2018/19 annual review of the Guardians of New Zealand Superannuation and NZ Superannuation Fund - post-hearing questions for written response

1. Listed domestic and global equities

Valuation represents a significant process for the Guardians and the Fund.
a. Please comment on the process undertaken to value investments for 2018/19 along with key challenges and judgements faced.

The vast majority of the assets of the Fund are measured at 'fair value'. The fair value of an asset is essentially the value that someone would be happy to pay and we would be happy to accept.

Assets for which observable market data is available (e.g. listed equities quoted on a stock exchange) are relatively simple to value. For assets where no observable market data is available (e.g. private companies), valuation can be significantly more complex and often subjective, requiring judgement by management. Inputs into the valuation of the latter may include: independent valuations, recent transactions, recovery value, and current market trends (the Fund's investment in assets of this type has decreased from the prior to the 2018/19 year).

Management uses valuation techniques for the Fund that are appropriate in the circumstances and for which sufficient data is available to measure fair value, maximising the use of relevant observable inputs. All assets and liabilities for which fair value is measured or disclosed in the financial statements are categorised within a fair value hierarchy as follows:

Level 1 - Quoted (unadjusted) market prices in active markets for identical assets and liabilities. An active market is one where prices are readily available and those prices represent actual and regularly occurring market transactions on an arm's length basis. The fair value of Level 1 assets and liabilities requires little or no judgement.

Level 2 - Valuation techniques that use observable market data. Such techniques include the use of market standard discounting methodologies, option pricing models and other valuation techniques widely used and accepted by market participants.

Level 3 - Valuation techniques that use inputs not based on observable market data. Unobservable inputs are those not readily available in an active market due to illiquidity or complexity of the product. These inputs are generally derived and extrapolated from other relevant market data and calibrated against current market trends and historic transactions. These valuations are calculated using a high degree of management judgement.

The level within which an asset or liability is categorised in the fair value hierarchy is determined based on the lowest level input that is significant to the fair value measurement as a whole.

An explanation on how fair value is judged for different asset classes is available on pages 145-146 of our 2018/19 Annual Report available here.

2. Employee incentives

Please update the Committee on the operation of the employee incentive scheme.

Remuneration at the Guardians consists of salary, KiwiSaver and participation in a discretionary benefits scheme.

Unlike other public sector organisations in New Zealand, staff salaries at the Guardians are not funded through parliamentary appropriation. Instead, they are paid for by the Fund.

Key considerations:
In structuring remuneration at the Guardians appropriately, we are conscious of the need to:

- reinforce the long-term objectives of the Fund;
- reinforce our investment strategy, which is based on a whole-of-Fund approach, rather than individual asset classes or investment portfolios;
- ensure remuneration encourages appropriate, but not excessive, risk taking; and
- be realistic about the periods for which staff are likely to remain with the Guardians and can reasonably expect to be rewarded for performance.

We aim to be clear about what people are paid for and why, and to be consistent, systematic and transparent in applying our remuneration policies. Our intent is to remunerate and reward people for their knowledge, skills, alignment to behavioural expectations and contribution in the roles they are performing. The components are as follows:

Base salaries
Employees receive a base salary, which is fixed and which reflects their role, contribution and level of experience. Base salaries are based on:

- independently determined job sizes;
- employees' competence in roles; and
- current, independent remuneration market data, based on upper quartile, New Zealand financial services sector rates.

Salaries are reviewed annually with any increases subject to meeting minimum performance expectations.

KiwiSaver
The Guardians matches employee contributions to KiwiSaver up to 8%.

Discretionary Benefits Scheme
A range of other benefits is also offered to permanent staff on a discretionary, non-contractual basis. These benefits include income protection, life, trauma and health insurance. The total cost to the Guardians of providing these benefits was NZD406,560 in 2018/19 (NZD250,970 in 2017/18).

Discretionary Bonus Scheme
As is the standard within the financial services sector, staff are eligible for performance pay on top of base salaries. The Guardians' discretionary bonus scheme is designed to incentivise employees and create a culture of good performance. All bonuses are at the discretion of the Board. There is no contractual requirement requiring the payment of any bonus in any given year to employees.

There are two components to the bonus scheme:

1. an individual performance component for which all permanent employees are eligible; and
2. a two-part Fund performance component, which applies to permanent members of the Leadership Team, Investments Group and Portfolio Completion Group.

More details on the operation of our remuneration scheme is available on pages 97-98 of our 2018/19 Annual Report [available here.](#)

3. What are the main people capability and capacity challenges faced by the Guardians and the Fund?

The employment market for professionals in the investment sector is highly competitive. We aim to build and maintain a team of talented people who can deliver value in terms of Fund performance. The Guardians is made up of people with significant expertise and experience in investment management and research, portfolio design, risk management and investment operations, along with highly skilled specialists in finance, human resources, law, IT and communications.

As with many workplaces, the labour market for these skills is tight. The Guardians aims to offer an attractive mix of remuneration and benefits, learning and development, culture and engagement, parental leave, flexible work arrangements, amongst other things, to build an attractive workplace. At the same time, we seek to ensure the work that our team members undertake is engaging, fulfilling, challenging and rewarding.

4. Preparing for growth: Long-term target state

The 2019 Annual Report notes the multi-year work programme underway on the 'long-term target state' for the Fund. a. Please provide the Committee with an update on this work programme, including preliminary outcomes.

Background

The long-term target state review was started because of the expected growth in the size of the NZ Superannuation Fund, based on the assumption that the Fund continues to meet its performance benchmarks, and with the resumption of Crown contributions in December 2017. The Guardians want to understand what is required to remain fit for purpose to fulfil our mandate and we are not inadvertently captured by incrementalism. As noted in the Annual Report, the work was designed to set a direction, not an end point, and to inform our longer-term strategic choices.

The work has been informed by the outcome of the five-yearly independent review (completed in 2019), which found that the Guardians is operating to best practice standards. It is also informed by other workstreams, including the current five-yearly Reference Portfolio review, the remuneration structure review, developing our information technology roadmap and a recent review by the Board of our investment beliefs.

The work is investment-led. We worked from an initial scenario that the Fund will be $70 billion or more in seven years. We researched the impact of scale on the active investment strategies and portfolio completion activities (these include hedging, investment implementation) . This included analysis of the relative pace and growth of investment opportunities and the growth in investment opportunities required to maintain our budgeted levels of active risk, the scalability of our access points (the way we access an investment opportunity), external manager and market capacity. By scalability, we mean the ability to increase our exposure to a particular investment opportunity.

Building on this work, we considered:

- The advantages we have in originating and/or managing opportunities in-house and in the development of investment partnerships to gain access to opportunities;
- An examination of where we have strengths or advantages (from our endowments) and where we have developed advantages over time;
- Where we need to develop internal investment capabilities and capacity.

The outcomes from this work were considered by our support function teams (HR, Investment Operations, IT, Legal, Finance, Tax, Risk, Communications) to the impact on their teams, and the capabilities and capacity they need to develop. This includes the long-term implications for IT. They have also been discussed by the Board and the wider team.

Outcomes

The outcomes or findings of this work include:

- Even at $70 billion, the Fund is still small by global standards;
- Most of our investment opportunities and activities are scalable;
- Ensure that the deal size is matched to the effort involved in making the investment (noting this relates to direct investments and we continue to deploy smaller amounts of capital to New Zealand business through managers);
- Data and data management is important for all parts of the business and investment activities;
- Developing capabilities implies the need for more specialist staff, but that must be balanced against cultural and whole-of-portfolio considerations (our one team, one Fund approach);
- Much of our advantage comes from our endowments (the advantages that come from our mandate including long horizon, known liquidity, independence and sovereign status). We have, however, developed additional attributes that can give us an advantage, such as our reputation, responsible investment practices, skillset and staff;
- Direct investing is less scalable and one-off deals or complex arrangements are resource-intensive for support staff, including Finance, Tax, Legal, Responsible Investment, Risk and Communications teams;
- We have an advantage in investing in the domestic market (size, reputation, sovereign status), but it can be difficult to find direct domestic investments of the scale we need;
- Our ability to make direct investments, particularly in the domestic market, is limited by the legislative restriction on taking a controlling interest (section 59) and requires us to work with partners. which makes it harder to achieve the scale we need.
- While we are better placed to originate domestic direct rather than international direct, the size of the domestic market is limited and we need to leverage our endowments to be preferred receivers of international opportunities through our managers and peers;
- We should have the agility to take advantage of opportunities that arise, but remain focused on our core competencies;
- We must have the depth / agility to absorb inevitable changes and big projects that arise;

- Technology is increasingly important and we need to have the right level of ambition (fast follower rather than leading edge). Our requirements are driven by the data, information and automation needs of the investment and non-investment teams;
- Stakeholder expectations and interest in responsible investment will continue to add to demands on the Communications, Legal and RI teams;
- As the 2019 Independent Review highlighted, culture and purpose are important to our staff. Building and maintaining our constructive culture, and developing our employee value proposition, are important to attract and retain our great team in a competitive global employment marketplace;
- We need to have longer-term workforce planning because of the length of time it can take to recruit the right people or develop appropriate skills in the existing team.

Next steps

The long-term target state sets a direction which will now be incorporated into our future strategy and planning and continue to be developed. In the nearer term, it has also been useful in determining what we will not focus on. It will inform the refresh of the Guardians' strategic plan to be carried out by April 2021. It is also being used to drive the strategic activities that we will focus on (including considering the impact that current legislative restrictions on 'controlling' an entity (i.e. owning more than half) has on investment opportunities (especially in infrastructure). The work will continue to be used as a reference in this context and there will be further discussions at Board strategy sessions in the year ahead.

5. Fund performance and risk

The Fund made globally competitive returns in 2018/19, albeit they were down in comparison with previous periods.
a. What were the main factors affecting returns as recorded in 2018/19?

The 2018/19 financial year saw two dominant macro-economic drivers:

1. Central bank policy decisions
   Interest rates increased through 2018 as a result of policy settings by the United States Federal Reserve. Indeed there was some semblance of normality returning at least to United States bond markets. Many equity markets struggled along until October when the weight of higher interest rates kicked in and, by the end of December, global equity markets had fallen 10% on average. In response, central banks about-faced and made accommodating overtones about the next moves for monetary policy. Equity markets reacted immediately and rallied 10% in January.
2. Global trade policy
   United States trade policy and trade tensions with China was the other key driver. What started as United States tariffs on steel and aluminium to protect local industries quickly morphed into tariffs imposed on imports from China as the United States sought to address its perceived current account imbalance and concerns around intellectual property. While tensions have eased, international trade is still impacted by friction at the border and regulatory distortions.

b. Which investment areas or sectors had the greatest returns?

Two-thirds of the Fund is invested in a indexed global reference portfolio made up of 80% equities and 20% fixed-income. In the 12 months to 30 June 2019 it returned 6.36% (after costs, before tax), while the actual portfolio made 7.02% (after costs, before tax), meaning value-adding strategies added 0.67% or $261m. A breakdown of the performance of our value-adding strategies can be seen on page 44 or our 2018/19 annual report available here.

6. Managing risk

Factors such as central bank policy decisions and trade tensions between the United States and China affected investment markets in 2018. a. How have factors such as international trade tensions (and more recently the Corona Virus) been considered in the Guardians risk management regime?

The Fund's asset allocation is anchored around its Reference Portfolio, which is made up of 80% global equities and 20% global bonds. The Reference Portfolio is structured in this way to maximise returns over the long-term subject to an appropriate level of risk. It also provides the benchmark for the performance of the actual portfolio, which includes the active investments that we make to improve the risk-adjusted returns to the fund. With such a strong weighting towards growth assets, when equity markets sell off, as is occurring with COVID-19, Fund returns drop. Equally, when equity markets recover, so do Fund returns.

We undertake active investments in order to add value to the Reference Portfolio. To do this, we take on active risk, or risk that the Fund's performance will be different from that of the Reference Portfolio's. Our active investments embrace contrarian investment strategies (buying when other investors are selling and vice-versa) in order to further enhance returns over a long time horizon. This extra market risk means the Fund will experience (sometimes substantial) mark-to-market losses when financial markets fall in value. The important thing to remember is that the Fund has the ability to ride out and potentially benefit from these short-term movements.

More information on our risk allocation strategy is available in our 2018/19 annual report on pages 42-43 of our annual report available here.

7. Government contributions

The Government restarted contributing to the Fund in December 2017 with Government contributions now totalling $9.9 billion net of tax. a. How has sustained growth in the Fund from Government contributions affected the Fund's investment strategy and its performance?

The resumption of contributions improves the liquidity position of the Fund, meaning it is better placed to take advantage of its "known liquidity" endowment. It places us in a stronger position to make direct investments, including in infrastructure.

More broadly, the resumption of contributions makes it easier for the Guardians to meet its legislative objective of smoothing out the future increased costs of providing universal superannuation for New Zealanders.

8. New Zealand Investment

The Guardians are an important investor in New Zealand. While the total amount of its investment in New Zealand continues to grow, it is decreasing as a proportion of the total Fund.

a. What strategies is the Fund employing to increase the amount of investment in New Zealand?

Direct NZ investments

Our direct investment activity in New Zealand commenced in 2006 when we acquired a stake in Kaingaroa Timberlands but was further cemented with a letter from then Minister of Finance Bill English in May 2009 directing the Guardians to identify and consider New Zealand assets as part of its portfolio. Importantly, the directive was not intended to be inconsistent with our duty to invest the Fund on a prudent, commercial basis. Following the directive, we undertook a review of the domestic opportunity and saw the potential to invest further into New Zealand outside traditional listed markets.

Our local advantage means we are strongly weighted to New Zealand-based assets relative to the size of the local market. Overall, we have just over NZD6.3 billion invested in New Zealand, or 14% of our 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 we have a further NZD1 billion invested directly in companies that are an extension of activities here in New Zealand.

While dollar figures of our investments in New Zealand increased from NZD2.4 billion to NZD6.3 billion in the seven 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.

If the Fund is to increase its exposure to New Zealand assets other than listed equities, having sufficient capacity and capability to make active, direct investments is critical (we are limited by market capacity from substantially increasing the Fund's exposure to listed equities and expansion capital funds). To help achieve this, we have established an Investment Hub to research and shape new investment opportunities of scale that would otherwise be unachievable in the New Zealand market, and added more staff to our New Zealand direct investment team. The formation of the Investment Hub has resulted in increased domestic market engagement by the Guardians across a range of sectors.

Te Pūia Tāpapa Fund

In March 2018, the Fund signed a Memorandum of Understanding (MoU) with Te Pūia Tāpapa Fund, establishing a preferred partnership agreement. Te Pūia Tāpapa was set up in late 2017 as a way for Iwi and Māori organisations to collectively and effectively invest together. The venture enables Iwi/Māori groups to pool resources in order to access large-scale, direct investment opportunities.

Developed as a partnership project by the Ministry of Business, Innovation and Employment, He kai kei aku ringa – the Crown Māori Economic Partnership, Ngāti Awa Group Holdings Limited and the Fund, Te Pūia Tāpapa today comprises 48 iwi (the largest social units in New Zealand Māori society), Māori land incorporations and trusts, Te Tumu Paeroa (the Māori Trustee) and other Māori organisations. Over NZD115m has been committed.

Under the MoU, Te Pūia Tāpapa and the Fund have committed to a preferred partnership relationship to be conducted in a spirit of mahi tahi (working together), transparency and good faith. This will involve the formal sharing of ideas and collaboration in areas of mutual interest. The two funds are aligned in a number of important respects - through an intergenerational investment horizon and focus, as well as similarities in investment approach, including the exercise of kaitiakitanga (stewardship) over assets.

Since signing the MoU, the Te Pūia Tāpapa Fund has recruited an investment manager, four independent Investment Committee members and two independent Board directors, and confirmed its Chairs. Working together with aligned people and groups will continue to be fundamental to our future success as a Fund. While there are various ways we can work collaboratively, Te Pūia Tāpapa is a new and exciting expression of mahi tahi as a basis for mutual commercial benefit. By coming together with compatible partners, Iwi/Māori investors and the Fund will have access to, and will seek to stimulate, opportunities that would not have existed otherwise.

b. What are the main areas/sectors proposed for investment and what are the main barriers to increasing that investment?

Auckland light rail
Our proposal to fund, design, construct, own and operate Auckland's light rail project, alongside Canadian investor CDPQ Infra, is currently being assessed by cabinet. Our consortium partner CDPQ Infra is a wholly owned subsidiary of Caisse de Dépôt et Placement du Québec (CDPQ), a CAD300 billion pension fund owned by the Government of Quebec. In addition to light rail, the Fund has a highly skilled team focused on pursuing other opportunities for domestic investment in infrastructure.

Rural land
In the past year, we made acquisitions totalling NZD80 million in rural land acquisitions. This included purchasing a dairy/beef farm in Southland, an apple orchard and a hops garden in Nelson. The latter two represented our first rural economic acquisition outside the established focus on the dairy and livestock sectors. In total, the Fund has NZD418 million invested in rural New Zealand, which is managed by farm managers FarmRight. A strong focus on our management of these assets is to improve the environmental sustainability of the farms and improve on-site health and safety performance. We continue to see rural land as an attractive long-term investment and a good diversifier for our portfolio. Last year, the Fund took a 27% stake in NZ Gourmet. Established in 1982 as a specialist exporter of premium quality New Zealand produce, NZ Gourmet produces and markets a range of high-quality fruit and vegetables.

Expansion capital
We have several New Zealand expansion capital mandates with local investment managers Direct Capital, Pioneer Capital, Pencarrow, Movac and Waterman, supporting the growth of businesses in New Zealand between early to late stage growth private equity. These businesses are often too risky for bank capital and typically too small for offshore private equity funds. Our most recent growth capital commitments that have continued deployment into new investee companies are:

- Jan 2017, committed NZD40 million co-mingled and NZD50 million flexible side-car funding to Direct Capital Fund V focusing on larger opportunities.
- Mar 2017, committed NZD60 million co-mingled and NZD60 million flexible side-car funding to Pioneer Capital Fund III focusing on mid-sized, export-oriented, growth

- businesses.
- Dec 2016, committed NZD25 million co-mingled and NZD25 million flexible side-car, to Movac Fund IV investment criteria focused on earlier stage software and technology companies.

We also hold substantial direct investments in: Datacom, Kaingaroa Timberlands, Hobsonville, Kiwibank, Fidelity Life, NZ Gourmet and several hotels.

Venture Capital Fund
In the May 2019 Budget, the Government announced it would give the Guardians a second fund—a venture capital fund - to manage alongside the NZ Superannuation Fund.

The Elevate NZ Venture Capital Fund is a Government initiative aimed at growing more innovative industries in New Zealand and lifting productivity. It aims to attract private sector investors to the domestic venture capital market to grow innovative, knowledge-intensive businesses. This is an important step towards future-proofing the New Zealand economy in a time of rapid technological change.

The fund will support early stage companies, help develop the early stage capital ecosystem in New Zealand and, by doing this, support innovation in the economy. The fund is expected to have a life of 15 years (consisting of a five-year investment period and a 10 year "harvest" period) and will receive up to $300 million over four years.

The Government tasked the Guardians with overall responsibility for the new fund because of our experience as an institutional investor and reputation for best-practice management. The Venture Capital Fund is a fund-of-funds programme and will be managed on behalf of the Guardians by the NZ Growth Capital Partners (formally NZ Venture Investment Fund).

More details on our New Zealand investment strategy is available here.

9. Conflict of interest

Please provide further detail on the breakdown of the potential conflicts of interest listed in the response to question 45.

Nature of Potential Conflict (2018/19 financial year)	Staff/Board Member	Contract/Policy etc. with conflict entity in last 3 financial years	Value	Steps taken
Standing disclosure of appointment as a director of Todd Family Office.	Board member Stephen Moir	No contracts or other arrangements were entered into.	N/A	The interest was recorded in the Board member's interests register. No conflicts arose.
Standing disclosure of appointment as	Board member	Co-investments have been made with Infratil in US renewable energy	N/A	The interest was recorded in the Board member's interests

Nature of Potential Conflict (2018/19 financial year)	Staff/Board Member	Contract/Policy etc. with conflict entity in last 3 financial years	Value	Steps taken
a director of Infratil. Infratil is a co-investor and NZSF may hold listed Infratil securities from time to time. Infratil is managed by Morrison & Co who also manage one of NZSF's mandates.	Catherine Savage	projects under the Morrison & Co mandate		register. If matters concerning Infratil come to the Board the Board member will be recused. The investment decisions were made before the Board member was appointed to the Infratil board and, in any event, were made at management and not Board level. No conflicts arose.
Standing disclosure of directorship with Fidelity Life Assurance NZSF has an investment in Fidelity and in Kiwibank (a potential competitor)	Board member Simon Botherway	NZSF invested in Fidelity in 2017. No other contracts or arrangements were entered into.	N/A	The interest was recorded in the Board member's interests register. The Board member is recused from Board discussions/decisions involving Fidelity. NZSF invested in Fidelity before the Board member joined the Guardians' Board and, in any event, the investment decision was made at management and not Board level. No conflicts arose.
Standing disclosure of directorships with Serko Ltd and Callaghan Innovation	Board member Simon Botherway	NZSF may hold listed securities in Serko from time to time. No other contracts or other arrangements were entered into.	N/A	The interest was recorded in the Board member's interests register. Decisions to trade shares in listed companies are not made at Board level. No conflicts arose.

Nature of Potential Conflict (2018/19 financial year)	Staff/Board Member	Contract/Policy etc. with conflict entity in last 3 financial years	Value	Steps taken
Standing disclosure of directorships with Rozetta Technology Limited	Board member Henk Berkman	No contracts or other arrangements were entered into.	N/A	The interest was recorded in the Board member's interests register. No conflicts arose.
Standing disclosure of directorship with Christchurch International Airport	Board member Catherine Drayton	NZSF may hold listed debt securities in the company from time to time. No other contracts or other arrangements were entered into.	N/A	The interest was recorded in the Board member's interests register. Decisions to trade shares in listed companies are not made at Board level. No conflicts arose.
Standing disclosure of directorship with Ngai Tahu Holdings Corporation Limited and Ngai Tahu Capital Limited NZSF has co-invested with Ngai Tahu in the Hobsonville housing development	Board member Catherine Drayton	NZSF co-invested with Ngai Tahu in 2016. No other contracts or arrangements were entered into.	N/A	The interest was recorded in the Board member's interests register. The Board member is no longer a director. NZSF's co-investment with Ngai Tahu was made before the Board member joined the Guardians' Board and, in any event, the investment decision was made at management and not Board level. No conflicts arose.
Standing disclosure of appointment to the Genesis Energy Board.	Board member Catherine Drayton	No contracts or other arrangements were entered into.	N/A	The interest was recorded in the Board member's interests register. No conflicts arose.
Standing disclosure of directorships with Southern Cross Medical Care Society	Board member Catherine Drayton	Existing contractual relationship for provision of insurance for staff.	N/A	The interest was recorded in the Board member's interests register. No conflicts arose.

Nature of Potential Conflict (2018/19 financial year)	Staff/Board Member	Contract/Policy etc. with conflict entity in last 3 financial years	Value	Steps taken
Standing disclosure of appointment as a director of Smartshares Limited.	Board member Lindsay Wright	No contracts or other arrangements were entered into.	N/A	The interest was recorded in the Board member's interests register. No conflicts arose.
Standing disclosure of role as Head of Asia at Matthews Global Investors (HK) Limited	Board member Lindsay Wright	No contracts or other arrangements were entered into.	N/A	The interest was recorded in the Board member's interests register. No conflicts arose.
Standing disclosures of directorships and shareholdings in family companies.	Board member Catherine Savage, Stephen Moir, John Williamson, Simon Botherway, Catherine Drayton	No contracts or other arrangements were entered into.	N/A	The interest was recorded in the Board member's interests register. No conflicts arose.