Setting Goals and Staying Focused

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NEW ZEALAND SUPERANNUATION FUND

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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Creating discipline

- Governance budget and risk budget to achieve the Fund's mission.

Possible Fund beliefs?
Vision and mission

- How does the board see the stakeholders needs and importance?
- What are the particular ways the Board measures 'success' in mission and value creation?

Vision/Mission

- Why the Fund exists
- Stakeholders
- What are its goals

Governance Budget

- Values
- Positioning
- Competitive advantage
- Structure
- Processes
- Resources

Risk Budget

- Optimal risk exposure and time horizon
- Optimal risk choice – alphas/betas

Source: Watson Wyatt Research

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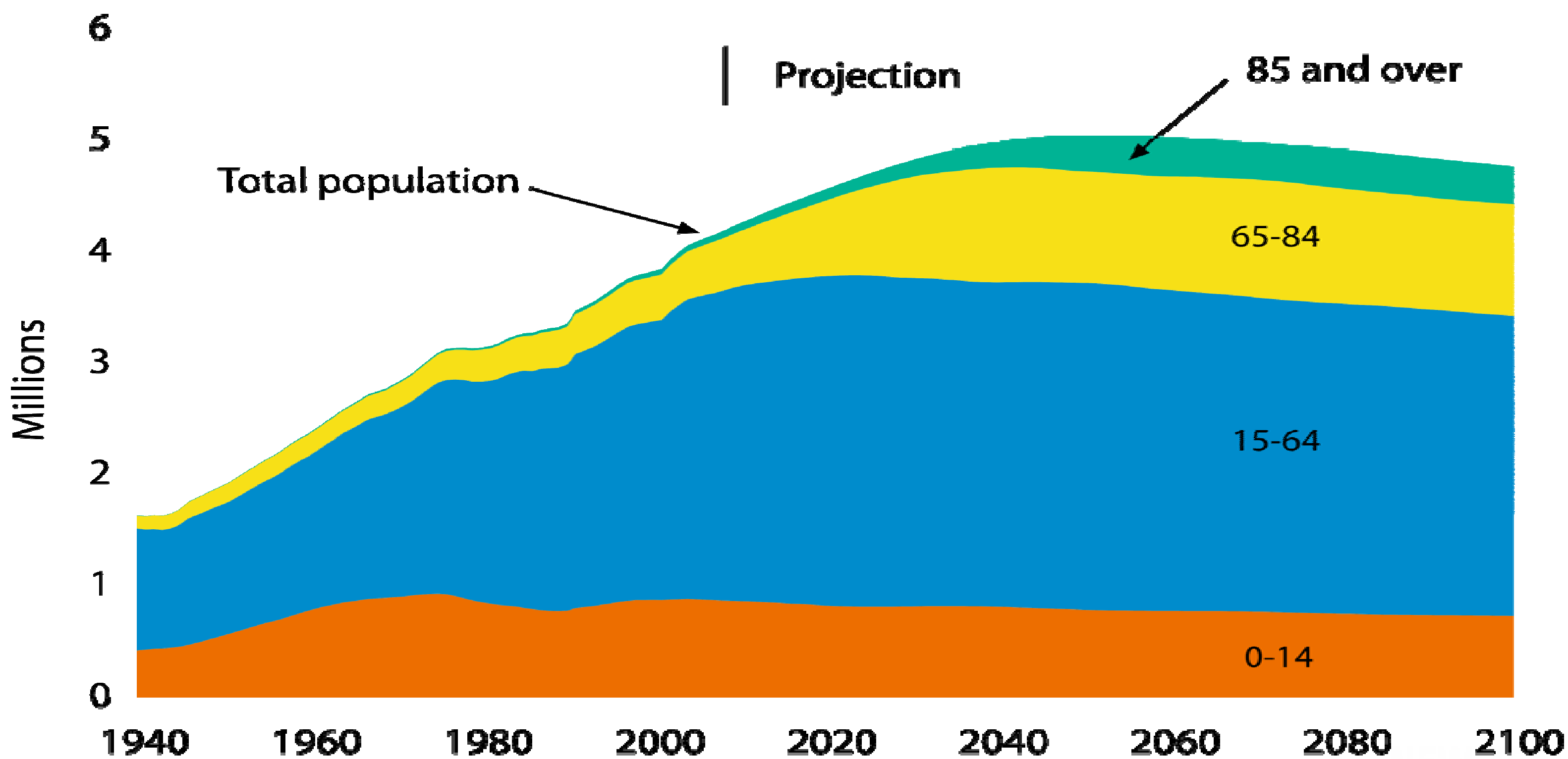
A Clear Purpose: the Superannuation Buffer Fund

Source: New Zealand Treasury



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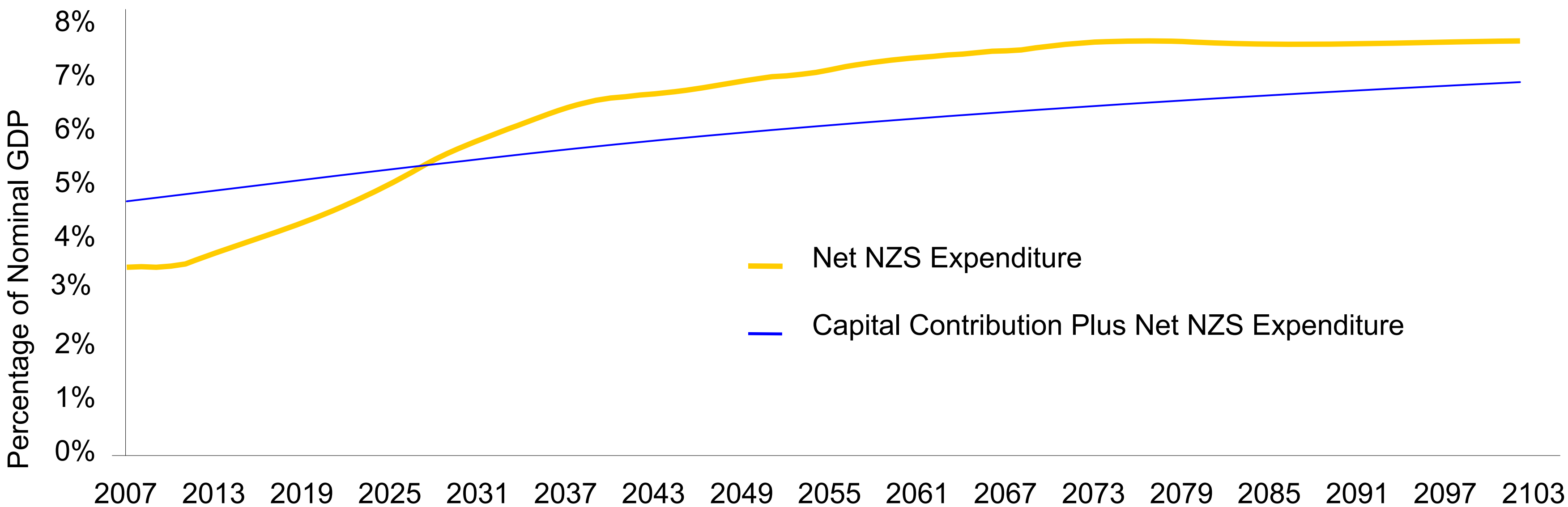
A Clear Purpose:
Smoothing superannuation costs over time



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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Risk and Return Goals

Return Goals	Risk Goals
Returns over cash	Volatility (Standard deviations)
Returns over CPI	Semi-variance (downside only)
Peer group measures	Tracking Errors vs. benchmarks
Relative SAA measures	Value at Risk
Contribution to the Government Net Worth	Probability of capital loss
Contribution to inter-generational GDP per capita	Expected shortfall
	Extreme Value Theory measures

Combined Goals
Maximising returns at an appropriate risk
Information ratio / Sharpe ratio
Risk adjusted return over minimum risk return
Success in smoothing inter-generational GDP

Source: Watson Wyatt Research

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Time Horizons

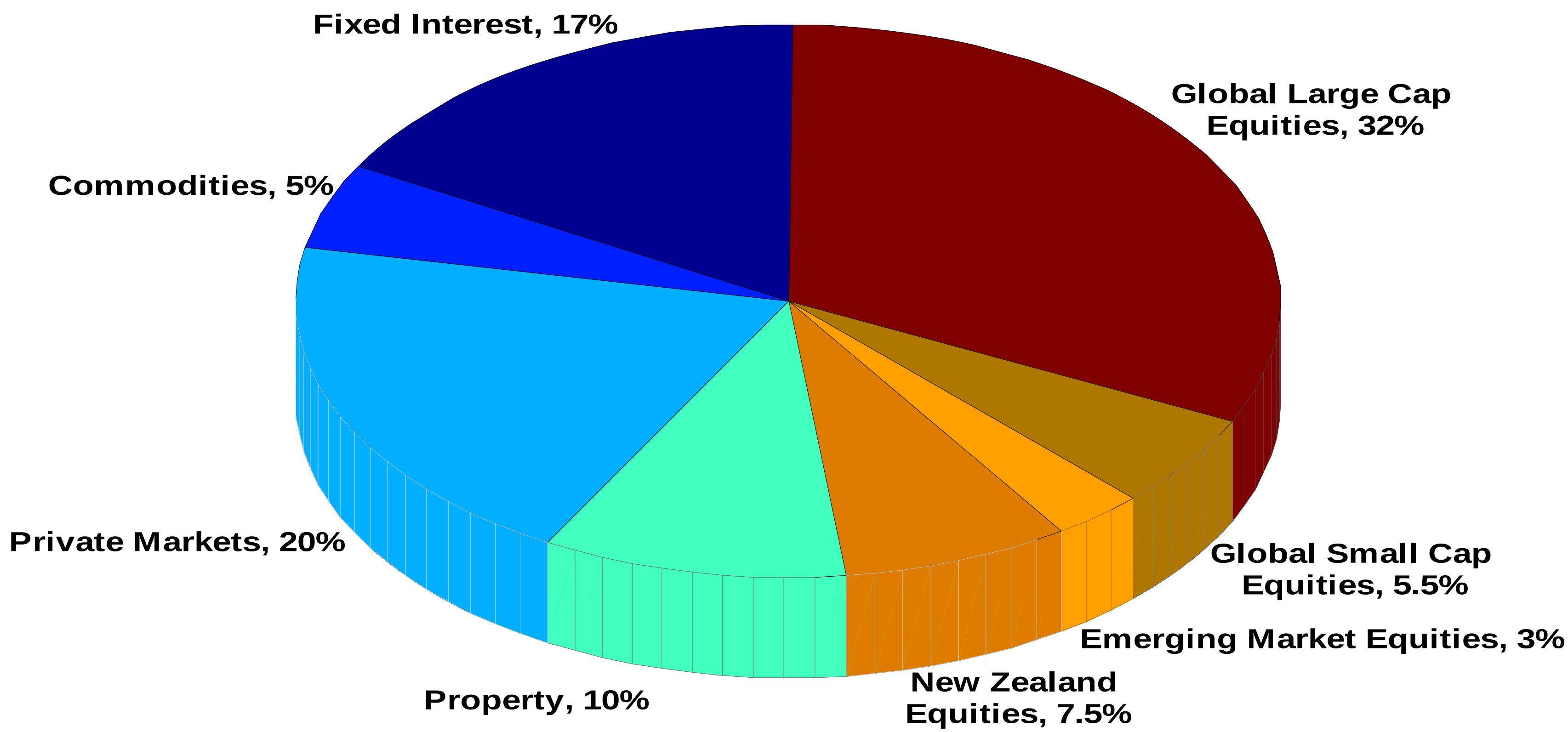
- The investment goal can be summarised as
  - Achieve the long-term results of the mission subject to
  - Adequate short-term results that don't compromise the long-term mission
- This might be expressed as 'Optimising long-term, satisficing short-term'
- Different time horizons have different significance, the table below sets out some of these considerations with suggestions on importance.

Horizon Period	Why is it important?	Overall importance
3 months	Manager performance is measured over this period	?
1 year	Financial reporting interval in the Fund accounts	?
3-10 years	The central period for 'success' for the Fund	?
10-20 years	Average duration of the Fund	?
> 20 years	Consistent with the longer term mandate of the Fund	?

Source: Watson Wyatt Research

Strategic Asset Allocation

Fund by Asset Class (%)



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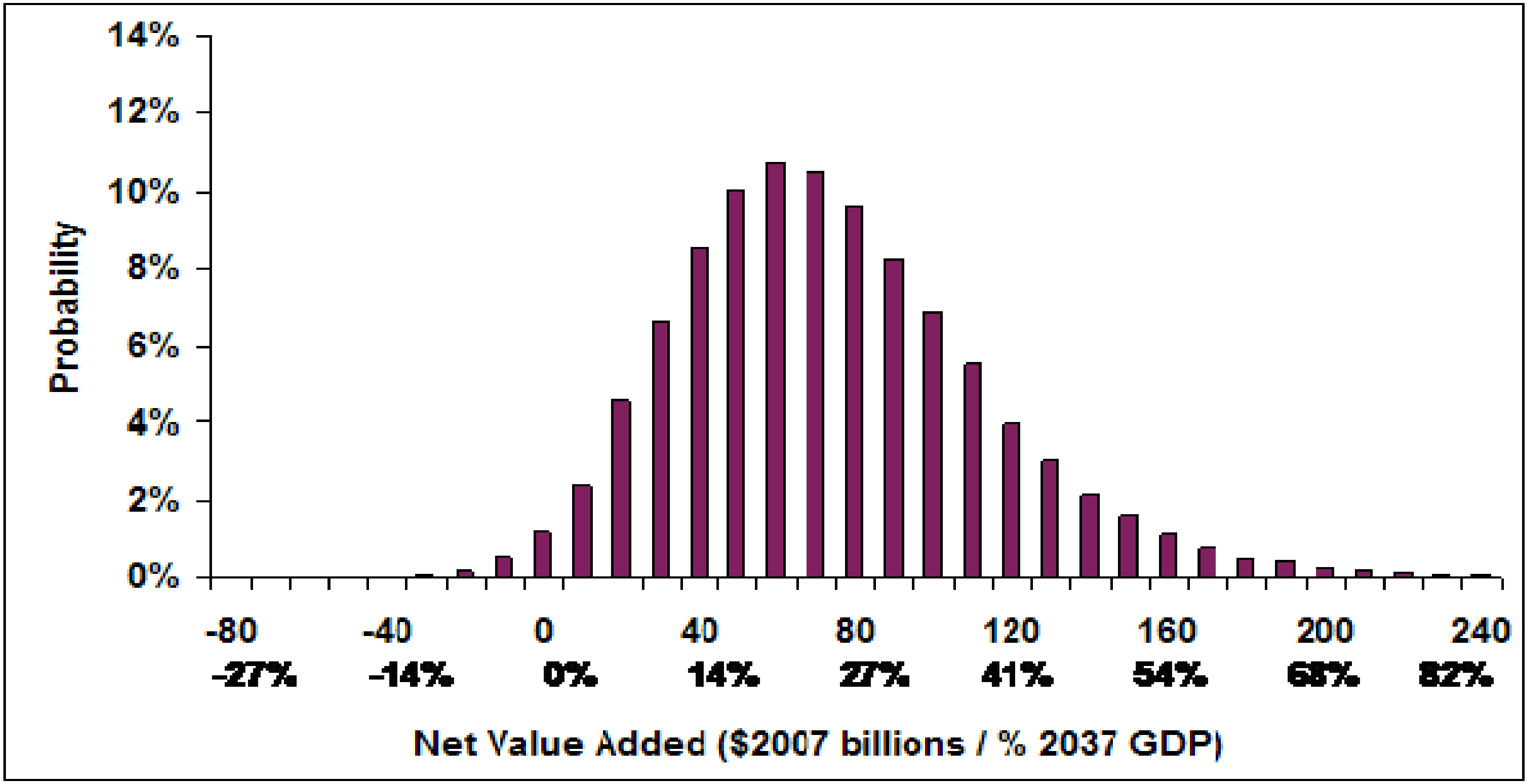
Distribution of expected returns

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



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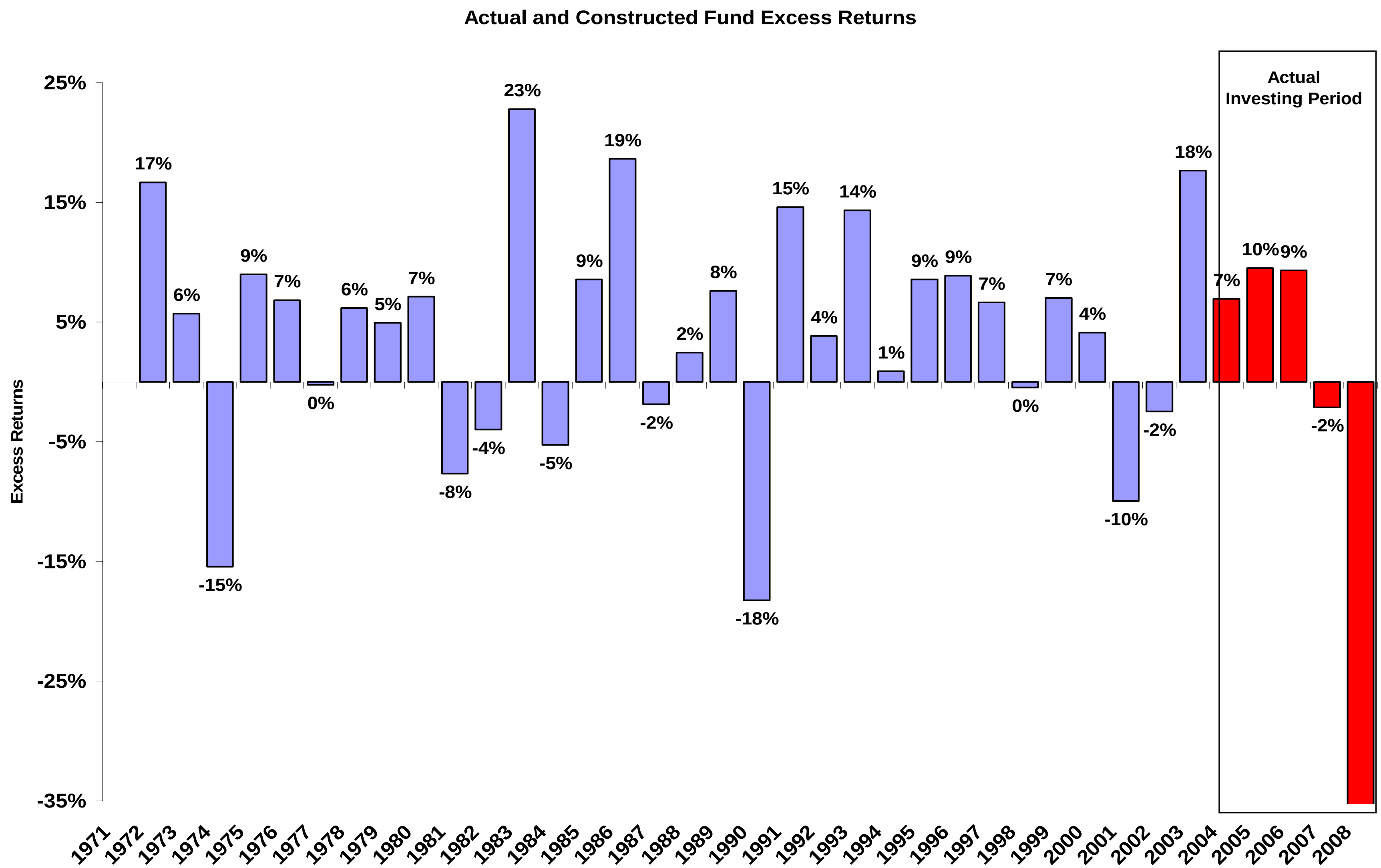
Fund Returns



Governance Budget

- "Governance budget" is time x expertise x organisational effectiveness
- The WW / Oxford research (Clark and Urwin: Best-practice investment) has identifies a number if things that move a fund from 'good to great' by studying a small number of funds that have made that transition.
- Of most importance to results were these four:
  - Strong investment beliefs commanding Fund-wide support that align with goals and informs all investment decision-making.
  - The use of a a highly investment competent management function tasked with clearly specified responsibilities, and accountabilities to the Board
  - Frame the investment philosophy and process by reference to the institution's comparative advantages and disadvantages *(which features in the Fund's Statement of Intent)*
  - Working within a learning culture which deliberately encourages change and challenges the commonplace assumptions of the industry.

Foundation Concepts

Research defines world class governance

Moving from good to great

Clark / Urwin Study of top 10 global funds cherry-picked by results and reputation

Their governance has certain parallels and differences from investment firms

They shared 12 best-practice factors central to their success

Source: Watson Wyatt Research

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Investment Facts and Beliefs
Support, strategy, organisation?

Facts	Beliefs
It is important to be clear about investment objectives for the Fund, risk tolerance, and the timeframe over which results are measured	Investors with a long-term horizon can outperform more short-term focused investors over the long-run
Risk and return are strongly related.	Expected returns are partly predictable within asset classes.
Investment markets are competitive and dynamic, with excess returns very difficult to find and constantly changing source	Identifying the life cycle of an investment is important to assessing the expected return
There are varied investment risks that carry premiums/compensations. Illiquidity risk is one such premium.	Long-horizon investment themes can be identified and exploited
Market volatility tends to cluster over short horizons but mean-reverts over longer horizons.	Underlying economic risks and investment rewards are not accurately reflected in market-cap benchmarks
Investment risks can be unbundled to make the Fund more efficient. This includes the separation of market (beta) and investment specific investment manager skills (alpha).	Some managers can outperform a market benchmark (produce alpha) over time.
Investment diversification reduces total risk	We can identify managers that will outperform the market benchmark (produce alpha) over time.
Individual investments should be made on their expected value-add to the Fund as a whole.	Responsible asset owners who exercise best-practice portfolio management should have concern for environmental, social, and governance issues of companies.
Principal/agent conflicts exist with outsourced investment managers	Improving ESG factors will improve the long-term financial performance of a company

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Mission: Manage the Fund in a manner that best enables future NZ governments to provide retirement income

Inputs

– Our People and Systems

– Our Competencies

– Our Values

– Our Investment Philosophy

Activities

– Strategic asset allocation

– Strategic tilts

– Investment manager and investment selection

– Investment risk management (liquidity, counterparty, etc)

– Responsible investment

– Reporting and monitoring

Outputs

- Market and excess returns

- Value-add returns

- UNPRI improvements

- Efficient portfolio

Risk Management

-Board and management Dashboard and 'budget'

-Risk management framework

Outcomes

- Cost-effective, fit-for-purpose, portfolio.

- Government and public confidence

Our Vision

A Great Team Investing in the Best Portfolio

<u>Our competitive advantages:</u> Quality decisions; Specific knowledge; Employer of choice; Innovative

<u>Our values:</u> Integrity; Inclusiveness; Innovation;

<u>Our investment philosophy:</u> Investment beliefs and Fund Characteristics

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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 upon us

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What needs to happen?

Issue	Reaction	Opportunity / Threat
Impact on financial markets	Asset allocation reflects weakening world economy, with chronically weak banking sector and systematic de-leveraging producing significant dislocation	Tactical and strategic
	Greater risk aversion growing in segments of investor base with a flight to quality in asset allocation	Markets have repriced risk
	Banking pressure to de-leverage leads to many distressed opportunities, with longer term paper priced at substantial discounts	Distressed assets Threat issue also
	Declining markets have led to investors favouring uncorrelated assets, with markets with appraisal values slower to re-price	Alternative assets
Risk	Recognition that risk models are not suited for jumps or financially stressed conditions, requiring more sophisticated view of risk incorporating black swans	New risk models Threat issue also
	Increasing attractions of building a macro overlay framework	New risk models
Leverage	Recognition that excessive use of leverage is big red flag, and a more sophisticated reporting framework for leverage is necessary	Steps to reduce leverage
Investment Managers	Increase evidence of overcrowding and capacity issues with managers in certain strategies, particularly when alongside leverage	Review of quant / leverage
	Increased manager event risk from weak capital / business model or compliance or risk management disciplines	Refinement of manager profile
	Excessive 2 and 20 type cost structures represent poor value for money	Cost constraints
	Time horizon of permanent capital organisations like pension funds in demand, allowing mandates to be stretched	Long-term investor profile

Source: Watson Wyatt Research

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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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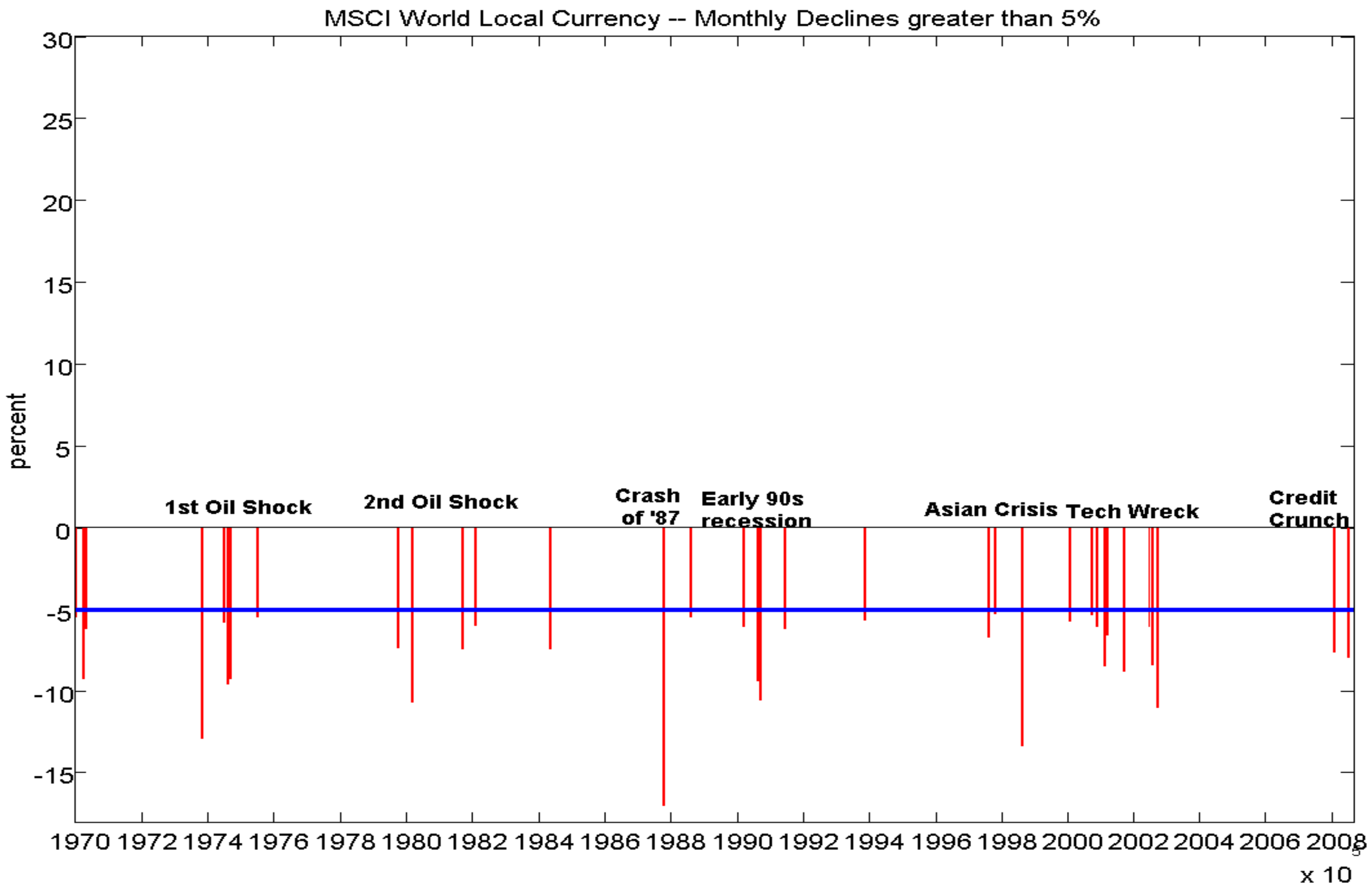
The Credit Crunch in perspective



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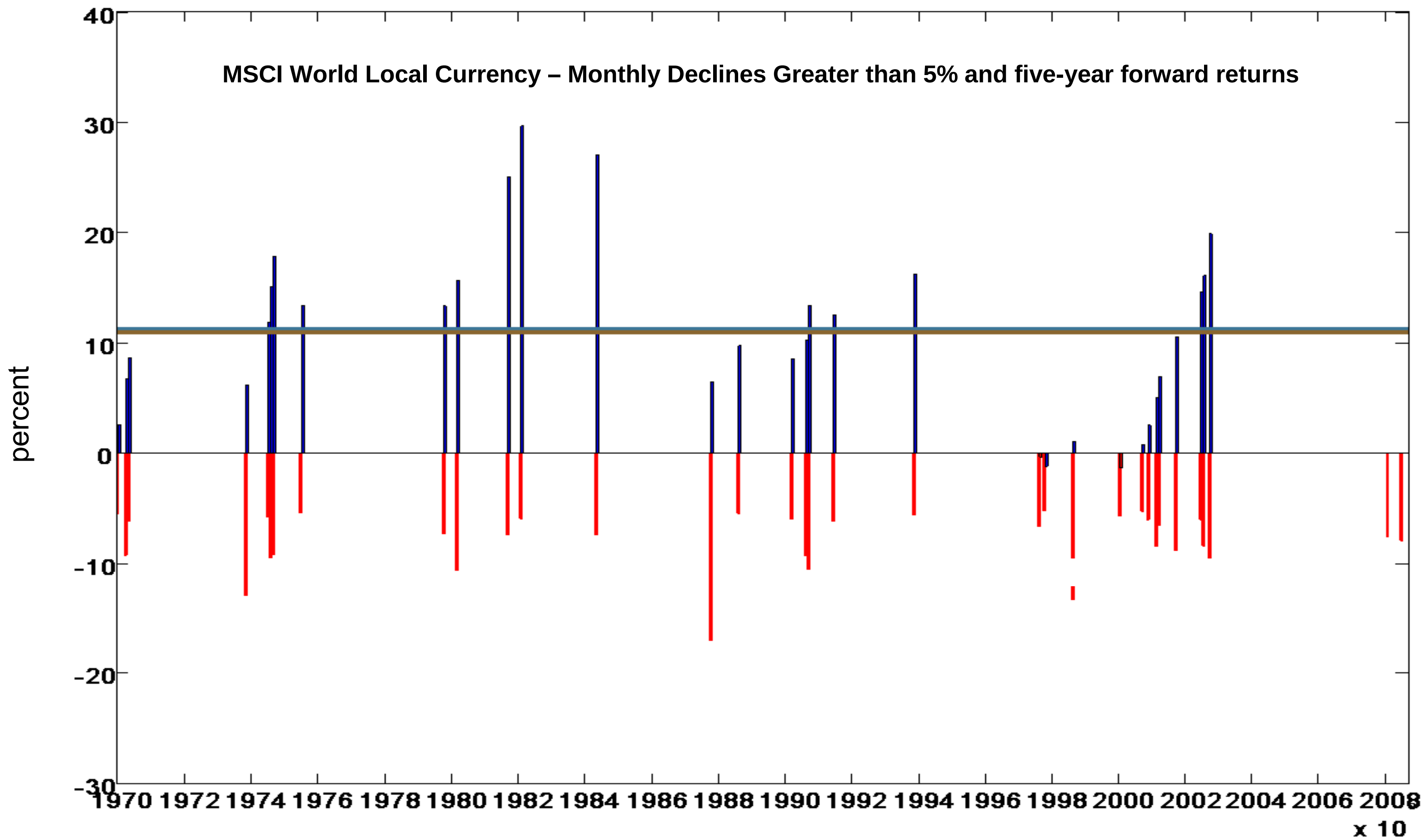
The Credit Crunch

in perspective



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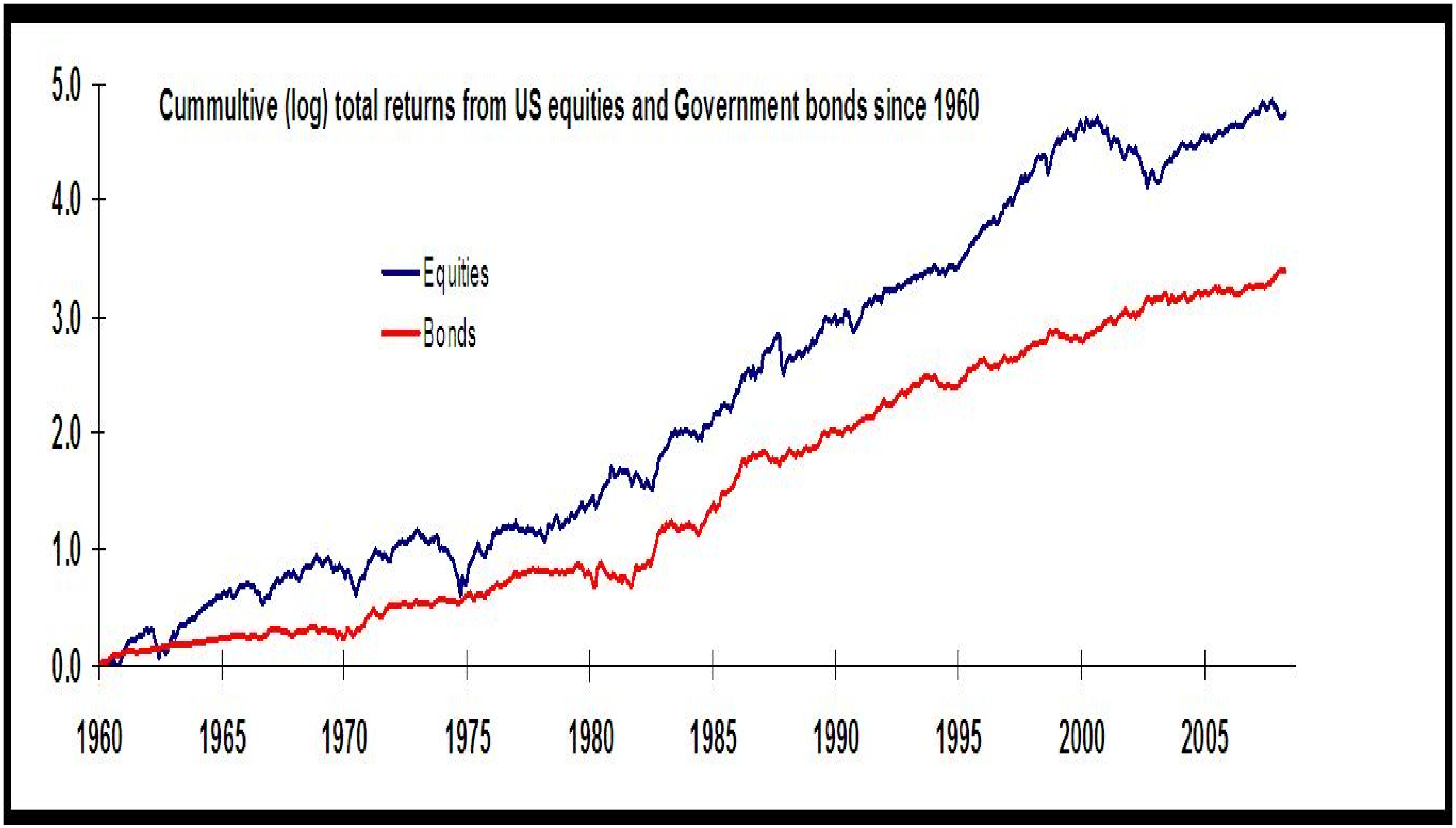
Opportunities for a long-term investor

Tilting the portfolio: Equities v Bonds



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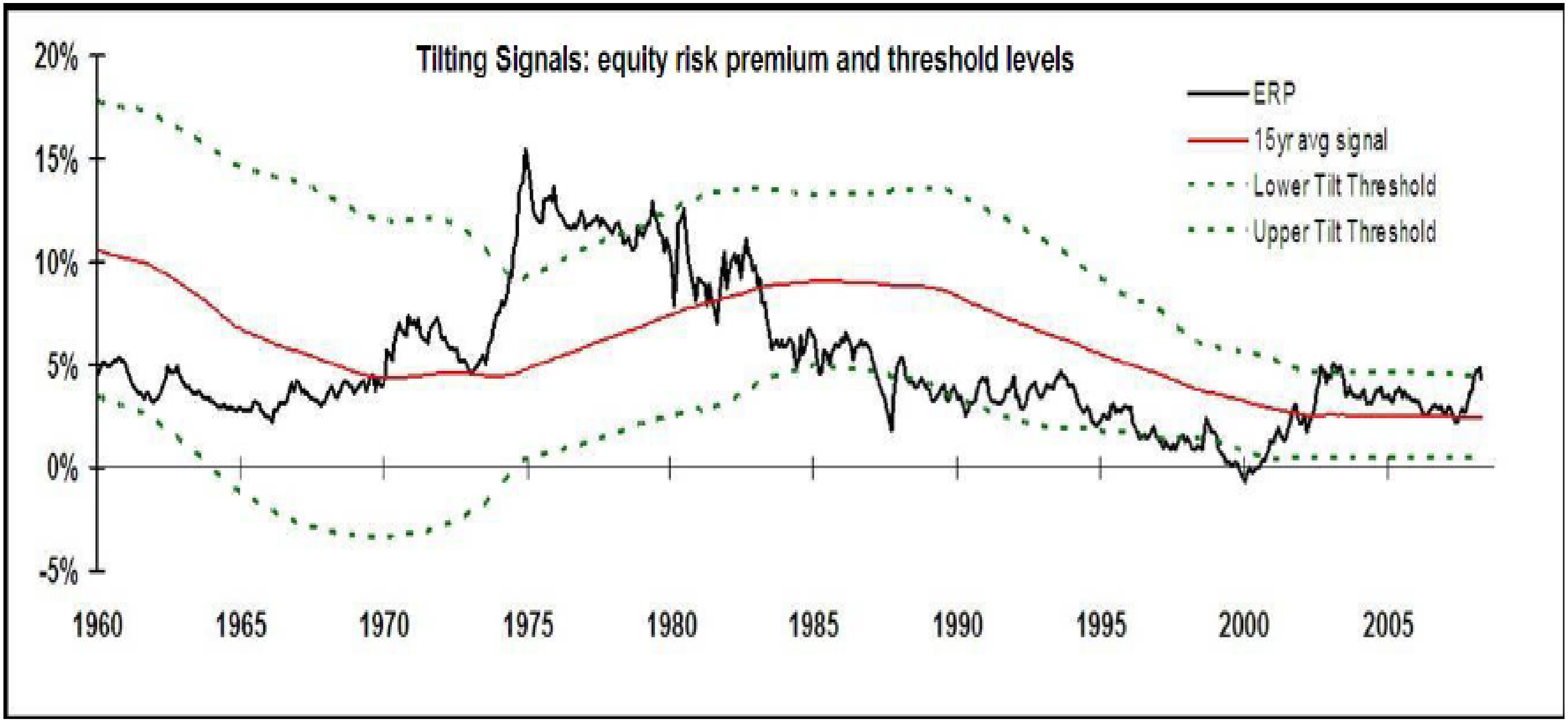
Opportunities for a long-term investor

Tilting the portfolio: Developing Signals



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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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