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"Extracting Sustainable Returns in a Global Context"

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Perspectives from a Sovereign Wealth Fund

Good morning and a big thank you to Pension Investment Association of Canada for both inviting me here, but also giving me considerable latitude for this presentation. I intend to make full use of it.

What I want to concentrate on are the things that SWFs and pension funds have in common. By understanding the similarities between pension funds and sovereign wealth funds, we can work together to maximise our expected investment returns. To achieve this, I think of the three Cs – by **C**omparing experiences and **C**ollaboration today, there is the prospect of **C**o-investment tomorrow.

So today, is a bit of group therapy. We are going to get to know each other better.

To that end, I will [contrarily] start with what makes Sovereign Wealth Funds and Pension funds different.

Sovereign wealth funds are simply pools of nationally-owned financial assets that are invested for specific economic purposes. These can be for:

- inter-generational transfers
- diversifying commodity wealth
- budget stabilisation
- and national economic development.

They can also be used as buffer funds for a specific future purpose. This is exactly the purpose of my fund, the New Zealand Super Fund.

The fund was created by Act of Parliament in 2001 in response to the challenge of New Zealand's ageing population.

The purpose of the Fund is to save now in order to help pay for the future cost of providing universal retirement income. In this way the Fund helps smooth retirement income costs between today's taxpayers and future generations.

Between 2003 and 2009, the New Zealand Government contributed NZD14.88 billion to the Fund. Contributions are scheduled to resume from 2020/21. From around 2032/33, the Government will begin to withdraw money from the Fund to help pay for New Zealand Superannuation.

The Fund will continue to grow until it peaks in size, as a proportion of GDP, in the 2080s. The Fund is therefore a long-term, growth-oriented, global investment fund.

Under the Act, we must invest 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.

All of these elements have equal weight, which gives us clear guidance, especially around responsible investment and I will return to this later.

I am also Chair of the International Forum of Sovereign Wealth Funds, or IFSWF as we snappily call it. It is worth going in to why IFSWF was created, because it illustrates just how far and how fast SWFs have come.

In the years leading up to the global financial crisis, the activities of SWFs were viewed, on the whole, with some suspicion. SWFs were variously considered agents of the state, executing chequebook foreign policy strategies. Or we represented flighty and destabilizing capital. Hot money changing direction with the economic winds. Or massive commodity wealth in the hands of the irresponsible.

To illustrate this last point let me tell you the story of the Pacific island Nauru, 4,000 kms north of New Zealand.

From the end of WW1 to independence in 1968, Nauru was administered by an unwieldly trinity of Britain, Australia and New Zealand, who exploited its phosphate reserves. Following independence, Nauru continued to strip mine its phosphate and in the 1970s and 1980s the country grew fabulously rich – with the world's second highest per capita income.

The islanders spent their money on a shipping line and airline, with seven planes and half a dozen ships. No matter that two-thirds of Nauruwas uninhabitable. Presidents would commandeer aircraft leaving paying passengers stranded; the police force bought a Lamborghini to enforce the island's 40kph speed limit along its 20 km of paved road. Famously, Nauru bankrolled a musical about Leonardo da Vinci. It flopped.

There was full employment, free housing and zero tax. But no thought of the next generation or a sustainable economy.

Unsurprisingly, the money ran out as a result of mismanagement. Leaving behind an island scarred by stripmining, with no harbour, no fresh water and no reliable source of power generation.

While the Nauru story was extreme, it illustrated the need for the responsible and far-sighted SWFs to act to improve both reputation, but also the governance and operations that underpin reputation.

Scroll forward to today and that position has changed dramatically. First, the GFC suddenly generated a sharp increase in the demand for the type of long term, countercyclical and contrarian capital that SWFs can provide.

Second, there has been growing knowledge and understanding between host and recipient nations of SWF capital, assisted by the voluntary development of the Santiago Principles which guide behavior governance and operations. The leading SWFs came together in 2008 to define, create and apply the Santiago Principles. IFSWF was created by its members to champion the Santiago Principles and encourages members to implement them as fully as possible. It is appropriate that we are here in Alberta, as the state's SWF, the Heritage Fund, is one of our most active and valued members.

IFSWF exists to facilitate improvements in global understanding of what sovereign investors do and why. To allow all members – old, new and prospective – to learn from each other's experiences. To inform our members' governance, accountability and operational methods, from which all interested parties can take courage and comfort.

So, the principles, conceived as a defensive reaction to wariness about sovereign capital have matured in both perception and reality. They now signal the positive impact of long term investment and the serious commercial intent of the sovereign investor. The principles are also vital in further distinguishing SWFs from pension funds. The legislation and governance that established and confers independence on SWFs also allow them to focus on the long term, yet without the specific liabilities that pension funds need to meet.

And this is the what I want to focus on today. How we can both use our long term horizons to deliver value.

The legislation establishing the New Zealand Super Fund enables us to operate beyond a three year election cycle. Inter-generational fairness and setting wealth aside for future generations do not come naturally to governments. As the Nauru example illustrates, it is common for current generations to want instant gratification and enjoy wealth now. Also, future generations do not get to vote for current governments, meaning their voice is never heard. Time inconsistency, myopia and principal-agent problems all drive inappropriate risk taking and insufficient financial provisioning for the future. Not saving now to meet a known demographic challenge implies an assumption that the challenge can be met successfully at some future unknown date and interest rate.

Investing for the long term is largely concerned with the ability to control the deployment of risk capital at all times, and especially at times of market dislocation and turmoil. In other words, the long-term investor must have the resources (particularly human capital) and discipline to resist short-term forces that that could cause a deviation from the long-term strategy. However, the term "long term" does not represent the same to all, and has to be considered in the context of a particular set of goals, endowments, beliefs and capabilities. In the NZSF we define a long-term investor to be one that can hold any *investment strategy for as long as they wish*.

The NZSF is a true long-term investor, able to invest in a countercyclical and contrarian way across economic and financial cycles; and benefitting from its stable risk appetite. We are able to maintain the necessary control because certain institutional characteristics are to the fore: a government and beneficiary that has granted a commercially-focused mandate to a Board that then decides independently on a desired risk-return profile and investment strategy for the Fund; the Board's support of management in the execution of the strategy; limited claims on capital; sufficient liquidity; and generally low levels of peer and agency risk.

The first advantage available to long-term investors is that they can ride out much of the shorter-term volatility in financial market prices and not be forced to sell assets when their holdings are worth the least. Long-term investors should have a stable risk appetite and profit from the fact that markets suffer from periods of extreme risk aversion (that is, non-stable or dynamic risk appetite) or outright panic.

The second advantage is that a long-term investor can pursue more illiquid investment opportunities. Long-term investors should hold assets for as long as it remains prudent to do so, and should not be forced to sell when it is not in their interest. The NZSF has demonstrated its ability to take on illiquid investments with long return horizons, with the confidence that it has bought into the asset at a good price and will be paid a deserved illiquidity premium by owning assets that more short-term investors cannot.

A third advantage is that long-term investors are, in principle, not driven by reputational or career concerns derived from short-term return comparisons. For example, the NZSF has used its ability to sell insurance effectively when other investors have not been able to manage volatility. The Fund's investments in catastrophe reinsurance and life settlements, and its various arbitrage strategies, have simply leveraged its stable risk appetite, investment horizon and liquidity profile – generating higher long-term returns given the inability of other, more short-term orientated investors to do the same.

The NZSF and other long-term investors have not only provided superior risk-adjusted returns to their owners, but in doing so, have also increased stability in global financial markets.

The majority of market participants are unable, for fundamental or behavioral reasons, to invest in a contrarian way. Consequently, they tend to sell assets and risk exposures when prices are falling and *vice versa*.

A study by the IMF investigated the causes of the observed procyclical behavior of institutional investors during the global financial crisis and identified the destabilizing effects of "institutional herding" (Papaioannou *et al.* 2013). Institutional herding occurred, with growing concerns about so-called "capital preservation" as the crisis intensified. Several investors responded by abandoning long-term investment strategies, reducing risk exposures, and switching to safer asset classes, usually with the intention to switch back as soon as market conditions improved.

These actions were generally misguided for reasons that could have been predicted at the time. First, market prices had already plummeted before the decision-making capability of most institutions could have reacted – hence investors were selling pro-cyclically and therefore locking in losses. Second, the residual fear in the market and the "blamestorming" amongst Boards, meant that many investors did not get back into risk assets until well after the global recovery in asset prices was underway. The net outcome is that institutional herding destroyed wealth, increased financial market volatility, and led to the demise of many sensible long-term investment strategies. The temptation to concede to short-term market fluctuations is a trap that significant swathes of the global investment community consistently fall into.

Fortunately for investors able to maintain their long-term focus, these oft-repeated mistakes increase their competitive advantage. During the crisis, we asked ourselves three critical questions. First, have our investment beliefs been challenged (for example, will markets not normalize and revert to their respective means in the long run, as previously believed)? Second, is our strategy correct (for example, buying more of an asset when its price has fallen and expected returns have therefore risen)? And third, do we have the capability to manage day-to-day financial operations in an unprecedented credit environment?

Both operational independence and governance clarity were critical to our capacity to stay the course, setting the NZSF apart from a large number of its peers. Our ability to be a long-term investor lies in our design and investment framework.

Embracing a contrarian strategy

Thirteen years is a short period for measuring the outcomes of a long-term investor, whose confidence in forecasted returns peaks at periods of two decades ahead when it expects to generate an average return of at least the risk-free rate plus 2.5%. A period of more than 20 years is long enough to reap the rewards of taking on ownership risk as an investor, as the rewards to owners of capital will generally outperform those of lenders, as long as they are patient and responsible investors. The relative inability of most investors to wait this long is why long-term investors can be even better rewarded. The evidence throughout economic history supports such long-term returns. Since 1926, the returns to investors in the US equity market outperformed that of US Treasury bills in every consecutive 20-year period, and the US borrowing rate by over 2.5% around 90% of the time. These historical return characteristics inform the NZSF's investment model, which includes a clear investment horizon, a well-diversified global portfolio, and embedded investment discipline to "stay the course" during volatile times – and indeed to take advantage of volatile times, when other investors cannot.

Around two-thirds of the Fund is invested passively, in line with the Reference Portfolio. We undertake active investment only when we have a high level of confidence that it will, over the long-term, be better than investing passively – by either improving the Fund's returns, reducing risk (e.g. through diversification) or both.

During our first years of investing the Fund's return expectations were often tested, but ultimately vindicated as returns remained within the confidence intervals initially established. Since inception, the NZSF has generated an average annual return of 9.72% (as at 31 August 2016, after costs and before NZ tax). This is 5.33% ahead of the risk-free rate of return – that is, more than double the cost of government debt (as measured by the 90-day Treasury Bill return).

A focus on medium-term averages, however, masks the month-to-month and year-to-year volatility experienced by this type of growth-oriented fund. For example, during the height of the global financial crisis, the fund lost 29.84% in the twelve months to February 2009. Amidst this global uncertainty, Crown capital contributions to the NZSF were halted as the Government turned its priority to debt reduction. However, the NZSF benefited in the years following the global financial crisis. It has grown rapidly, returning 15.83% per annum (as at 31 August 2016) since the trough. These returns were the result of the Fund taking advantage of global asset prices that fell far below their medium-term value in the aftermath of the global financial crisis.

The NZSF's strategy and performance has demonstrated that it can be sensible, given the right endowments, for debt and investment to co-exist. A degree of caution around debt is appropriate for individual families with mortgages, career risk, health risk and the need to access cash for day-to-day requirements – and for institutions facing massive income shocks and uncertain liabilities. However, for a diversified and sovereign-backed investor like the NZSF, with its liquidity profile and unusually long-term horizon, investment returns can, and have, comfortably exceeded the cost of capital.

The most fundamental aspect of any countercyclical investment strategy is that the investor's appetite for risk should remain stable throughout the economic and financial cycle. The NZSF's risk appetite remained constant throughout its turbulent first decade of investing. Rebalancing policies, which ensure that the portfolio retains the targeted level of risk and balance of risk exposures even when asset prices (and perceived risk) move, are an important reflection of the fund's constant risk appetite.

Active investment strategies and implementation

The NZSF introduced a number of active contrarian or counter-cyclical investment strategies, such as strategic tilting, selling rather than buying insurance, and being opportunistic in direct investing in private markets when there is a clear gap between the current price and an asset's long-term value. With these simple investment strategies, it joined a minority group of disciplined contrarian or countercyclical investors.

The NZSF does not purport to forecast market troughs and peaks, we regard this as a futile practice that too often leads to pro-cyclical investment behavior and missed opportunities.

Instead, as a long-term investor, we maintain a focus on the NZSF's horizon and liquidity profile, and our investment beliefs. We consciously focus on the NZSF's robustness to financial volatility and seek to ascertain how it could gain from the shorter-term fads, fashions and pro-cyclical investment strategies of other investors that dominate the global financial environment. We are particularly focused on ensuring our investment strategies align with our overarching investment beliefs. Long-term and contrarian investing often requires the allocation of capital in times of considerable uncertainty, because these are the times when expected returns are the most attractive, even after adjusting for the higher risk. In doing so, they reiterate the central importance of anchoring the NZSF's strategy in its purpose, capabilities and, ultimately, its managers' beliefs about the drivers of long-term returns.

We also adopt a "single-fund view", which is different from how most global funds and large institutional investors operate, with their emphasis on sticking to traditional asset-class allocations. The latter approach can lead to mechanistic and rigid "bucket filling" (in each asset class) and significant remuneration complexity as each asset-class expert demands his/her specific allocated portion.

We use risk budgets to ensure we allocate active risk consistently over baskets of investment opportunities. We believe risk budgets are the best means to ensure a single-portfolio focus for the whole team, rather than simply meeting an asset-class quota. Within a Board-approved overall active risk budget for the Fund, various investment opportunities with similar underlying drivers are grouped together into baskets by our Investment Committee. The investment opportunities in each basket have similar risk characteristics e.g. diversifiers, market pricing or asset pricing. The Investment Committee allocates the overall risk budget across these baskets. Teams of investment professionals monitor investment opportunities relating to a given basket, making risk allocation recommendations and informing investment and divestment activities.

Risk budgets help us assign capital judiciously, allowing investment professionals who are deeply familiar with investment opportunities to be closely involved in decision-making. Our investment teams are partly incentivized and remunerated on how much value the NZSF as a whole added relative to the Reference Portfolio (over a four-year moving average period). This is partly why we chose a Reference Portfolio over a more elaborate strategic asset allocation. The latter is a mixture of passive and active investment decisions, which can blur ownership of the risk and mask active investments that may not make economic sense.

Another important aspect that we consider is responsible investment. And I use the term, responsible not ethical – they are two different things. Our founding legislation requires: "avoiding prejudice to New Zealand's reputation as a responsible member of the world community." Just as importantly, we have an investment belief that environmental and social governance are material to long term returns. 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.

These benefits arise from avoiding the poor performance and enterprise failures that can arise from lax governance, and weak environmental and social practices. As such, we look to integrate Responsible Investment considerations all through our investment process.

While ESG factors may be hard to quantify, we will benefit directly if they are taken into account in all our investment activities. This integrated method is different to treating RI as a 'gate' or 'hurdle' for an investment proposition, or only as a way to manage risk. Being a responsible investor implies that we must behave as the owners of assets rather than just investors in various securities. It is also important to ensure that our agents, be they fund managers, boards, or company executives, act in our interests and are seeking to maximize long term returns for the Fund.

Some examples of how the Fund's performance can improve through good ESG management include:

- Less principal-agent conflict between ourselves as the asset owner and the asset managers that we employ – including fund managers, advisors, CEOs and management teams;
- More consumer support of the businesses we invest in;
- Safeguarding a company's "social license to operate";
- General risk management and early detection of risks that could otherwise be overlooked; − Less legal and regulatory risk (e.g. health and safety; environmental);
- More dynamic, innovative and productive companies;
- Potential returns from investing early in the life cycle of assets with ESG drivers
- Making best use of our long time-horizon so that we are properly responding to slow-burn global trends such as climate change and population changes

Conclusion

The NZSF experience and that of other SWFs, underlines the importance of understanding and capitalizing on the unique endowments of a fund.

In the case of the NZSF, the most important endowments include its sovereign status, its enabling legislation and governance model that establishes double arm's length independence from the Government owner, a long investment horizon, a defined liquidity profile and full integration of responsible investment into investment decisions. These endowments allow the NZSF to be a true long-term investor, able to invest in a counter-cyclical and contrarian way across economic and financial cycles – benefitting from its stable risk appetite. Second, the NZSF example underlines the importance of having an agreed and clearly-articulated set of investment beliefs – to ensure the disciplined selection of investment strategies and use as a compass for decision-making in times of market stress.

It is increasingly understood that sovereign wealth funds are an important institutional commitment to successfully achieving the difficult task of long-term investment. At the same time, the growth in life expectancy has also pushed out the time horizons of pension funds and increased the pressure for higher returns. Pension funds and SWFs have similar objectives and time horizons. A short-term focus results in companies placing too much emphasis on short-term profitability, invest less and perform less well in the long term. This means that investors and society miss out on returns and economic growth. Long-term investment deepens qualitative knowledge, restricts risk and results in a more responsible investment policy.

By acting together in anything from investment mandates to rewards and incentives for asset managers to improving engagement on ESG issues with companies, pension funds and SWFs can both deliver greater value for our stakeholders and beneficiaries.

There is much for us to learn from each other through my old friends the three Cs – comparison, collaboration and ultimately co-investment. I hope that I have gone some way towards this today. I am happy to offer both IFSWF and the New Zealand Super Fund as willing collaborators with the PAIC and its members.

And let me end by returning to the island of Nauru. After nearly two decades of debilitating poverty, alleviated only by the dubious benefit of an Australian refugee centre, the Nauru government has created a new Trust Fund, with proper governance and oversight and a clear mandate to create a sustainable source of wealth for our beneficiaries.

An objective we all share.

Thank you.