

Review of the Guardians of New Zealand Superannuation

Presentation summary of main report

July 2019



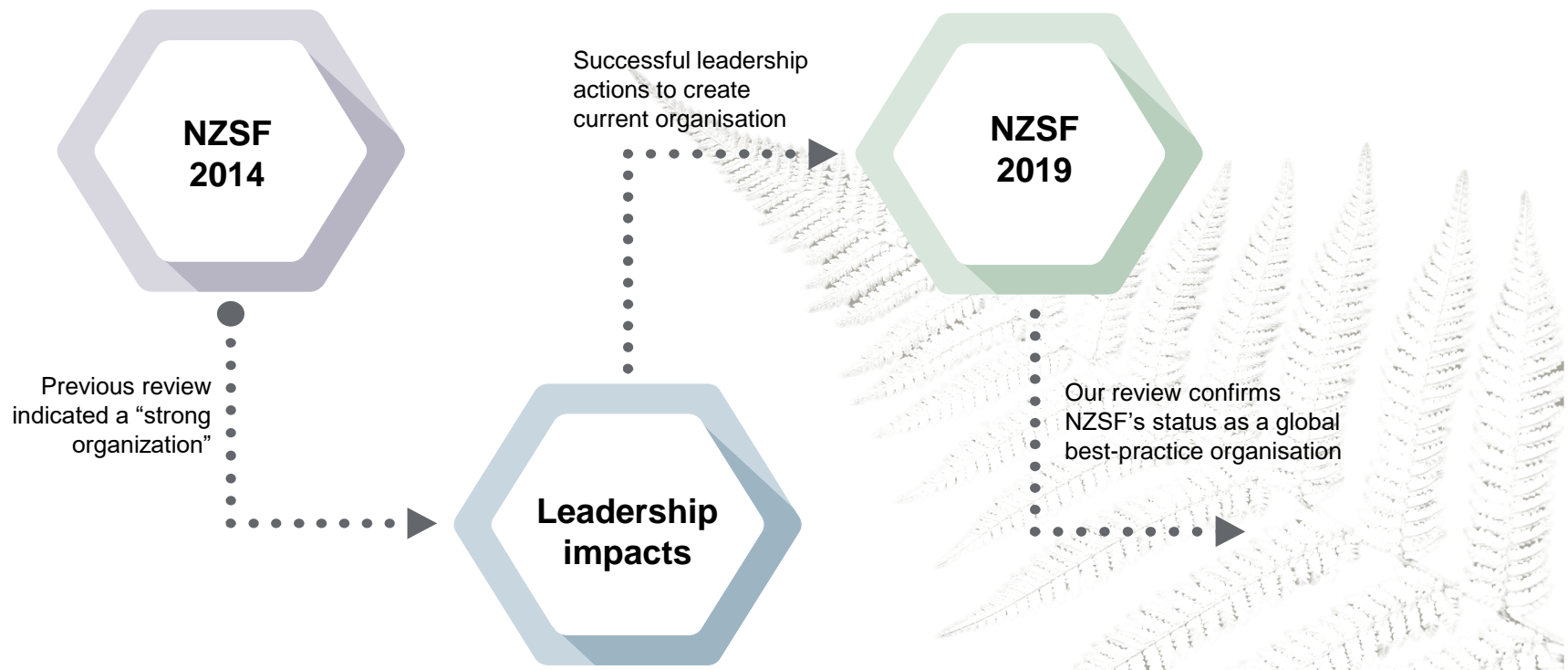
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The Guardians is operating at global best-practice levels

- The Fund's results over the last 5 years have been excellent, reflecting the organisation's effectiveness in carrying out its mandate.
- The Guardians has been operating at global best practice in its activities.
- It has achieved this state principally through the devotion and inspiration of its leaders who have ensured that constant attention to improvement has been the defining cultural characteristic of the organisation.

“ *Waiho mā te tangata e mihi | Let someone else praise your virtues* ”

~ James Kerr, *Legacy*

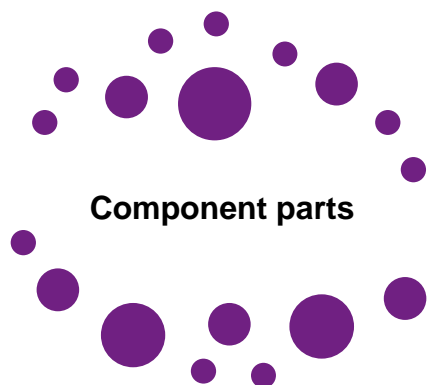


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The review in summary

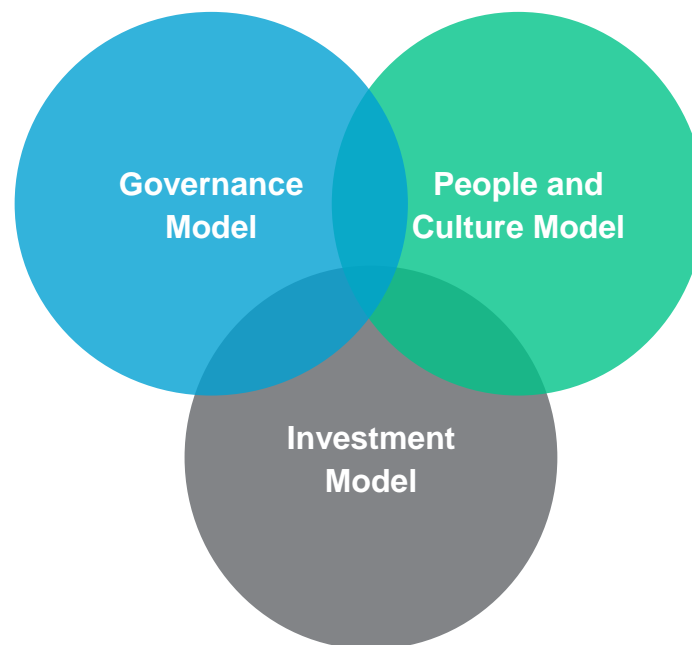
The review in narrative

- An independent review represents strong governance in its own right, by supporting accountability and constructive feedback
- “Best practice” is where the organisation compares *very well* to peers in strong performance and enablers of good practice
- Best practice assessment involves judgment, not least because it is not a static concept and is formed by piecing together component parts



The review in figures

- 5 recommendations
- 13 suggestions
- AAA governance model – exceptional rating shared by at most 3 or 4 peer funds globally
- AA culture model – excellent rating
- AA investment model – excellent rating



3

The governance model is exceptionally strong

- Management quality and Board quality and their interaction, and operational independence, are fundamental to governance quality and are the cornerstone to organisational effectiveness
- The Board and Management operate at global best-practice levels, by reference to the key principles: board and team composition; role; process; and culture, as summarised in the figure below.

Recommendations

- We recommend that the Guardians review its organisational beliefs, values and strategic principles
- This work should include consideration of stakeholder expectations and focus particularly on the sponsor (Crown's) position
- Suggestions to maintain Board effectiveness include greater use of external advice and attention to Board continuity

1

Strategic focus



Delegation

2



3 Effective management and oversight



4

Competent and diligent board members and leadership



5

Board and leadership shaped and sized appropriately



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Chair and CEO set direction and facilitate best practice



Diverse thinking and unified decisions

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8

Well-grounded principles



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Effective and balanced governance framework



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Strong and positive culture



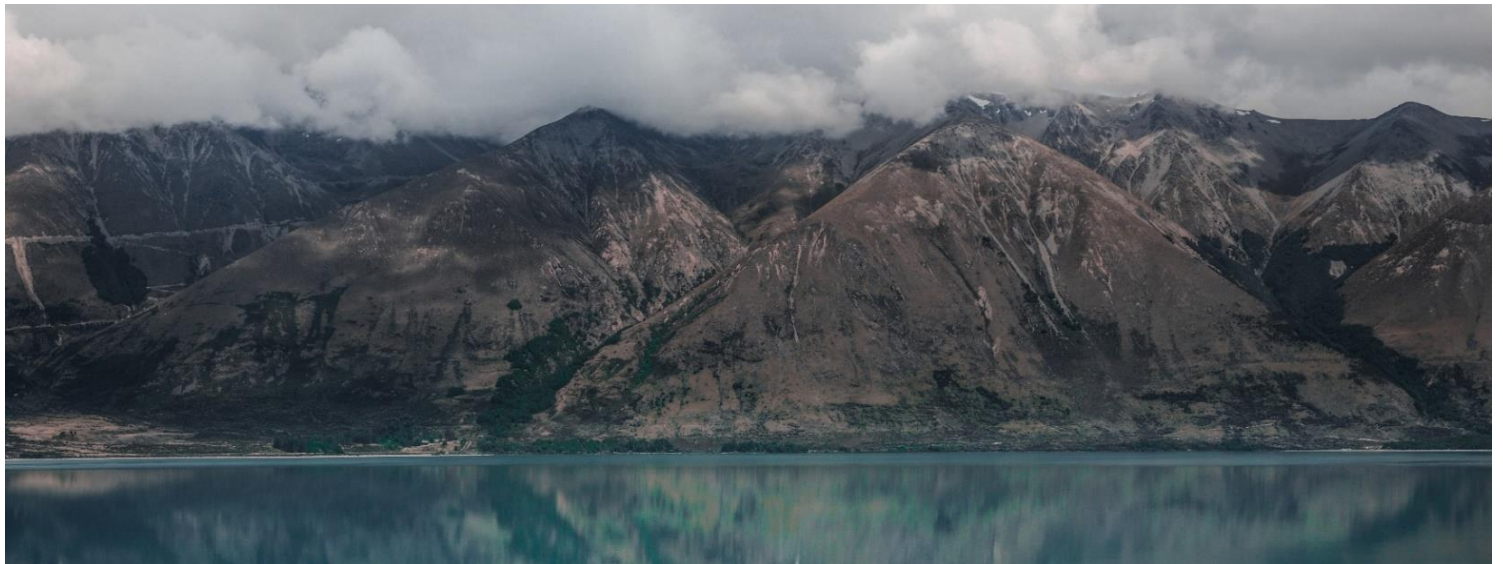
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The culture is excellent but has room to grow further

- Effective culture combines cultural strength; cultural alignment with strategy; leadership action using culture; and associate ownership of culture. All of these are present at the Guardians:
 - **People culture** – how the workforce is treated and how it behaves
 - **Purpose-driven culture** – connecting their work to benefit to current and future generations of New Zealanders
 - **Positive leadership** – sets the tone at the top and carries consistent application of good values

Recommendations

- There is room to develop culture further
- We suggest that Management and the Board could evolve the cultural effectiveness of the organisation through:
 - doing further work to pinpoint the Guardians' culture and communicate it
 - work to mitigate the effects of sub-cultures and organisational size on effective culture
 - work on diversity and inclusion and servant leadership
 - staying innovative with fresh ideas



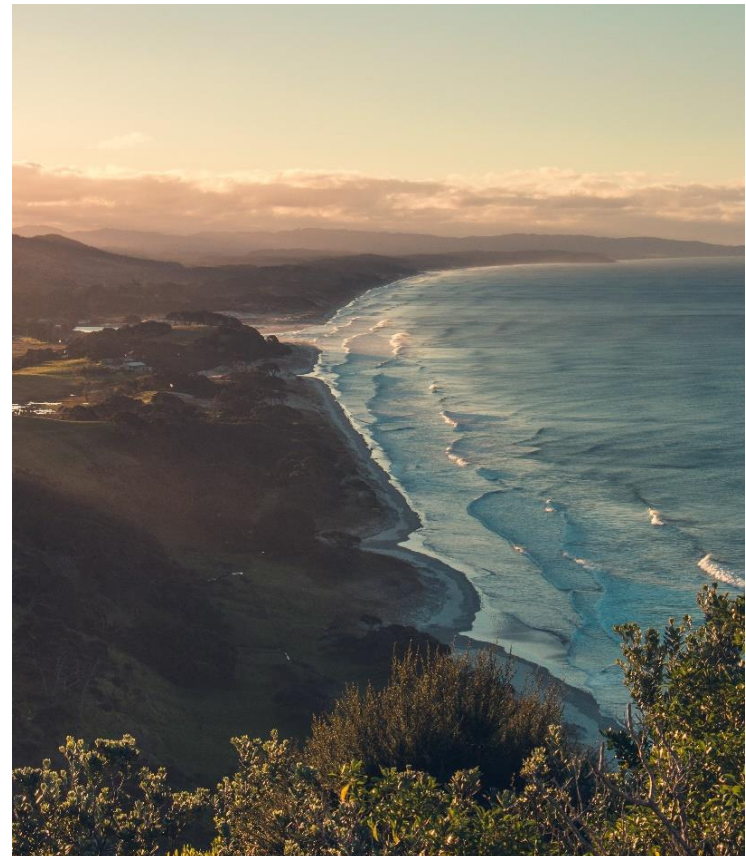
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The people model has issues with compensation

- In terms of talent:
 - we are impressed with the quality of the Management team
 - the capabilities of the Management team, given the current size and complexity of the portfolio, is in line with best practice
 - but the NZ location of the Fund does represent a structural impediment in terms of hiring specialised skills
 - which the organisation is off-setting through its engagement with outside firms.
- In terms of EVP (employee value proposition):
 - The organisation does well in the intrinsic motivations like personal development
 - But it does less well with compensation:
 - Lower variable compensation relative to peers
 - Changes to the Crown Entities Act create difficulties for setting CEO remuneration and create constraining follow-on effects

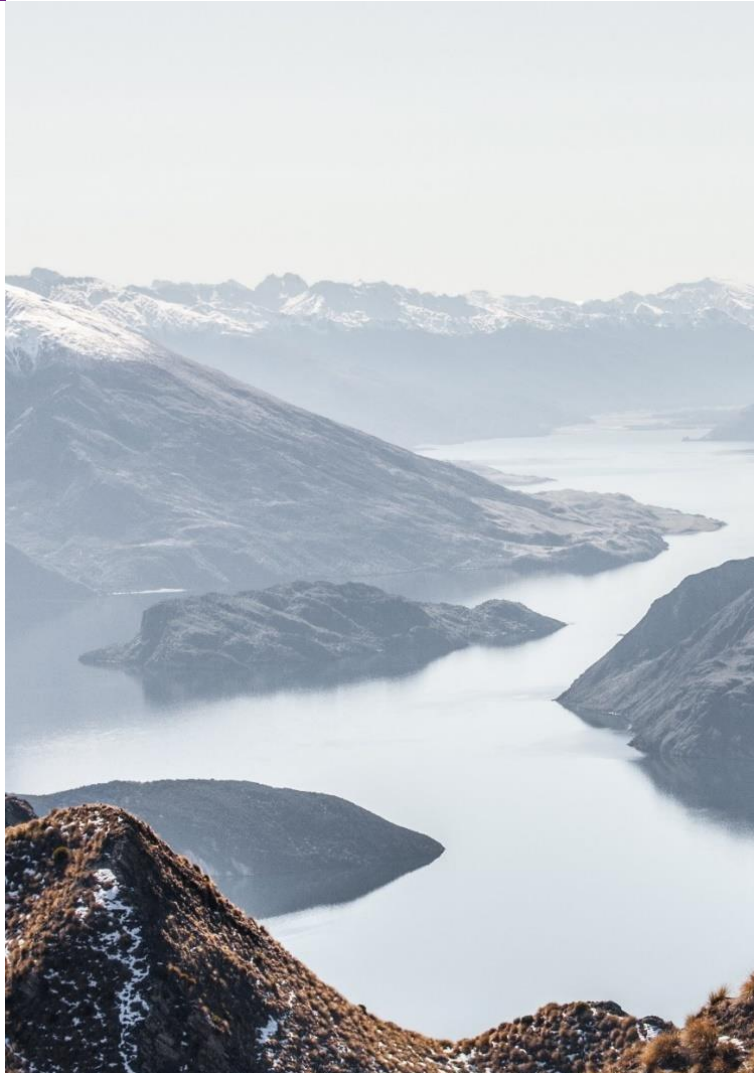
Recommendations

- We recommend that the Guardians should review its compensation structure and implementation, to assist with its EVP



6

The Guardians' investment model is very impressive



- The Guardians has developed an exceptionally well-thought-out approach to investing – it makes good use of both their natural and developed advantages
- The approach has strong intellectual rigour and sound thinking, coupled with pragmatism and a very good understanding of what drives financial markets
- Many aspects of the investment model represent best practice – including the approach to risk budgeting, the integrated portfolio construction approach, the management of liquidity risk and the ability to react dynamically to opportunities.
- The Guardians' approach to investing in New Zealand sensibly combines the Ministerial directive to actively seek and consider NZ investments; whilst also complying with the terms of their investment mandate.
- The approach to ESG integration and stewardship is also impressive. However Responsible Investing is a developing area with positive momentum and so there is a need for the Guardians to continue to evolve and innovate to maintain their position as a leader.

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The ex-post returns are also very impressive



- The Fund's realised returns, both in absolute terms and the value added, are very impressive.
- A significant contributor to the Fund's absolute returns has been the high risk profile adopted, and the strong returns delivered by equities and other risky assets over the past 5 years.
- However, the value added has also been significant: +2.6% p.a. over the past 5 years, with an information ratio well in excess of 1 – this represents an excellent return for the amount of active risk taken.
- Contributions to the value added have come from a number of different sources, but strategic tilting has been the dominant source.
- We suggest that Management consider whether the returns achieved from strategic tilting are consistent with their beliefs on the reliability of mean reversion “working” for the different assets used in programme.

But the investment model has certain challenges

- It will be challenging to achieve the Fund's mandate over the next decade, under our assumption that market conditions will be less supportive than experienced over the past 5 years.
- The Fund's large exposure to equity risk means that it is exposed if equity returns disappoint over a prolonged period.
- Peers are increasingly competing for the same opportunities, making attractive new investments harder to find.
- Responsible Investing (RI) is set to become an increasingly mainstream part of the landscape.

Recommendations

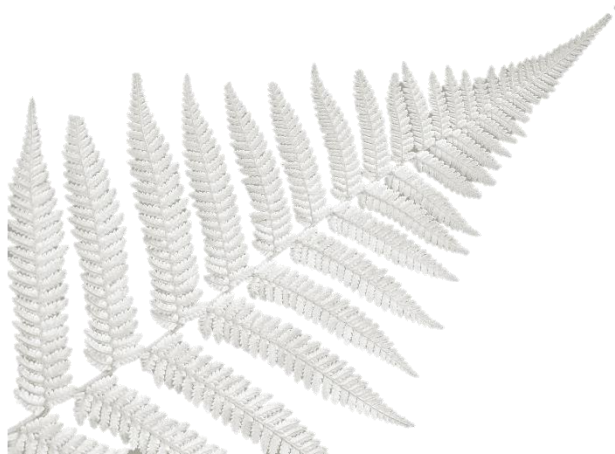
- We recommend the Guardians should:
 - Make greater use of a risk factor framework, as an additional lens through which to view the portfolio and to help identify diversification opportunities
 - Make greater use of reverse stress-testing or "pre-mortems"
 - Allocate more resources to focus on RI issues



Further suggestions

Governance and people models

- The Board could benefit from greater use of external advice, particularly on issues that are highly complex or contentious.
- Management could give greater attention to identifying and reducing bias in decision-making.
- Management could introduce more holistic dashboard reporting of all Fund risks
- Greater consideration could be given to scenarios as part of the Long Term Target State review



Investment model

The Board could:

- Consider the most appropriate process for determining the reference portfolio
- Confirm that it remains comfortable with the size of the strategic tilting programme, in the context of the Fund's overall active risk budget
- Assign greater time to strategic dialogue on RI issues and the oversight of RI actions

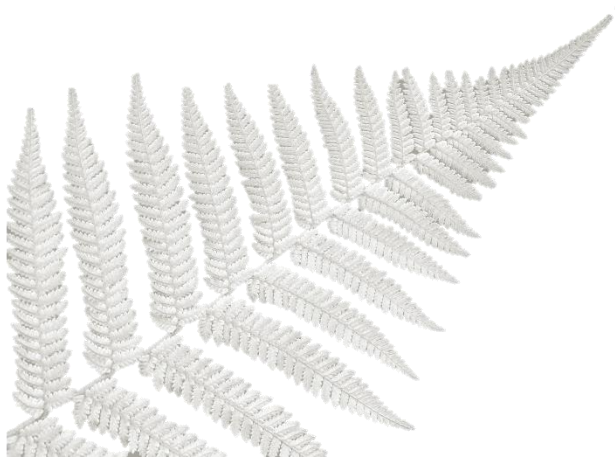
Management could:

- Review the long-term cash rate assumptions as part of the next reference portfolio review.
- Review the case for having a 100% currency hedge in the reference portfolio
- Consider whether the current level of process rigour is consistent with maintaining creativity

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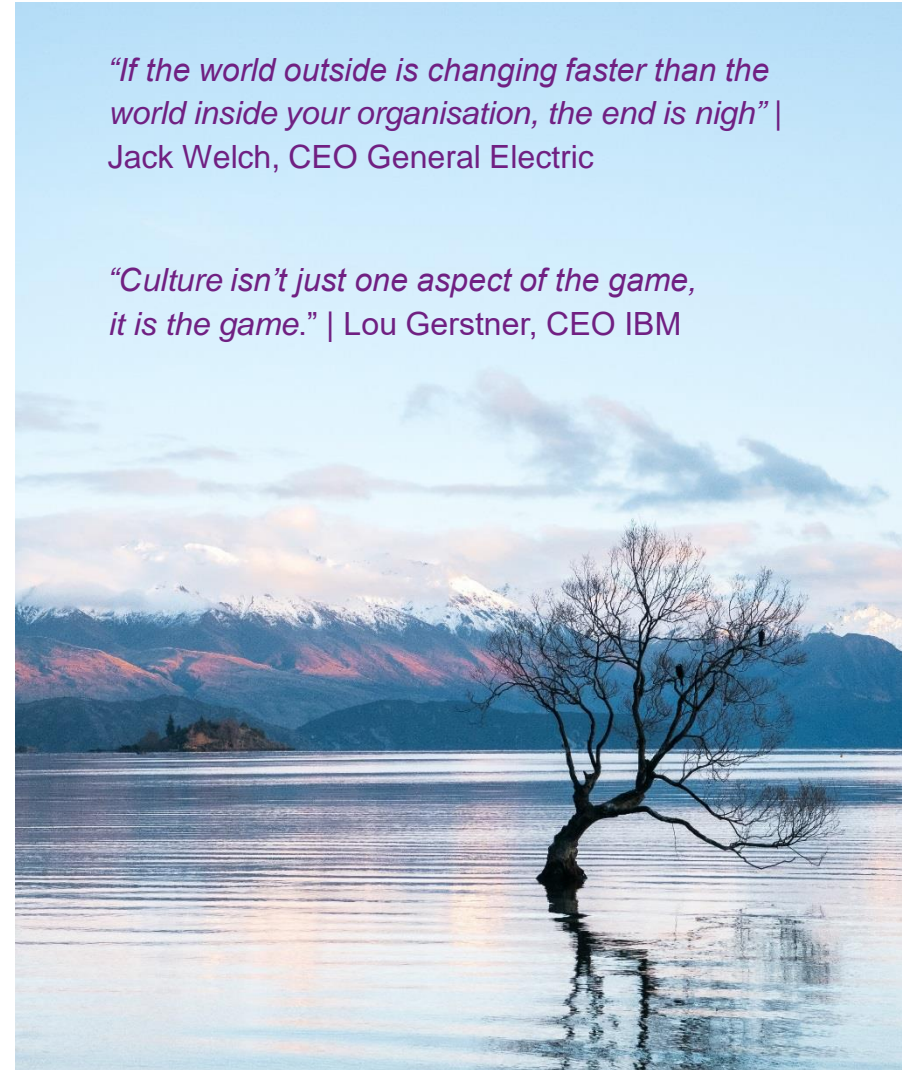
Final thoughts

- This review concludes with “so far so good” on the Guardians’ journey since 2003, and more particularly the great progress made in the last 5 years
- But the Guardians and the Treasury should think deeply about the accelerating change in the industry and the “Red Queen race”, where increasing speed is needed to survive and thrive
- The Guardians should be particularly keen to manage stakeholder expectations and in particular secure its positive relationship with Treasury and the Crown
- The Guardians should be giving increasing attention to its culture



“If the world outside is changing faster than the world inside your organisation, the end is nigh” | Jack Welch, CEO General Electric

“Culture isn’t just one aspect of the game, it is the game.” | Lou Gerstner, CEO IBM



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