Guardians of New Zealand Superannuation

Statement of Intent

For the period 1 July 2004 to 30 June 2007

modified with effect from 1 December 2004

1. INTRODUCTION

Part V of the Public Finance Act 1989 requires the Guardians of New Zealand Superannuation ("the Guardians") to prepare a Statement of Intent each year. In addition section 65 of the New Zealand Superannuation Act 2001 ("the Act") requires the Guardians to include in this document some specific comments on the expected performance of the New Zealand Superannuation Fund ("the Fund") over the next financial year, as well as the risks to that performance and steps being taken to manage those risks.

The purpose of the Statement of Intent is to summarise the objectives of the Guardians for the 2004/5 year and to set out expectations around performance of the Fund.

All decisions relating to the business of the Guardians are made under the authority of the Guardians Board ("the Board"), in accordance with section 53(1) of the Act. All members of the Board were appointed by the Governor General on 30 August 2002.

2. NATURE AND SCOPE OF ACTIVITIES

The function of the Guardians is to manage and administer the Fund in accordance with the Act. The Fund was established by the Act and is the property of the Crown. The initial transfer of assets from the Treasury to the Guardians, totalling $2.402 billion, occurred on September 30, 2003 and ongoing contributions to the Fund are calculated by reference to a formula set out in section 43 of the Act. These are expected to average $2.2 billion per year over the three year period covered by this Statement of Intent. Under the Act no withdrawals are allowed from the Fund until after 30 June 2020. Detailed information on the background leading to the establishment of the Fund, the expected level of contributions to the Fund, and the policies implemented by the Guardians for the management of the Fund's assets are available on the Fund's website (www.nzsuperfund.co.nz) .

At the beginning of the 2004/5 financial year, the Fund's assets are expected to be $3.885 billion. Over the next three financial years, the balance of the Fund (reflecting contributions from Government and investment income earned net of fees and after payment of tax) has been estimated by Treasury to be as follows:

As at 30 June	***Balance***
2005	$6.32 billion
2006	$9.04 billion
2007	$12.07 billion

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

(a) best-practice portfolio management;
(b) maximising return without undue risk to the Fund as a whole; and
(c) avoiding prejudice to New Zealand's reputation as a responsible member of the world community.

Consistent with the obligation to introduce best practice portfolio management, the Board has considered an extensive range of external and internal advice before arriving at decisions in key areas such as asset allocation and portfolio construction. On an ongoing basis, the Board has tried to ensure that it has the expertise and resources to deliver on best practice before moving to implementation. To this end, the Board and management have initiated a number of relationships with successful investment institutions around the world who have been recognised for their insights. Through the adoption of the principles driving the success of these institutions, the Board believes that the management of the Fund will increasingly move towards standards that might be regarded as best practice. In addition, the Guardians participate in an international benchmarking survey designed to measure the effectiveness of investment policy and operational cost effectiveness.

The balance between risk and return in the portfolio is a continual focus for the organisation and is addressed in section 3.

The Board will ensure that the conduct of the organisation, and the composition of the investment portfolio, will not prejudice New Zealand's reputation. Through the development of a policy on ethical investment, as part of its general statement of investment policies, standards and procedures, a number of controls operate to mitigate this risk. During the year the investment portfolio will be reviewed by international screening organisations able, through extensive research, to detect any investment which might breach the Fund's policy for ensuring New Zealand's reputation as a responsible member of the world community is not prejudiced.

The Act makes it clear that the Guardians have responsibility for the management of the Fund's assets and decisions relating to the business of the Guardians are to be made by, or under the authority of, the Board. The Act gives the Board all powers necessary to manage, direct, or supervise the management of the Fund.

The Minister of Finance may, after consultation with the Guardians, give directions regarding the Government's expectations as to the Fund's performance, including the Government's expectations as to risk and return, but such a direction must not be inconsistent with the Guardian's duty to invest the Fund on a prudent commercial basis. Any direction given by the Minister must be in writing and signed and dated.

The Guardians must have regard to any such direction and must notify the Minister how they propose to do this as well as report any such directions in their annual report and how they have had regard to them. No directions have been received by the Board to date.

Except for expenses directly related to meeting obligations that are directly related to the operation of the Fund, including fees payable to investment managers or the custodian, the expenses of the Guardians are met out of money appropriated by Parliament for that purpose. Section 7 of this document outlines how these appropriated funds will be spent over the period covered by this Statement.

3. MEASURING THE PERFORMANCE OF THE GUARDIANS

3.1 BACKGROUND

The key criteria for measuring the performance of the Guardians will be the return generated on the assets allocated to the Fund by the Government. The key performance objective of the Guardians is to provide a rate of return on the Fund's assets which exceeds the risk free rate of return (measured as the return on 90 day Treasury bills) by a compound average of at least 2.5% per year over rolling 20 year periods. This will be assessed net of investment management costs but gross of tax paid to the New Zealand Government.

Given that no assets are expected to be drawn down from the Fund for almost 20 years, and it is expected that the Fund will remain in existence for many years after the first withdrawal, this is an appropriate period of time over which to assess the effectiveness of the Guardians' investment policies. However, it is also recognised that there will be interest in performance over shorter periods of time. While updates are provided monthly on the Fund's website (www.nzsuperfund.co.nz), rolling five year periods should provide a basis to assess the effectiveness of the Guardians' investment policy to meet the long term objectives of the Fund without being overly distracted by short term market volatility.

In managing the Fund's assets, the key role of the Guardians is to balance the risk involved in allocating assets to investment markets against the return expected from that exposure. Returns on the Fund's assets are expected to come from three sources:

***(i) The risk free component*.**

This is the return on short term sovereign debt, a proxy for the return attainable with little or no investment risk.

***(ii) Reward for market risk*.**

This represents the compensation investors expect to receive, over and above the risk free return, by investing in assets which are expected to produce an attractive premium in return for the risk involved. The size of the risk premium varies with different types of assets. The strategy adopted by the Guardians is to seek to raise the overall return to the Fund by investing in a diversified range of assets. The strategic asset allocation of the Fund reflects the Guardians' view of the most effective combination of assets given the level of risk deemed suitable for the Fund.

(iii) Reward for active management risk.

Over and above the returns expected from investing in different types of assets, the selection and appointment of investment managers who seek attractive opportunities within markets can provide additional returns to the Fund. While some sectors are not expected to provide adequate compensation for taking active management risk, and the Fund will simply seek the market return, other sectors do justify this additional risk and expense. Where appointed, all active managers appointed by the Fund have agreed performance targets they are expected to meet.

The combination of these three sources of return will drive the return on the Fund's assets. It is important to note that over short periods of time, actual investment returns for any asset class or active manager may differ widely from the medium to long term expected returns. In general, the higher the prospective returns to each asset class, or active manager, the greater the likely variation in annual returns. It is also relevant to note that the expected return over relatively short periods of time may vary significantly from the key objective of exceeding the risk free rate by an average of at least 2.5% pa.

3.2 ESTIMATING THE RETURN ON FUND ASSETS FOR 2004/5

While the investment strategy established by the Guardians is based on maximising returns over long periods of time, consistent with the purpose of the Fund, section 65 of the Act requires the Board to comment on their expectations about the performance of the Fund over the 2004/5 financial year in sufficient detail to enable meaningful assessment against those expectations at the end of the year.

As noted in 3.1, the key deliverable of the Guardians is a rate of return, net of costs, averaging at least 2.5% above the risk free rate over rolling twenty year periods. Over a single year, recognising the volatility in total returns that can be experienced in such a short period, the Board's key objective is to add value through the selection and combination of investment managers. The Board estimates that a return of at least 0.5% pa, after manager fees, should be able to be added to the market returns on the portfolio (i.e. the return that a purely passive approach to investment would have generated).

The Board has no particular confidence in an expected rate of return on the Fund over a period as short as one year. However by developing a set of assumptions about investment markets over a ten year period, it is possible to produce a range of estimates of the medium term performance of the Fund. For the period commencing with the 2004/5 year, the Board estimates the mid point of this range of estimates to be 9.0%[1].

For the purposes of complying with the requirement of section 65 of the Act, this figure represents the Board's expectation about performance over the 2004/5 year as a single year in the next ten year cycle.

It is very important to note that there is significant uncertainty around this figure and the estimated standard deviation of returns is in the order of 11% pa. This means that around two years in every three, returns would be expected to be between -2% and +21%. Returns in the range of approximately -13% to + 32% could be expected around 95% of the time.

The estimated average earnings of 9.0% over the next ten years has been arrived by combining estimates of the risk free rate, the market risk premium and the expected return from active management as outlined on page 4. The components are as follows:

- ***The risk free rate @ 5.3%***:

  There is no specific market mechanism for pricing in the future expected risk free rate of return however the pricing of longer term Government debt provides useful information in this area. Current bond yields reflect the expectations of finance market participants about future levels of interest rates, together with a premium for holding longer term debt (the 'term premium'). These yields can, however, fluctuate widely over short intervals and for this reason the Board prefers to look at period averages as well as current levels.

  For the three months to June 2004, yields on 10 year New Zealand Government debt have averaged close to 6.1%. Separating the implied rate of return for cash from the term premium is a judgement however some guidance is offered by considering average yield curve slopes over long periods, both in New Zealand and abroad.

  Based on this analysis, the term premium for 10 year debt is estimated to be 0.8% which suggests that the expected long term cash rate is 5.3% pa. In the Board's view this is a reasonable expectation for the average level of risk free return over the next ten years.

[1] This figure represents the estimated 10 year geometric return on assets. For the purposes of modelling of contributions to the Fund and its closing balance as at June 2005, it is appropriate to use the one-year equivalent. Under the assumptions used the one-year equivalent of 9.0% geometric over 10 years is 9.5%. See Brian McCulloch, "Geometric Return and Portfolio Analysis", New Zealand Treasury Working Paper 03/28 for a full explanation.

- ***The reward for market risk @ 3.2% :***

  The reward for market risk is defined as the margin between the risk free rate and the return that would be generated if the portfolio was invested in line with the strategic asset allocation and all of the Fund's investments performed in line with their benchmarks (i.e. produced zero reward for active management). Over the next ten years the reward for market risk is projected to raise returns by approximately 3.2% pa. Realised returns to risk fluctuate widely, meaning that reliable average levels are only observable over very long periods. Accordingly this figure is a judgment representing the Board's weighted average expectation across the entire Fund based on the likely asset allocation. The Board believes that this projection lies towards the middle of the range of assumptions commonly used by investors.

- ***The reward for active management @ 0.5%.***

  Active management is assumed to add at least a further 0.5% pa. to Fund returns (net of fees paid to managers). As with market returns, value added by active management will fluctuate from period to period. The assumption used reflects the performance objectives agreed with managers, the permitted discretion they have been granted in order to meet them, and broad experience of similar organisations in appointing active managers.

3.3 VARIATION IN RETURN FROM PREVIOUS ESTIMATES

It is relevant to note that the Board's estimate of compound average returns of 9.0% pa over the next ten years varies from the estimate of long term earnings on the Fund established at the time of completing the initial portfolio analysis one year ago. This figure was set at 9.2% pa and, although no specific time period was attached to the estimate, it was widely regarded as representing the Board's estimate over a twenty year period.

The move to comment on expected Fund earnings over a ten year period is largely driven by the unavailability of market estimates of cash rates beyond ten years. All future earnings estimates will be established by using the methodology outlined above.

The reduction in expected earnings is primarily due to changed expectations about the premium deliverable from listed equity markets. In early to mid 2003, when these estimates were produced for the Board, there was an expectation of a return to fair value in equity markets following a sustained decline in prices since 2000. With global equity markets delivering returns in excess of 30% since April 2003 a significant component of that anticipated return has now been realised. This inevitably leads investors to reduce their expectations of future yields from equities compared with their position a year ago. While further analysis of the likely reduction in the market return on the Fund's portfolio as a result of this continuing, a realistic estimate is a reduction of 0.2% pa from 2003/4 levels. This explains the difference between 9.2% pa and 9.0% pa.

4. RISKS TO THE PERFORMANCE OF THE FUND AND ACTIONS TAKEN TO MANAGE THESE

4.1 RISKS TO PERFORMANCE

There are a number of risks to achieving the performance objective of the Fund over relatively short periods of time. The variability of returns from sectors and managers over any one year period has previously been outlined and remains the predominant consideration when comparing returns over the short and long term.

The three key risks to the performance of the Fund are as follows:

4.1.1 Over the short term returns from investment markets are below long term expected levels.

The Fund holds exposure on a wide range of assets around which long term reward assumptions are made. In making these assumptions considerable care is taken, and they are reviewed at least annually, but the risk remains that the market returns for the Fund are considerably below expectations, especially over relatively short periods of time. Factors affecting short term performance include:

- The risk that equity markets, broadly, do not yield the expected return over the risk free rate to investors;
- The risk that within equity markets there may be non-uniform performance with some sectors significantly underperforming others. Examples include divergence in returns by sector, geographic region, style (growth versus value) and size (large versus small stocks);
- The risk of significant movements in currencies;
- The risk of default on the fixed income assets;
- The risk of significant movements in interest rates which have not been anticipated by, and priced into, markets.

Based on the assumptions referred to in section 3.2, the probability of the Fund's returns exceeding the risk free return in a single year is just over 64% rising to around 97% over ten years. The probability of exceeding the risk free rate by at least 2.5% pa. is about 56% in a single year, rising to 76% over ten years and approximately 98% over 20 years.

4.1.2 The performance of the selected investment managers is below expectations.

In configuring the portfolio within each asset class, the Guardians select a combination of active and passive managers as appropriate. Where active managers are utilised, the requirement to deliver superior returns also entails some risks and these managers may fall short of the objectives set for them by the Board. Accordingly, while the Board acknowledges that the performance of an individual manager may be below the level of their benchmark over short periods of time, it is expected that over a market cycle, excess returns (after costs) will be generated. Over a year there is a focus on ensuring that the combination of managers in any sector is effective and collectively an above market return is generated.

4.1.3 The investment policy is not efficiently implemented.

The combination of asset classes within the portfolio, and investment managers within an asset class, substantially define the investment policy of the Fund. Movements in markets prices combined with strong inflows of cash into the Fund have the potential for these combinations to drift and reduce the effectiveness of the policy. There is also the potential for the cost of transactions, if not carefully monitored, to reduce the performance of the Fund.

4.2 STEPS TAKEN TO MANAGE THESE RISKS TO PERFORMANCE

By formally reviewing expectations about each asset class and considering the combination of assets to produce a well diversified portfolio, the Guardians are seeking to manage the uncertainty outlined above. A combination of inputs from internal management and external advisors will be used to make this review process as effective and efficient as possible. Attention will be paid to the following key areas:

4.2.1 Adopting an appropriate risk profile.

The broad investment principle of the Guardians is to achieve its return objectives for the Fund without taking undue risk. These returns are achieved by holding a range of exposures to different types of markets, market factors and managers. A core function of the Guardians is to ensure that these risks are as well spread as possible and that each has received appropriate weight.

The Fund has some key characteristics that influence its tolerance for investment risk. The first drawdown is not envisaged until around 2025 and the Fund is expected to receive regular inflows up until this point. While this does not mean the Fund can be indifferent to the risk of volatility in short term performance, it does mean that it should be less sensitive to this than many investors. This constitutes a clear advantage, since many of the excess returns offered by markets arise because most investors cannot be so tolerant.

Analysis commissioned by the Board before taking over the management of the Fund's assets suggested a properly constructed basket of growth assets (i.e. non-interest bearing securities) should constitute a minimum of one half of the initial assets of the Fund, with the optimal level lying between 70-90%. This recommendation was tested across a range of return assumptions and economic scenarios and, while it can never be exact, it appeared to be reasonably robust. On this basis the Board decided to initially invest 80% of the Fund in growth assets.

While this has been agreed as a broadly appropriate long term split between growth and defensive (i.e. interest bearing) assets, this split will be reviewed at least annually.

The Guardians also recognise the risk to returns from movements in currency. Recognising the favourable interest rate differential between New Zealand and most other markets, the Board's initial policy is to fully hedge its currency exposure to international bonds and hedge 60% of the currency exposure to international equities. The assumptions underlying this policy will be reviewed early in 2004/5 and the policy may change to reflect the results of this work.

4.2.2 Avoiding concentration of risk.

The risks of the investment process can be greatly reduced, and the probability of meeting the investment objective similarly enhanced, by appropriate diversification of the mix of investments.

The power of well priced, lowly correlated assets to deliver favourable returns over the longer term is probably the most powerful tenet of best-practice investment management. A wide range of investments made by the Fund, while increasing the number of risks, collectively reduces the variability of total Fund outcomes. The benefit is that either a higher level of prospective returns can be attained for a given level of risk, or else the risks around a given target return can be reduced. Either way the likelihood of achieving the investment objective is enhanced.

Accordingly, geographic diversification, as well as the allocations towards small cap stocks and emerging markets, reduces the exposure to broad movements in equity markets. Similarly, gaining exposure to diversified sources of credit and duration in bond markets diversifies away from movements in interest rates in the sovereign bond market of any one developed nation.

Investment in a range of illiquid assets (including property, private equity, commodities and infrastructure) provides further diversification away from listed equity markets. Once introduced, these are expected to provide additional returns as a reward for the illiquidity of these sectors and, while there is risk involved in each of these sectors, in general their introduction is expected to substantially reduce overall risk to the Fund through greater diversification.

As at June 2004, the Fund had not invested in these sectors. The Board has determined that investment in these areas should be delayed until it has access to relevant specialist expertise. Should investing in these asset classes not progress in line with the Board's expectations, the expected return on the Fund's assets over the next ten years would need to be adjusted. The impact of this would be a reduction in annual average compound earnings of approximately 0.2% pa.

4.2.3 Careful selection and monitoring of external managers.

Investment managers should only be appointed if there is a high degree of confidence that they will increase the probability of the Fund meeting its performance objectives. The Fund can be thought of as possessing a portfolio of managers just as it holds a portfolio of assets. Each manager needs to possess sufficient skill to exceed their individual return objectives after fees and expenses.

Managers often exhibit bias in their approach to security selection. This may be explicit and intended (such as with value or small cap focussed equity managers) or subtle and unintended. The Guardians aim to clearly understand, and monitor, the likely size and pattern of value added by the managers, as an appropriately structured portfolio of managers constitutes an additional source of return diversification. Specific resources within the organisation, and external research on domestic and global managers, are focussed on this challenge. The Board will measure the effectiveness of the decision making in this area by measuring performance in each sector where active managers have been employed against the market return for the sector.

Over time, as further research and analysis is undertaken by the Guardians, the net return generated by active management is expected to increase.

4.2.4 Accessing quality advice.

In addressing these risks, it is desirable that the Board receive quality external advice to complement and review the internal analysis by management. This is particularly true in areas:

- which can not be effectively performed by staff (e.g. the regular monitoring of prospective international investment managers);
- where contestability of advice is important (e.g. the setting of strategic asset allocation);
- which are highly specialised (e.g. unlisted assets like private equity, forestry, property and infrastructure).

The Board will engage external advisors on these and related issues to the extent resources permit.

4.2.5 Managing investment operations carefully.

To reduce the risk of investment performance being affected by poor implementation of strategy, a number of processes are adopted:

- setting parameters around the strategic asset allocation and ensuring that the portfolio remains within these ranges through rebalancing;
- supporting management’s ability to reduce leakage from the Fund through the close monitoring of transaction costs incurred by managers and the custodian;
- monitoring the performance of service providers to ensure ongoing quality and cost competitiveness; and
- managing the tax efficiency of investment vehicles.

5. ORGANISATIONAL STRUCTURE

5.1 Board structure

The Board may delegate any of the functions or powers of the Guardians to a committee of the Board, or any person, but may not delegate the power to delegate or to grant a power of attorney or the power to appoint investment managers and custodians.

For the 2004/5 year, the Board intends to operate the following committees:

- ***Audit and Governance Committee*****:** Oversees the establishment of the governance framework, delegated authorities, compliance (including tax compliance) and audit functions, and reviews key financial statements;

- ***Responsible Investing Committee*****:** Oversees the implementation of the ethical investment policy (under s61(d) of the Act) and the policy for the exercise of voting rights (under s61(i) of the Act)

- ***Employee Policy and Remuneration Committee*****:** Oversees the development of employment policies and monitors performance of key employees.

5.2 Management Structure

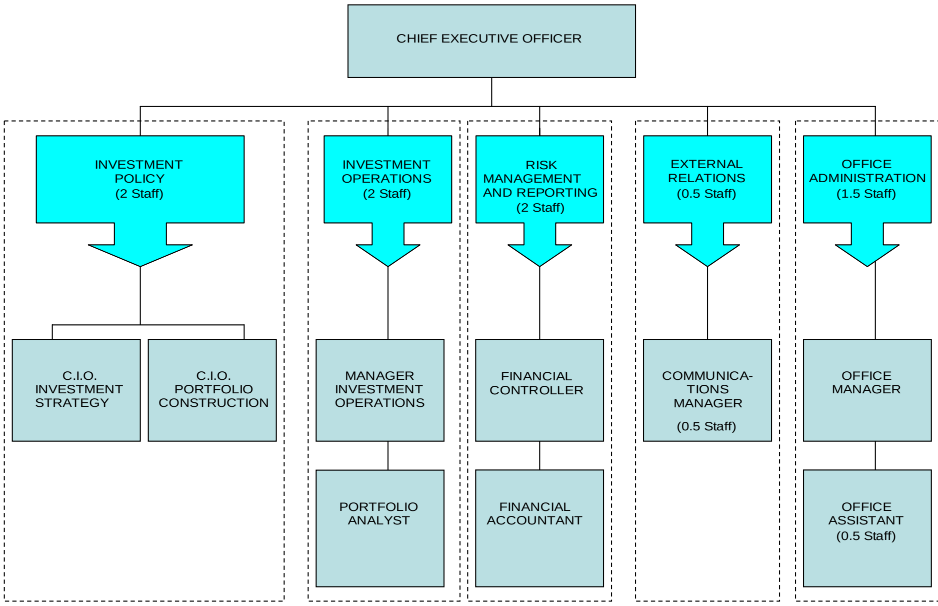
The Board has appointed a chief executive officer who, in turn, has appointed a number of other members of the management team. Best practice in institutional funds management suggests that the development of skills and experience in internal management is critical for effective decision making and operational risk management. Improved investment performance generally flows from this investment in resources.

At the commencement of the 2004/5 year, there were 6.5 full time employees. In order to meet the responsibilities of appropriately managing the rapidly growing portfolio of assets, it is recognised that the management team needs to grow. It is planned to increase this to the equivalent of 9 full time positions in 2004/5. This is expected to remain appropriate for the management of the core portfolio during 2005/6 and 2006/7. The additional resources will be allocated to:

- an additional person in investment operations (managing the efficiency of the financial transactions of the Fund and the analysis and reporting of performance);
- the equivalent of an additional person in the area of financial control, risk management and internal audit;
- office administration (part time).

The Board's view is that an investment in a small team of quality staff is a very effective strategy to ensure continuous improvement to portfolio construction, and the management of risks around the implementation of investment strategy.

The staffing structure is outlined below. It is relevant to note that no provision is made for specialist internal resources in the area of unlisted assets. International best practice supports, over time, the development of specialist internal staff in these areas to complement external advisors. A key benefit is the transfer of skills from external advisors to the organisation and, particularly in private equity, the development of relationships to maximise access to quality investment opportunities. Depending on the progress made in these assets over the next few years, additional appointments in this area may be justified.



5.3 External Specialist Advice

As discussed above, the Board recognises that in order to achieve its objectives there is a requirement for high quality external advice to supplement the internal management team. This is expected to include:

- Advice on the Fund's asset allocation, portfolio construction and the selection of investment managers. Although there has been significant development of internal management's capacity to lead in this area, it remains appropriate to complement, or supplement as appropriate, this with independent external review to ensure the Board has access to rigorously contested advice;
- Legal issues, including interpretation of the Guardians' statutory responsibilities and the negotiation and preparation of contractual documents;
- Management of the tax obligations of the Fund;
- Accounting and audit issues for the Fund.

5.4 Investment Management Services

The core function of the Guardians is the development of the Fund's investment policy, including the selection of investment managers. At least in the medium term, the Board's plan is that the day-to-day management of the Fund's assets will be outsourced to specialist external managers. Considerable emphasis is placed on ensuring that the combination of managers is optimal within each asset class.

This includes:

- the combination of active and passive managers in each asset class;
- the specialisation and style of each investment manager;
- the anticipated ability of the manager to provide a return above the broad market and the risks taken by the manager to achieve that; and
- the cost of their services.

As noted above, the Board believes that additional returns on the Fund can be generated through the effective combination of investment managers and its performance in this area will be reported to stakeholders.

6. KEY PRIORITIES FOR 2004/5

In 2003/4, the Guardians' priorities focused on the establishment of the framework to take over the management of Fund assets from Treasury. This included the establishment of the initial investment policy of the Fund and the appointment of key staff to implement this. During 2004/5, the focus will move to increasing the sophistication of the Fund's investment policy and building on the processes and systems used in the management of the Fund to add additional value. The following broad priorities have been identified:

1. Investment Policy	• Review of risk budgeting methodology to optimise return expectations for risk; • Review current strategic asset allocation to improve diversification benefits; • Review and formalise procedures for selection and management of external investment managers to produce consistent excess returns from active management; • Prepare framework for the introduction of illiquid assets to the portfolio to improve risk-adjusted returns, subject to available resources.
2. Investment Operations	• Formalise reporting capabilities in performance measurement and attribution, portfolio characteristics and risk analytics; • Expand procedures to enhance returns through improved efficiencies in portfolio implementation; • Implement strategies for enhancing returns through securities lending (subject to legislative approval); • Review and formalise procedures in relation to the investment of cash flow and portfolio rebalancing.
3. Risk Management	• Enhancement of internal control policies to improve risk management of Fund assets; • Formalise benchmarking of effectiveness and efficiency of Guardians' operations with international peers; • Further develop portfolio screening capability to support compliance with ethical investment policy.
4. External Relations	• Enhancement of public accountability through further website development;
5. Organisational Development	• Further recruitment as appropriate and retention and development of internal skills; • Further develop the regime for accessing and leveraging off international experience in institutional management. • Ongoing development of effective governance model to promote accountability and results.

7. FINANCIAL MANAGEMENT

The accounts of both the Guardians and the Fund are to be maintained and reported in accordance with the Act and the Public Finance Act 1989.

Section 52 of the Act states that the expenses of the Guardians must be met out of money appropriated by Parliament for that purpose. Section 41(2)(b) of the Act provides for money to be paid out of the Fund to meet any obligation that is directly related to the operation of the Fund. The costs of investment managers and custodians are also to be met directly from the Fund as provided for in section 41(2)(a) of the Act.

For the year to 30 June 2004, the appropriation to cover the operating expenses of the Guardians under section 52 was $3.0 million. Appropriations are subject to GST and therefore the annual amount net of GST is $2.667 million. This amount was also paid in the 2002/3 year.

As the Guardians were in their very early stage of development during 2002/3 there was an operating surplus of approximately $580,000 at 30 June 2003. This was carried over to the 2003/4 year. By the end of the 2003/4 year this had reduced to $353,000 and it was agreed, in turn, that this would carry over to the 2004/5 year.

In the Statement of Intent issued on 30 June 2004, reference was made to the Guardians' view that the appropriation would need to be increased from the existing level in order to meet the obligations under the Act.

On 1 December 2004, the Minister of Finance announced an increase in the appropriation for both the remainder of the 2004/5 year and for the two subsequent years. The increase for the current year is an additional $1.15 million inclusive of GST (equivalent to $1.022.2 million net of GST). When this is combined with the existing appropriation of $2.667 million (net of GST) and the operating surplus from previous years of $0.353 million, the total resources available to the Guardians for the 2004/5 year increase to $4.042 million (net of GST).

A revised estimate of operating expenses for the 2004/5 year has been prepared against this figure.

For the 2005/6 and 2006/7 years, the Minister of Finance has confirmed that the appropriation will be $5.30 million inclusive of GST (equivalent to $4.711 million net of GST). Estimates for these years in this modified Statement of Intent, reflect this increased appropriation. The increased appropriation over this three year cycle will be used to increase the capacity of the Guardians in the key areas of:

- Developing strategies to improve the risk/return efficiency of the Fund;
- Selection and monitoring of external investment managers;
- Boosting the control environment and developing an internal audit function;
- Developing strategies, and selecting agencies, for progressing investment into the alternative assets in order to better diversify the portfolio; and
- Improving transactional efficiencies in the Fund to raise returns.

FORECAST FINANCIAL STATEMENTS FOR THE GUARDIANS

PROJECTED STATEMENT OF FINANCIAL PERFORMANCE

YEAR ENDING 30 JUNE

	Forecast 2005 $000	Forecast 2006 $000	Forecast 2007 $000
Appropriation for operating expenses	3,689	4,711	4,711
Interest	27	23	33
Total revenue	**3,716**	**4,734**	**4,744**
Employee Remuneration and Related Costs	1,882	2,157	2,157
Travel and Accommodation	182	252	252
Office Accommodation	191	203	203
Office Services/ Telecommunications	152	152	152
Market Information Services	109	113	113
Professional Fees	1,073	1,410	1,410
Board member fees and expenses	304	324	324
Depreciation	99	123	108
Total expenses	**3,992**	**4,734**	**4,719**
	(276)	0	25

PROJECTED STATEMENT OF FINANCIAL POSITION

YEAR ENDING 30 JUNE

	Forecast 2005 $000	Forecast 2006 $000	Forecast 2007 $000
Non Current Assets			
Computer Equipment @ cost	163	246	282
Leasehold Improvements @ cost	42	42	42
Office Equipment @ cost	151	152	152
Accumulated Depreciation	(173)	(298)	(405)
Total non current assets	**183**	**142**	**71**
Current assets			
Cash & Receivable	860	1,130	1,412
Current liabilities			
Creditors and accruals	666	894	1,080
Net current assets	**194**	**236**	**332**
Total Net Assets	**377**	**378**	**403**

PROJECTED STATEMENT OF CASH FLOWS

YEAR ENDING 30 JUNE

	Forecast 2005 $000	Forecast 2006 $000	Forecast 2007 $000
Cash flows from operating activities			
Cash provided from:			
Appropriation for operating expenses	4,054	5,204	5,300
Cash disbursed to:			
Operating expenses	4,015	4,807	4,785
Net GST payable	188	245	267
Net Cash flows from operating activities	**(149)**	**152**	**248**
Cash flows from investing activities			
Cash was provided from:			
Interest on bank account	27	23	33
Cash was applied to:	-	-	-
Net Cash flows from investing activities	27	23	33
Net increase/(decrease) in cash held	(122)	175	281
Opening cash brought forward	636	514	689
Closing cash balance	**514**	**689**	**970**

STATEMENT OF ACCOUNTING POLICIES

1 Reporting entity and statutory base

The Guardians of New Zealand Superannuation ("the Guardians") was established as a new Crown entity by section 48 of the New Zealand Superannuation Act 2001 ("the Act") and became operative from 30 August 2002. The core activity of the Guardians is to manage and administer the New Zealand Superannuation Fund ("the Fund").

The Fund was established by section 37 of the Act. Until such time as the Guardians is ready to invest the Fund the accumulated contributions are being held by the New Zealand Debt Management Office. A separate financial report has been prepared for the Fund showing the accumulated contributions receivable.

2 Measurement basis

These financial statements have been prepared in accordance with section 41 of the Public Finance Act 1989.

The financial statements are prepared on the historical cost basis. The reporting currency is in New Zealand dollars.

3 Particular accounting policies

The following particular accounting policies, which significantly affect the measurement of financial performance, financial position, and cash flows, have been consistently applied:

(a) Goods and Services Tax

The Guardians is subject to GST on the revenue received by way of appropriation for operating expenses and can recover GST on expenses incurred. These statements are accordingly prepared exclusive of GST.

(b) Income Tax

As a public authority the Guardians is exempt from income tax.

(c) Statement of cash flows

The statement of cash flows has been prepared using the direct approach.

(d) Fixed Assets

Fixed assets are shown at cost less accumulated depreciation. These assets are depreciated over their estimated economic lives which range from three to five years.

4 Changes in accounting policies

There are no changes in accounting policies.

FORECAST FINANCIAL STATEMENTS FOR THE NEW ZEALAND SUPERANNUATION FUND

FORECAST STATEMENT OF FINANCIAL PERFORMANCE

For the year ending 30 June

	Estimated 2004 $m	Forecast 2005 $m
Investment income	216	486
Total Operating Revenue	**216**	**486**
Manager fees	4	20
Custody Fees	1	3
Other Costs	1	1
Total Expenses	**6**	**24**
Net Operating Income Before Tax	**210**	**462**
Income tax expense	70	152
Net Operating Income After Tax	**140**	**310**

FORECAST STATEMENT OF MOVEMENTS IN TAXPAYERS' EQUITY

For the year ending 30 June 2005

	Estimated 2004 $m	Forecast 2005 $m
Public Equity as at 1 July	**1,884**	**3,934**
Net surplus after tax	140	310
Total Recognised Revenues And Expenses	**140**	**310**
Capital contributions from the Crown	1,910	2,107
Public Equity as at 30 June	**3,934**	**6,351**

FORECAST STATEMENT OF FINANCIAL POSITION

As at 30 June

	Estimated 2004 $m	Forecast 2005 $m
ASSETS		
Current Assets		
Cash	5	5
Receivables	33	34
Provision for tax	15	1
Total current assets	**53**	**40**
NON CURRENT ASSETS		
Investments	3,938	6,451
Total non current assets	**3,938**	**6,451**
TOTAL ASSETS	**3,991**	**6,491**
LIABILITIES		
Current Liabilities		
Payables and accruals	21	25
Total current liabilities	**21**	**25**
Non Current Liabilities		
Deferred tax	36	115
Total non current liabilities	57	140
TOTAL LIABILITIES	57	140
NET ASSETS	**3,934**	**6,351**
represented by:		
Public Equity		
General Funds	3,934	6,351
TOTAL PUBLIC EQUITY	**3,934**	**6,351**

FORECAST STATEMENT OF CASH FLOWS

For the Year Ended 30 June

	Estimated 2004 $m	Forecast 2005 $m
Cash flows from operating activities:		
Cash was provided from		
Dividends and interest	60	128
Cash was applied to		
Operating expenses	49	80
Net cash flows from operating activities	11	48
Cash flows from investing activities:		
Cash was provided from		
Sale of investments	4,592	9,874
Cash was applied to		
Purchase of investments	8,391	12,029
Net cash flows from investing activities	(3,799)	(2,155)
Cash flows from financing activities:		
Cash was provided from		
Transfers from the Crown	3,794	2,107
Cash was applied to		
Net cash flows from financing activities	3,794	2,107
Net increase/(decrease) in cash held	5	-
Opening cash brought forward	-	5
Closing cash balance	5	5

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

1 Reporting entity

These are the financial statements of the New Zealand Superannuation Fund, a fund created under section 37 of the New Zealand Superannuation Act 2001. This Act commenced on 12 October 2001.

The New Zealand Fund is managed and administered by Guardians of New Zealand Superannuation. Guardians of New Zealand Superannuation was established as a new Crown entity by section 48 of the New Zealand Superannuation Act 2001 and became operative from 30 August 2002.

Annual capital contributions are made by Government into the New Zealand Superannuation Fund for investment, and for the purpose contributing to the cost of paying New Zealand superannuation after 2020.

2 Statutory base

The financial statements have been prepared in accordance with the Financial Reporting Act 1993.

3 Measurement base

These financial statements are based on the general principle of historic cost with the exception that investments and financial instruments are stated at market value.

4 Accounting policies

The financial statements are prepared in accordance with New Zealand generally accepted accounting practice. The accounting policies that materially affect the measurement of financial performance, financial position and cash flows are set out below.

(a) Budget figures

The budget was included in the Statement of Intent of the Guardians of New Zealand Superannuation and was approved by Guardians of New Zealand Superannuation on behalf of the New Zealand Superannuation Fund for the year.

(b) Capital contributions

(i) Fund capital contributions

The Crown is required to make contributions to the New Zealand Superannuation Fund in accordance with sections 42 to 44 inclusive of the New Zealand Superannuation Act 2001. These contributions are treated as capital contributions for accounting purposes.

(ii) Superannuation annual expense payments

The Minister of Finance, under section 45 of the New Zealand Superannuation Act 2001, must ensure that sufficient money is transferred into the New Zealand Superannuation Fund in each year to meet the net cost of New Zealand Superannuation entitlements. For accounting purposes these transfers are treated as capital contributions and are offset by capital withdrawals.

(c) Capital withdrawals

(i) Fund capital withdrawals

In terms of section 47 of the New Zealand Superannuation Act 2001 no withdrawals of Fund Capital are permitted in any financial year before 1 July 2020.

(ii) Superannuation annual expense payments

The net cost of New Zealand Superannuation entitlements are treated as capital withdrawals for accounting purposes. These amounts equate to the associated capital contribution.

The payment of New Zealand Superannuation is an expense of the Crown and is recorded separately in the Crown Financial Statements.

(d) Income tax

In accordance with section 76 of the Act the New Zealand Superannuation Fund is treated as if it is a body corporate for tax purposes and is therefore subject to income tax on any income derived from investments, and that income is to be treated as gross income of the Fund under the Income Tax Act 1994.

The income tax expense recognised for the year is based on the accounting surplus, adjusted for permanent differences between accounting and tax rules.

The impact of all timing differences between accounting and taxable income is recognised as a deferred tax liability or asset. This is the comprehensive basis for the calculation of deferred tax under the liability method.

Deferred tax is provided for on unrealised gains and losses in the value of investments.

A deferred tax asset, or the effect of losses carried forward that exceed the deferred tax liability, is recognised in the financial statements only where there is virtual certainty that the benefit of the timing differences, or losses, will be utilised.

(e) Investments

Fixed Interest Securities have been valued at the closing market value, excluding accrued interest. Equities and unit trust investments have been valued at their closing market value.

(f) Receivables

Receivables are stated at their estimated realisable value.

(g) Liabilities

Liabilities are stated at their estimated amounts payable.

(h) Income recognition

Interest income is accounted for on an accrual basis.

Dividends and distributions are recognised upon securities' and Funds' applicable 'ex-date'.

Any unrealised gains or losses arising from the revaluation of investments or conversion to New Zealand dollars as at balance date, and realised gains and losses on the sale of investments during the year are included in the statement of financial performance. Realised gains and losses are calculated with reference to the weighted average cost of investments sold during the year.

(i) Foreign currency transactions

Transactions denominated in a foreign currency are converted to New Zealand dollars at the exchange rates in effect at the date of the transaction.

Foreign currency monetary assets and liabilities at balance date are translated at the rates of exchange ruling as at that date.

Realised foreign exchange gains and losses represents gains and losses upon sale of investments that relate to foreign exchange movements in assets, and gains and losses upon settlement of forward exchange contracts. Unrealised foreign exchange gains and losses represent the translation of foreign denominated assets and liabilities.

(j) Statement of cash flows

The following are the definitions of the terms used in the statement of cash flows:

Operating activities include all transactions and other events that are not investing or financing activities, including cash flows from the settlement of forward foreign exchange contracts. Investing activities are those activities relating to the acquisition, holding and disposal of investments. Investments include securities not falling within the definition of cash.

Financing activities are those activities relating to capital contributions, and payments of superannuation expenses (from 2020).

Cash means cash balances on hand, held in bank accounts, demand deposits and other highly liquid investments in which the New Zealand Superannuation Fund invests as part of its day-to- day cash management.

Where cash is allocated to investment managers it is classified as Investments.

(k) Financial instruments

The New Zealand Superannuation Fund is party to financial instruments as part of its normal operations. These financial instruments include bank accounts, short-term deposits, investments, receivables and payables. Financial instruments, including derivatives that are hedges of specific items, are recognised on the same basis as their underlying hedged items. All financial instruments are recognised in the statement of financial position and all revenues and expenses in relation to financial instruments have been recognised in the statement of financial performance.

Short term deposits and investments have been recorded at net market value and all other financial instruments are shown at their estimated fair value.

All forward foreign exchange contracts are valued at market value.

(l) Changes in accounting policies

There have been no significant changes in accounting policies during the year.