NZSUPERFUND
Te Kaitiaki Tāhua Penihana Kaumatua ō Aotearoa

Guardians' Comments on Final Report of 5-year Independent Review dated 15 August 2014

18 August 2014

A. RECOMMENDATIONS

Promontory Recommendation	Guardians' View	Guardians' Comments
Recommendation 1: Period of organisational consolidation We recommend that the Guardians consolidate the changes that have been made in the past few years and put a temporary pause on any further major changes, either in investment approach or organisational structure, until such time as all previous changes have been absorbed across the entire organisation.	**Agree**	We note that the risk budgets, which Promontory describes as being the natural progression from the Risk Allocation Process, are currently being implemented. Beyond this, we are not contemplating any significant change in either investment approach or organisational structure. However, we note that the concept of best-practice, to which we aspire, is not a static one and requires ongoing innovation. Therefore, if the case for certain changes is pressing, we will ensure that each is measured and reported appropriately.
Recommendation 2: Derivatives We recommend that the Guardians develop: • a separate and comprehensive 'Derivatives Policy' and also detailed associated 'Derivatives Procedures' setting out the legislative context in which derivatives can be used in managing the Fund, the constraints on their use, and the mechanics of how the Guardians ensure that they are used within the intended limits; and • an additional report for the Board, and also for annual reporting to the Minister, that confirms that the use of derivatives complies with the Act and the Minister's guidance.	**Agree and this is underway**	We are currently developing a separate Derivatives Policy and Procedures along the lines recommended. The monthly Board report and quarterly report to the Minister will include positive confirmation that the use of derivatives is consistent with our Act and the Minister's Letter of Expectation. We note this compares with the current process in which any non-compliance is notified to the Minister immediately under the 'no surprises' protocol. There has been no non-compliance to date.
Recommendation 3: A single coherent policies and procedures manual We recommend that the Guardians consolidate their investment policies and procedures framework into a single authoritative reference point for understanding the investment philosophy and practices employed by the Guardians in managing the Fund. The procedures should set out the way in which various issues are addressed (both in principle and in technical detail), and the detailed steps and controls involved in implementing the investment philosophy.	**Agree**	We believe that investment policies and procedures are comprehensive. However, we will consider how best to enable clear presentation of these in a single document. We note that as stated in the Report, *"the observation relates to the documentation of the procedures, not to the procedures themselves, which were, by and large, adequate…"*

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Recommendation 4: Appointment of a Chief Risk Officer We recommend that the Guardians appoint a Chief Risk Officer to: (1) provide organisation-wide and independent oversight of risk; (2) maintain the Guardians' risk infrastructure (including ensuring that all policies, procedures and controls are up to date and adequate); and (3) provide assurance to the Board and management on these matters.	**Agree to consider**	We agree to consider this role as part of our organisational planning process on the grounds identified in the recommendation. Against this, we note that as an investment management entity we have two types of risk: investment risk and implementation risk (everything else). Investment risk and return are the fundamentals of our business, and their interplay is the basis of all investment decisions, from policy to individual asset selection. Our approach thus far has been to encourage ownership of risk at all levels of the organisation. Artificially separating risk from return and allocating overall responsibility for risk to a CRO may lead to worse decisions and outcomes.
Recommendation 5: Mandate of the Risk Committee We recommend that the Guardians broaden the mandate of the Risk Committee to clarify that it has independent oversight of the measurement of all risks, including investment risks.	**Agree**	The Risk Committee currently reviews the investment risks that the Investment Committee takes on. It also maintains full oversight of the measurement of all risks, including investment risks as specified in the Board's Risk Appetite Statement. The independent oversight of the measurement of investment risk is provided by the Head of Portfolio Risk and Compliance. These measurements are reported to the Board, Risk Committee, and Investment Committee on a monthly basis. However, we agree the Risk Committee's Terms of Reference can be made more explicit in this regard.
Recommendation 6: Imputed cost of managing the Reference Portfolio We recommend that the Guardians regularly refresh the current methodology underlying the cost of managing the Reference Portfolio and sample the market at a minimum every three years to recalibrate the cost assigned of managing it.	**Agree**	We plan to review the imputed cost of managing the Reference Portfolio as part of the 2015 Reference Portfolio review, and at least three-yearly thereafter. At present, we believe our estimate of 30bps is conservative.
Recommendation 7: Appointment of a Compliance Officer We recommend that the Guardians appoint	**Agree to consider**	We will consider this role in conjunction with assessing whether to appoint a Chief Risk Officer.

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a Compliance Officer, as part of the CRO's team, to ensure effective oversight of compliance risks across the organisation. The Compliance Officer would not take responsibilities currently performed by the General Counsel and various operational teams, but would work with these groups to coordinate compliance activities and provide line-of-sight over all compliance obligations.		
Recommendation 8: Board remuneration We recommend that the Minister increase the remuneration levels of the Board members to align with industry best practice and to ensure that the Board is able to retain the necessary knowledge and skills to discharge its duties effectively.	**A matter for Government**	This is a matter for Treasury, the State Services Commission, and the Guardians Nominating Committee.
Recommendation 9: Guardians' remuneration arrangements We recommend that the Guardians: • improve the documentation of their bonus programme, to cover both eligibility to the programme and the bonus allocations; • commission an external review of the maximum bonus rates allocated to front office and senior management against industry benchmarks in New Zealand and Australia, as well as comparable sovereign wealth funds in developed countries. The objective should be to keep the Guardians' remuneration levels competitive. Reviews should be carried out at least every three years, or more frequently if staff turnover becomes a concern; • review the basis for calculating Fund performance for bonus purposes, with a view to linking them more closely with the performance of the actual portfolio relative to the Reference Portfolio.	**Agree**	

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B. SUGGESTIONS

Promontory Suggestion	Guardians' view	Guardians' Comments
Suggestion 1: Board reporting on use of derivatives We suggest that the Guardians include in their reporting to the Board on the use of derivatives, an analysis of the non-linear impact of options on the risk profile of the Fund and the use of derivatives by external managers.	**Agree**	We have one option, and this is included in our quarterly stress-testing programme. The impact of exercising this option, and any future options entered into by the Fund, will be measured and reported appropriately.
Suggestion 2: Analysis of tail risks We suggest that the Guardians identify tail risk as a specific risk category and continue to develop their approach to conducting regular, dynamic stress analyses of the portfolio under a range of potential tail risk events and report these to the Board. The analysis could include proposals on early warning signals and exit strategies (or entry strategies where appropriate).	**Agree in part**	We note we already take explicit account of tail risks in our portfolio modelling and we conduct regular, dynamic, stress tests and scenario analysis of the portfolio. The results of these are provided to the Board and have been shared with Promontory. Where tail risks exist in specific investment strategies, they are taken into account in determining our approach to a strategy and the sizing of any positions (e.g. variance swaps and strategic tilting). We do not believe we are capable of modelling early warning indicators of fat-tail events. However, we agree we should have a clear view of the implications of "shocks" and our actions.
Suggestion 3: Risk Registers We suggest that the Guardians review the process, justifications and documentation of the Risk Registers, with the objective of making the Registers a more dynamic tool for use by business units. We suggest the documentation should include: separating more clearly causes, risks and impacts; providing justifications and assumptions underlying each of the likelihood and impact ratings and reasons for material differences between them; and a control framework that assesses controls on a design and performance basis.	**Agree**	
Suggestion 4: Risk Records We suggest that, as the Guardians review their Risk Records architecture, they seek to simplify it and better link it to the major risk categories identified at the enterprise level.	**Agree. Endorses actions already underway**	

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Suggestion 5: Disclosure policy We suggest that the Guardians consider, as a matter of good practice, adopting and implementing a disclosure policy (or modify the existing Communications Policy) to highlight the need for all disclosures issued by the Fund to be fair, balanced and not inadvertently misleading. The Guardians should also consider broadening the range of disclosures to include aggregated information about external management fee arrangements and the performance of sub-indices within the Reference Portfolio.	**Disagree in part**	The Report confirms the Guardians approach to transparency to the Minister and other Stakeholders is excellent overall. It is important for stakeholders to assess the Fund on a long-term whole-of-Fund perspective. We consider that our disclosures are relevant, fair, and balanced. The specific matters Promontory recommends are: 1. Sub-indices of the Reference Portfolio. This information is available from PEARL. However, the external purpose of this disclosure remains unclear given the focus on portfolio level performance. 2. Fees paid to external investment managers. Visible base and performance fees are already disclosed in our Financial Statements. These cannot be disaggregated to a greater extent given the commercial sensitivities around fee arrangements. All returns are measured post all costs and expenses. Accordingly, it is not clear to us what value this information would provide to stakeholders. 3. Specific reference to a Case Study (insurance related investments) in the 2013 Annual Report. This case-study showed returns since inception. It is difficult to see what other performance measure would have been appropriate. 4. The returns over the 90-day Treasury bill and the Reference Portfolio are both available on the website. Our refreshed website will be available by September. As part of this, we are considering the best way to communicate the return information and will take Promontory's comments into account.
Suggestion 6: Alignment of performance reporting We suggest that the Guardians take a proactive approach to shifting the primary focus of all their performance reporting to align with the performance of the Reference Portfolio.	**Agree**	We report against both performance measures (Reference Portfolio and Treasury Bills), and will ensure the appropriate measure is used for each audience. The T-Bill rate remains relevant as it is an easy to understand proxy of the

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		government's cost of borrowing – and answers the question of many, which is "Have the Guardians returned more than what the government could have saved by repaying government debt?" We note that in the Treasury's annual Investment Statement, it uses both performance metrics.
Suggestion 7: Reassess disclosures about accuracy of data We suggest that the Guardians conduct a disclosure risk assessment of information provided to all stakeholders to ensure that information is fairly presented with appropriate safeguards and balancing disclosures where appropriate.	**Agree**	We will consider the nature of the disclosure accompanying our NAV information to ensure that the long-term nature of the Fund and the different valuation cycles of assets is clear.
Suggestion 8: Review of forecasts and assumptions We suggest that the Guardians provide a semi-annual look-back analysis to the Board of historical outcomes against assumptions and forecasts made at the time of key investment decisions.	**Disagree**	We regularly review the performance of our investments and compare this with our expectations at the outset of the relevant investments. These reviews are reported to the Board. The appropriate time frame for assessing the success of an investment strategy varies considerably, so applying a standard 6 month time frame will likely not provide particularly useful results.
Suggestion 9: Realign compliance risk statements We suggest that the compliance risk assessments be better aligned to the RAS.	**Agree. Endorses actions already underway**	
Suggestion 10: Alignment of policies We suggest that the full suite of policies, including the SIPSP and all supporting policies, be refreshed annually to ensure that the policies are up to date, use consistent terminology and keep pace with the ongoing changes in the Guardians' operations. In line with the Guardians' transparency objectives, the policies listed on the website need to be the current versions.	**Agree in part**	We agree that the SIPSP and all the supporting policies to the SIPSP should be reviewed annually; however, we are comfortable that all other policies are reviewed in line with the current timetable. Policy owners are already responsible for ensuring ongoing changes to policies are actioned. We believe the website changes currently underway will ensure that only the current version of policies will be published.
Suggestion 11: Monitoring of external managers We suggest that the Guardians formalise a	**Disagree**	Non-compliance by managers is reported to the Risk Committee and the Board. We do not agree with formalising a standardised definition of

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definition of 'material' for breach reporting by external managers and standardise it across its external manager monitoring programme (considering revising IMA language accordingly) and add a category to the Board Dashboard to report on material compliance breaches by external managers that have not been resolved within an appropriate time period.		'material' breach and standardizing it across the external manager monitoring programme for the following reasons: • Materiality means different things in different contexts within various Investment Manager Agreements (IMAs) and can be both qualitative and quantitative. It would be very difficult to attempt to define what is material and as such, it is standard market practice not to define "material". • Standardisation is not consistent with the objective of materiality clauses, which is to make clear our expectations of the manager's disclosure behaviour. While we provide examples, we do not wish to provide a "checklist", because it prompts a checklist mentality, which creates more risk than any checklist could resolve. • Our preference is to communicate our clear expectations of manager behaviour; to have the flexibility to treat incidents (disclosed or otherwise) case-by-case; and ultimately we have a clear ability to terminate IMAs if expectations are not met. • We note the 'no surprises' policy between ourselves and the Minister is formulated on exactly the same basis. It does not define 'surprise' because it seeks to place the onus of disclosure on us.
Suggestion 12: Oversight of affiliated external providers We suggest that the Guardians consider enhancing its oversight of outsource providers to recognise and require additional due diligence and monitoring where the outsourced provider is a related party.	**Agree**	