Commerce Committee
2013/14 annual review of the Guardians of NZ Superannuation
Written questions 128 – 135

128 How does the performance of the New Zealand Superannuation Fund compare to that of other comparable sovereign wealth funds?

Value add and cost performance – CEM Benchmarking

The Guardians participate in an annual cost structure benchmarking survey by CEM Benchmarking. CEM assesses the cost structure and value add of the Fund against more than 300 funds from around the world, focusing on 19 funds with of similar sizes, with active investment management strategies and similar risk profiles. CEM is the best available measure of relative performance of sovereign wealth and pension funds.

We aim to achieve a rating of 'median cost, median value-adding' or better in the CEM survey. This rating provides an independent benchmark of whether we have added value net of all costs, and managed costs. Succeeding in adding value net of all costs will result in better long-term investment returns for the Fund.

CEM's most recent report, for the calendar year ended 31 December 2013, found that the Fund's net five-year value-add was above the median value add of its peers. Costs were below the median. The report is available on our website at:
https://www.nzsuperfund.co.nz/performance/cost

Return comparison – New Zealand

Locally, the Fund continues to perform favourably compared to the 'growth' funds listed in Eriksens Global's Master Trust Survey to 31 December 2014 and in www.interest.co.nz's analysis of KiwiSaver growth fund returns to 31 December 2014. The Eriksens Master Trust survey reports on the performance of the leading New Zealand wholesale (employer) investment funds.

We include NZ tax paid in our performance figures, as it is a return to the Crown (the Fund has paid NZ$4.4 billion tax since inception in 2003). For ease of comparison with the Eriksen and www.interest.co.nz figures, however, we have also provided the Fund's returns on an after NZ tax basis below:

Period to 31 December 2014	**New Zealand Superannuation Fund returns (after costs, before NZ tax)**	**Estimated New Zealand Superannuation Fund returns (after costs, after NZ tax at effective tax rate of 28%)**	**Eriksens Global's Master Trust Survey – all Growth Funds**
Five years	14.79% p.a.	10.70% p.a.	5.5% p.a.
Four years	14.70% p.a.	10.65% p.a.	5.8% p.a.
Three years	19.59% p.a.	14.13% p.a.	9.2% p.a.
Two years	19.84% p.a.	14.31% p.a.	9.0% p.a.
One year	13.90% p.a.	10.01% p.a.	8.9% p.a.

Interest.co.nz's analysis of the three year returns of Growth KiwiSaver Funds to 31 December 2014 shows returns ranging from 7.6% p.a. to 12.8% p.a. (after tax and costs).

The estimated NZ Superannuation Fund return over this period was 14.13% p.a. (after tax and costs).

We note that Fund performance is a function of risk and that we are not aware of the specific risk profiles of the funds in the Eriksens and www.interest.co.nz surveys. This is why the CEM survey is the best indicator of relative performance.

Best practice – application of Santiago Principles

The Santiago Principles are a set of 24 voluntary IFSWF guidelines that assign best practices for the operations of sovereign wealth funds. The Principles recognise that it is important for sovereign wealth funds to demonstrate to their home countries, to the countries in which they are invested and to the international financial markets in general that they are properly established and that their investments are made on a purely economic basis.

The Santiago Principles monitor three important areas of operational practice for sovereign wealth funds - legal framework, institutional framework and governance framework, along with investment policies and risk management.

Geoeconomica produces an index measuring compliance with the Santiago Principles by Sovereign Wealth Funds.The NZ Super Fund was ranked fully compliant with the Principles in the 2014 Geoeconomica Index.

Responsible Investment

We benchmark our responsible investment practice through annual United Nations Principles for Responsible Investment (UNPRI) assessments. The UNPRI is the international standard for best practice in responsible investment. Signatories are required to report on how they apply the six UNPRI principles. The assessment processes provide a measure of how effectively each fund is carrying out the principles relative to other similar UNPRI signatories.

The UNPRI is piloting a new assessment approach, with a focus on scoring performance by asset class/business practice. The Fund's 2013/14 RI Transparency Report (self-assessment) was released in June 2014. However, benchmarking data comparing our performance to peer funds under the new assessment approach is not yet available from the UNPRI.

In 2010 and 2011, the most recent periods for which UNPRI benchmarking is available, we received a top-quartile rating across all six UNPRI principles. This indicates that we are managing responsible investment issues and risks to a best practice standard and means we are one of the best performing UNPRI signatories globally.

Transparency

The Fund has been recognised both domestically and internationally for its transparency and public reporting:

- The Fund has achieved a 10/10 rating in the San Francisco-based Sovereign Wealth Fund Institute Transparency Index since inception. As at Q4 2014 the Fund was one of only 11 sovereign wealth funds to achieve a 10/10 rating in the index.
- The Human Rights Commission rated the Guardians 1st out of 91 Crown entities in a 2014 review of the Guardians' Annual Reports from 2007-2013. The Guardians achieved a compliance rating of 100% for its 'good employer' public reporting.
- Since our last Select Committee appearance the Guardians have received a series of awards and recognition for excellence in reporting and disclosure, including: Gold

Award, 2014 Australasian Reporting Awards; Finalist, 2014 Global RI Reporting Awards; Winner, Best First-Time Entrant, 2013; Australasian Reporting Awards; Finalist, 2013 Global RI Reporting Awards; Winner, Best Public Sector Report, 2013 NZICA Annual Report Awards.

129 The Committee notes that the Guardians costs were above average when compared to other sovereign wealth funds in 2013/14. What steps are the Guardians taking to manage costs?

This observation is from CEM's survey for the calendar year ended 31 December 2013 (not the 2013/14 financial year). Importantly, CEM found that value-add (returns net of all costs) for the calendar year was above the peer median.

To assess whether costs are high or low given each fund's unique asset mix and size, CEM calculates a benchmark cost for the Fund. CEM's benchmark cost reduced in 2013 compared to 2012 levels. As Mr Orr noted to the Select Committee, this change reflects a shift by peer sovereign wealth and pension funds towards more direct investment using in-house investment professionals, and less investment through external managers. We were earlier to adopt this strategy than most peers.

Fund costs are primarily driven by the level of active investment undertaken by external managers. We only invest actively when we have a high level of confidence that doing so will generate stronger risk-adjusted net returns than the low-cost, passive equivalent. We also give careful consideration to whether an external manager is the best access point to each investment opportunity. Our target operating model expresses a preference for direct investment rather than through external managers, where feasible. We invest directly where doing so offers improved risk-adjusted returns, interests are aligned, and we have the capacity and governance to successfully implement and manage the investment.

The Fund terminated a number of external active managers in 2013/14, along with some external advisers. The funds are now under cheaper, passive management. Furthermore, a number of private equity funds in the portfolio have reached the end of their drawdown periods, after which point fees are generally based on the net asset value of the fund concerned, rather than initial commitments by investors.

In dollar terms, total Fund expenses reduced from $112.8 million in 2012/13 to $107.7 million in 2013/14. Expenses excluding performance fees paid to external managers, also reduced, from $86.2 million in 2012/13 to $79.3 million in 2013/14.

Fund expenses are projected to increase gradually in line with our strategy to undertake further direct, active investment.

We continue, however, to have a strong focus on managing costs, including reducing fees paid to external managers and achieving operational efficiencies. Recent and current initiatives include:

- removing external advisors and bringing manager search/selection and monitoring entirely in-house;
- increasing our focus on negotiation of external investment mandate terms e.g. paying fees on invested capital rather than committed capital;
- benchmarking external mandate terms (to the extent possible) to ensure our terms are at or close to market;
- renegotiating mandate terms where possible (for example, we re-negotiated the terms of all our passive equity mandates when adding a third passive equity manager);

- targeting fewer but deeper manager relationships to achieve better terms and lower set-up costs (to explain, fixed costs for a $200 million commitment are the same as a $50 million commitment);
- improving the usefulness of the Guardians' internal cost allocation tool by reference to baseline data;
- increasing the team's focus on innovation.

130 What steps are being taken to implement the recommendations made by Promontory in the five yearly review of the Guardians?

We expect to have completed this process by June 2015. The status of each recommendation is set out below:

1. period of organisational consolidation – agree. No further action required.
2. separate Derivatives Policy and associated Procedures – agree and in progress.
3. single policies and procedures manual – agree and in progress.
4. appointment of a Chief Risk Officer – see Q133.
5. mandate of the Risk Committee – See Q132
6. imputed cost of managing the Reference Portfolio – agree and in progress
7. appointment of a Compliance Officer – to be considered in conjunction with assessing whether to appoint a Chief Risk Officer.

131 The Committee notes that establishment of a New Zealand Direct Investment Team. Please describe the work of this team and how its performance will be measured and reported.
The New Zealand Direct team is responsible for natural resource investments (timber and rural) in New Zealand and globally, and for opportunistic equity investments in New Zealand of approximately $100m-$300m+, spread across sectors and vintages (these include our current stakes in Datacom and Metlifecare). The team, which has a long-term, active approach to investment governance, comprises analysts to undertake due diligence and operational support, portfolio managers to monitor investments, and leadership tasked with deal origination.

As set out in our Statement of Performance Expectations for 2014/15, we aim to increase the total number of deals explored, and the number of suitable deals taken to due diligence stage. This will be reported on in our 2014/15 Annual Report.

132 The Committee notes that the Guardians are benchmarking the capability and function of the Risk Management Committee. How does the Guardians' Risk Management Committee compare to that of other sovereign wealth funds?
We have agreed with and implemented Promontory's recommendation to make the Risk Committee's Terms of Reference more explicit in regards to the independent oversight of the measurement of investment risk. The Risk Committee maintains full oversight of the measurement of all risks, including investment risks as specified in the Board's Risk Appetite Statement.

Independent management oversight of the measurement of investment risk is provided by the Head of Portfolio Risk and Compliance. These measurements are reported to the Board, Risk Committee, and Investment Committee on a monthly basis.

In 2012, we participated in a risk-management survey by CEM Benchmarking. CEM surveyed its Global Leaders Group of 27 leading pension and sovereign wealth funds on risk-management practices including staff, governance, organisational design and enterprise

risk management. The survey results confirmed that risk management at the Guardians and of the Fund was developing in line with best-practice standards at other funds overseas.

133 The recent Review of the Guardians recommended the appointment of a Chief Risk Officer. Will the Guardians be implementing this recommendation? If not, please explain the rationale for not doing so.
The Guardians are currently considering this recommendation and have not yet come to a final decision. Our initial reservations, as noted in our response to Promontory's report, were that as an investment management entity we have two types of risk: investment risk and implementation risk (everything else). Investment risk and return are the fundamentals of our business, and their interplay is the basis of all investment decisions, from policy to individual asset selection. Our approach thus far has been to encourage ownership of risk at all levels of the organisation. Artificially separating risk from return and allocating overall responsibility for risk to a Chief Risk Officer may lead to worse decisions and outcomes.

134 The Committee notes that the Guardians updated the responsible investment framework. Please describe the main changes that were made to the framework. How will these changes strengthen the Guardians' responsible investment?
The main change to the responsible investment framework has been to provide for exclusion as an end point to engagement or where engagement is not considered likely to be effective. Previously the framework only provided for 'category'-type exclusions such as the manufacture of cluster munitions.

135 Please describe the steps that the Guardians are taking to improve the efficiency and effectiveness of the engagement programme. How will these steps ensure that the Guardians investments are in line with its Responsible Investment Framework?
Steps that we are taking to improve our engagement programme include:

- working towards more focused direct engagements (with global and NZ companies) and evaluating outcomes; and
- incorporating environmental, social and governance factors into company analysis, stock selection and engagement as part of the Fund's recently-established internal New Zealand active equities mandate;
- leading the establishment of a group of institutional investors to promote good corporate governance practices in the New Zealand market and engagement with New Zealand companies on corporate governance matters;
- reviewing external expertise and resourcing options to support the implementation of our international responsible investment engagements;
- continuing to educate staff and embed responsible investment knowledge within the broader investments team.

The Responsible Investment Framework is designed to ensure consistent decision-making and clear processes at the Fund in regards to engagement, exclusion and other investment ownership activities such as voting. The portfolio is monitored on a daily basis to ensure compliance with Fund exclusions.

We also actively monitor the Fund for breaches of our responsible investment requirements. The internationally-recognised UN Global Compact, which covers four key areas: human rights, labour, environment and anti-corruption, is the key standard against which we measure companies' behaviour.

It is important to understand, however, that with investments in more than 6,500 companies globally (the majority of these relatively small, passive holdings) there will always be companies in our portfolio that may not meet these standards of good corporate practice.

We take a range of factors into account when prioritising which companies to engage with, paying particular attention to ones where we have significant holdings (which is often the case in New Zealand). We also factor in the significance of the breach; our ability to collaborate with other investors or engage directly with the company (again, this can be easier within New Zealand than overseas); the potential effectiveness of engagement, given the context the company is operating in and their responsiveness; and the resources required.

Where companies have breached our standards, we utilise our position as shareholders to encourage them to implement improvements in their policies and practices. We engage because we believe that companies should act responsibly and that by improving their management of environmental, social and governance issues, companies can improve their long-term financial performance.

If companies have made sufficient progress in addressing the issues they are facing, engagement ends and the company is monitored for further breaches. Where companies have not responded to engagement or engagement is unlikely to be effective, we may in certain cases decide to exclude companies from the Fund. Exclusions are only applied in rare situations where we believe engagement is not the best course of action, particularly where there appears to be no solution and/or no willingness to rectify the breach of standards. If we exclude a company from the Fund then we make that decision public and give the reasons why.