



21 March 2016

Hon Bill English
Minister of Finance
Parliament Building
Private Bag 18888
WELLINGTON

Dear Minister

ANNUAL LETTER OF EXPECTATION

Thank you for your letter of 4 December 2015 setting out your expectations of the Guardians of New Zealand Superannuation ("Guardians") and of our 2016/17 Statement of Performance Expectations and Statement of Intent.

Shareholder returns

We note the Minister's focus on the importance of the New Zealand Superannuation Fund ("Fund") achieving its long-term performance objectives.

The Fund has a strong performance track record, having returned 9.05% p.a.¹ since inception in 2003. Over its lifetime, it is ahead of its key performance benchmarks, having:

- exceeded the passive Reference Portfolio benchmark by an estimated \$4.0 billion; and
- exceeded the Treasury Bill return, a measure of the Government's cost of debt, by \$11.6 billion.

It is important to take a long-term view of Fund performance. Monthly and annual returns will reflect varying and often volatile market conditions. The Fund is fortunate in being able to look through and profit from short-term market cycles.

The Guardians' investment approach and strategies are designed to leverage the Fund's competitive advantages as a long-term, operationally-independent sovereign investor with a certain liquidity profile. Over the long-term (rolling 20 year periods), based on the Fund's current, growth-oriented risk/return profile, we estimate that the Fund will exceed the equilibrium Treasury Bill return by around 3.7% p.a.. At this level of return, the Fund will therefore add many billions of dollars to Government and national savings, over and above the alternative option of reducing Government debt. This expectation is based on economic logic, long-term historical investment performances, and our modelling of likely future outcomes. This research is also supported by global expert opinion and the global investment practice of the vast majority of long-term endowment and pension funds.

The longer the time frame, the higher our level of confidence that the Fund will add value over and above its benchmarks.

¹ Performance return figures are unaudited and provided after costs, before NZ tax.

Crown Asset Liability Management

We will continue to provide information and support to Treasury as part of the work-stream to understand and test the resilience of the Crown balance sheet.

Investment Management Expenses

We note your expectation that costs incurred in implementing our investment strategy are appropriate in the context of managing Crown assets. We recognise that controlling costs is central to maximising investment returns for the taxpayer. We only invest actively when we have a high level of confidence that doing so will generate stronger risk-adjusted net returns than the low-cost, passive equivalent. We continue to focus on managing fees paid to external managers and achieving operational efficiencies. The Fund continues to out-perform peer fund value and cost benchmarks, as shown by the annual CEM Cost-Effectiveness Survey available on our website.

Use of derivatives

We note your expectation that Crown Financial Institutions should use derivatives judiciously. Our approach reflects these expectations. We continue to shift our portfolio exposures between physical and synthetic access points according to whichever option is the most cost-effective and efficient at the relevant point in time. Where we do use derivatives, comprehensive liquidity monitoring and reporting, and counterparty risk management measures, are in place. Board reporting processes for derivatives include confirmations from management that the use of derivatives has been judicious.

General Expectations

We acknowledge and understand your expectations regarding Crown scrutiny of large investments; joint ventures; CFI collaboration; the Statement of Performance Expectations; Official Information Act requests; and 'no surprises' policy.

Expectations specific to the Guardians: International Forum of Sovereign Wealth Funds Annual Meeting

This meeting will be held 8-11 November 2016 in Auckland. We will continue to keep you and your officials apprised of progress.

On behalf of the Board, I would like to thank you for your support of the Guardians' independence. The Guardians' ability to invest the Fund on a commercial basis, free of political interference, is an important endowment and continues to be central to the Fund's success.

Yours sincerely



Catherine Savage
Chairperson