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NZSUPERFUND
Te Kaitiaki Tāhua Penihana Kaumatua ō Aotearoa

1 March 2017

Hon Steven Joyce
Minister of Finance
Parliament Building
Private Bag 18888
WELLINGTON

Dear Minister

ANNUAL LETTER OF EXPECTATION

We write in response to the previous Minister's letter of 12 December 2016 setting out expectations of the Guardians of New Zealand Superannuation ("Guardians") and of our 2017/18 Statement of Performance Expectations and Statement of Intent.

Shareholder returns
We note the Minister's focus on the importance of the New Zealand Superannuation Fund ("Fund") achieving its long-term performance objectives.

The Fund has returned 9.9% p.a.[1] since inception in 2003. It is significantly ahead of its key performance benchmarks, having:

- exceeded the passive Reference Portfolio benchmark by an estimated $5.1 billion; and
- exceeded the Treasury Bill return, a measure of the Government's cost of debt, by $15.4 billion.

It is important to take a long-term view of Fund performance. Monthly and annual returns will reflect varying and often volatile market conditions. The Fund is fortunate in being able to look through and profit from short-term market cycles.

Investment Management Expenses
We note the expectation that costs incurred in implementing our investment strategy are fully transparent and appropriate in the context of managing Crown assets. The Guardians' primary focus is on adding value to the Fund net of all costs. We may choose to pursue an active investment strategy if we believe it will deliver superior risk-adjusted returns over time, after all costs are deducted. Costs and their impact on Fund performance are a key consideration. We provide detailed disclosure over costs in our Annual Reports including how the Fund benchmarks against other pension and sovereign wealth funds in an annual global cost-effectiveness survey by CEM.

Risk Profile
The Fund has a stable risk appetite and strong weighting towards growth assets, in keeping with its long-term purpose. We are confident that risk management processes, both in terms of investment risk and enterprise risk, are in line with global best practice investment management.

[1] Performance return figures are unaudited and provided after costs, before NZ tax.

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We use the Sharpe ratio of the Fund to measure its return per unit of risk. The Sharpe ratio uses standard deviation to measure a fund's risk-adjusted returns. The higher a fund's Sharpe ratio, the better a fund's returns have been relative to the amount of investment risk it has taken on.

Based on the construction of our Reference Portfolio, over the long term (rolling 20 year periods) we expect to generate returns of 2.7% over the Government's cost of borrowing, with annual volatility of total returns of 13.5%, making an expected Sharpe Ratio of 0.2.

We expect the Fund's actual portfolio to add value to the Reference Portfolio by about 1% p.a. This means the expected returns for the actual portfolio are 3.7% above the Government's cost of borrowing, with a higher volatility of 14.2% p.a. and a Sharpe Ratio of 0.26. The Fund's annual realised returns since inception have been about 5.6% p.a. above the Government's cost of borrowing, with annual volatility of total returns of 9.5%, making a realised Sharpe ratio of 0.6. So far, therefore, the Fund has generated more returns for each unit of risk taken, than we expect over the long run.

We note the expectation regarding Ministerial consultation over any planned strategic changes that would materially alter the risk profile of the Fund.

Flow of Information
We will continue to engage openly with Treasury in regards to the Crown Asset and Liability Management (CALM) project.

Complex Products and Activities
In the Minister's letter he observed that there had been an increase in the complexity of investment activity being undertaken by the CFIs, including an increase in the use of derivative instruments.

In the case of the NZ Superannuation Fund the derivatives we use are standard market products.

We also note that that the Guardians' use of derivatives to obtain the Fund's passive exposures has in fact decreased over the past five years, as detailed in our 2015/16 Annual Report. This is an outcome of us continuing to shift our passive portfolio exposures between physical and synthetic access points according to whichever option is the most cost-effective and efficient at the relevant point in time.

Derivatives remain critical to the efficient implementation of our currency hedging, strategic tilting programme, and other value-adding investment strategies. Where we do use derivatives, comprehensive liquidity monitoring and reporting, and counterparty risk management measures, are in place. Board reporting processes for derivatives include confirmations from management that the use of derivatives has been judicious. These confirmations are also included in our quarterly Ministerial report.

Other Expectations
We acknowledge and understand your expectations regarding Board relationships, CFI collaborations, the 'no surprises' policy, and Crown policy decisions.

We note and will act on your wish for the Board to meet with Treasury to discuss this letter in 2017. In particular, given the Board's role and responsibilities, we would like to understand what is intended by your expectation regarding Ministerial consultation over any planned strategic changes that would materially alter the risk profile of the Fund.

Yours sincerely

Catherine Savage
Chairperson