NEW ZEALAND SUPERANNUATION FUND

# Guardians of New Zealand Superannuation

# Statement of Intent

## For the period commencing 1 July 2005

# Contents

# 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 2005/6 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 Board of the Guardians of New Zealand Superannuation ("the Board"), in accordance with section 53(1) of the Act.

# 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 assets of the Fund consisted of a transfer of Treasury bills totaling $2.402 billion on 30 September 2003. Subsequent contributions are calculated in accordance with a formula set out in section 43 of the Act. Based on estimates prepared by the Treasury, and forming part of the May 2005 Budget, these are expected to average $2.32 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 at least 30 June 2020. Detailed information on the background leading to the establishment of the Fund, the expected level of contributions by Government, the asset allocation and expected risk/return profile as well as 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 2005/6 financial year, the Fund's assets are expected to be $6.47 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*** |
|---|---|
| 2006 | $9.28 billion |
| 2007 | $12.30 billion |
| 2008 | $15.65 billion |

The Act makes it clear that the Guardians have responsibility for the management of the Fund's assets. Decisions relating to the business of the Guardians are 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 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.

The requirement to operate the Fund in line with global best practice brings both great opportunities and challenges. It has meant that the Board has, since inception, sought to identify organisations around the world that are distinguished for their results. Management has been encouraged to establish relationships with these organisations in order to learn from their experience. In general, this has proved to be a source of considerable insight and encouragement. Best practice is, by definition, evolving. In developing the Fund, the Board's position is that recommendations from management should reflect the distillation of internal research and external expert review. The source of the external review varies with the task but generally reflects the principle that where specialist insights are available these should be utilised.

The balance between risk and return in the portfolio has been a focus over the 2004/5 year with the first review of the Fund's strategic asset allocation being completed in early 2005. This resulted in a decision to progressively increase the weighting to non-listed assets (private equity, infrastructure, timber, absolute return strategies and commodities) to further diversify the sources of investment income to the Fund. The expected effect of this move is to reduce the overall risk in the Fund without compromising long term return expectations.

The combination of the Fund's long investment horizon, and the lack of need for liquidity, makes such a move achievable. In 2005/6 the focus will move to effectively implementing the increased allocation to these sectors. A detailed report on the analysis undertaken leading up to this change in asset allocation is available on the Fund's website.

The Guardian's objective is to ensure that neither the way its business is conducted, nor the composition of the investment portfolio, will prejudice New Zealand's reputation as a responsible member of the world community. To mitigate the risk of this occurring through the inclusion of inappropriate investments in the portfolio, the Guardians have developed a policy on responsible investment. In 2005/6 the emphasis will move to integrating the Fund's approach with that of other institutional investors around the world to improve its effectiveness. The policy forms part of the general statement of investment policies, standards and procedures.

The Board of the Guardians provides a quarterly report to the Minister of Finance on the progress of the Fund. The Board of the Guardians has responsibility for setting the investment strategy for the Fund. The Minister of Finance may, after consultation with the Board, give directions regarding the Government's expectations as to the Fund's performance, including the Government's expectations as to risk and return. The Act notes that such a direction must be in writing, signed and dated, and not be inconsistent with the Guardian's duty to invest the Fund on a prudent commercial basis. 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. No directions have been received by the Board to date.

The Act requires the expenses of the Guardians to be met out of money appropriated by Parliament for this purpose. Expenses directly related to the operation of the Fund, including payments to investment managers and custodians, are able to be paid out of the Fund.

# 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 Fund's assets. 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. It is also recognised, however, that there will be interest in performance over shorter periods of time. While updates are provided monthly on the Fund's website, measuring performance over rolling five year periods strikes an appropriate balance between organisational accountability for decision making and the very long investment mandate that the Guardians have been given.

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 (beta)*

The long investment horizon of the Fund, and the lack of need for short term liquidity, means that the Fund can be invested outside the risk free markets in the expectation that adequate reward will be received to compensate for the risk involved. A range of assets, which have traditionally provided investors with this premium above the risk free rate, are available to the Guardians. The size of the risk premium varies with different types of assets. The strategic asset allocation of the Fund reflects the Guardians' view of the most efficient combination of market risk premia.

### *(iii) Reward for active management risk (alpha)*

While the combination of market risk exposures is expected to make the main contribution to the Fund's return, the exploitation of market inefficiencies within some sectors is also expected to be relevant. This has generally been achieved by allowing portfolio managers to take positions away from the relevant index exposure in a given asset class on the basis that they have demonstrated skill in being compensated for this risk. Increasingly, through a range of emerging strategies, investors are also able to capture the skill of portfolio managers without needing to take exposure to the market in which the excess returns are being generated. These strategies are presently being explored by the Guardians on the basis that they may represent a more efficient way (i.e. greater probability of reward for the same amount of risk) to add additional return to the portfolio than a more traditional approach.

It must be noted that in some asset classes, the absence of a benchmark for the sector as a whole makes it difficult to clearly distinguish between the return offered by the market (beta) and the excess return from portfolio managers' skill (alpha). This applies to sectors like private equity and infrastructure. In these cases, excess returns for active management are often measured with reference to the most appropriate listed equity or debt market proxy plus a margin for the illiquidity.

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 sector, or active manager, the greater the likely variation in annual returns. It is also relevant to note that the expected return for the total fund 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 2005/6

While the investment strategy established by the Guardians is based on maximising returns over long periods of time, section 65 of the Act requires the Board to comment on its expectations about the performance of the Fund over the 2005/6 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 20 year periods. The investment strategy of the Guardians is designed to maximise this long term return. Accordingly, the Board places no particular emphasis on the expected rate of return on the Fund over a period as short as one year, and has no particular confidence in its one year estimates of returns.

For the purposes of meeting the requirement of the Act to provide a one year estimate, it is appropriate to work back from the longer term assumptions made by the Guardians.

In March 2005, the Guardians published a report on how the investment strategy of the Fund is expected to evolve over coming years. Assuming that the Fund moves relatively steadily to its revised asset allocation, and taking into account the expected long term returns for the full range of asset classes and the correlation between them, an estimate of the long term return of the Fund can be made.

Our analysis suggests that over the next 30 years, the average expected excess return over the risk free rate is approximately 3.75% with a volatility (equivalent to one standard deviation around this mid-point) of 1.90% (i.e. an excess return in the range of 1.85% to 5.65% two thirds of the time).

As part of the ongoing development of a rigorous risk budgeting framework by management, analysis of likely returns over the next 10 years has also been undertaken. This takes into account (in a way that the 30 year estimates do not) the current valuation levels in a range of asset classes. This analysis reveals that, at present, most asset classes are relatively highly priced in historical terms, and appear likely to deliver lower than their long term expected return over the next decade as values return to more sustainable levels. The result of this analysis is that for the current balance of the Fund, the expected excess return over the risk free rate over the next 10 years is likely to be approximately 1% lower than the expectation over the next 30 years (i.e. to be closer to 2.75% than the 3.75% outlined above).

In order to provide an estimate of the return over the 2005/6 financial year, the Board believes that the most suitable approach is to assume that the return will be equivalent to the average expected return for the current Fund balance over the next 10 years. Based on the approach outlined on page 6, the estimated return for the next decade, and therefore the Board's expectation of the return for 2005/6, is 8.65% (after deducting investment management costs).

The components are as follows:

- **The risk free rate @ 5.4%**:

  The Board has nominated the risk free rate, for the purposes of measuring the excess return generated by the implementation of its investment strategy, as the yield on 90 day NZ Treasury bills. This is measured each fortnight in line with contributions to the Fund.

  While there is no specific market mechanism for pricing in the future expected rate of return on such short term securities, 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 May 2005, yields on 10 year New Zealand Government debt have averaged close to 6.0%. Separating the implied rate of return for cash from the term premium is a judgment, 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 0.6% which suggests that the expected long term cash rate is 5.4% pa. In the Board's view this is a reasonable expectation for the average level of risk free return over the next ten years.

- **The reward for market risk @ 2.75%:**

  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. As discussed above, estimates of this reward are lower over the next 10 years than over the longer term as they reflect the expectation than most asset classes are presently highly valued and returns over the next stage of the market cycle will be more subdued as a result. While the period of time over which markets might return to more favourable valuations is not clear, given the present starting point a downward adjustment to expectations is appropriate.

  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 weighted average expectation across the entire Fund based on the targeted asset allocation. The Board believes that although this projection is low by historic standards, it is consistent with current expectations of informed mainstream investors.

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

  While considerable progress has been made by the Guardians in developing the capacity to generate sustainable returns from active management, including the recognition of the ability to separate active risk from market risk in implementing investment strategy, further work remains to be done in determining the exact contribution that is expected from this exposure as part of the Fund's risk budgeting model.

Work scheduled for 2005/6 will enable greater precision in estimating the contribution of active risk to the total risk budget, but in the interim it is appropriate to maintain the original estimate of 0.5% across the portfolio. This comprises the expected reward for active risk from market exposures, the contribution of 'market neutral' strategies which do not have associated market exposures, and the performance of private markets (private equity, infrastructure, timber etc) where the lack of clear market benchmarks means the measurement of active return is imprecise.

It is very important to note that there is significant uncertainty around the average estimated earnings over the next decade of 8.65% p.a. The estimated standard deviation of annual returns is in the order of 10% pa. This means that around two years in every three, returns would be expected to be between approximately minus 1.5% and +18.5%. Returns in the range of approximately minus 12% to + 29% could be expected around 95% of the time.

## 3.3 Variation in return from previous estimates

It is relevant to note that the Board's estimate of average returns of 8.65% pa over the next ten years is lower than the equivalent estimate in the June 2004 Statement of Intent (9.0%). This in turn was lower than the estimate in the 2003 Statement of Intent (9.2%) which coincided with the beginning of the investment programme.

As noted above, the reduction in expected earnings substantially reflects increases in market pricing over the period. Since the rally in developed sharemarkets began in mid 2003, these markets have delivered investors close to a 50% return on their holding (excluding currency movements). This leaves the ratio of share prices to corporate earnings comparatively high compared with historical averages. Taken as a whole, the earnings yield (the ratio of corporate earnings to current sharemarket prices) for global equity markets is about 5%. While long term growth in earnings means that expected returns will be above this level, both absolute returns and the margin above risk free interest rates are likely to be below what investors have historically enjoyed.

At the same time, yields on listed property are at 30 year lows and credit spreads for most grades of non-sovereign debt are near historic lows. While the move to 'alternative' asset classes will reduce the Fund's exposure to these pressures, the increasing demand for these assets from investors suggests it will take time to build meaningful exposures of appropriate quality assets.

While the role of the Guardians is to manage the Fund in a way to limit the effect of assets declining in value, in an environment where there are relatively few sectors which seem undervalued, it is appropriate to note that total returns over the next few years are likely to be lower than long term historic averages.

The objective of the Guardians remains to deliver a return which averages at least 2.5% above the risk free rate over rolling 20 year periods. Analysis of the expected earnings of the Fund's current strategy over the long term indicates that there is a very high probability of this target being exceeded but the Board acknowledges that given rather high current valuation levels across almost all sectors, and the expectation that these will return to longer term averages, achieving this level of excess returns over the shorter term may be more challenging.

# 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*

This issue has been specifically addressed in the previous section. 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 changes in interest rates which can be anticipated by, and priced into, markets.

Based on the assumptions referred to in section 3, and using the target asset allocation outlined in March 2005 (towards which the fund will be progressively moving), the probability of the Fund's returns exceeding the risk free rate over the long term (30 years) is approximately 98%. Over the same period, the probability of generating an excess return above the risk free rate of more than the target 2.5% is approximately 75%.

Over periods as short as one year, these probabilities are substantially lower (around 80% for a return greater than zero; around 60% for a return greater than the risk free rate; and 50% for a return more than 2.5% above the risk free rate).

### *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 higher after fee returns than the market would deliver entails the manager taking risk and these managers may fall short of the objectives set for them. 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.

### *4.1.3 Operational risk is not well managed*

The combination of asset classes within the portfolio, and investment managers within an asset class, substantially defines the investment policy of the Fund. These policy settings need to be efficiently implemented and the middle and back office services provided by the Guardians' service providers need to be of a consistently high quality.

There is a need to monitor portfolios for compliance with the investment mandates, ensure that asset valuations are correct, ensure that transaction costs in the portfolio are managed to minimise leakage and ensure that the portfolio is rebalanced in line with policy positions to ensure the Fund remains within target ranges for each asset class.

## 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 as possible. Attention will be paid to the following key areas:

### *4.2.1 Diversifying the Fund's investments to reduce 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. In considering the most appropriate combination of market exposures for the Fund, the Guardians acknowledge that the Fund's long investment horizon enables it to have exposure to a variety of assets that would not be appropriate for many shorter term 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.

A detailed review of the initial asset allocation was undertaken during 2004/5. This led the Board to conclude that the 80% allocation to growth assets remained appropriate but that the diversification benefits of exposures outside listed equity and debt markets were greater than first appreciated. With the first priority of building a portfolio of listed assets having been completed during 2004, the Board decided to focus on developing the Fund's unlisted assets programme over 2005.

As the published analysis shows, increasing the allocation to these sectors to around one third of assets is expected, over time, to lower the overall risk of the Fund. Continuing refinement of this analysis is a very practical step being taken by the Guardians to improve the efficiency of the risk and return profile of the Fund.

### *4.2.2 Using the allocation to active risk carefully*

Allocating risk to investment managers in order to generate above market returns (alpha) should only occur if there is a high degree of confidence in the manager to deliver this. The development of a rigorous internal methodology to establish a degree of conviction in external managers is a step taken by the Guardians to ensure the Fund's active risk allocation is prudent.

The Board requires management to undertake ongoing monitoring of active managers to confirm their credentials to continue to be allocated active risk. This is designed to ensure that the allocation of this type of risk does not become inadvertent.

While active risk has been traditionally attached to market exposures, the relatively recent initiatives to separate alpha and beta are of interest to the Guardians. Work scheduled during 2005 to become more familiar with these strategies should improve the efficiency of active risk in the portfolio.

### *4.2.3 Accessing quality advice*

In addressing these risks, it is desirable that the Board receives quality external advice to complement 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); and
- which are highly specialised (e.g. unlisted assets like private equity, forestry, property and infrastructure).

In setting the key policy framework for the Fund, it is the Board's practice that opinions from at least two sources are sought, at least one of which is external to the organisation.

### *4.2.4 Managing investment operations carefully*

To reduce the risk of investment performance being affected operational constraints or inefficiencies, a number of processes are adopted:

- Setting parameters around the strategic asset allocation and ensuring that the portfolio remains within these ranges through rebalancing;
- Reducing leakage from the Fund through the close monitoring of transaction costs incurred by managers and the custodian;
- Monitoring the performance of key service providers to ensure that the Fund's needs continue to be met;
- Developing appropriate risk management strategies and indemnity provisions to reduce the impact of operational losses; and
- Managing the tax efficiency of investment vehicles.

### *4.2.5 Managing foreign currency exposures*

The Guardians also recognise the risk to returns from movements in foreign currencies against the New Zealand dollar. Reflecting the favourable interest rate differential between New Zealand and most other markets, the Board's policy is to fully hedge its currency exposure in international bonds and hedge 90% of the currency exposure in the global equities portfolio to New Zealand dollars.

Given the historically high value of the NZD against most of the currencies to which the Fund is exposed, the Board has resolved to reduce the level of currency hedging on global equities from its policy level of 90% to 72.5% for the time being. This reflects the expectation that the NZD will return to a more sustainable level over the medium term. This risk will continue to be monitored, along with other market risks, as part of the ongoing risk budgeting framework.

# 5. Organisational structure and governance

## 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 2005/6 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. The Board has a formal delegation agreement with the CEO who, with the Board's approval, has further delegated some powers to other staff members. Observations of the most successful institutional investors suggest 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. The Board's view is that an investment in a small team of quality staff is a very effective strategy to ensure continuous improvement in the development of the Fund's investment strategy and the management of risks around its implementation.

At the commencement of the 2005/6 year, there will be the equivalent of 11 full time employees in the following areas. Two additional staff have been built into the operating budget over the 2005/6 year.

| **Area of Responsibility** | **Number of Positions** | **Roles** |
|---|---|---|
| General Management | 1 | Chief Executive |
| Investment Policy Development | 3 | Chief Investment Officer; Head of Public Markets; Research Analyst |
| Investment Operations | 3 | Head of Operations; Head of Strategic Projects; Investment Operations Manager |
| Finance and Audit | 1.6 | Chief Financial Officer; Financial Accountant |
| External Communications | 0.4 | Communications Manager |
| Office Management | 2 | Office Manager; Receptionist |

## 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 in appropriate areas. Leadership in the areas of asset allocation, risk budgeting and portfolio construction will be in-house with external advisors complementing this to ensure the Board has access to rigorously contested perspectives in setting investment policy.

In specialist areas, where it is not practical to develop adequate internal expertise at this stage of the Fund's development, appropriate experience will be accessed. This will include those alternative asset classes where the Fund is seeking to build a portfolio of investments and prospective opportunities need to be evaluated.

This approach has been adopted to date in the areas of New Zealand private equity and global timber assets. These relationships will, over time, lead to the Guardians developing the appropriate experience in these sectors to be able to evaluate the merits of future opportunities.

## 5.4 Investment Management Services

The core function of the Guardians is the development of the Fund's investment policy. This revolves around the setting of the asset allocation, adjusting this as appropriate in light of market conditions, and implementing this through allocations to external investment managers. It is the Board's intention that the day-to-day management of the Fund's assets will continue to be outsourced to specialist external managers. While this may be reviewed in time, especially in the domestic markets, at this point the Board believes the most effective use of management's skills is to focus on creating the most appropriate investment policy mix, and ensuring it is implemented efficiently whilst minimising operational risk.

# 6. Key priorities for 2005/6

The Board of the Guardians agrees an annual set of priorities for management as part of the business planning process. The business plan for the Guardians identifies the vision of the organisation as follows:

"By focusing on international best practice in portfolio design and implementation, and through developing a clear framework for balancing risk and return, we expect to develop into New Zealand's most respected institutional investor and be regarded as a centre of excellence internationally".

In order to achieve this vision, the Board has adopted the following guiding principles, and supporting strategic objectives.

| Guiding Principles | Supporting Strategic Objectives |
|---|---|
| • We recognise the opportunities that our long investment horizon gives us and we will develop an investment strategy that exploits these | • Intelligently use risk to deliver returns on Fund assets |
| • We aim to capture global innovation in the design of our investment portfolio without compromising rigour or prudence | • Operate to best practice standards by investing in ideas, and accessing advice and experience, from around the world |
| • We recognise that efficient implementation of investment policy generates value and we will confidently manage the attendant risks. | • Maximise earnings for the Fund through investing in operational efficiency while managing risks through effective controls. |
| • We recognise that we manage public assets and we need to be open in our dealings, and transparent in our reporting, in order to maintain confidence in our activities. | • Build and maintain relationships with stakeholders through open communication to support the achievement of the Fund's aims. |
| • We believe a commitment to good governance is critical to success | • Develop an internal governance model which clarifies responsibility and promotes accountability<br>• Invest in a talented and committed team of people. |
| • We acknowledge the importance of parties we outsource to and will invest in those relationships to maximise value and encourage mutual respect | • Build partnerships with external service providers to ensure the Fund's interests are continually advanced |

In turn the strategic objectives are supported by a range of operational objectives which the Board agrees with management annually. The key operational objectives for 2005/6 are as follows:

| | |
|---|---|
| 1. Intelligently use risk to deliver returns | • Enhance the risk budgeting framework to accommodate adjustments to the strategic asset allocation based on the relationship between current market pricing and forecast future returns<br>• Refine strategies for effective utilisation of active manager risk, including for separation of market and active risk in the portfolio, and building this into the risk budgeting model<br>• Implement allocations to infrastructure, commodities, property, timber and domestic private equity to build towards 2007 targets<br>• Develop and implement global private equity and absolute return strategies programme<br>• Further integrate policies for responsible investing, including engagement with investee companies, into portfolio management |
| 2. Operate to best practice standards | • Undertake comprehensive review of current model for middle/back office support to ensure adequacy for expected future requirements<br>Enhance database of Fund transactions to ensure future capability for portfolio analysis |
| 3. Maximise earnings through operational efficiency while managing risk through effective controls | • Formalise internal control policies and build into comprehensive risk management plan for the Fund<br>• Develop and implement internal audit programme<br>• Implement strategies for capturing transactional leakage from Fund and/ or for reducing operational risk. |
| 4. Build and maintain relationships with stakeholders | • Review structure and functionality of Guardians' website to promote greater understanding of Fund activities<br>• Maintain media and community profile to promote comfort with Guardians' operations |
| 5. Develop governance model and invest in talented and committed people | • Scope appropriate organisational model with balance of internal and external resources and undertake further recruitment as appropriate, for development of skills complemented by strategies for retention of skilled staff.<br>• Further develop the regime for accessing and leveraging off international experience in institutional management |
| 6. Build partnerships with external providers | • Review arrangements with key service providers to promote financial alignment through appropriate performance fees |

# 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.

Guardians of New Zealand Superannuation

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.

On 1 December 2004, the Minister of Finance announced an increase in the appropriation from which the expenses of the Guardians are to be met. For the 2005/6 and 2006/7 years, the gross annual appropriation is $5.30 million. As the Guardians must remit the GST on this appropriation to the Inland Revenue Department, the effective income from the appropriation for each year is $4.711 million.

In addition, the Guardians expect to carry forward an operating surplus of $400,000 from previous years. This will be allocated equally between the 2005/6 and 2006/7 years to fund expenditure in those years which did not take place in the 2004/5 year.

Accordingly, while the financial statements indicate an annual operating loss of approximately $175,000 in both 2005/6 and 2006/7, this will be covered by the surplus carried forward from previous periods.

Estimates of operating expenditure against this income for the 2005/6 and 2006/7 years are attached. This marks the end of the current appropriation cycle.

New Zealand Superannuation Fund

Forecast financial statements for the New Zealand Superannuation Fund are also provided. Investment income, after management expenses, is calculated based on the estimated earning rate of 8.65% which is outlined in section 3.2 of this report. Expenses incurred in delivering this income have been estimated as 0.50% comprised as follows:

- Investment management expenses (for both listed and unlisted assets) 0.39%
- Custody and other operations related expenses 0.09%
- Other investment related expenses (audit, SRI obligations etc) 0.02%

Tax on investment income has been applied at 31%

# Forecast financial statements for the Guardians of New Zealand Superannuation for the years ended 30 June

## 1. Projected Statement of financial performance

| | 2006 $000 | 2007 $000 |
|---|---|---|
| Income from Parliamentary Appropriation | 4,711 | 4,711 |
| Interest | 23 | 22 |
| **Total Revenue** | **4,734** | **4,733** |
| Board Related Expenses | 325 | 325 |
| Employee Remuneration and related costs | 2,488 | 2,488 |
| Staff Travel and Professional Development | 260 | 260 |
| Office Accommodation, Supplies, Telecommunications & Depreciation | 485 | 485 |
| External Communications | 75 | 75 |
| Professional Fees | 1,275 | 1,275 |
| **Total Expenses** | **4,908** | **4,908** |
| **Operating Surplus/(Deficit)** | **(174)** | **(175)** |

## 2. Projected Statement of Financial Position

| | Forecast 2006 $000 | Forecast 2007 $000 |
|---|---|---|
| **Non Current Assets** | | |
| Computer Equipment at cost | 229 | 309 |
| Leasehold Equipment at cost | 175 | 175 |
| Office Equipment at cost | 166 | 166 |
| Accumulated Depreciation | (320) | (447) |
| **Total non current assets** | **250** | **203** |
| **Current assets** | | |
| Cash & Receivable | 1,120 | 1,027 |
| **Current Liabilities** | | |
| Creditors and accruals | 644 | 677 |
| **Net current assets** | **476** | **350** |
| **Total Net Assets** | **726** | **553** |

## 3. Projected Statement of Cashflows

| | Forecast 2006 $000 | Forecast 2007 $000 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Cash provided from: | | |
| Appropriation for operating expenses | 5,300 | 5,300 |
| Cash disbursed to: | | |
| Operating expense | 4,944 | 5,040 |
| Net GST payable | 306 | 286 |
| **Net cash flows from operating activities** | **50** | **(26)** |
| **Cash flows from investing activities** | | |
| Cash provided from: | | |
| Capital appropriation from the Crown | 192 | - |
| Interest on bank account | 23 | 22 |
| Cash disbursed to: | | |
| Purchase of fixed assets | 82 | 90 |
| **Net cash flows from investing activities** | **133** | **(68)** |
| Net increase/(decrease) in cash held | 183 | (94) |
| Opening cash brought forward | 495 | 678 |
| **Closing cash balance** | **678** | **584** |

# Forecast financial statements for the New Zealand Superannuation Fund for the years ended 30 June

## 1. Forecast Statement of Financial Performance

| | Estimated 2005 $m | Forecast 2006 $m |
|---|---|---|
| Investment Income | 624 | 684 |
| **Total Operating Income** | **624** | **684** |
| Manager Fees | 15 | 30 |
| Custody Fees | 5 | 7 |
| Other Costs | 1 | 1 |
| **Total Expenses** | **21** | **38** |
| **Net Operating Income Before Tax** | **603** | **646** |
| Income Tax expense | 192 | 200 |
| **Net Operating After Tax** | **411** | **446** |

## 2. Forecast Statement of Movements in Taxpayers' Equity

| | Estimated 2005 $m | Forecast 2006 $m |
|---|---|---|
| **Public Equity as at 1 July** | **3,956** | **6,474** |
| Net Surplus after tax | 411 | 446 |
| **Total Recognised Revenue and Expenses** | **411** | **446** |
| Capital Contributions from the Crown | 2,107 | 2,337 |
| **Public Equity as at 30 June** | **6,474** | **9,257** |

## 3. Forecast Statement of Financial Position

| | Estimated 2005 $m | Forecast 2006 $m |
|---|---|---|
| **ASSETS** | | |
| **Current Assets** | | |
| Cash | 10 | 10 |
| Receivables | 57 | 57 |
| **Total Current Assets** | **67** | **67** |
| **Non Current Assets** | | |
| Investments | 6,492 | 9,379 |
| **Total Non Current Assets** | **6,492** | **9,379** |
| **TOTAL ASSETS** | **6,559** | **9,446** |
| **LIABILITIES** | | |
| **Current Liabilities** | | |
| Payables and accruals | 57 | 58 |
| Provision for tax | 2 | 1 |
| **Total Current Liabilities** | **59** | **59** |
| **Non Current Liabilities** | | |
| Deferred Tax | 26 | 130 |
| **Total Non Current Liabilities** | **26** | **130** |
| **TOTAL LIABILITIES** | **85** | **189** |
| **NET ASSETS** | **6,474** | **9,257** |
| Represented by: | | |
| **Public Equity** | | |
| General Funds | **6,474** | **9,257** |
| **TOTAL PUBLIC EQUITY** | **6,474** | **9,257** |

## 4. Forecast Statement of Cash Flows

| | **Estimated 2005 $m** | **Forecast 2006 $m** |
|---|---|---|
| **Cash flows from operating activities:** | | |
| *Cash provided from* | | |
| Dividends and interest | **165** | **129** |
| | | |
| *Cash was applied to* | | |
| Operating expenses | 210 | 135 |
| Net cash flows from operating activities | (45) | (6) |
| | | |
| **Cash Flows from investing activities:** | | |
| *Cash was provided from*: | | |
| Sale of Investments | 2,697 | 3,900 |
| | | |
| *Cash was applied to* | | |
| Purchase of Investments | 5,076 | 6,231 |
| Net cash flows from investing activities | (2,379) | (2,331) |
| | | |
| **Cash flows from financing activities:** | | |
| *Cash was provided from:* | | |
| Transfers from the crown | 2,107 | 2,337 |
| | | |
| **Net cash flows from financing activities** | **2,107** | **2,337** |
| | | |
| **Net increase in cash held** | **(317)** | **(0)** |
| | | |
| Opening cash brought forward | 327 | 10 |
| **Closing cash balance** | **10** | **10** |

# Notes to the Financial Statements

## 1) <u>Reporting Entity</u>

These are the financial statements of the New Zealand Superannuation Fund (the "Fund"), a fund created under section 37 of the New Zealand Superannuation Act 2001 (the "Act"). This Act commenced on 11 October 2001.

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

The Crown is required to make capital contributions to the Fund for investment based on a percentage of GDP as set out in the Act.

Capital contributions are made by the Crown into the Fund on a fortnightly basis for the purpose of investment, and funding the net cost of New Zealand superannuation entitlements ("superannuation entitlements").

## 2) <u>Statutory Base</u>

The financial statements have been prepared in accordance with the Financial Reporting Act 1993 and the New Zealand Superannuation Act 2001.

## 3) <u>Measurement Base</u>

The financial statements have been prepared on the basis of historic cost with the exception that certain assets and liabilities are measured at market value.

## 4) <u>Specific Accounting Policies</u>

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

### *4.1 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.

### *4.2 Capital Contributions*

*a) Fund Capital Contributions*

The Crown is required to make capital contributions to the Fund in accordance with sections 42 and 44 inclusive of the Act. Fund capital contributions are made by the Crown to the Fund on a fortnightly basis for investment for the purpose of contributing to the net cost of paying New Zealand superannuation entitlements after 2020. These capital contributions are recorded in the statement of movements in taxpayers' equity.

*b) Superannuation entitlement payments*

The Minister of Finance, under section 45 of the Act, must ensure that sufficient money is transferred to the Fund in each year to meet the net cost of superannuation entitlements. These transfers are treated as capital contributions from the Crown in respect of funding the net cost of superannuation entitlements and are offset by capital withdrawals and recorded in the statement of movements in taxpayers' equity.

### *4.3 Capital Withdrawals*

*a) Fund Capital Withdrawals*

Under section 47 of the Act, no withdrawals of fund capital contributions are permitted in any financial year before 1 July 2020.

*b) Superannuation entitlement payments*

The net cost of superannuation entitlements are treated as capital withdrawals by the Crown in respect of funding the net cost of superannuation entitlements and are recorded in the statement of movements in taxpayers' equity. These amounts equate to the associated capital contributions. The payment of superannuation entitlements is an expense of the Crown and is recorded in the Crown financial statements.

### *4.4 Income Tax*

In accordance with section 76 of the Act the 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 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 on 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.

### *4.5 Investments*

Fixed interest securities are valued at the last quoted sales price as of the closed of business on the day the securities are being valued. Equities are stated at the end of the day market value as quoted by the relevant exchange at balance day. Investments in unit trusts are stated at market value based on unit prices provided by the underlying fund manager at balance date.

Investments in alternative assets are generally held in the form of listed securities, pooled vehicles or unlisted securities. Listed securities are stated at the end of day market value as quoted by the relevant exchange at balance date. Pooled vehicles are stated at market value based on prices provided by the underlying fund manager at balance date. Where investments are held other than by way of listed securities or pooled vehicles they are valued according to accepted market practice to approximate as closely as possible fair value, based on independent valuations at balance date.

### *4.6 Receivables*

Receivables are stated at their estimated realisable value.

### *4.7 Income Recognition*

Interest income is accounted for on an accrual basis. Divided income and distributions are recognised on the 'ex-date'.

Any unrealised gains and losses arising from the revaluation of investments or conversion to New Zealand dollars 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

### *4.8 Foreign Currency Transactions*

Transactions denominated in a foreign currency are converted to New Zealand dollars ("NZD") at the exchange in effect at the date of the transaction. Foreign currency monetary assets and liabilities at balance date are translated at the rate of exchange ruling as at that date.

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

### *4.9 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.

**Investing activities:** are those activities relating to the acquisition, holding and disposal of investments. Investments include securities not falling within the definition of cash, including cash flows from the settlement of forward foreign exchange contracts.

**Financing activities:** are those activities relating to capital contributions and to payments of superannuation entitlements (from 2020). As the current funding by the Crown of superannuation entitlements flows directly from the Treasury to the Ministry of Social Development it is not considered cash flow of the Fund is accordingly not recorded in the statement of cash flows.

**Cash:** and cash equivalents is includes cash balances on hand, held in bank accounts, demand deposits and other highly liquid investments in which the Fund and its managers invest as part of its day-to-day cash management.

### *4.10 Financial Investments*

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

Investments are recorded at market value, which equates to fair value, and all other financial instruments are shown at their estimated fair value.

All forward foreign exchange contracts are valued at market value based on the 4pm London close.

### *4.11 Prior Year Comparatives*

Certain prior year comparatives have been reclassified to conform to current year presentation.

## 5. Changes in Accounting Policies

During the year, the accounting policy for alternative assets was established. This policy is consistent with GAAP and best industry practice.