Looking Beyond the Credit Crunch:

The Benefits and Challenges of Being a Long-Term Investor

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INFINZ, 24 September 2008

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Outline for today

- Features of a long-term investor
- Sovereign Wealth Funds and New Zealand Superannuation Fund (NZSF)
- NZSF as a long-term investor
- Putting the current financial turmoil in perspective
- Staying focused on performance

Being a long-term investor?

- A clear purpose
- Discipline to stay the course
- Deliberate financial exposure
- Able to communicate the challenges to key stakeholders

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Sovereign Wealth Funds: the new long-term investors?

- Growing in number but small in dollars relative to global capital market ($US2-3 trillion compared to global financial assets of $US190trillion)

- Promote fiscal prudence, economic development, macroeconomic stability – **clear purpose**

- Promote global financial stability – long-term investors that can ride out short-term volatility – **deliberate financial exposure**

- But, to do so needs sound governance and transparency **– discipline to stay the course**

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Sovereign Wealth Funds: issues and concerns?

- **Investment for non-economic purposes** or poorly considered
- Government ownership could increase **protectionist instincts** in recipient countries and constrain global capital movement
- Create **moral hazard** within domestic economies

➢ Hence need to ensure SWFs are **balanced** between

- Goal dependence and operational independence

- Transparency for stakeholder understanding and commercial activity

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Sovereign Wealth Funds: generally accepted principles and practices

- Significant global effort to establish GAPP almost complete
- Desire to ensure SWFs act in best interest of maintaining:
  - Financial stability and free flow of capital;
  - Comply with domestic regulations;
  - Operate in a transparent and sound structure
- GAPP is an evolving voluntary set of aspiration principles
- Covers main aspects of Structural/Legal, Investment, Transparency

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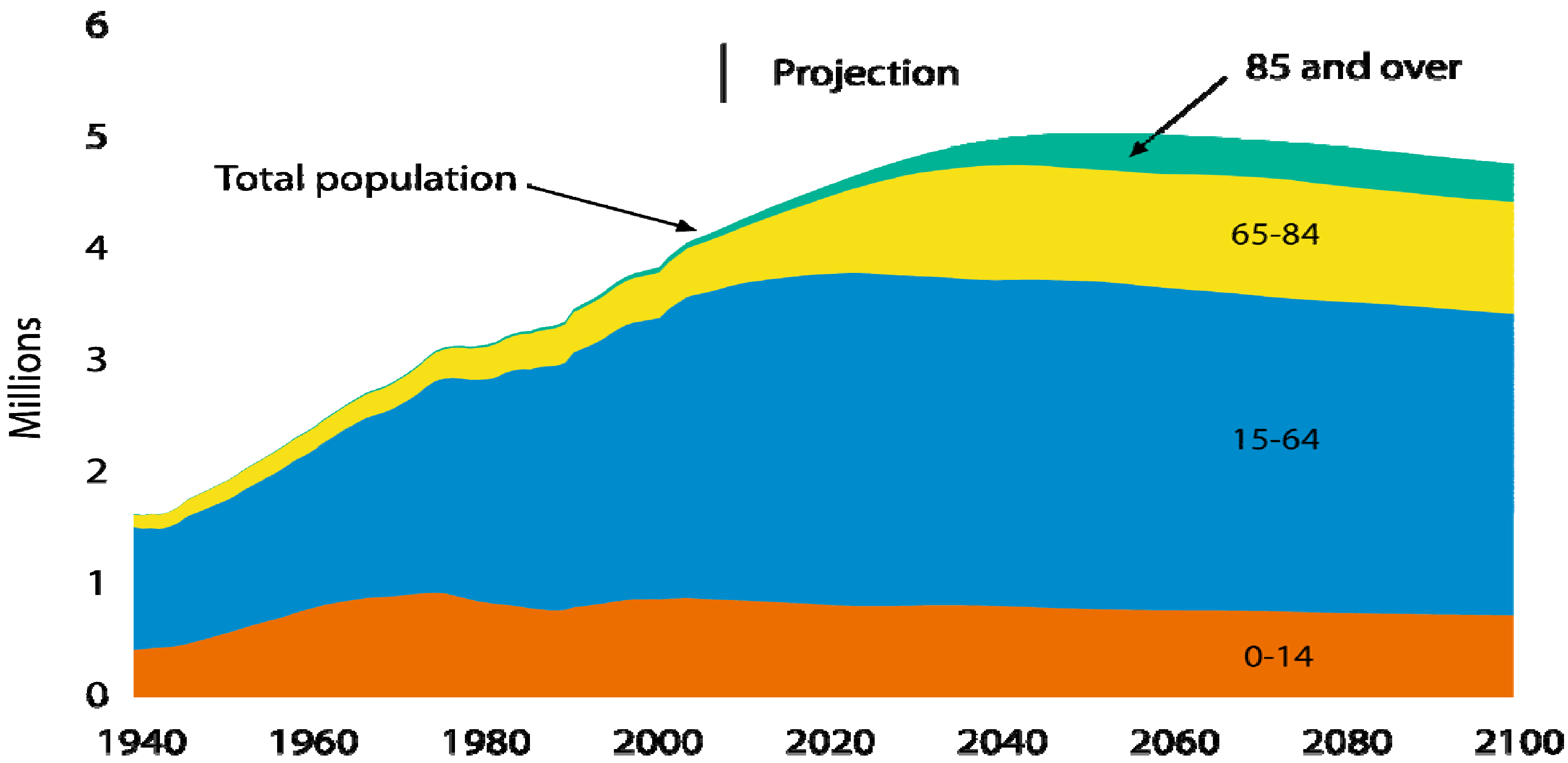
A Clear Purpose:
the Superannuation Buffer Fund

Source: New Zealand Treasury



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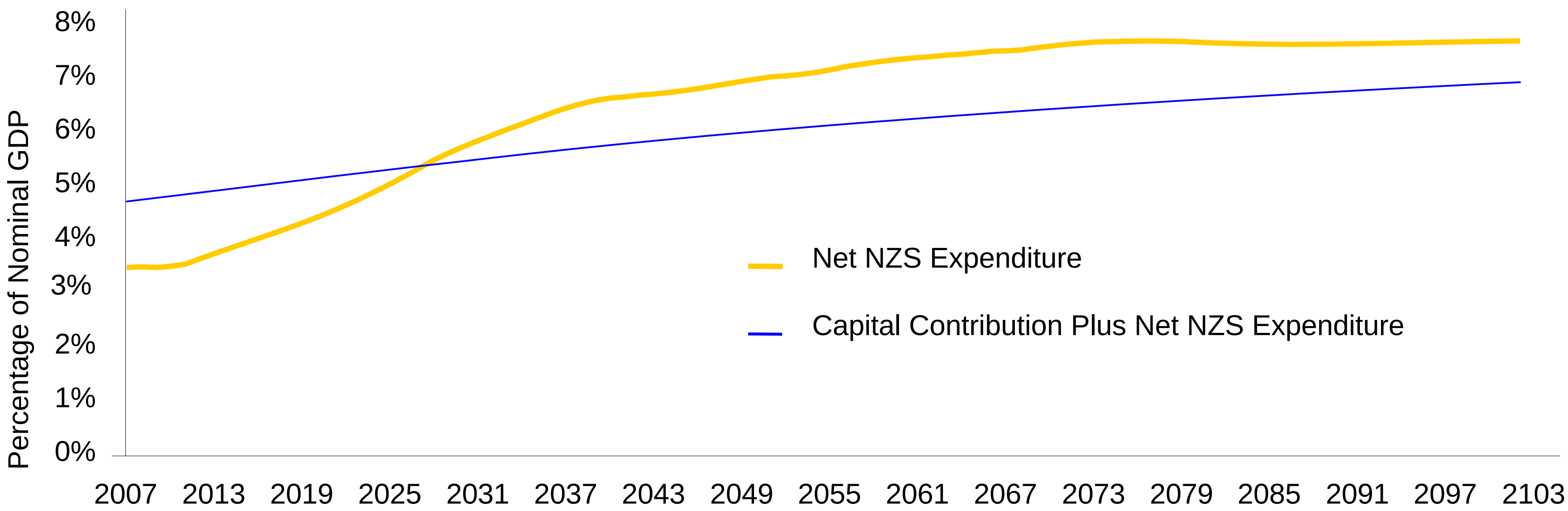
A Clear Purpose: Smoothing superannuation costs over time



Source: New Zealand Treasury

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Discipline to stay the course: Governance arrangements of the Guardians

- Clearly defined portfolio of Crown financial resources
- Managed by an independent governing body

"The Guardians …. must invest the NZSF in a prudent, commercial basis, and in doing so, ….. consistent with:

- ➢ Best-practice portfolio management; and
- ➢ Maximising return without undue risk to the Fund as a whole; and
- ➢ Avoid prejudice to New Zealand's reputation as a responsible member of the world community"

Add-value by returns > risk-free rate and passive alternative

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Deliberate Financial Exposure: Strategic Asset Allocation

- The Guardians' endowments include their:
  - Long-term investment horizon – matching long-term liabilities
  - Ability to invest across the near full range of asset classes globally; and
  - Liquidity risk premium due to no capital withdrawals until at least 2020

- Key decision:
  - Mix of markets and assets that the Fund will on average be exposed to

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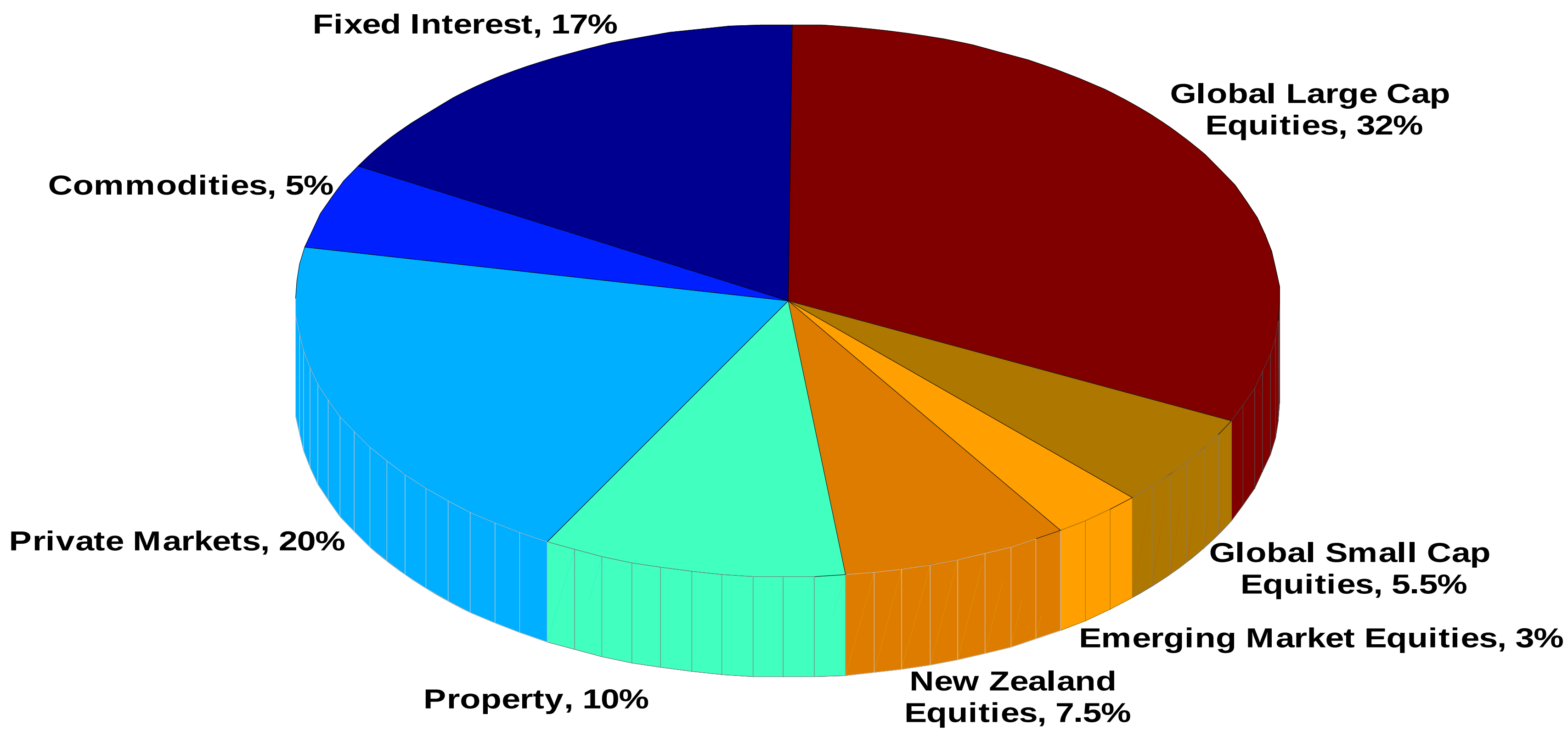
Strategic Asset Allocation

Fund by Asset Class (%)



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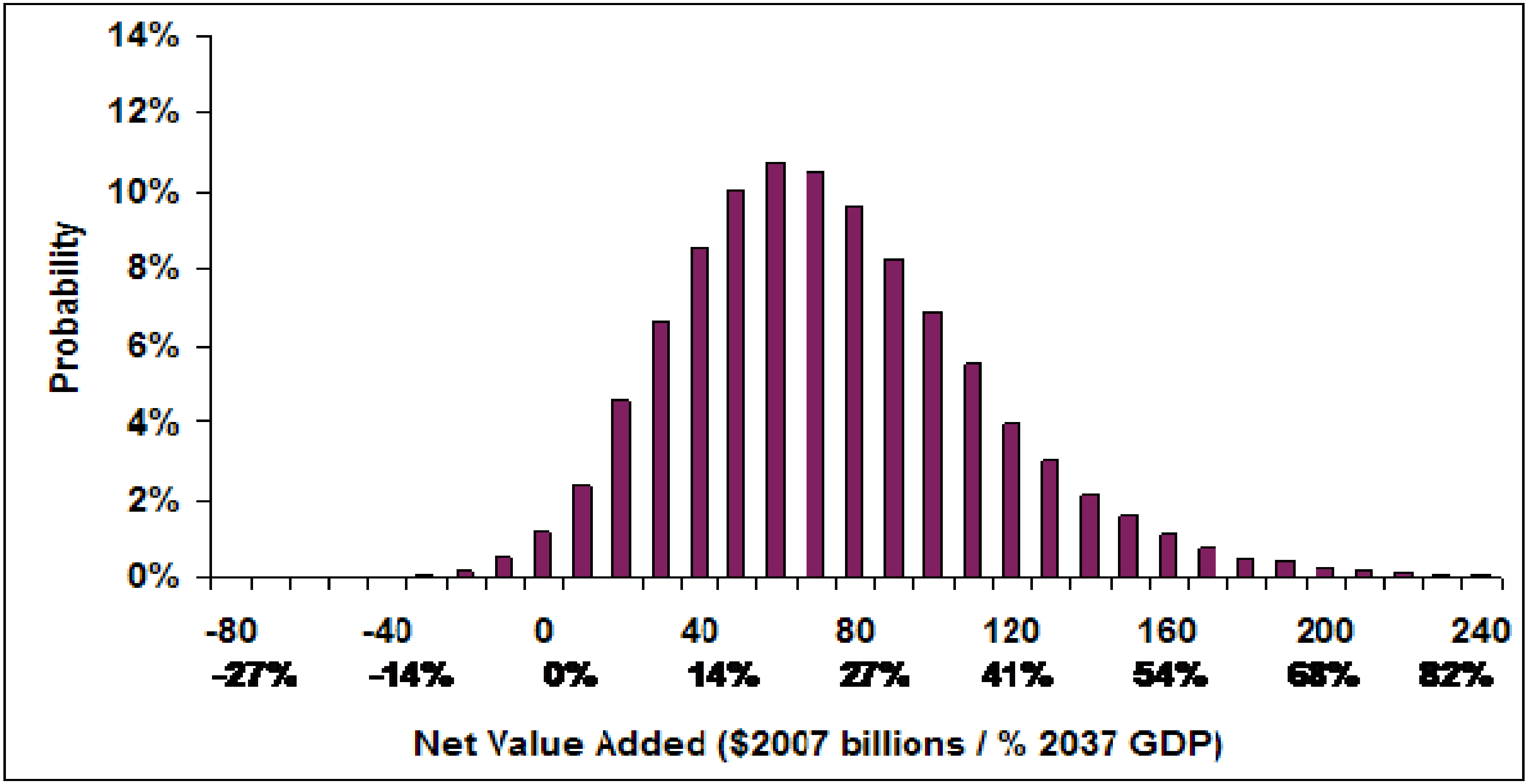
Distribution of expected returns

over a 30-year investment horizon (against T-bills)



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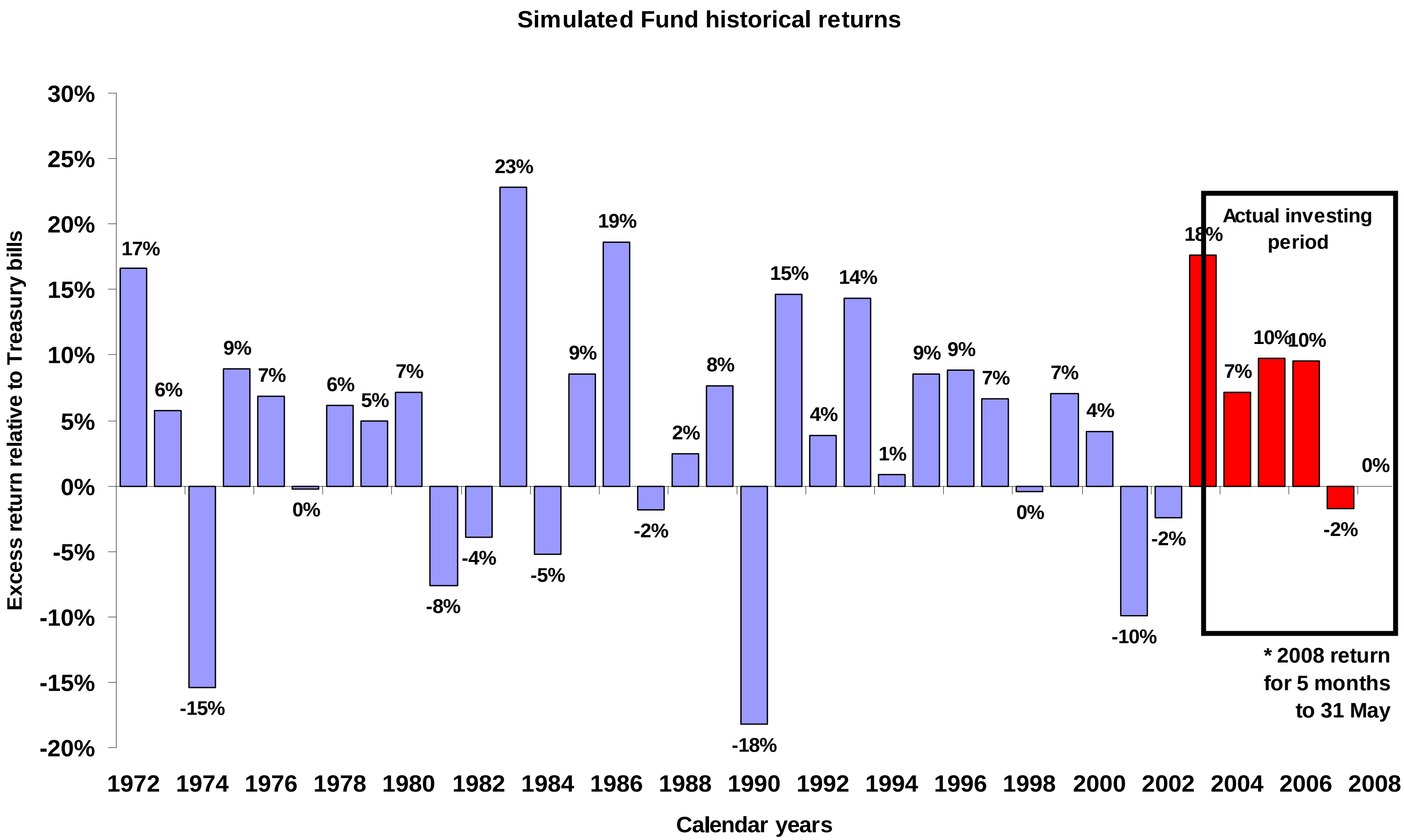
Communication

Excess returns: actual and back-cast



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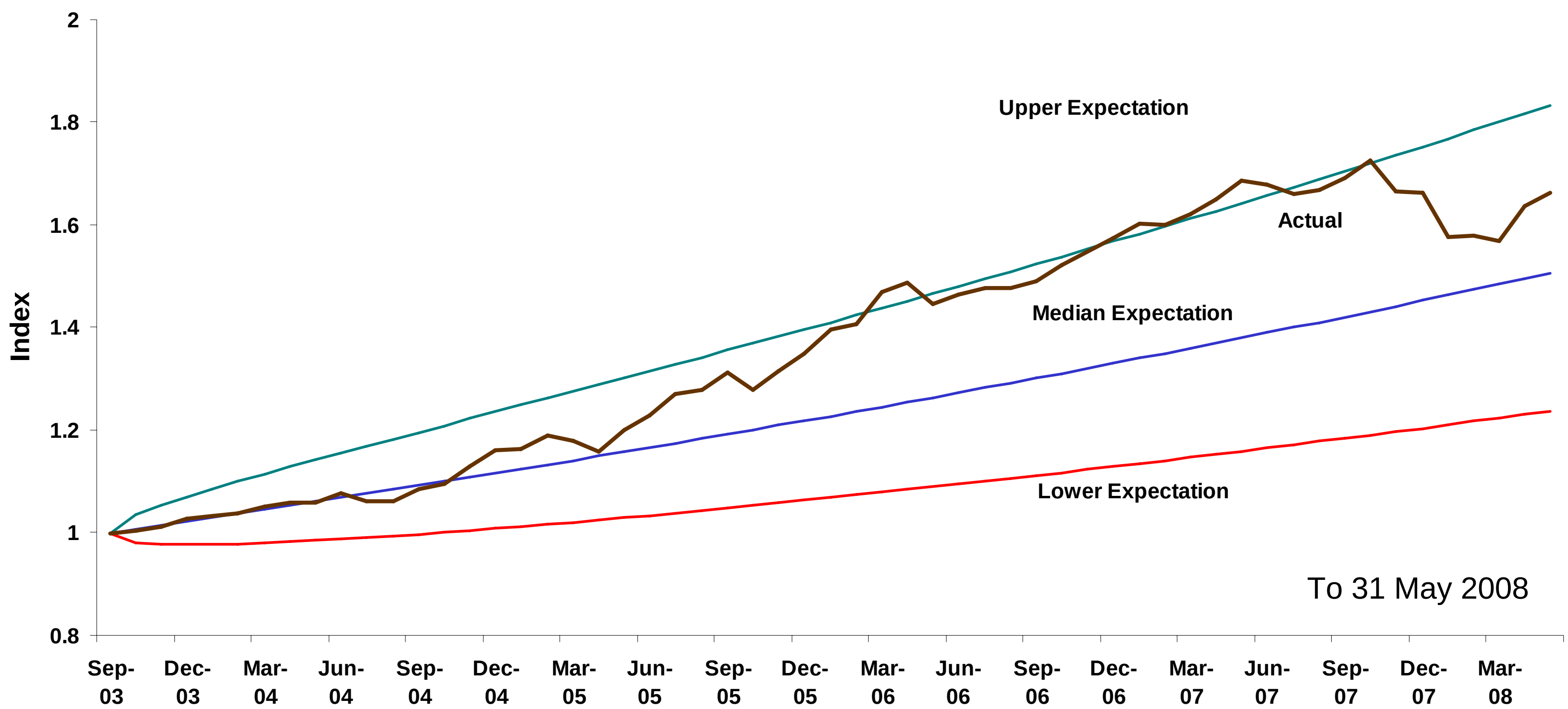
Communication

Actual and expected cumulative returns and 68% confidence interval



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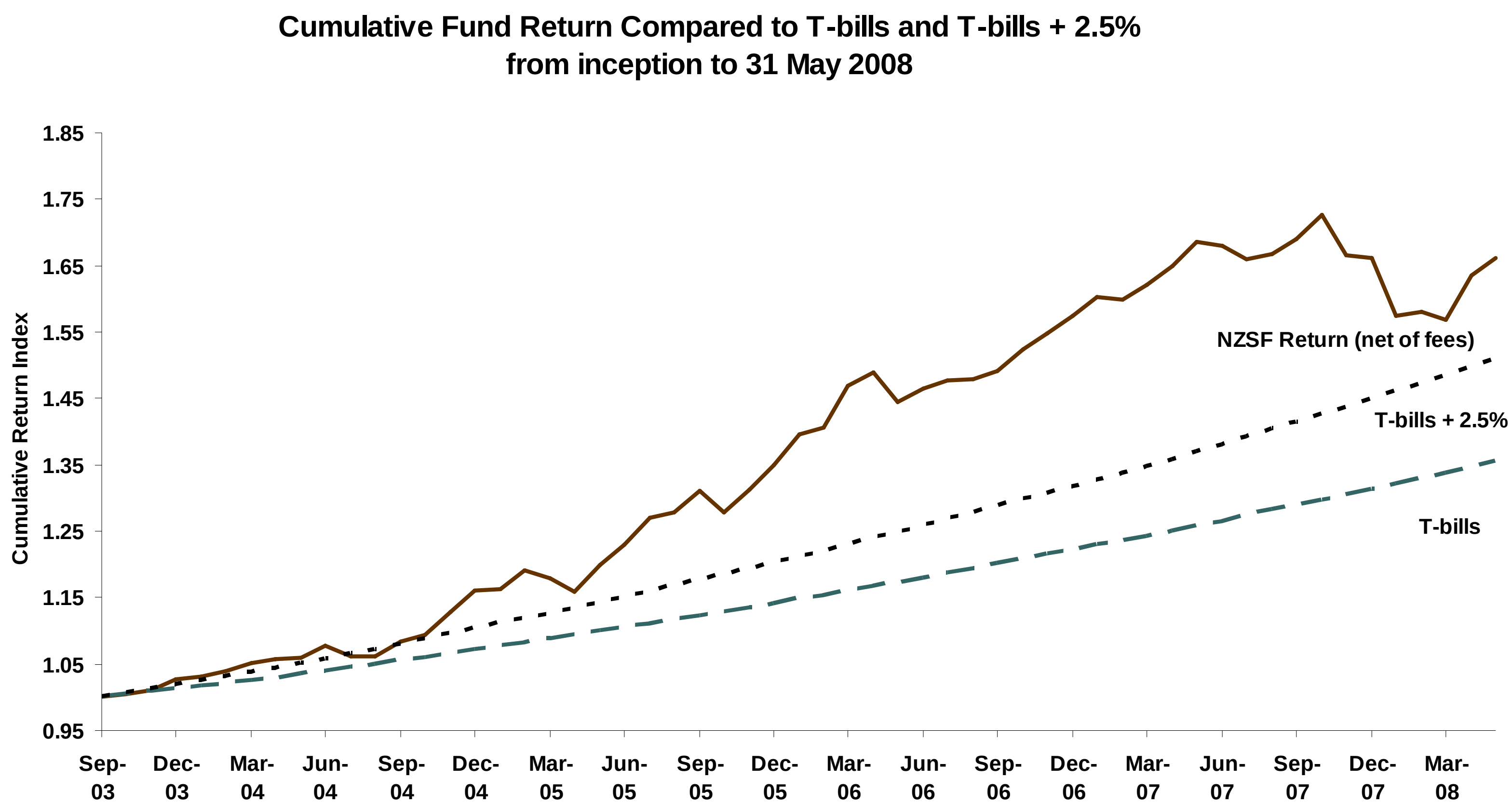
Fund cumulative return

compared to risk-free rate*



* Cumulative return net of fees from September 2003 (inception) to May 2008 compared to risk-free (Treasury bill) rate

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The Credit Crunch

Implications of the current environment

- **Financial markets**
  - Roots in excessive leverage, declining US house prices and mortgage defaults
  - … leading to difficulties in pricing asset-backed derivative securities
  - Difficulties in pricing risk and increased counter-party default risk
  - The credit crunch:
    - reluctance to supply credit to counter-parties
    - skyrocketing loan roll-over costs
    - difficulties in raising new capital to cover mark-to-market losses…
  - And now, unprecedented levels of central bank and government intervention

- **Macro feedback**
  - Declining levels of consumer/business confidence, spending, investment
  - Reduced earnings and profitability
  - Growth slowdown in both developed and emerging economies, recessions likely in several cases

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The Credit Crunch

in perspective

- **What they said:**
  - "… the crash of 1987 bears an uncanny resemblance to the crash of 1929" **– George Soros**
  - "We've never faced a problem of this scale. The answers aren't going to be happy ones." **– US Senate Banking Committee on Savings and Loan Crisis of early 1990s**
  - "[The UN] likens the current crisis to the Great Depression of the 1930s" **– The New York Times, reporting on the UN's assessment of the Asian crisis**
  - "The largest financial shock since the Great Depression." **– IMF on the present mortgage-precipitated crisis**
- **What we know:**
  - The problem is well-identified
  - There is significant resolve to fix it
  - Dramatic actions already taken
- **Our Focus:** Not on short-term timing, but on being prepared for an improving situation over the long-term

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The Credit Crunch and the long-term investor

- **Opportunities**
- Potential to buy assets at attractive valuations
  - Equities
  - Private equity and unlisted assets
  - Property
  - (Distressed) Debt

BUT..

- A challenge to maintain investment discipline in the face of likely short-term losses
- Maintain discipline in evaluating opportunities
- Remain mindful of overall risk profile

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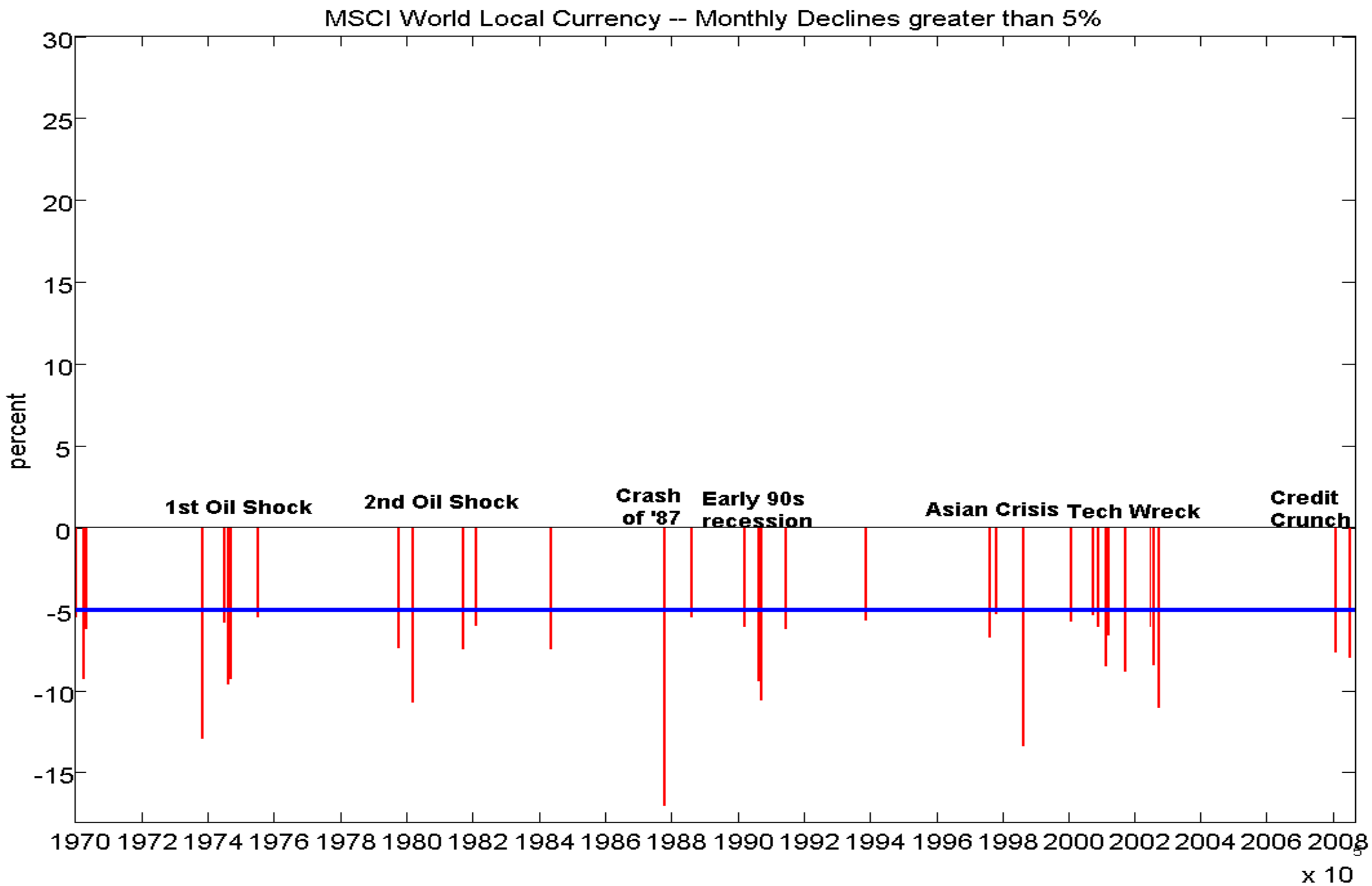
The Credit Crunch in perspective



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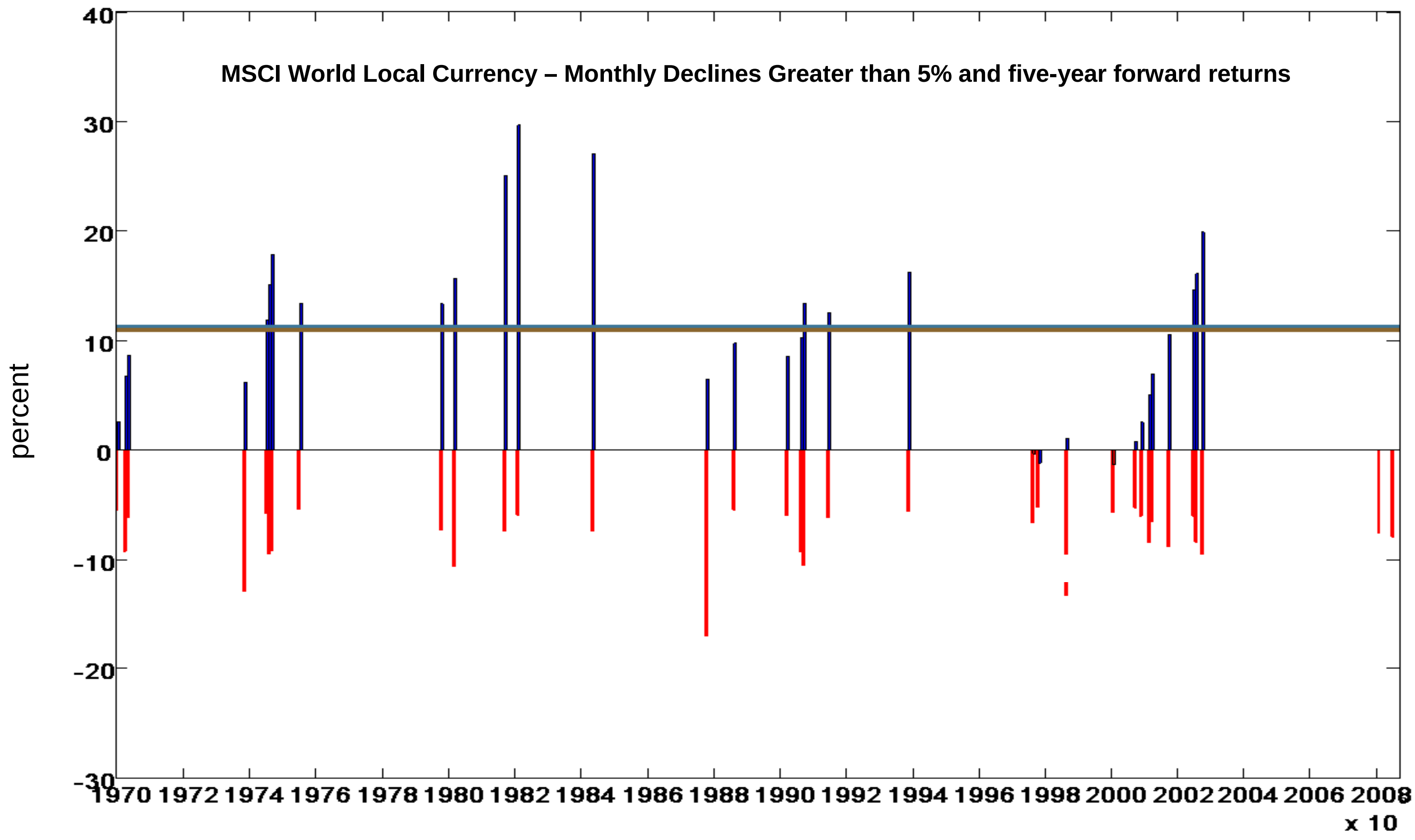
The Credit Crunch

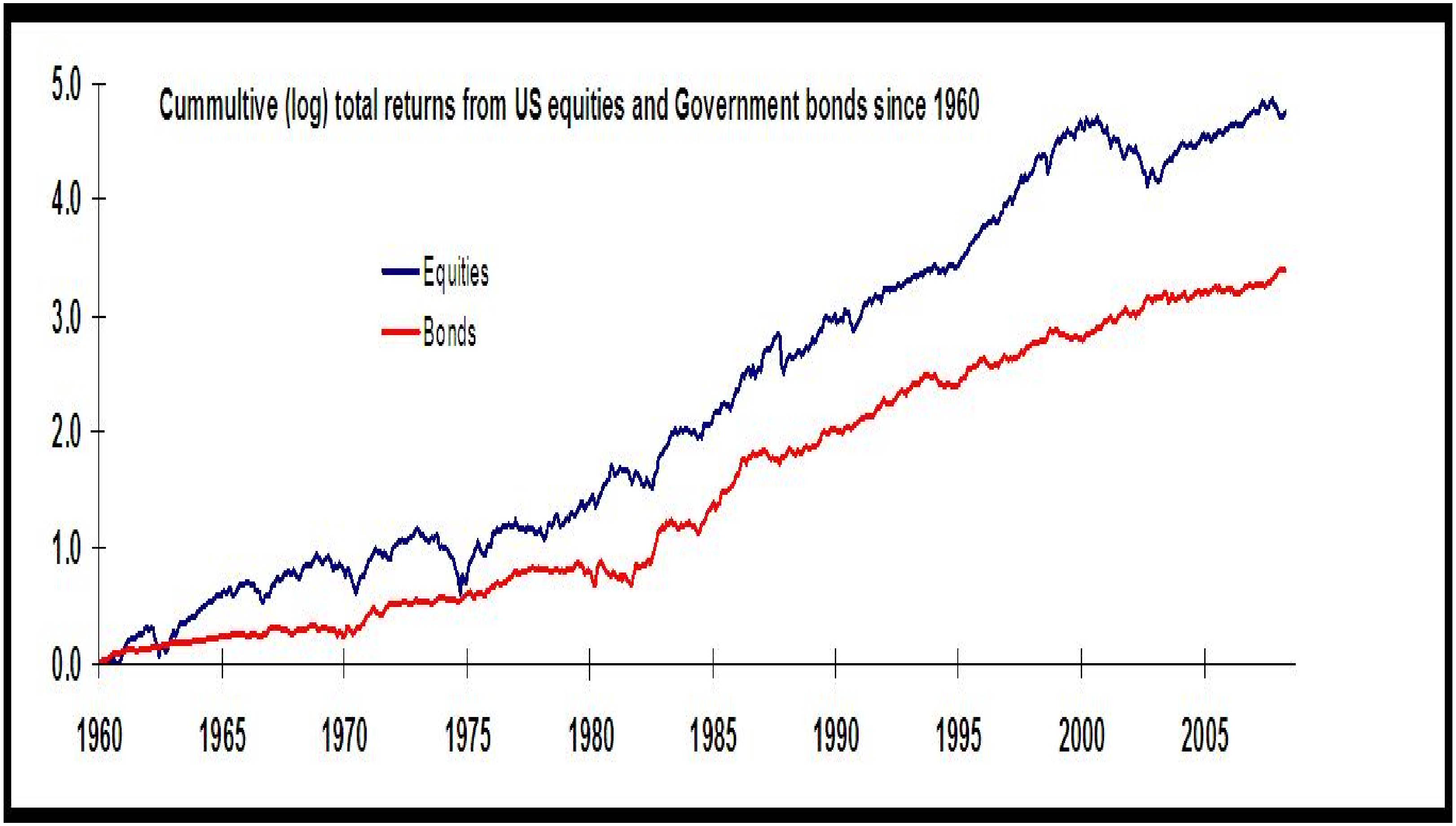
in perspective



FUND

Opportunities for a long-term investor

Tilting the portfolio: Equities v Bonds



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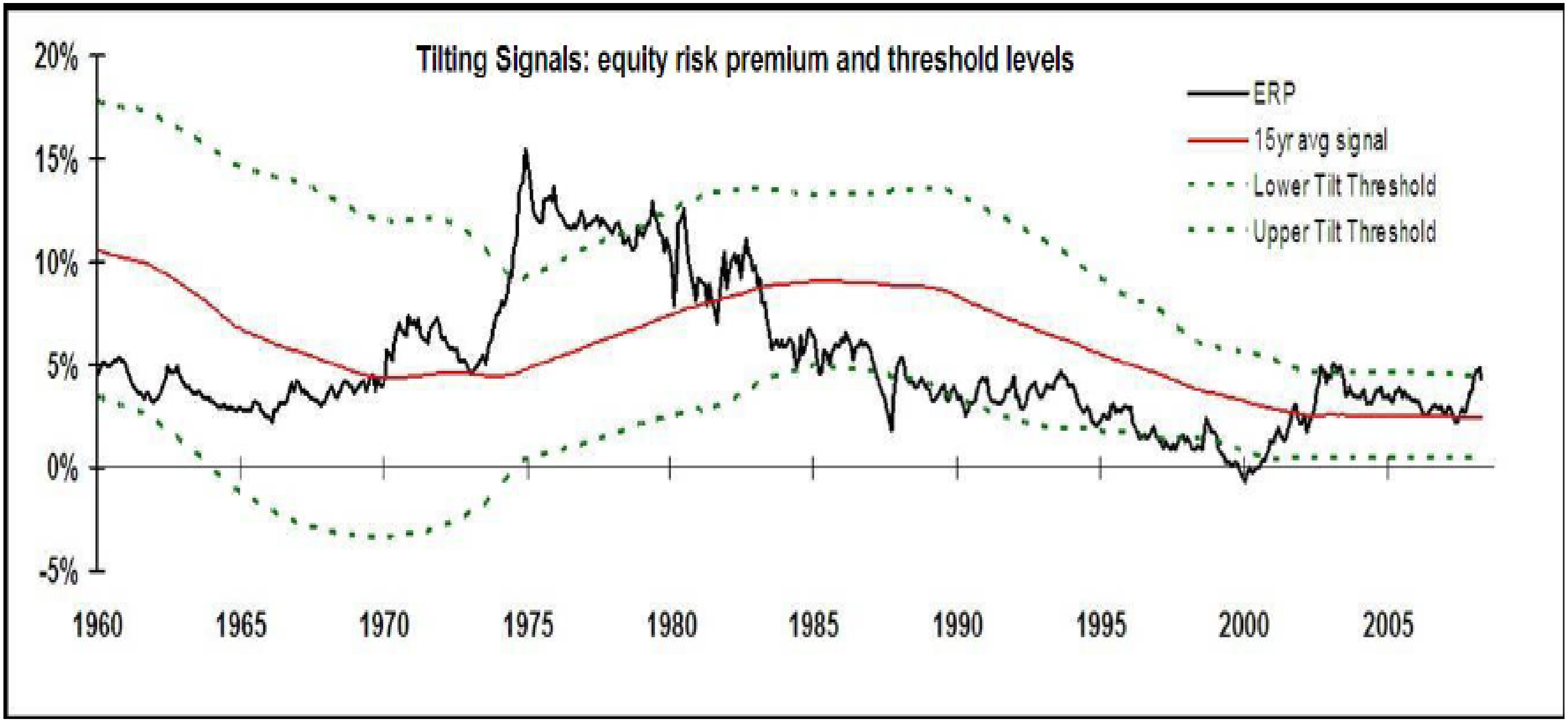
Opportunities for a long-term investor

Tilting the portfolio: Developing Signals



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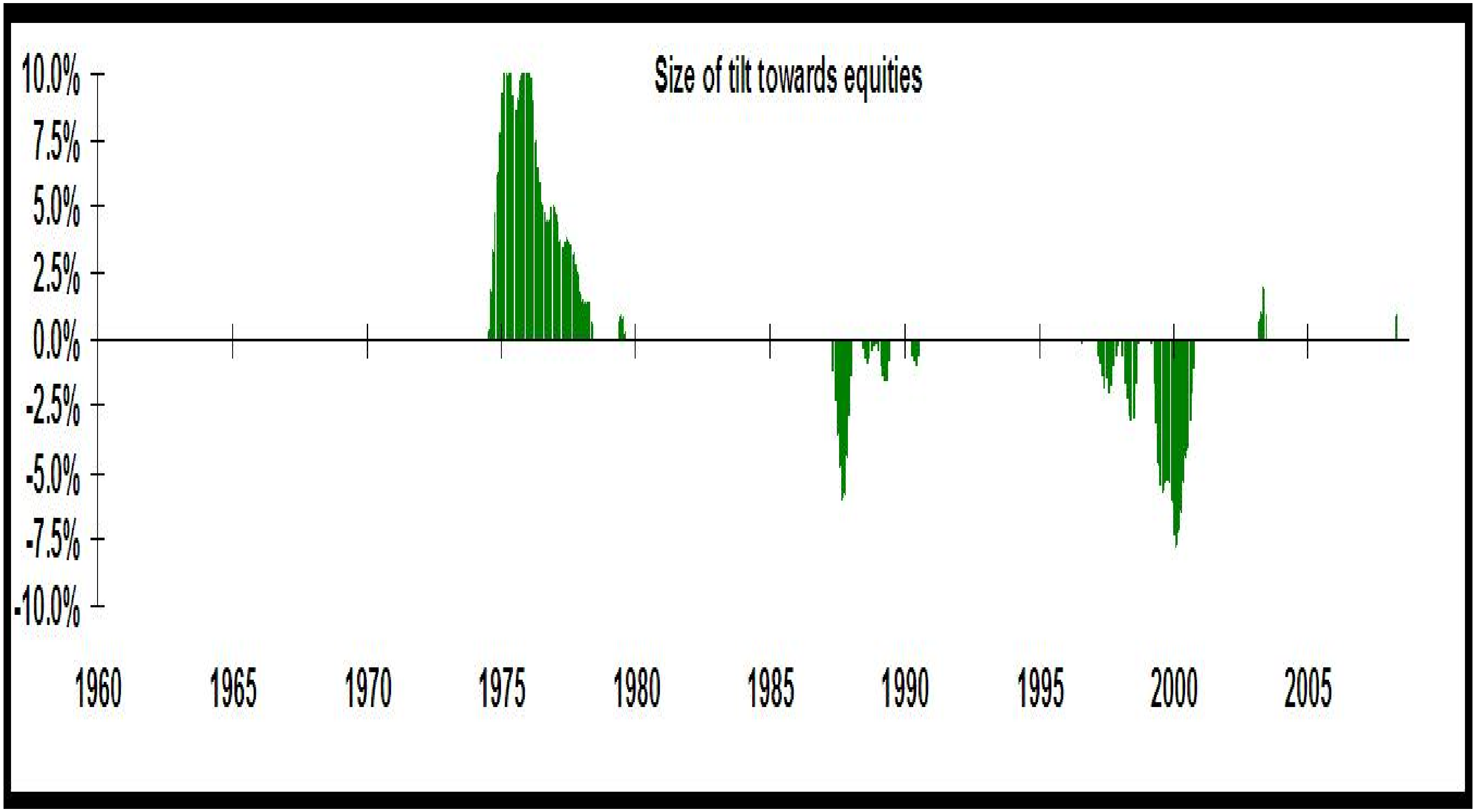
Opportunities for a long-term investor

Tilting the portfolio: Equities v Bonds



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Opportunities for a long-term investor

Tilting the portfolio: Equities v Bonds

	The SAA investor	The 'tilting' investor	The 'spooked' investor
Fund return	10.8%	11.0%	10.4%
Fund std dev	12.6%	12.5%	12.6%
Sharpe ratio	0.86	0.88	0.83

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Summary: Principles of Long-Term Investment at the Fund

- **A clear purpose**: smoothing superannuation costs over time
- **Discipline to stay the course**:
  - Well-defined organisational and accountability structure
  - Structure strategies and incentives to be invariant to short-term market-movements
- **Deliberate financial exposure**:
  - Diversification through the SAA
  - Maintain flexibility to evaluate and buy into new investment opportunities…
  - … while undertaking thorough diligence and maintaining risk commitments
- **Communication to key stakeholders**

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