NZSUPERFUND
Te Kaitiaki Tahua Penihana Kaumātua o Aotearoa

C3 - Restricted Confidential

24 December 2019

Hon Grant Robertson
Minister of Finance
Parliament Building
WELLINGTON

By email: Grant.Robertson@parliament.govt.nz

Dear Minister,

Re: Annual Letter of Expectations

Thank you for your letter of 24 October outlining your expectations for the Guardians of NZ Superannuation. I am happy to provide you with our response, setting out our vision for how the NZ Super Fund can contribute to our country's economic, social and environmental wellbeing, at the same time as fulfilling our mandate of best-practice investing to help smooth the future cost of providing universal superannuation.

We appreciate your acknowledgement of the work of the Board over the past year and have valued the engagement we have had with you and other members of the coalition government.

Fit for purpose

Under the NZ Superannuation and Retirement Income Act 2001, the Guardians must invest the NZ Super Fund on a prudent, commercial basis and, in doing so, must manage and administer the Fund in a manner consistent with:

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

Being fit-for-purpose means ensuring we are meeting each of these requirements, which are explored in more detail below.

Best practice portfolio management

The Guardians has identified several endowments that enable us to deliver on our purpose, including:

- long-term horizon - we have the ability to invest in illiquid assets and to ride out short-term market movements;
- known liquidity profile - we have a public funding formula that determines our cash flow;

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- operational independence - Fund investments are made on a purely commercial basis, and;
- sovereign status – this is often favourably regarded by business partners and allows us to pay lower tax in some jurisdictions.

These endowments, which arise from the structure of the Fund itself, optimise the Guardians' ability to generate superior investment returns over what could be achieved by passively tracking the market. This expectation is based on economic logic, long-term historical investment performances, and our modelling of likely future outcomes. This research is supported by global expert opinion and the global investment practice of the vast majority of long-term endowment and pension funds.

Part of our ongoing best practice portfolio management includes running scenarios on market changes; running lower levels of risk when assets expensive, and planning for shocks. We will continue to keep you informed on these and other investment performance activities that impacts the Fund’s ability to meets its purpose, in addition to our ongoing programme of reporting to Treasury, and other processes such as the Reference Portfolio review.

Taxation
As part of creating the conditions for best practice portfolio management, we continue to advocate to officials for the benefits of making the NZ Super Fund tax exempt, given most comparable domestic and international peer funds have this status. The current situation creates:

- a deadweight cost (from having to manage taxation requirements),
- an actual cost from not being able to claim sovereign tax exemption status in other countries (meaning we pay tax in some foreign jurisdictions), and
- most importantly, results in real withdrawals from the Fund in periods when contributions are suspended. In ‘normal’ times when government is contributing to the Fund, any tax paid is netted off by higher contributions to ensure the Fund meets the objective of covering a certain level of superannuation cost. In periods when contributions are suspended, the Fund still pays tax, in effect “withdrawing” capital that would otherwise be available to invest and therefore deferring the point the Fund can fully contribute to smoothing the cost of New Zealand superannuation.

We were pleased the Taxation Working Group supporting ending this anomaly and urge you to consider granting the exemption as part of Budget 2020, given it will result in no change to the Government’s financial statements.

Independent Review
As you note, the 5-yearly Independent Review was carried out this year by respected global business advisory firm Willis Towers Watson. The review was very useful for us and in the coming year, the Guardians will be considering and implementing the relevant findings of the review; key pieces of work include:

- reviewing our investment beliefs – this work is being done as part of our review of the Reference Portfolio and future target state review;

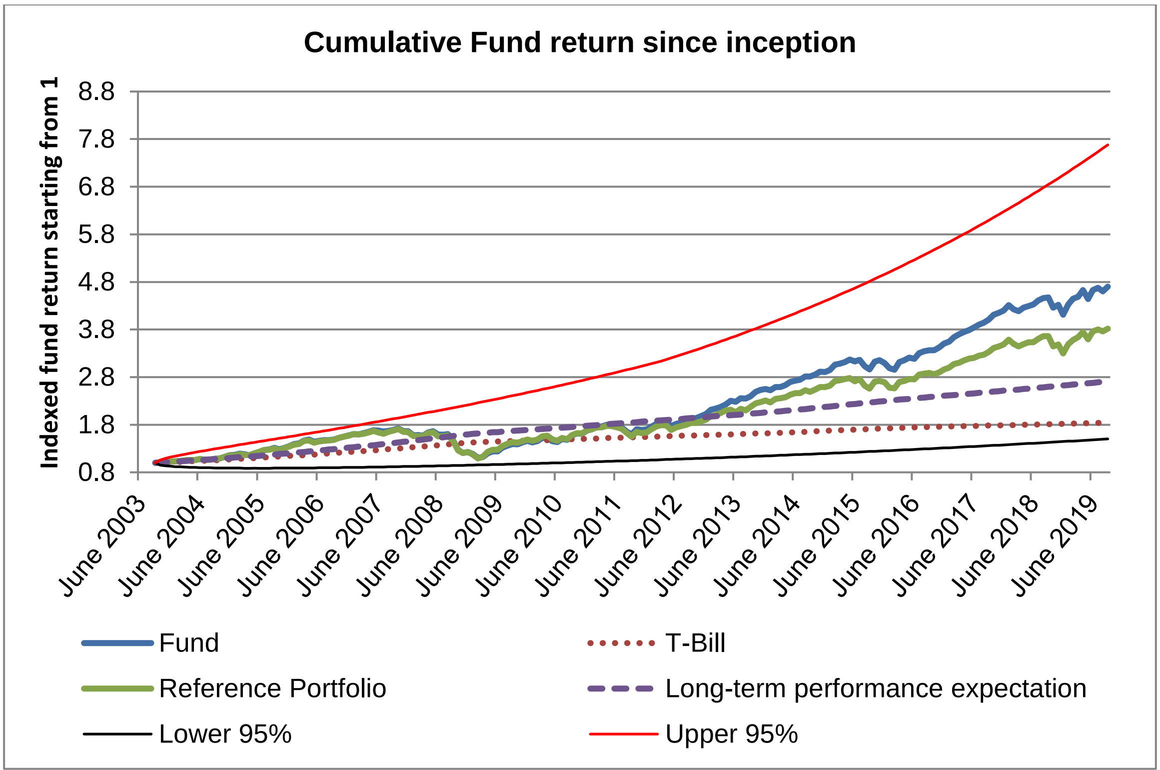
- increasing focus on responsible investment – next year we will be refreshing our responsible investment approach and are currently in-market recruiting for an additional RI team member, and;
- reviewing our remuneration structure and design – the review found the Guardians has "below average" remuneration rates compared to similar institutions. We are conscious of the public sector considerations concerning remuneration. However, these need to be balanced against our need to attract and retain the best people in order to secure the ongoing success of the Fund particularly as we consider our ability to compete in a highly competitive market for this talent.

We are working on our response to the review and envisage updating our formal response by June 2020 once the relevant work streams have been completed. In addition, we are also open to engaging with other CFIs on insights gained from the review that might be relevant to their respective organisations.

Crown risk

The Fund's long-term horizon means it is able to adopt a higher risk/higher return profile, made up of 80% growth assets (equities) and 20% fixed income (bonds and other instruments). We are confident that risk management processes, both in terms of investment risk and enterprise risk, are in line with global best practice investment management.

Since inception in September 2003 the Fund has returned 10.10% p.a. (after costs, before NZ tax). It has exceeded the 90-day Treasury Bill return by 6.23% or $26.1 billion, and the Reference Portfolio by 1.41% p.a. or $8.5 billion. The below graph show the Fund's relative performance since inception:



Sharpe Ratio
In 2017 we began reporting the Fund's Sharpe Ratio in our Annual Reports. This ratio compares the portfolio returns above cash returns as a ratio of the volatility of returns. The higher the ratio, the greater the return for the risk taken, and vice versa.

The Sharpe ratio enables us to compare the risk-adjusted performance of our benchmark, the Reference Portfolio, with that of our Actual Portfolio, and also against our expectations.

	Since introduction of Reference Portfolio (July 2010) to 30 June 2019	Since inception (Dec 2003) to 30 June 2019
Reference Portfolio Sharpe ratio* (expected)	0.20	0.20
Reference Portfolio Sharpe ratio (realised)	1.24	0.49
Actual Portfolio Sharpe ratio (expected)	0.26	0.26
Actual Portfolio Sharpe ratio (realised)	1.36	0.54

Our long-run expectation is that the 80% growth, 20% fixed income Reference Portfolio will achieve a Sharpe ratio of 0.20. For the Actual Portfolio, we expect a slightly higher Sharpe ratio of 0.26, representing an increase in return for the value we expect to add through active investment, adjusted for the risk taken to generate this.

The Reference Portfolio has generated a higher Sharpe ratio than the 0.20 we expected. On a since inception basis, the Sharpe ratio of the Reference Portfolio is 0.49. Since its introduction in 2010, the Reference Portfolio has had a Sharpe ratio of 1.24. This means that the Reference Portfolio has experienced higher than expected returns, and lower than expected risk, over both periods.

The Actual Portfolio has also generated a better Sharpe ratio than we expected, over both periods. Since July 2010, the Actual Portfolio's realised Sharpe ratio has been 1.36, greatly exceeding the expected ratio of 0.26. Again, this has been driven largely by returns exceeding expectations and, to a lesser extent, lower than expected risk. On a since inception basis, the Actual Portfolio has realised a Sharpe ratio of 0.54. Over both periods, the Sharpe ratio of the Actual Portfolio compares favourably with that generated by the Reference Portfolio.

CFI Information Strategy project
Treasury has indicated it is aiming to recommence its information strategy project in 2020. This project seeks to implement a repeatable data collection process that enables aggregated reporting and the collection of key credit and market risk data, in order to better understand their implications to the Crown. The primary objective is to support Treasury's understanding of aggregated investment and risk exposures and support fiscal strategy planning. The Guardians looks forward to engaging with Treasury on this piece of work to ensure that the necessary data can be provided in an efficient and cost effective way.

Use of derivatives
The Guardians utilises derivatives primarily to hedge risk in the portfolio. As part of the board's oversight and compliance monitoring role, we receive an attestation from the General Manager of Portfolio Completion and Chief Investment Officer that there is clear

visibility of where the Guardians has used derivatives, either as hedges, cost efficient access points to passive reference portfolio exposures, or active positions consistent with internal investment mandates; and we have robust supporting control frameworks, including:

- counterparty controls;
- liquidity replenishment systems, and;
- collateral mandates management including minimum liquidity requirements.

We are comfortable that management has the requisite skills and is applying appropriate control, policies and procedures to these instruments.

Partnership

Recognising that we occupy an important part of the investment landscape in New Zealand, the Guardians is committed to taking a proactive leadership role in promoting good corporate governance in New Zealand companies and in helping lift and improve knowledge levels in financial institutions across the country.

Sustainable Finance Forum
Our major external piece of local engagement focused on the Aotearoa Circle's Sustainable Investment Forum. Our CEO Matt Whineray co-chairs the Forum alongside Westpac's Karen Silk. Recently it launched an interim report into how New Zealand's financial system can support transition to a low emissions, resource efficient, just and inclusive economy.

The Aotearoa Circle is a partnership of public and private sector leaders who are working to build sustainable prosperity by reversing the decline of our natural resources. It is seeking submissions on the interim report, with the goal of producing a final report in July 2020.

Otago University Chairs of Investment Committees
Recently we co-organised the inaugural Chairs of Investment Committees event with Otago University. The one-day event was attended by approximately 50 people from investment entities of various sizes and focused on twin themes of best-practice governance for investment committees and their boards, and the importance of including environmental, social and governance factors in investment decisions. We envisage this becoming an annual event and hope it results in valuable insights being shared across New Zealand's investment community.

Other activities
This year Guardians staff have also been involved in helping develop financial and investment management expertise with several other public sector institutions, including:

- Supporting establishment of the Green Investment Fund;
- Continuing provision of responsible investment expertise to ACC, Government Superannuation Fund and National Provident Fund, and
- Ongoing engagement in with the Pacific Island Investment Forum, including support for harmonising regulatory mattes across the Pacific to better facilitate local co-investment by sovereign wealth, pension and other funds.

Citizenship

Contribution to New Zealand's economic wellbeing
The NZ Super Fund is now an important part of the New Zealand economy. Overall, just over NZD6.3 billion of the Fund invested in New Zealand, or 14% of total investments. To provide context about the relative size of our local investments, while New Zealand makes up just 0.1% of listed global equities, approximately 4% of the Fund is invested in local

shares. Internationally a further NZD1 billion of the Fund is invested directly in companies that are an extension of activities here in New Zealand.

While dollar figures of Fund investments in New Zealand increased from NZD2.4 billion to NZD6.3 billion in the 10 years since 1 July 2009, the proportion of the overall Fund that is invested in New Zealand (in value terms) has reduced from 21.3% to 14%. The proportional drop also reflects the strong performance of global equities in recent years, even after significant new investments by the Guardians in New Zealand.

While we envisage continued growth in exposure to local assets and continue to work via the NZ Investment Hub for opportunities, it is important to note that given the increasing total size of the Fund, the percentage invested in New Zealand will likely continue to drop.

Capital Markets Taskforce
Guardians CEO Matt Whineray sat on the steering committee that produced the Capital Markets 2029 report aimed at improving the functioning and effectiveness of New Zealand's investment and financial system

Responsible investment
Part of the Willis Towers Watson review focused on the Fund's Ethical Investment Framework. It evaluated the framework in relation to our legislative requirement to manage the Fund in a manner consistent with "avoiding prejudice to New Zealand's reputation as a responsible member of the world community", as well as in the context of international best-practice standards.

One of the Fund's key investment beliefs is that identifying and managing ESG factors helps us to find new opportunities, steer our capital towards more attractive areas, and manage long-term investment risks. We expect that our returns will be higher, and downside risks lower, over the long term.

The independent report says responsible investment is a rapidly developing area of investment practice that is set to become increasingly mainstream. It found the Guardians' approach to responsible investment to be impressive and said there was a need to continue to evolve and innovate to maintain the Fund's leadership position in the area, for which more resource would be needed in the future. To this end the Fund is looking to add capacity to its RI team.

Social media investor initiative
New Zealand's CFIs are leading a global collaborative engagement with Facebook, Twitter and Alphabet in response to the livestreaming and distribution on social media platforms of the murders of 51 people in two mosques located in Christchurch. There are now 95 investors participating in the engagement, representing over NZD12 trillion of assets under management.

The objective of the engagement is for the social media companies to strengthen controls to prevent the live streaming and distribution of objectionable content (defined as content that promotes or supports, or tends to promote or support, acts of torture, terrorism or the infliction of extreme violence or extreme cruelty). We have been working closely with the Prime Minister's office to ensure our engagement complements the work of the Christchurch Call.

We acknowledge that the companies have made progress towards strengthening controls to prevent objectionable content being livestreamed and shared across platforms. Technological advances and cross industry collaboration are progressing well. But, in our view, the companies have not given us confidence that the risk is managed with the appropriate level of governance and proportionality to the scale of the problem. Engagement is ongoing.

Also in response to the Christchurch shootings, the New Zealand Government quickly announced its intention to ban the kinds of semi-automatic weapons used in the attack. The Guardians moved in concert to introduce a new category of ethical exclusions: companies involved in the manufacture of civilian automatic and semi-automatic firearms and magazines or parts prohibited under New Zealand law.

Climate change

The aim of the NZ Super Fund Climate Change Investment Strategy is to improve investment resilience to climate change risk over the long-term horizon of the Fund. In June 2017, we transitioned our NZD14 billion passive global equity portfolio (constituting 40% of the Fund) to low carbon, selling our passive holdings in 297 companies worth NZD950 million.

We re-applied our carbon exclusion methodology in June 2018, and again in June 2019, and have expanded our due diligence and manager monitoring processes to incorporate analysis of climate change factors, including an assessment of each external manager's ability and commitment to adhering to our climate change objectives. This year, we also made further progress in reducing the carbon exposure of the Fund's actively managed equity holdings, such as transitioning our emerging markets portfolios to a lower carbon approach.

In 2016, we developed carbon reduction targets for the overall Fund. Measured relative to our original Reference Portfolio, by 2020 we aim to:

1. Reduce the carbon emission intensity of the Fund by at least 20%, and
2. Reduce the potential emissions from reserves of the Fund by at least 40%.

We use carbon foot printing to measure the carbon exposure of the Fund and to track progress towards our 2020 carbon reduction targets. Our 2019 carbon footprint assessment reported that the total Fund's carbon emissions intensity is 42.9% lower than our baseline level, and its exposure to potential emissions from reserves is 51.9% lower.

In 2017 we created a bespoke methodology for reducing our carbon exposure of our listed portfolio based on independent third party data on emissions intensity and fossil fuel reserves provided by MSCI ESG Research. Our focus was on stocks with high carbon footprints without regard to sector. The methodology identifies stocks that exceed thresholds for either emissions intensity or for fossil fuel reserves, and which are not considered to be standout performers. Specifically, stocks in the top quartile of MSCI ESG Research's "Carbon Emissions" score – reflecting less risk due to better management than their peers with respect to climate issues have been retained in the portfolio.

Stocks that were not in the top quartile have been eliminated from the portfolio one-by-one until we met specific reduction targets for the passive physical global equity portfolio. These targets were set at -70% carbon fossil fuel reserves and -50% emissions intensity compared to the Reference Portfolio. Given we met our 2020 targets, over the next financial year work will be undertaken to review our targets and to assess if and where in the portfolio further carbon reductions can be made.

Aside from the Fund, the Guardians was pleased to achieve Toitū carbonzero certification (a recent rebrand of what was Enviro-Mark Solutions' carboNZero certification). The vast majority of our emissions have been incurred through air travel, following by office electricity use and waste to landfill, which have been offset by purchase carbon credits. We are also happy to report our overall emissions profile is down from previous years, even as the Fund has grown.

We are also involved in the C100+ programme, which is an investor initiative focused on the world's largest corporate greenhouse gas emitters. Since launch in December 2017, the C 100+ has grown into one of the largest investor-led engagement initiatives with over 370 investor signatories representing over US$35 trillion in AUM. Currently, 161 global companies have been engaged across 33 markets accounting for up to 80 percent of global industrial emissions. They are critical to the decarbonisation of investment portfolios and the global economy. We are not leading on any companies, as none of the top 100 emitters are New Zealand-based. However, we are supporting engagement with: Coal India, Lukoil, Petrochina and PTT as these companies are already on our Engagement Focus List for other issues.

We also continue to be involved in the One Planet Sovereign Wealth Fund initiative with MFAT and international peer funds to increase efficiency in global capital allocation, share knowledge and collaborate towards the smooth transition to a more sustainable, low-carbon economy.

Other RI initiatives:

- **Mining and Tailings Safety Initiative** – NZ Super Fund was one of the first organisations to support this initiative in the days following the tailings dam collapse in Brazil in January this year.
- **Transition Pathway Initiative** – provides detailed insights that help us understand how the companies in our portfolio are preparing for a low carbon economy. The insights can help us position the Fund to be more resilient to the risk associated with climate change.
- **Modern Slavery** – In August 2018, NZ Super Fund Head of Responsible Investment Anne-Maree O'Connor was appointed a Commissioner for the United Nations Finance Commission on Modern Slavery and Human Trafficking. The Commission will serve as a time-bound forum for a wide range of financial sector stakeholders to discuss the sector's role in tackling modern slavery and human trafficking. Bringing together members of the survivor community, hedge funds, institutional investors, retail banks, global regulators, and the United Nations, the Commission will develop a concrete roadmap to accelerate action by the financial sector in combating modern slavery. A two-year initiative, the final report titled 'The Finance Sector Roadmap on Combatting Modern Slavery and Human Trafficking' was released at the United Nations General Assembly in September 2019.
- **Winter cropping taskforce –** we welcomed the Government's establishment of the taskforce and have worked closely with DairyNZ and MPI on issues relating to animal welfare on our farms. While no systemic issues have been identified with our operations, we are working through several recommendations for improving procedures, so on-farm activities meet the high-level expectations of our environmental and animal welfare policies.

- **Corporate Governance Forum –** our Head of Responsible Investment Anne-Maree O'Connor continues to play a role in the Forum to support development of better ESG disclosure processes for New Zealand, so they can be better assessed by investors.

Expectations Specific to the Guardians

Venture Capital Fund
We have formed close working relationships with Treasury, the Ministry of Business, Innovation and Employment and NZ Venture Investment Fund on the establishment of the new Venture Capital Fund (VCF) and are in the final stages of finalising the policy framework and the contract with NZ Venture Investment Fund that will govern its operation and establish its structure. We look forward to launching the Fund, so it can fulfil the Government's desire to see investment in New Zealand's early-stage growth companies and development of our country's venture capital market.

It is important that the mandate to oversee the VCF is separate to the Guardians' mandate to invest the Fund to help cover the future cost of superannuation. This ensures the Guardians commercial independence is maintained and allows it to continue to invest the Fund in investment opportunities that are appropriate for its purpose.

Reference Portfolio Review
The Reference Portfolio is a notional, low-cost portfolio designed to meet our purpose to maximise returns without undue risk to the Fund as a whole. It is a long-run, equilibrium construct – the actual portfolio is where we form judgements about risk premiums diverging from equilibrium and the Reference Portfolio holds us to account for those decisions. The Reference Portfolio serves as both a governance benchmark and an articulation by the Board of the risk appropriate for the Fund's purpose and mandate.

Under our Investment Risk Allocation Policy, the reference portfolio must be reviewed no less frequently than every 5 years, with the current review due in 2020. The Reference Portfolio review is one of the most important decisions for the Board and we look forward to continuing to keep your officials up to date on this important mahi.

Infrastructure investments
We note your encouragement to seek infrastructure investments for the Fund in New Zealand. As you are aware, we have recently submitted an innovative and fully-funded bid to design, build, own and operate Auckland's City Centre to Māngere light rail project. Production of our proposal represented a considerable investment on behalf of the Guardians and our international partner CDPQ Infra. Officials are due to provide Cabinet with their assessment in February 2020. Should we be successful, we look forward to engaging with government on contractual matters before undertaking a substantial engagement campaign with stakeholders and the wider public to further enhance our technical solution.

We remain interested in all types of domestic infrastructure investments that meet our requirements for risk-adjusted commercial returns. We supported establishment of the Infrastructure Commission, so as to build a forward view of the pipeline of projects that are required by the country, and are engaged with Inland Revenue on the Tax Work Programme on consideration on what tax incentives might spur additional international infrastructure investment, in line with recommendations from the Tax Working Group.

Finally, I appreciate the Government reappointing me chairperson until March 2021. I look forward to another successful year at the Guardians before handing over to new leadership.

Yours sincerely,

Catherine Savage
Chairperson Guardians of NZ Superannuation