2011/12 financial review of Guardians of New Zealand Superannuation

Report of the Commerce Committee

Contents

Recommendation 2

Introduction 2

Benchmarking and performance 2

Investment strategy and risk management 3

Responsible investing 3

Appendix A 4

Appendix B 5

Guardians of New Zealand Superannuation

Recommendation

The Commerce Committee has conducted the financial review of the 2011/12 performance and current operations of the Guardians of New Zealand Superannuation and recommends that the House take note of its report.

Introduction

Guardians of New Zealand Superannuation is a Crown entity established under the New Zealand Superannuation and Retirement Income Act 2001 to manage, administer, and invest the New Zealand Superannuation Fund, to reduce the tax burden on future New Zealand taxpayers of the cost of New Zealand superannuation. A board appointed by the Minister of Finance oversees the management team, which develops and implements investment policy. Under section 47 of the Act, no capital withdrawals from the fund are allowed before 1 July 2020. Capital contributions will cease by 2031, when the Crown will start to make capital withdrawals from the fund.

In the 2009 Budget the Government announced it would reduce contributions to the fund until the Crown operating balance returned to a sufficient surplus. At present the Treasury estimates this will happen in the 2017/18 financial year.

The asset mix of the fund is weighted toward growth assets, such as equity in companies. Total public equity in the fund increased slightly from $18.652 billion in 2010/11 to $18.703 billion in 2011/12. The fund outperformed expectations of the entity's portfolio for the year (-0.23 percent), returning 1.21 percent (before tax, after costs) for 2011/12.[1]

Guardians of New Zealand Superannuation's revenue was $24.242 million for 2011/12, precisely equal to its expenditure.

Benchmarking and performance

We congratulated the entity on sustaining good long-term performance during the period in review. Despite the turbulent investment markets associated with the global financial crisis, the fund has exceeded its performance benchmarks.

The Guardians use global and domestic benchmarks to compare its operating and cost structures and share, compare, and contrast global funds. We heard that it sits in the top quartile in terms of adding value to investments, and in the lowest quartile in terms of costs. Cost control has partly been achieved by reducing the use of external managers in favour of management in-house.

We note that the entity considers its financial returns over the last 12 months to have been at the forefront of a strongly performing global market. The return on the fund since its inception has averaged 7.05 percent per annum. We were told that there is no annual target because, for a long-term investor, meeting short-term targets would unnecessarily increase risk.

[1] The Guardians benchmark the performance of its actual portfolio and the value added through active investment strategies.

Investment strategy and risk management

We heard that the Guardians factor in the potential for larger returns that it expects to receive in order to balance the risks associated with any particular investment. The higher the risk, the higher the expected return.

The Guardians has not done much preliminary work on the potential sale of state-owned assets. We note that it does intend to undertake more work in this area when pertinent information becomes available and would take into account any uncertainties and associated risk when making investment decisions regarding these assets at the time of sale.

We asked if the risk profile of the fund had been shifted toward more aggressive returns, noting the recent changes relative to the reference portfolio. We heard that the Guardians had widened its investment strategies, resulting in higher return for similar risk.

We wanted to know how the Guardians values its illiquid assets and how it could quickly recognise and mitigate substantial losses. It told us that its auditors, both internal and external, closely oversee valuations. An internal valuation working group also work to formulate the values of unlisted assets.

We heard that as a standing principle all overseas investments were fully hedged against exchange rate risk.

Responsible investing

The Guardians told us that it considers environmental, social, and governance issues when making investment decisions. It has a legislative requirement to consider responsible investment issues, and believe it is also obliged to do so as a matter of good investment practice. It said it has actively positioned itself in the top quartile of the United Nation Principles for Responsible Investment.

We asked about the Guardians' screening processes for ensuring that it does not invest in companies involved in nuclear weapons or similar industries. It told us it is confident of its precautions. It has connections with global screening operations and it receives constant updates on a dynamic market. It has no plans to change this strategy, and have long since divested any investment in companies involved in the manufacture of nuclear warheads.

We note that the Guardians has made "resource scarcity" one of its three main "themes" for investment. It explained that this means one of its key aims is to avoid areas in which demand will slow in the long term, such as fossil fuels. The overall aim is to invest in an area of secure long-term demand.

Appendix A

Approach to this financial review

We met on 21 February and 21 March 2013 to consider the financial review of the Guardians of New Zealand Superannuation. We heard evidence from the Guardians of New Zealand Superannuation and received advice from the Office of the Auditor-General.

Committee members

Jonathan Young (Chairperson)
Kanwaljit Singh Bakshi
Dr David Clark
Hon Clayton Cosgrove
Clare Curran
Peseta Sam Lotu-Iiga
Mojo Mathers
Mark Mitchell
Dr Jian Yang

Evidence and advice received

Guardians of New Zealand Superannuation, responses to written questions 1–116.

—— Responses to questions 13, 17, 20, 29, 30, 32, 46, 47, 51, 52, 58, 78 and 82 (Appendix A).

—— Response to question 3 (Appendix B).

—— Letter from Hon Bill English (Appendix C).

—— Forecast Statement of Service Performance (Appendix D).

—— Guardians and New Zealand Superannuation Fund Update 2011/12, PowerPoint presentation.

Office of the Auditor-General, Briefing on Guardians of New Zealand Superannuation dated 21 February 2013.

Organisation briefing paper, prepared by committee staff, dated 30 January 2013

Appendix B

Corrected transcript of hearing of evidence 21 February 2013

Members

Jonathan Young (chair)
Kanwaljit Singh Bakshi
Hon Clayton Cosgrove
Hon David Cunliffe
Clare Curran
Julia Anne Genter
Peseta Sam Lotu-Iiga
Mark Mitchell
Dr Jian Yang

Witnesses

Gavin Walker, Chair of the Guardians of New Zealand Superannuation
Adrian Orr, Chief Executive Officer of the Guardians of New Zealand Superannuation

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Young — Gentlemen, welcome to the Commerce Committee. Thank you for appearing. If you'd like to take us through your presentation—maybe, first, introductions would be great and then we'll follow that up with questions.

Walker — Firstly, good morning on behalf of the members of the New Zealand Superannuation Fund who are here with us this morning. For those of you who don't know, my name is Gavin Walker and I am the chairman of the New Zealand Superannuation Fund. I'd like to introduce my fellow executives. On my right-hand side, Adrian Orr, who's probably known to many of you, who is the chief executive officer of the fund. Behind me on my right-hand side, Stewart Brooks, who's the general manager finance, and behind me—you can hardly see her—is Catherine Etheredge, who is head of communications for the fund.

To help with today's discussions we have prepared a brief presentation, which has obviously just been handed out to you. What we don't propose to do is to address this presentation in detail, but we will focus on those points that we deem are important on each page. Should at the end of the presentation there be any matters that you wish to address more fully, then please feel free to ask one of us and I'm sure we'll do our very best to answer them as we can. I'd like to talk to the early slides in the presentation and then I'll hand it over to Adrian to address the balance of the pack, and at the end of Adrian's presentation I'll provide a brief summary. What I'd

like to do is suggest that we turn to page 3 of the pack and I'd just like to make the following two points in relation to page 3.

First of all, just to refresh us all that the New Zealand Superannuation and Retirement Income Act of 2001 was the vehicle by which the New Zealand Superannuation Fund was established with the purpose of successive Governments using the fund as a vehicle to save today and invest these savings in order to smooth in future years the tax burden of New Zealand superannuation between taxpayers of today and also those of the future. Secondly, it's likely that a successive Government will begin to withdraw money from the fund to help pay for New Zealand superannuation somewhere in the order of 2029/2030.

If I turn to page 4, I'd just like to draw your attention to the mandate of the Guardians, and the Guardians is the Crown agency vehicle charged with managing the fund, to invest the funds that the fund has on a prudent and commercial basis consistent with the following: firstly, best practice portfolio management; secondly, to maximise the returns without undue risk to the fund as a whole; and, thirdly, but not least, doing so in a manner that avoids damaging New Zealand's reputation as a responsible member of the international community. The fund's mission statement is therefore to maximise the returns over the long term without undue risk so as to reduce the future imposts on New Zealanders in terms of future superannuation requirements.

On page 5 we make reference to the directive received from the Minister of Finance in May 2009 regarding investment in New Zealand. The essence of that directive was for the Guardians to identify and consider within the bounds of section 58 of the Act ways of increasing the allocation to New Zealand assets in the fund. Further in the presentation Adrian will discuss how we've met that directive by identifying, considering, and selectively investing in New Zealand opportunities that meet our investment return and risk criteria. At this juncture I'd like to hand over to Adrian, who'll walk us through the balance of the pack.

Orr Thank you, chair, and good morning everyone. It's a pleasure and an honour to be here representing the Guardians. I'm the CEO of the Guardians of New Zealand Superannuation. I will follow what the chairman's just done, which is just provide a couple of headlines on each of the pages going ahead. Obviously this will be the public record. We're an incredibly transparent operation and we always invite people to look at our website and get involved and understand what we're doing and what we're about.

Keying off from where the chair left, our task is to maximise a return without undue risk and invest without prejudice to New Zealand's reputation globally. We kick off from that point around what is undue risk, and we see that as we want to maximise the chance of us being successful, i.e. meeting our purpose. So from that starting point we look at what combination of investments we can make that will maximise long-term returns whilst being within a manageable risk profile. We do that from our

own perspective, i.e. we think about what are our particular advantages and how can we maximise those advantages.

They include the fact that we have a very long horizon in our investment—2030 is the current scheduled first capital outflow. We are a very liquid portfolio. We have known liquidity requirements, so that allows us to go into certain types of investment activities that a lot of other—in fact, the vast majority of—funds wouldn't be able to do. And we have this operational independence in terms of our governance in the sense that we are able to really discipline ourselves, have a very clear focus about our purpose, have a very clear focus on what our operational capabilities and our investment strategies are, and then hold the course, because that's the critical part around the long-term investment. In order to do that as well we put a very high priority and importance on being transparent and being able to communicate what our activities are, because that's about bringing stakeholders and our board with us in what can be some very challenging investment activities. Risk-return is completely related to risk, hence you must take risk on board.

In terms of slide 7, this gives you an idea of, starting from that position, how we've ended up investing and we do it in a very simple way. We have what would be a notional portfolio that we call our reference portfolio, and that is a portfolio that we could hold in a passive, listed, simple, most cost-effective form that would achieve our purpose. That's just the reference portfolio. And you can see—it's the top corner there—that over 80 percent of that reference portfolio is in growth assets, so direct holdings of equity or property and where we want to take part in the capital growth of those assets as well as the ongoing dividend yield or interest income that comes from those assets. So in that sense it's a high-octane portfolio. It's highly exposed to growth and all of the volatility that comes with it because we can afford to be exposed to that because of our horizon and our liquidity and our governance disciplines.

We then say: "Can we add value over and above just that simple passive reference portfolio by further leveraging our comparative advantages?". That is, can we actively invest and go into different asset classes where we can gain returns from risk premia that other people generally can't access. The obvious one there would be, say, the illiquidity premium—going into unlisted asset classes or direct investments where generally people don't want to go there because they are nervous that they might have to sell, they need the cash, and if you're into some of these other active investments, where you have to sell quickly or because of reasons out of your control, then you might end up in very bad positions having to sell, you know, fire sale assets.

So we have our reference portfolio plus our value-adding investment strategies that equals our total portfolio. And you can see there that the actual portfolio we hold has a combination of standard listed global equities, global fixed interest, plus a lot of alternative investment—direct investment—activities: timber, private equity, all sorts of other types of activities. The beauty of this construct is that you measure what you want to

manage and we can be managed well to it. So we have clarity on what we are earning through the passive listed, over and above just simple debt instruments, and we are learning—we can very clearly identify whether we are adding value in addition to that through the active investment strategies we take. So we can be held accountable to total return and the value-add over and above the passive return.

On page 8, I just wanted to give the committee just a feel for what we have been doing since we last sat in front of a select committee over and above the business as usual—the investing. A very important part of our activity has been driving a single focus through our fund and our fund activity. There's one fund, one return—all people work for that one fund. That is, we have developed frameworks for which we have been globally recognised where we can look at any single investment and compare it with all other opportunities that might be in front of us at a point in time in two ways. One, about its financial attractiveness—that is, given the risks that are inherent in an investment, are we being adequately rewarded, and are we being better rewarded than of the other alternatives in front of us—an apples with apples approach. That's the financial attractiveness and then we also have established a very clear process around gaining our confidence that that financial attractiveness will exist, because we're always talking about expected returns.

So we end up with a confidence-adjusted, risk-adjusted, expected return and that confidence-adjustment is about how we are undertaking that investment. Can we have the flexibility to get in and out as we need? Have we got enough line of sight over the risk that's involved in that investment—the line of sight over the way in which capital is being allocated to that investment? And are we getting the most cost-effective access to that investment? You know, we could take a property on through a listed vehicle, a direct vehicle, through a private equity structure, or even some other derivative form; we are always looking for the most cost-effective access. Those have been the two driving things that I can now confidently say we are there. And it's in a pretty unique environment for a global fund to be in a situation that we are, to be able to assess investments as we do.

On page 9 we refer to our very strong held investment beliefs around environmental, social, and governance issues. We have both a legislative requirement to consider responsible investment issues. We also believe we have a strong investment requirement to do that as well. So we have actively positioned ourselves into the top quartile of the United Nation Principles for Responsible Investment as a participant, as an investor, in there. And we are showing leadership across the wider Crown financial institutions in terms of we have resourced ourselves to the point of being able to undertake a very deliberate responsible investment programme through all of our portfolio. That programme is largely about embedding environmental, social, and governance decisions into our search for investments both through investment themes as well as manager selection, our ongoing monitoring against global best practice standards, and then our

activities—whether it is either to engage with companies or, at an extreme, exclude investments, and you've seen the list of exclusions we've made as well as the many, many engagements we've had. We do that as transparently as possible using global best benchmarks that are available.

On page 10, a very brief overview of how we benchmark—you know, what gets measured gets managed. We have global and domestic benchmarks that we believe are truly best in breed comparing our operating structures and cost structures. We use the global CEM benchmarking, which has thousands of global funds that we share, compare, contrast. Our governance performance, part of it is obviously is on display today, but we're a very important member of the International Forum of Sovereign Wealth Funds and we help develop globally agreed practices and principles around how these should be operated and of course we adhere and transparently put out how we do that against it.

The important stuff—the dollars. Again, on a monthly basis, we can report how we are performing relative to both the opportunity costs, the Government's short-term borrowing cost, as well as our expectations being both the Treasury bill return plus 2.5 percent, which we think on average we should outperform, which we have been to date, as well as our reference portfolio—i.e. are we outperforming just passive investment through our activity? Then there are the other issues around our commitment to transparency, responsible investment, and overall risk management. We report against all of those and we spend a lot of time with our global peers. We have put the three Cs there. We spend a lot of time with global large funds around comparing how we do our business; collaborating on issues of common concern; and, most important, looking for co-investment opportunities where we can stand on the shoulders of some global giants and work with them.

How have we performed? On page 11, in terms of financial returns over the last 12 months, it has been a very strong performance from global markets and we've been at the forefront of that. Since inception, we're almost 10 years old now and we started first investing in September 2003. Since we began investing we've got an annual rate of return of 8.3 percent. That sits well ahead of the equivalent Treasury bill return of just over 5 percent and sits ahead of our reference portfolio, the passive portfolio, as well. These numbers they do translate into large dollar—billion—additional, both excess return to the Treasury bill and value-add over and above the passive investing. So although small percentages, you are keying off a big number so you can see the returns there in black and white.

And for those who like pictures, which includes me, on page 12 that's just a simple graph to outline if you had invested a dollar with us back in 2003 how would you have got on if you had just put it with Treasury bills, or Treasury bills were 2.5 percent, or with the reference portfolio, and how we've actually invested. So you can see there just visually how we've got on.

In terms of page 13 is just the fund's size as at the end of January this year. We're just south of NZ$22 billion in terms of total fund size. That's off $14.8 billion that has been the capital contributions from the Crown.

In terms of cost control on page 14, it's nice to see a cost graph where the lines go down. You can achieve that by making sure the denominator goes up as well. It's cost as a proportion of total funds under management, which is an important driver for us. The cost going down hadn't been a large part of our external performance fees. We have been increasingly through time managing more of the investments ourselves actively in-house and that has been driven around improved confidence about the financial attractiveness. So our work on what gives us confidence as an investor has led us to do more investment ourselves internally and that has been rewarded both in the return side—net returns—and in part through that cost activity. Of course that has come with increased internal capability as we have grown the team out.

Page 15 is just to show you just a quick global snapshot of where sit amongst our peers. To do the apples with apples comparison we compare both our value-add—how much investment over and above passive investing—and our costs and I am pleased to report that we sit in the top quartile in terms of value-add of our investing over the horizon of this against our peers and in the lowest quartile around our costs. So we feel that we are on the right path in terms of managing those.

Lotu-Iiga Cost as a percentage of total cost?

Orr Yes, yes. The graph on page 15 is interesting. All those speckles—it looks like a kind of a disease outbreak there, we're the red dot—

Cunliffe You want to be in that zone.

Orr Yeah, you want to be in that top left-hand corner. Those costs are measured by funds who are undertaking the same types of investment activities. So those who have decided to be involved in active investment—so it's getting proper apples with apples there.

Page 16—no one else will do it for us, so we will—is just outlining some of the external benchmarks. Global award around the innovation—that's primarily around the ability to think as a single fund rather than operating within different investment silos and you can see in terms of Treasury, transparency, the leadership, and responsible investment stuff. That's last year; that just makes this year much harder.

On the New Zealand investment front we are very pleased with the progress we are making. It hasn't been simple progress. Our New Zealand directive is to actively seek and consider investments subject to meeting the overarching best practice activity. So when we approach New Zealand investments, we think very hard about: "What additional return are we getting for the additional risks we might be taking on by concentrating our portfolio here in New Zealand?". As you can see, we have 24 percent of the fund now; just short of a quarter of the fund is invested domestically across a combination of listed equity and direct investments, private equity

investments, and they are managed by very specific investment strategies that we've developed in order to make sure that we act consistent with our overarching goal of a strong performing portfolio.

You have to kick a lot of tyres to get some investments on the ground in terms of actively seeking. You know, we've looked at well over 100 types of opportunities. We've really got into bed and worked hard with a dozen or so of them and we've managed to invest quite large lumpy sums of money on a few which we mention on page 18, which we're happy to answer questions on. So I'll pass it back to the chairman.

Walker Thanks, Adrian. I think there are just a couple of core messages we'd just like to leave with the committee this morning. The first is that despite the turbulent investment markets associated with the global financial crisis, the fund has exceeded and continues to exceed its performance benchmarks. Secondly, we are a long-term fund, which allows us, probably more so than any other fund in New Zealand, to identify and invest in both domestic and international opportunities where we are rewarded with the long-term horizon views that we can and do take.

As we have seen in the past, and I have no doubt that we will witness again in the future due to the very nature of the investment markets, there will be periods of volatility and negative returns that investment markets and thus the fund will experience from time to time. I think, however, that the fund has a very sound and strong governance—independent governance—model in place and I think this, combined with the target operating model to the fund means that we are very well equipped to managed such periods of volatility. In fact, I'd I go one step further and say that we are in a position that we can take advantage of times of volatility.

On behalf of Adrian and myself and the team we would like to thank you sincerely for having this opportunity to make this presentation to you and we look forward to addressing, no doubt, the many questions that you do have. Thank you.

Young Thank you very much, Mr Walker and Mr Orr for your presentations—very comprehensive, thank you. Congratulations on your returns as well. I think it's been a great performance that you've overseen.

Cosgrove I just reiterate the chairman's point. Given the climate, it's a stunning—pretty stunning—performance. Those who I recall were opposed to your being set up are now starting to eat their words in a big way. I'm interested in a general sense in your investment and risk management strategy. In its crudest form—and correct me if I'm wrong—generically you look to buy cheap and sell when it's up, in its crudest form, presumably. You're after cheap—good-quality, but cheap—assets. So do you look, for instance, at assets where there is perhaps uncertainty, where there are assets being sold at the bottom of the market, say where there are supply issues that outstrip demand and devalue those assets. Are those the things you factor in?

Orr Yes. Yes is the answer. There are two legs. The first leg is about how we get the exposure to the level of risk that we think isn't undue—so in other

words, exposure to the growth asset. And we do that with the aim of diversification. So by far the biggest part of the total risk that sits in this fund is through just access to global listed markets that give us that diversification—i.e. we don't have a view of who's going to outperform what. Then the second part, the value-adding over and above that, is in large part, as you describe. We think: "What else can we do, given our attributes, that might allow us to access investments that other people just can't?". And those reasons can happen and really in the simplest investment form that is when their current price may be well divorced from what we think their long-term underlying value.

Cosgrove Just on that point, you'll be aware, and I'm sure you are focusing on it, that the Government intends to sell a number of electricity companies—State-owned. Do you, in your investment strategy, where there are uncertainties, factor in, as one commentator calls it, an uncertainty discount in your investment strategy?

Orr We definitely do factor in the risk premia we think we need to gain for holding an investment. Any investment, whether it be a building, a listed equity, a fixed-interest instrument—you know, an electricity-generating company—has the same underlying risk nutrients. You'll have a certain amount of market risk in terms of just like owning equity. You might have credit risk, as who is the person who is standing behind.

Cosgrove Legal risk.

Orr You'll have legal and operational risk. You'll have liquidity risk—how long does it take to buy and sell it, on that side? You'll have these underlying nutrients, and we will break down an investment and say what combinations of that sit in this particular activity—are we being rewarded sufficiently for that? So the higher the risk, the higher the return, we would expect.

Cosgrove So in the case of the State-owned enterprises that are on the block, you'll be aware—I presume, you are focusing on it—of the legal uncertainties around those that still exist, in terms of the Supreme Court action, the contractual uncertainties that exist in respect of Meridian and the Tīwai contract. If those uncertainties still exist at the time of sale, one would presume that you would be looking for, and factoring in, an uncertainty discount in the price you would pay, given that if Tīwai doesn't go ahead, you have got 14 percent projections are of capacity on the market, then it rolls on to do we close a power station—blah, blah, blah, blah, blah. Supply outstrips demand. The reason I ask, I suppose, is because is it that the Government's made great play of mums and dads being first in the queue, and they include, interestingly in their definition, your fund, which is an interesting concept.

Orr What's the question? Question rather than statement.

Cosgrove I'm coming to that. You've given other members latitude, so just, you know, taihoa and take a breath. This is a reasonably important issue, I would have thought. Even you fullas might want to take note of it, because you could hypothesise that selling in a down market, the shareholder is

likely to get at the bottom of the market, which we are at, a lesser price. And you guys and other investors are more likely to factor in uncertainty discounts and demand [*Interruption*] so you're not paying over the odds. What's your strategy and what are you focusing on around that?

Orr — For us, there are two legs again. The first leg is to the extent that if these assets are floated, they will become part of the New Zealand capital markets and we would end up holding a passive holding of the former State-owned enterprise, whatever form it is. So we have 5 percent of our listed equity allocated to New Zealand - listed markets that have been sitting in our reference portfolio. So we would end up being a passive holder of that.

The next question is would we want to hold more than that, and that comes down to that price value consideration. Within that price you have to factor in all of the types of uncertainties that exist in any investment. We are investors in infrastructure, we are investors in a lot of illiquid assets, so this would not be a unique or new issue. Regulatory risk is something that any investor faces in any investment through time, and you would expect for it to be reflected in the price. It's there, but of course there is one price for all investors. So that's what, you know, we would have to approach.

Cosgrove — So would you in your own investment strategies—I assume, but I will not put words in your mouth—that it would be extraordinary if the superannuation fund decided, for instance, to divest itself of assets at the bottom of the market.

Orr — To divest itself, you say?

Cosgrove — To divest itself. Would that be a strange investment strategy for the superannuation fund to make?

Orr — You would have to think about it from the portfolio as a whole for our purpose. We do actively position the portfolio so that we don't find ourselves in a position of being a forced seller—i.e. when we are selling when we don't believe the value of that asset is going to be reflected properly to us.

Cosgrove — But as a general rule—

Young — Which brings me to my supplementary, if I can just come in. Thank you. Mr Cosgrove is presenting some hypotheticals, which we understand, because—

Cosgrove — Well, no, there are a few facts in there, too.

Young — In terms of your investment portfolio, you look for a long-term investment strategy—

Orr — That's right.

Young — —which would probably indicate that energy consumption in New Zealand would increase, despite the scenarios that Mr Cosgrove presents, of which some are hypothetical, some are current, and no doubt will be proceeded through in due course. So in terms of that long-term strategy, if you were to

look at those offerings, what would your view be if there were, at that particular point in time, an excess of supply?

Orr — For us, you're absolutely correct, a strong point of differentiation for a fund like ours is that we can take a very long horizon view to an asset. So we would certainly be thinking about that asset over any investment over the life cycle of the investment, with that. You will still need to boil that back down to how much of that future, or whatever it is, anticipated future, is presented in the current price that's there—i.e. is it already priced in or is it actually not priced in and we can pick something up where the price might be below the long-term value at that time? This is for us to take an active investment strategy on the way through.

These strategies, just so I can make the select committee clear, on our website we put down the underlying purposes of various investment strategies. With regard to infrastructure, which is a clear strategy, we like that because true infrastructure may be inflation proofed. That gives us certainty through time, whether inflation goes up or down. They can often be stable cash flows, which would help liquidity but also help diversification—i.e. if the New York Stock Exchange is hitting its normal tantrum. It's still going to get a reasonably stable return from a reasonable proportion of the assets. So we will be looking at it from the perspective of our fund. How does it improve the performance of our fund, of the way it works?

Cosgrove — Could I just pursue a couple of things there? Presumably there is a major risk with the fund, initially, anyway, in that there will be a price that's offered. If these uncertainties, i.e. Tīwai, are not sorted before that, then at least in the short term you guys could take a hit, unless you're focused on an uncertainty discount. Correct?

Orr — To the extent that it's just prices and we are owning it, then you'd have a market-to-market movement in the values.

Cosgrove — So, despite the chairman sort of trying to make it myth or legend, do you agree with Contact Energy, PricewaterhouseCoopers, Statistics New Zealand, and the electricity—another agency—market that we are facing a flat demand period?

Orr — I'm not an energy expert, so we'd have to sit there and look at all of those issues when it comes to our investment decision-making. That is the consistent view from most people.

Cosgrove — Just one final question, because you've got a pretty formidable pedigree, in respect of your experience and we are lucky to have you. As a general rule when you're either looking to invest in a company, but certainly where you're offering a company on the market, isn't it the case that in order to maximise the price that you want for your return that you tie down any uncertainties, say, legal, that you resolve any contractual issues, especially those that might impinge on demand for your product or service, and therefore impinge on the price—you tie all those things down and get them resolved if in order to maximise the attractiveness, the financial

	attractiveness, to the market, and therefore maximise the return on sale price? If that is a general rule—unless I've gone completely nuts—in the investment community, is that generally the go?
Orr	The general rule as an investor is all of the issues would be considered. From the perspective of someone making an offering, as long as it's transparent as to what state the asset is when they're selling it, then it's really up to the purchaser to decide am I prepared to take on whatever residual risk is sitting there, and that would be—
Cosgrove	But as a general rule, from an investor's point of view, surely—
Orr	You would be wanting to be rewarded for all of the outstanding risks.
Cosgrove	If these risks were considered high, for instance, the demand for your service takes a hit, then presumably as an investor you would be looking very, very carefully at an uncertainty discount and the fact that you weren't going to be paying over odds for those shares.
Orr	Yep. The higher the risk, potentially the higher return, and that is reflected often through a lower entry price.
Young	I'm presuming that you don't have holdings in other equities or investments that are without risk.
Orr	That's the only reason we get rewarded, because we prepare to take on risk.
Young	So risk is actually just part and parcel of all of that, as you can imagine.
Orr	That's what we do.
Lotu-Iiga	Before I get into my questions, look, at this stage of the proposed transactions that my colleague here has referred to, it's premature, I would presume, to go through that whole—you haven't done due diligence or any risk analysis at this point to even comment. Would that be fair?
Orr	That's correct.
Lotu-Iiga	Thank you.
Cosgrove	Sorry, just to summarise—
Lotu-Iiga	No, no you've had your go.
Cosgrove	I just want to clarify something. No risk analysis at all in respect of potential investments—
Lotu-Iiga	No, hang on, he's not allowed. I've asked the question.
Young	We're going back to Sam, because you've had a run of about eight questions.
Lotu-Iiga	Thank you.
Young	Sam has had one question that was interrupted.
Lotu-Iiga	Can I just say, first and foremost, well done on your long-term performance, which you've acknowledged in your annual report. I recall when you came here first—when I was first here in Parliament—you had a 22 percent loss and I don't think the committee got too down on that,

because we knew your long-term objectives and we knew the financial climate at the time, just as you bounce back with 15 percent returns and 25 percent returns. So well done—7.05 percent over the life of the fund I think is to be commended.

My question on the, I suppose, benchmarking on the Treasury bills, because there has been some analysis that has looked at other benchmarking over a longer term bond rate—just your comments on that, but specifically with reference to how other sovereign funds measure that type of return, please. It is 250 basis points over the bills.

Orr — I just want to make it clear that the Treasury bill is not our benchmark. The Treasury bill is a very simple measure of the opportunity cost of putting the money into this savings vehicle versus paying down Government debt. So that's just an opportunity cost measure, and it's why it sat there. The reason we have Treasury bill plus 2.5 percent there is because that is an expectation, not a target, of what a fund that is broadly 80 percent growth, 20 percent fixed income, should achieve on average over time. That is a 20-year moving average. In other words, we should be getting both the risk-free rate, the Treasury bill, plus 2.5 percent, which is the risk premia, the reward for taking on additional risk by having exposure to growth.

Lotu-Iiga — But that's the risk-free rate at that time, right—at any point in time? Or how do you—

Orr — Yes, it's always at any point in time.

Lotu-Iiga — I suppose my point is that at any point in time it can vary, correct?

Orr — That's right.

Lotu-Iiga — So I suppose the question is, and I'd like the other question answered if you could, how does that compare with how other sovereign funds are?

Orr — Now, with other sovereign funds it is incredibly similar. In the sense that some funds are often explained as they'll have a certain amount of real growth plus inflation—for example, the Australian Future Fund and Norwegian Fund have CPI, so that's consumer price inflation, plus 4 percent or plus 2 percent or depending on what their particular liabilities are and what their risk profile is. That in itself actually boils back down to what we have, because sitting in the Treasury bill there is a certain amount of real growth plus the nominal part. So a T-bill plus 2.5 expectation is very similar to a CPI plus 4.

The reason that we don't have a target is because we don't want to be in a position that we think is incorrect as a long-term investor, where we are forced to put more and more risk on to the table to meet short-term targets, when the opportunities just aren't there. So if you've got an annual target, it kind of forces you to take on more risk when the premiums are declining, which is when you should actually be taking risk off the table. That's how we try to operate.

Cunliffe — Just a supplementary question, if I look at the graph on page 12, it is interesting to compare the recovery portion from September and October

2008 through to, I guess, something like mid-2010, where the returns for the fund actually lagged the benchmark portfolio, and the strong performance in the latest uptick from about September 2011, where the returns to fund have greatly exceeded that of the reference portfolio. Does that imply a change in the risk profile of the fund, climbing into a little more risk to get those more aggressive returns? Or is it simply more skilled decision-making? How would you explain the differences?

Orr — It's sitting through here, you know, it's always death through simplicity, although there is one line there, the brown line, the total fund, the underlying assets and investment strategies that make up that line have definitely changed through time.

Over the first period up till probably almost the beginning of 2007, it was largely a passive listed portfolio with very little additional active investment. Through the next period up to going through the global financial crisis, the fund was very limited in the active investment strategies it was taking. We had timber investments, direct active, we had some direct property investments, active investment, and we had some multi-strategy hedge fund - type investments.

In that latter part, since 2009 and onwards, we have managed to have a much wider range of active investment strategies going on. In terms of the risk it's looking for additional return for the same level of risk. That's the value-add type concept, and the board—

Cunliffe — But the risk to Government profile has changed as an ingredient.

Orr — We have managed to have a wider set of investment strategies going on. In particular, one of the large investment strategies where we spend a lot of our risk budget on is what we call strategic tilting. That is where if we believe that current pricing in equity markets or foreign exchange or fixed income and property—if current market pricing is well divorced from what we see as the long-term fair value of those markets, then we will either take on, if it looks very cheap, more; if it looks expensive, we'll get out.

Through a big part of that period global markets had been so beaten up, with pricing so far below any what we see reasonable sense of long-term fair value, we have had a very large, additional allocation towards some of those asset classes, and that has paid off very well.

Lotu-Iiga — You've talked about investing in illiquid assets. We know that there's, you know, by and large there's a premium on some of these assets, and you've referred to some of them: private equity, timber, and some of your infrastructure projects. Some of these are difficult to value, you know; it's not market to market, and it's not a shared portfolio. I suppose, you know, when you have volatile markets and the global financial crisis, with some of these assets—and they can lose value quickly—you've got in place, presumably, some risk management, you know, tools to look at how they change value. First, how does that work through in practice? Second, if you see some substantial losses, as you saw in, I think, the 2009 financial year,

how do you get that out quickly and report it and identify it and realise those, you know, within a fixed time period?

Orr I'll open up, but I'll pass over to the chair. But we have a very clear set of established practices and behaviours that we go through across all of our asset classes. First one, of course, is the standard—the audit committee have a very strong oversight, our own audit committee plus the external auditors, over the way in which we go through valuations. You're correct. Some assets, you get mark-to-market pricing every day. Some assets, we only get them monthly—some of our timber valuations. Some are done only annually through different types of accounting practices of valuation that go on. We have an internal valuation working group that focuses specifically on that latter group to ask how you can triangulate different ways of getting at what an unlisted value is. The simplest and most wonderful method is observing transactions of similar assets or your own assets that go through that side. There's other cash-flow methods of valuing that go through. So we try and take as many different approaches as you can to get at a value, and we—

Lotu-Iiga And, I suppose, critically, these are internal processes, right?

Walker Not necessarily and not exclusively. The way that we think about this from a governance point of view, and Adrian's quite right, that this is one area where, in any investment portfolio when you are dealing with unlisted assets, it could be suggested that a level of discretion is applied in terms of determining the valuation of non-listed assets. So to overcome that concern at the fund, what we've done is we've actually appointed external, independent parties to help us, help the board, review the underlying value of those assets. And, if I take forestry as an explicit example, what we've done there, we've evolved our thinking too, I might say, over the last few years. First of all, we even rotate now those independent valuers every 2 to 3 years, and we've recently gone to a second stage where we now separate the valuers in terms of valuing the underlying land—where we own the land—as distinct from appointing a separate valuer to value the forest.

In addition, we are always looking at international comparatives. In other words, in terms of forests held in Canada or Latin America, what's happening to the underlying value of those forests? And we also look at international forestry transactions, so, where forests have been bought and sold both within New Zealand and internationally, what's happening to the value parameters around those transactions, and what does that mean for us in terms of the carrying value of our own assets? So there's a high level of transparency and an independent view brought to it.

Lotu-Iiga I'm satisfied with you. Just on that last point, and it's a final sort of supp. Given the exposure to overseas, particularly equities, managing exchange rate risk, do you want to just comment on that quickly, because I know someone else wants to ask? That's an important part.

Orr Yeah, the currency risk is a very simple one in that we 100 percent hedge our portfolio back into New Zealand dollars as a standing principle. We do that because we pick up a significant positive interest rate differential by

being back in New Zealand dollars—about 1.5 percent per annum on that side. We do have an active investment strategy, though, where we can at times deviate from that hedge, but that goes onto our risk book. In other words, that's an active decision where, if we decide not to 100 percent hedge but, for example, leave an open foreign exchange exposure based on a valuation model, then that gets marked into the "active" book. And we do do that from time to time.

Cosgrove Sorry, could I go back to my question a little while ago? Could I just get you to—it was a supplementary I was going to ask. I just wanted you—in case I didn't hear it right—Sam asked you as to had you done any risk management work, in respect of analysis, in respect of the upcoming asset sales of electricity companies; and was I correct in hearing that you've done absolutely no risk management analysis or analysis on those at all?

Orr We have not done any detailed analysis around those opportunities at this point. Some of the key issues still remain to be put on the table for us to be able to do the type of due diligence that we would need to do to have the confidence to take an investment beyond just a passive holding.

Cosgrove So no detail, but you have done some analysis, and I presume part of that analysis is scenario planning?

Orr We're aware of what the assets are that have been talked about, and we have seen various reports from standard, publicly available documents. We haven't gone beyond that.

Bakshi Looking at your performance graph, it is quite similar to the NZX50 graphs, which constantly went up until 2007 and then dropped until almost 2009, and yours also is on the same lines. How do you feel that—what's the future of the investments in New Zealand? How confident you are about those?

Orr You're correct that the single biggest driver of our performance in the short term—i.e., this volatility—is the performance of listed equity markets. The New Zealand equity market performed very similar to global markets. They had a very strong rally in the first part of the new millennium, absolutely smashed in the global financial crisis, and have fought their way back since on that side. That volatility that we have seen in these markets sat within our initial confidence index of this, which is why we've always reported and, as the Minister mentioned, why we completely anticipate continued volatility, but with long-term growth rewards.

Genter Thank you for your presentation. Sorry I wasn't here for the beginning of it. I have some questions specifically about responsible investment, and I was interested to see that there's been some work done on integrating responsible investment more broadly across the investment group, but wondering if there's been any progress on beefing up the screening so that you're confident that you are divesting in companies that aren't involved in tobacco and nuclear weapons and similar.

Orr We are confident that we have the best in breed access to the screening available globally. We hold over 6,500 shares in different companies, and we

are connected to global screening operations. Our investment managers know and have responsibility for ensuring that the investments that we've said should not be in there are not in there, so, you know, we are doing the best that is available to us. We continuously also like and receive updates from other groups who tell us, you know, because it's a continuously dynamic market, as to what companies are coming in and out of our portfolio, and what those companies are actually doing. And, so, you know, that's why we operate transparently—so that people can, from time to time, which they do, inform us of changing company behaviours or arising issues. So it's a very deliberate framework for identifying what issues matter to us and why and how they can be flagged to us in our portfolio, and then a deliberate process that we have internally as to what we should do about that.

Genter — Has the delivery of nuclear systems been changed at all in its category? Is it a reason for excluding investment in companies or not?

Orr — For our fund, we have been long divested from companies that are involved in the manufacture of nuclear warheads. We stopped our divestment at that point based on legal advice we received, which is linked back to the New Zealand legislation, antinuclear legislation. Some of the other CFIs have also divested from firms that are involved in the maintenance of those nuclear weapons, so there is a difference, a minor difference, between the Crown financial institutions on that specific issue. And we've been working with them as to how the various boards of the CFIs got to those different positions. We've been in that situation now for, I think, over 3 years, and the legislation's on our website, and our decision process of how we got there to that point.

Genter — So there's no plan to change that at any time to expand the possibilities for excluding—

Orr — I think there's always a watching brief on these issues—you know, how are companies changing through time, etc. So at the moment we don't have any specific plan to be revisiting that, but I would never say never.

Genter — I note that you've introduced resource scarcity as of three main themes for investment. Can you tell me practically what that means?

Orr — Yes. I mean, so, investment can be kind of driven by two sides. One, it can be supply driven, where people are coming up with great ideas and cunning plans, and they come and sell those to you, and you do your own due diligence. The other one is demand driven, where, being a long-horizon investor, we can sit here and think about what type of issues in the future—what things now that we know are happening may lead to opportunities in the future. And some of those issues that we've seen coming up are exactly around resource scarcity, a very clear and continuous—in fact, that is the underlying reason for economics. And we're saying, OK, with that, being a long-horizon investor, are there certain things that we may be able to get into either because other funds can't, because they might have liquidity issues or risk premium they're not prepared to take on, or because the horizon over which they're worried about is just too long, or the entry price,

you know, we might be able to find, get an earlier life cycle. So we've pushed hard on that theme to come out and to say, OK, are there investible activities? That's the hard part. We can think about great themes. The next bit is then: "And so what?". The challenge is, if I have thought about it, then it's probably already in the price. So it's about saying, are there then, you know, from that, are there ways in which we can get into some of these things—might be alternative energy activities, and we are actively considering and looking at those types of areas. The key economic drivers are that we don't want to be as best as possible having a portfolio where we end up with stranded assets, for example, or regulatory risk that says you can no longer use a certain fossil fuel. So, you know, we want to avoid stranded assets, we want to be in assets where consumers have very high demand, or we want to be an early adopter of the next big thing. So that's how we use it.

Young All right. Well, thank you very much, Mr Orr, Mr Walker, for your presentation today. Again, congratulations on a good return for this last financial year you've reported on. Thank you for your staff that are here today, and all the best for this coming year ahead. Thank you.

conclusion of evidence