Guardians of New Zealand Superannuation:

Maintaining focus, staying the course

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Today’s discussion

Agenda

Context

- **Why we exist and what we care about**
- **Performance update**

Maintaining focus, staying the course

- **The GFC**
- **Case Study: Strategic Tilting**
- **Looking ahead**

Appendices

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Why We Exist:
Our Mandate

- **Set out in section 58 of the New Zealand Superannuation Act 2001**

- **We must invest the Fund on a prudent, commercial basis consistent with:**
    - Best-practice portfolio management
    - Maximising return without undue risk
    - Avoiding prejudice to New Zealand's international reputation

- **Legislation does not prescribe what this means – it is up to the Guardians to determine**

- **Sets the context for all investment**

What Matters:
The absolute return net of all costs

We think across decades

- The long-term return to the Fund net of all costs and foreign taxes is the ultimate measure of fulfilling our mission
- Current reference point is outperforming 90-day Treasury bill (T-bill) rate
- Based on our portfolio blueprint (risk profile) and our expectation of the value we can add to it, we expect to outperform T-bills by at least 2.5% per annum over the long run
- It is measured on a time-weighted basis before NZ tax, as tax is a return to the Crown

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Performance 2008-09

A difficult year – both absolute and relative performance

- Most external managers performed poorly in uniquely poor conditions
- Marked-to-market losses in securities lending cash collateral pool
- Both frankly discussed in Annual Report

Organisation responded positively

- Maintained long-term focus and captured rebound
- Revised manager selection process and manager-selecting activities
- Improved in-house capacity to manage risk, improve efficiencies and expand strategies
- Temporarily increased risk exposures into recovery

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Performance update

Post fees, pre-NZ Tax Returns to 31 December

Month to 31 December	FYTD 31 December	Since inception to 30 September
2.40% ($358m)	**17.44% ($2.36bn)**	**6.23% ($2.46bn)**

Fund size at 31 December

Contributions since inception	$14.88 billion
Contributions less NZ tax paid since inception	$13.53 billion
Fund size at 31 December	$15.96 billion
Fund size relative to contributions since inception	**$2.43 billion**

The Global Financial Crisis: Preparation or Anticipation?

Be prepared

- Building strong diversification into the Fund to best withstand volatility
  - Across asset classes
  - Investment strategies
  - Across geographies

- Since inception we warned of the wide possible paths our returns could follow in any one year

Stay focused on goal – long-term

- We do not expend significant investment effort on trying to predict highly volatile short-term market movements

- We took advantage of stressed conditions

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The Global Financial Crisis: Reaction

What we did

- Liquidity management
- Counterparty risk assessment
- Stress testing
- Communication with Board and stakeholders
- Looked for and took opportunities

Stopping put?

- Not necessary to realise illiquid assets
- Risks in converting to cash at peak of crisis
- Severity and pace of impact on asset prices meant prevailing market signal was a ‘buy’

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The Global Financial Crisis: Lessons learned

What we learned

- Renewed appreciation of nature of risks
- The capacity to be opportune has high value
- More wariness around investing with crowds
- Importance of Liquidity and Counterparty risk assessment
- Confirming the value of regular, proactive communication with key stakeholders
- Stay focused on long-term goal

Case Study: Strategic Tilting

What is it?

- A dynamic asset allocation strategy first initiated in April 2009 – markets near their lows, volatility still extremely high.
- Listed asset class weights (risk exposures) and FX exposure adjusted up to Board agreed limits around benchmarks according to medium to longer run relative return prospects or signals.
- Return prospects are forecast using 'simple' valuation based models.
- Involves 'leaning against the wind' – risk of short-run losses incurred for the prospect of longer-run gains.

What does it rely on?

1. **Our 'investment belief' that long-run returns (premia) are at least partially predictable and mean reverting.**
2. **That mean reversion is not something that can be definitively 'proven' (e.g. Cochrane vs. Stambaugh), despite centuries of evidence that markets are prone to boom-bust cycles.**

Sustainability of the strategy still a key issue – we think the strategy is a source of excess returns but the worst outcome is to start then lock-in a 'losing' position.

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Strategic Tilting:
How does it work?

- Run internally - involves changing the Fund's risk profile based on a relatively small number of bets. Not clear whether could be externally managed given business risk.
  - ➢ Need clear governance and accountability structure.

- Board has delegated decision-making to an internal committee, with reporting obligations to the Board.

- Committee is presented with paper from Portfolio Research team; paper is debated throughout organisation.

- Default is tilts will be applied according to model-based signals, but judgmental discretion to reflect "off model" factors allowed.
  - ➢ Judgment forms part of the reporting obligations.

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Strategic Tilting: Results

- Went live early April 2009 (overweight in large cap equities, credit and property vis-à-vis Sovereign bonds; implementation via derivative positions).
- Initial tilts in-line with model signals, following extensive internal debate on the crises, market reaction, plus consultation with external asset managers with contrasting views (e.g. GMO, Bridgewater, AQR etc).
- Key judgment: doom and gloom overdone
- Given speed and size of market rebound, all tilts in response to the GFC off by end of August 2009.

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Strategic Tilting: Next steps

- Broadening the range of markets we tilt over.
- Appetite to significantly increase the extent to which we deviate from Reference Portfolio risk profile, particularly when we think the market is not offering an adequate reward for risk.
- Build into the framework portfolio stress tests and scenario analysis.

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Looking ahead

This is a good time for more opportunistic investment

We have a strong team and organisation

- **Clear strategies across diverse asset classes**
- **GFC-hardened organisational backbone**
- **Well placed for future and for current stressed market conditions**
- **Additional capabilities added to capture opportunities – Treasury, NZ Direct**

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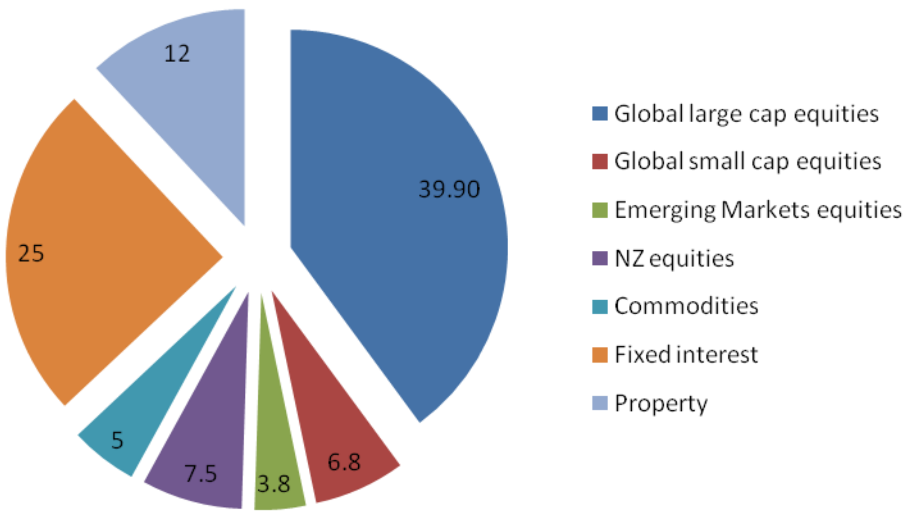
How we Invest:
1. The reference portfolio

Reference portfolio = a notional, low-cost, equilibrium asset allocation reviewed every couple of years

- Low-cost implementation of our Strategic Asset Allocation
- We could stop with the reference portfolio and have a simpler, smaller Fund
- However we believe we can add value to that achievable from the reference portfolio, through active management
- The reference portfolio plus exposures added through active management = the 'actual' portfolio

Portfolio composition at 30 June 2009



How we Invest:
2: The 'Actual' Portfolio

Reference portfolio + the sum of the exposures added by active management activities

Active management activities encompass:

- 'Capture' excess returns – all activity in public and private markets, via internal and external mandates
- 'Tilting' – opportune leaning into or away from prevailing market winds
- 'Completion' – efficiency and risk management

In Q4FY09 we 'tilted' into property and equities and away from fixed interest

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The New Zealand investment directive

What it says

- *"It is the Government's expectation, in relation to the Fund's performance, that opportunities that would enable the Guardians to increase the allocation of New Zealand assets in the Fund should be appropriately **identified and considered** by the Guardians."*

What it doesn't say

- There is no prescribed Fund minimum, as such it is not inconsistent with our mandate to invest on a prudent, commercial basis

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Impact of reduction in funding

What happened

- Government to reduce contributions to the Fund until the Crown operating balance returns to surplus sufficient to resume
- Treasury estimates this to occur in 2021
- Received a one-off $250 million contribution in July 2009 but we are assuming zero contributions until 2020

What it means

- Our investments in property and other asset classes will not be as large as they would have been

What it doesn't mean

- A change in our diversified approach to manager selection, markets and strategies

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