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NZSUPERFUND
Te Kaitiaki Tāhua Penihana Kaumatua ō Aotearoa

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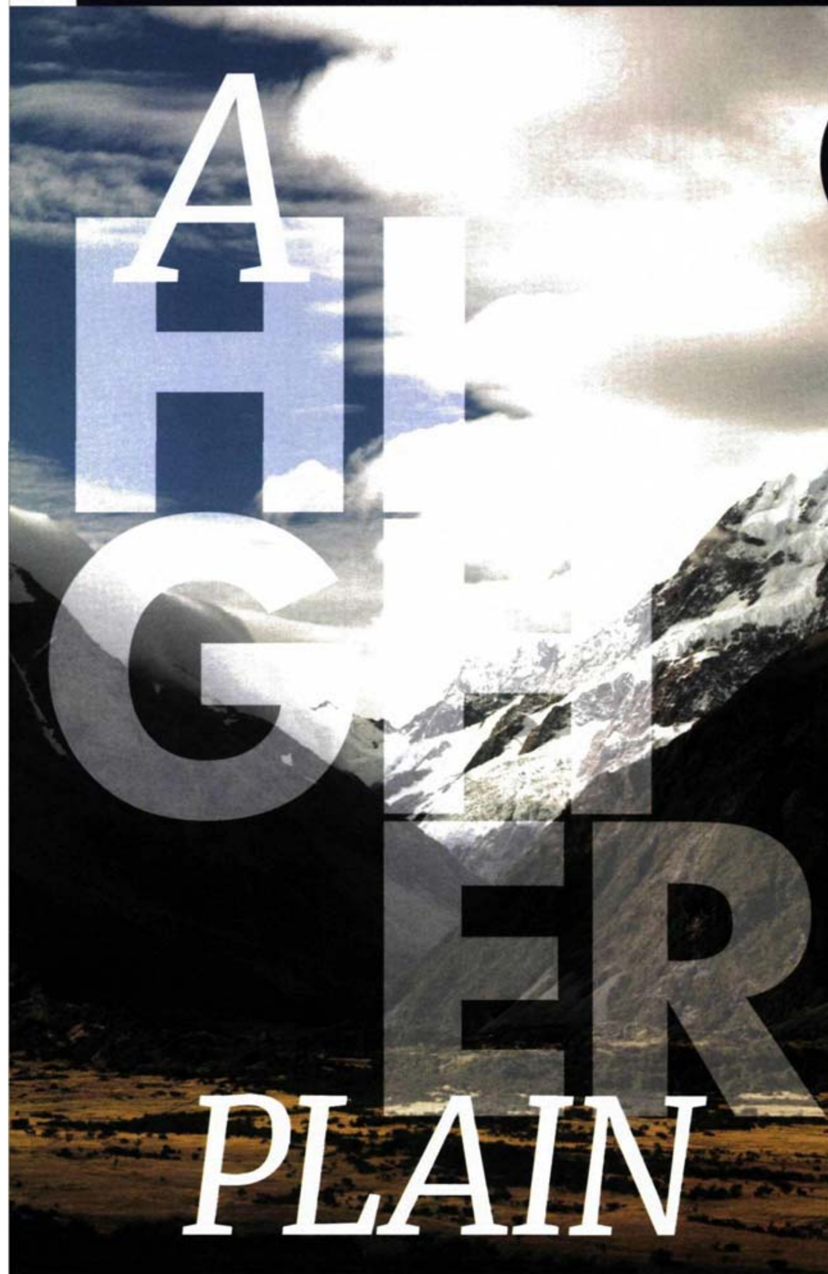

From being self-reliant on asset allocation to employing a partnership style with its managers – based on the mutual exchange of ideas – NZ Super has an advanced approach founded on the confidence of its investment ideas. DAVID ROWLEY visited the NZ $29.6 billion fund to find out how it does this.

On the climb towards the optimal investment set up NZ Super has taken more strides than most. It is self-reliant on asset allocation and manager selection processes, so no longer uses the services of an investment consultant; it has created its own system for justifying the worth of any transaction it undertakes in comparison to another. It also prefers to employ a partnership style with its fund managers, involving an exchange of ideas and a respect for each other's knowledge. For this it has negotiated flexible mandates with managers, under which it has the ability to control future allocations of risk capital.

Matt Whineray, chief investment officer of the fund, sums up the change by saying his team has become "a smarter purchaser of fund management services".

Internal consultant

At the root of NZ Super's advanced approach is the confidence and ownership of its investment ideas. Since 2013, NZ Super has not used investment consultants. It carries out its own investment analysis in-house and subscribes to information services to get data on managers. This is a considerable feat considering that, of the 115 staff NZ Super employs, around one third are in the back office, one third are in the middle office, and the remaining 40 staff are in the front office. The fund also leverages the knowledge of its managers, but the core investment decisions arise from within the fund.

Part of the thinking is that the business of choosing the best manager does not return enough for the effort applied, compared to the returns received from the hours spent finding good investment bets or diversification.

Whineray reasons that every investor is trying to find a top quartile manager, and they cannot all be right: "We want to spend a lot more time on identifying the opportunity and take the pressure off getting the absolute best manager, because one of our investment beliefs is that skill is rare."

Instead, the investment team spends most time working out if a market, or on occasions an individual security, is mispriced versus long-term market trends,

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Matt Whineray, chief investment officer, NZ Super (right). Adrian Orr, chief executive, NZ Super (below).

The only place with any true economies of scale is intellectual thought and that is where we spend most of our time

and whether it offers diversification benefits to other assets.

To make the process robust, NZ Super has even analysed to what extent it can be confident about bets. The team concluded that it can have more confidence if it can see and articulate the drivers of the opportunity, and there is a clear rational basis for that.

The fund's chief executive, Adrian Orr, articulates the business logic of this exercise. "The only place with any true economies of scale is intellectual thought and that is where we spend most of our time, and where we can have a competitive advantage," he says.

A further help to the 'clear rational' basis for its ideas is the use of a reference portfolio. This is a passive portfolio of 80 per cent equities (including 5 per cent in New Zealand equities) and 20 per cent fixed income that, on long-term trends, has been calculated as meeting the fund's return goals. Every investment decision that differs to the reference portfolio is measured to see if the time, expense and opportunity are worth it. The actual portfolio is currently

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We look at that and say we do not think, on average, an active manager ends up delivering positive returns after fees

67 per cent global equities (including 5 per cent in New Zealand equities), 12 per cent fixed income, 6 per cent property, 5 per cent timber, 4 per cent infrastructure, 3 per cent private equity, 2 per cent 'other private markets', and 1 per cent farmland.

"Every strategy has clarity around the horizon, the expected return, the hurdle rate for getting involved and its proxy what are you going to sell to buy," says Orr. "We can measure exactly the value we are adding per strategy."

Once this process has been completed for an investment opportunity, the smartest work has often been done.

"How you get access to your idea becomes mechanical then; we are interested in the opportunity first and foremost, how we access it becomes a very secondary issue," he says.

The mechanical issues are whether external expertise is needed to access the idea and whether that is worth it after fees, or whether in some cases it can be accessed through derivatives placed by the internal team.

"What we are trying to do is reduce the need to be able to identify managers that have skill. If we can get access to an under-priced market in a passive or a synthetic way, then that is good for us," Whineray says.

The fund uses derivatives because the cost to implement (buy or sell) is materially lower than buying or selling physical securities. Implementation of equity tilts, for example, physically costs circa 10 bps, but only 1-2 bps for futures.

"The futures markets we use are also very liquid and operate longer (extended) hours relative to equity exchanges, thereby giving us more flexibility in terms of when to execute," says Whineray.

Flexibility

The certainty about why the fund is allocating to an opportunity and what they want to get out of it inevitably leads to a different conversation with a fund manager.

Whineray explains how the fund not only chooses an investment, but gets to dial it up or down as the team's level of confidence in it changes. "We want control over how our risk is allocated," he says.

"A black-box, closed-end fund where you make your commitment and you hope you get your money back in 10-15 years' time, where you have no ability to change that allocation or see what is going on inside, is a much less interesting prospect for us than a flexible mandate with a manager, where we say 'we really like this opportunity – you help us get access to this'," he says. "If that mandate dries up we do not have to keep funding it."

He contrasts this with the traditional private equity model or unlisted asset fund model, where there is a three to five year lock in and the investment manager is incentivised to get that money invested.

NZ Super has flexible mandates with Elementum (US$50 million) and Leadenhall (US$150 million), where it decides on the amount invested twice a year based on the attractiveness of the market or as a reaction to a market dislocation, in consultation with the managers.

"In our view," says portfolio manager Greg Slusarski, "the risks involved in this market do not change over time – but the price we are getting paid for taking those risks does."

For this reason the investment team keeps a very close tab on the pricing as well as soft indicators such as capital flows, which would be informed by the number of new funds being set up, the dollar value of alternative capital flowing into the market, and how much exposure is being reinsured.

The desire for flexibility might appear to create more work, but often it means taking the simpler path. Given the fund's belief that confidence in a market outranks faith in an active manager, often this leads to an allocation to a passive manager, particularly for global equities.

"Those markets are very efficient with lots of active managers trading against each other," says Whineray. "We look at that and say we do not think, on average, an active manager ends up delivering positive returns after fees."

The public markets that NZ Super believes are conducive to active managers include emerging market equities and New Zealand equities. Even the average active managers in New Zealand are able to deliver positive net returns, notes Whineray.

"We like those markets as we do not have to be able to choose the best managers," he says. "We still try to choose the best managers, but if we miss and hit the second quartile

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we are still going to improve the portfolio, because we chose an opportunity that was rich rather than choosing a skilled manager in an efficient market."

Passive equity managers will generally cost the fund in the region of 5 bps, depending on the size and nature of the investments. The cost of active management varies enormously but can be more than 10 times the price of a passive manager, depending on the type of mandate and the manager's track record.

This belief in the process and its logic is such that the fund gave up on its tailored debt index, which included high yield, emerging market and inflation linked bonds, originally created as a means to deliver broader market representation.

"We have gone back to the Barclays Global Aggregate. After the hassle and cost [of creating the index and the process] we do not think it makes any difference," he says. "For the size it was in the portfolio it was not worth it to make a difference."

Cultural shift

Not all fund managers want to work this way. While in public markets separate tailored mandates have been commonplace for years, this is not the case in unlisted markets.

Whineray says unlisted managers will need to have greater sophistication around which assets are allocated to their pooled fund and which to the separate accounts.

"Not all want to do it, as it is much easier to put all the investors in one fund, with one annual report and meeting," he says.

The fund's success in gaining such deals leads Whineray to believe that it is not only fund size that helps in getting them, but that there is a cultural shift happening.

"Some managers get it while others do not, but we can see the market moving that way," he says.

Partnerships

In the past few years, NZ Super has moved toward bigger and closer relationships with a smaller range of fund managers. This has depended on the willingness of each manager to work in partnership, not just in delivering flexibility over future risk allocations, but also in a strategic sense. For example, the fund's NZ$300 million mandate with Bridgewater Associates, which has been in place for nine years, has delivered important add-on benefits through knowledge sharing and assistance.

"Managers are more than just return and fee streams," Whineray says. "We look for a willingness to share information and perspectives."

Central to the fund's partnerships is a team, formerly called manager monitoring, but now referred to as portfolio intelligence. Run by Paul Gregory, the team's responsibility is to bring in external intellectual property from fund managers and be a champion of that internally, connecting it with the investment analysis and portfolio completion teams. This can play a part in influencing portfolio tilting.

The bigger, closer relationships occur with the managers most willing to share ideas, or those that are simply the most strategically useful.

"Where do we think the best value from those manager relationships can come? Let's spend more time on those," says Whineray. "And let's spend less time on the ones that don't have any great input into the rest of the opportunities we are looking at."

THE REFERENCE PORTFOLIO

"The Reference Portfolio is selected as the lowest-cost access to the most relevant, liquid, market exposure the Fund needs to meet its mandate, providing both economic return and a benchmark for active investment. The Guardians expect the Reference Portfolio to return 7.7 per cent over 20-year periods, 2.7 per cent above the estimated risk free (Treasury Bill) interest rate." – Statement from NZ Super website.

NZ Super's reference portfolio is used as a benchmark upon which all investment decisions that depart from its allocation of 80 per cent equities and 20 per cent fixed income are made. It is also used by the board to judge the performance of the investment team. Part of the logic is that if the fund can find a growth asset with better prospects than global equities, it will buy it. Chief executive, Adrian Orr, says: "Active is not about increasing the risk – it is about getting better bang for buck on the risk."

The reference portfolio also helps the fund think about costs. Its reference portfolio can be run for 25 bps and with 12 people in the team. The fund's current investment costs are 44 bps, including performance fees on active mandates, and its total staff amounts to 115. In 2007, the fund had 17 staff and paid 101 bps in investment fees.

REFERENCE v ACTUAL PORTFOLIO