“HOW WE INVEST” WHITE PAPER

INVESTMENT MANAGER SELECTION AND MONITORING

By Paul Gregory & Chris Jagger

AUGUST 2015

www.nzsuperfund.co.nz
email:enquiries@nzsuperfund.co.nz

NZSUPERFUND
Te Kaitiaki Tāhua Penihana Kaumatua ō Aotearoa

PREFACE

This paper provides an insight into how investment managers fit into the Fund's overall investment process and should be read in conjunction with our previous White Paper: *Investment Manager Skill*. A reading of our recent White Paper: *2015 Reference Portfolio* will also provide useful context.

Developing these papers has helped us provide a consistent vision to staff, to focus our time and resources appropriately and to avoid re-litigating some of the fundamental investment questions that investors deal with on an ongoing basis. I hope they also enhance your understanding of how we go about investing the NZ Super Fund.

Matt Whineray
Chief Investment Officer

FIND OUT MORE AT:
www.nzsuperfund.co.nz/publications/papers-reports-reviews

WHY APPOINT AN INVESTMENT MANAGER?

As discussed in more detail in the Reference Portfolio white paper, our default preference is for simple, listed, passive exposures. Thereafter, it is for active exposures which we manage ourselves. This is because we have most confidence in the expected return of an investment when it is simply the market return (for passive exposures), or, for active exposures we manage ourselves, because (i) we can see and articulate the return drivers and (ii) we can change the risk allocation through time, according to our view of the investment's attractiveness.

We use an investment manager only in circumstances where we do not have the capability to manage a particular investment ourselves; we do not have sufficient capacity to add a particular investment to the responsibilities of our internal teams; or we are not physically close enough to an investment to be confident in delivering the expected return.

We note that we make extensive use of investment managers for much of our passive market exposure, because they provide us with scale, systems and market breadth and depth capabilities that we don't have and at a very low cost such that we need not develop those capabilities in-house.

The remainder of this paper focusses on active managers – where we expect that they will deliver better than the market return for the risk that they take.

WHAT DO WE LOOK FOR?

Prior to commencing an investment manager search process for a particular investment opportunity, we have a very clear idea of why we need a manager in the first place. We have a view (which we expect the manager to help us refine during the search process) about:

- The **risks** of a particular opportunity and what capabilities are therefore necessary to manage them (financial and otherwise – e.g. an ability to manage corporate turnarounds; Environmental, Social and Governance risk);
- The **drivers of returns**, including how they might change;
- The **measures of success** i.e. what public markets equivalents and other performance hurdles we expect an investment manager to beat to demonstrate the value of using that manager's capabilities;
- The appropriate **cost** to access the investment, including fee structures to motivate the manager to best employ their capabilities in our interests, without materially eroding – or eliminating – excess returns;
- Our preference for **flexibility** so that we can retain control over allocation of risk/capital to the investment opportunity; and
- The potential for two-way **knowledge sharing** about the opportunity we have chosen the manager to access, and broader subject matter as appropriate to their experience and abilities.

These factors reflect what we have said in our *Investment Manager Skill* paper: it is not enough for us to be confident that we have found the capabilities we want. We must also be able to access them in a way which we believe maximises the alignment between the manager and ourselves, in meeting our investment objectives for our overall portfolio.

If we cannot align ourselves to the manager we have found – e.g. through fees, reporting requirements, structures that protect us against changes in strategy, ownership or key personnel – then we can still walk away. The Reference Portfolio is always available to provide us with highly transparent, low-cost, growth-oriented exposure.

HOW DO WE APPOINT AND MONITOR INVESTMENT MANAGERS WHO SATISFY OUR CRITERIA?

When we have satisfied ourselves that a particular manager has the capabilities we want, we focus on identifying the source(s) of those capabilities. Typically, this will be some combination of a manager's experience, strategy, discipline, processes and execution capabilities. All of these are tangible and measurable, which is crucial to our establishing confidence that the manager's capabilities are *repeatable*.

Isolating tangible contributors also means that we can identify what might threaten each, and establish a monitoring programme accordingly. This is the basis of our process for establishing and re-assuring ourselves, on an annual basis, that a manager will continue to produce the returns we expect (and to conduct itself more broadly as we expect).

WHAT ARE OUR APPOINTMENT AND MONITORING CRITERIA?

We use eight factors reflecting our view that for a manager's capabilities to be repeatable, a manager needs to demonstrate:

- Viability (they are credible and stable as an organisation e.g., financially, legally etc., such that they can deliver on their strategy over time);
- Structure & Focus (the legal structure and terms ensures that the manager's interests are aligned with ours);
- Trust (we are confident that the manager will do what they say they will do, and always act in our interests);
- Risk Awareness & Management (the manager has robust systems and processes for identifying, assessing, managing and reporting investment and non-investment risks);
- People Capabilities (the manager's team has the necessary competencies and depth to execute on the investment strategy);
- Process Capabilities (the manager has the necessary tools, systems, networks and processes to execute on the investment strategy);
- Opportunity Consistency (the manager can demonstrate that they understand our investment objective and how their strategy will deliver, and they consistently execute their strategy as we would expect); and
- Performance (the manager has demonstrated performance in executing on the investment strategy)

Each manager we appoint gets an initial score which is refreshed annually (or if something happens which requires a review sooner – e.g. if a key person leaves). A number of principles govern the review process:

- Where a score decreases to a certain point, the manager must act to rectify the problem or, where possible and appropriate, we will exit, terminate or suspend our relationship with the manager;
- We use multiple sources of information, not just reporting from the manager;
- We encourage input from other internal teams to each review, to ensure that the resulting score is a Fund-wide, and not an individual, view;
- We write reviews as simply and clearly as possible, with as much supporting information as possible, so that a first-time reader can understand why we have appointed a particular manager (and, beyond the first review, why we retain them);
- We share our high-level review conclusions with our managers – we see this as an ongoing process to improve investment performance in our external mandates and our portfolio as a whole.