivatives and how management ensures their use is judicious.

Management also prepares assessments of operational risk, as part of our due diligence processes, to ensure any new and/or complex investment activity is compliant with changing market conditions and practices, and to ensure the investment is able to be managed within the current risk monitoring structure of the Fund.

The Board and management are closely engaged with evolving market and regulatory changes with respect to derivatives and derivative clearing, and note your request to keep the specific approvals provided by your office in mind in this regard.

We have provided briefings and information on our use of derivatives annually to Treasury since the expectation regarding judicious use was first introduced in 2013. While we are confident that our approach is in line with global best practice, we understand Treasury has not yet formed a view of what constitutes the judicious use of derivatives. If you consider that a different interpretation is more appropriate, we would welcome your feedback. We are very open to further discussions on the matter and any suggestions by Treasury for improvement would be welcomed.

Flow of Information

We note and will comply with your request that we support Treasury in respect of its information sharing project. We continue to have reservations over the efficiency and effectiveness of this project, including specific concerns around information security, managing confidentiality and probable use, and we are working with Treasury in good faith to resolve these issues. We know that Treasury shares our desire to ensure that the level of resource required for this project does not add significant cost to the Guardians, detract from the achievement of our strategic objectives, nor contravene the framework created by our governing legislation.

Ethical Investment
The Guardians' Responsible Investment Framework, which is designed to ensure compliance with our legislative framework, is reviewed and updated on a regular basis. We commit significant resource to benchmarking against best practice, including through our participation in the annual UNPRI Responsible Investment Benchmarking and Transparency reports. In 2016 we received an A+ rating from the UNPRI for overall responsible investment strategy and governance. The Fund was also named as one of the world's 25 most responsible asset allocators by Bretton Woods II. We continue to provide support to our fellow CFIs on responsible investment matters.

Other Expectations
We acknowledge and understand your expectations regarding Board relationships, the 'no surprises' policy and Crown policy decisions.

As requested, the Board will meet with Treasury to discuss the Letter of Expectations.

Yours sincerely

Catherine Savage
Chairperson