

28 February 2019

Hon Grant Robertson
Minister of Finance
Parliament Buildings
By email: grant.robertson@parliament.govt.nz

Dear Minister,

2019/20 Strategic Issues and Response to Letter of Expectations

We write in response to your Annual Letter of Expectations of 17 December 2018. Thank you for your acknowledgment of the Board's work over the last year.

Strategic Issues

Thank you also for the opportunity to set out the key strategic issues facing the Guardians of New Zealand Superannuation ("Guardians") and New Zealand Superannuation Fund ("Fund").

Our Endowments

The Fund has four critical endowments which give us the confidence to enter into the best investments available to maximise the Fund's long-term returns and achieve its purpose. The endowments are:

- *Long Fund horizon* - we have the ability to invest in illiquid assets and to ride out short-term market movements
- *Known liquidity profile* - we have a public funding formula that determines our cash flow
- *Operational independence* - the Guardians has operational independence from the Government and Fund investments are made on a prudent, commercial basis
- *Sovereign status* - this allows us to pay lower tax in some jurisdictions and is often favourably regarded by business partners.

The inter-generational nature of the Fund is also reflected in the unique process of consultation across the House that is required to enact changes to its legislation.

Understanding of and support for the Fund's endowments by stakeholders is critical if the Fund is to successfully fulfil its purpose of pre-funding the cost of universal superannuation, and in so doing enhance inter-generational equity and the wellbeing of future New Zealanders. We appreciate the time you have spent discussing our endowments and how they connect to our investment approach with us over the last year, and look forward to your ongoing support.

Ultimately the most critical endowment is operational independence, as without this, we are unable to make full use of our long horizon and known liquidity profile.

State Sector Reform

We have made submissions on the State Services Commission's State Services Reform Discussion Document, noting that the Fund does not provide services directly to the public, has commercial

objectives, operates in a competitive global market with a high degree of independence from Government and is not required to have regard to Government policy. In our view, the Guardians should therefore be excluded from the proposed extended definition of the Public Service – as was indicated in the discussion document produced by the Commission.

Tax Working Group Submissions

The Guardians made two submissions to the Tax Working Group and also met with the Group to discuss these submissions and answer any questions. The substantive submission points were an income tax exemption for the Fund and a nationally significant infrastructure tax regime. In its final report the Tax Working Group recommended that the Government give favourable consideration to exempting Fund from New Zealand tax obligations, and also found our points on infrastructure tax had merit and should be considered. The Government's decisions on these matters are important to the Fund, and our CEO and Head of Tax are available to meet with you and your cabinet colleagues to discuss them further, if this would be of assistance.

Scalability and Long-Term Target State

The Fund is projected to grow strongly following the resumption and scaling up of Government contributions to the level required by our legislation, which is projected to occur in 2021/22. With this in mind, we are continuing to work on long-term organisational planning with a focus on ensuring the Guardians is adequately resourced to manage the growing Fund. This work involves a consideration of which of our current investment activities are easily scalable and which are not; and which investment opportunities are suitable for in-house management, and which are better out-sourced to external investment managers. This work is continuing. Over the next year we anticipate recruiting more staff, both in the investment and back-office teams, and continuing the significant investments we have made in information technology and operational systems over recent years.

Risk Culture

Last year, in light of a significant global focus on risk culture in the finance and investment industry, the Guardians engaged PWC to undertake an assessment of the Guardians' Risk Culture. This was a major piece of work involving extensive consultation with staff. Pleasingly, PWC found that there was a strong awareness of appreciation of risk across the Guardians, a culture of speaking up, and a commitment to openness and transparency. PWC has also identified a number of key areas of opportunity to further enhance the risk Guardians' culture. They are:

- The interplay between investment and non-investment risk;
- The perceived openness of senior leaders to being challenged; and
- The way we recognise good risk behaviour outside of the formal performance appraisal process.

We are currently considering how best to target these areas as part of our ongoing focus on the Guardians' risk culture. We will report on this matter further in our 2018/19 Annual Report.

Guardians' Response to Letter of Expectations

Fit for purpose

Our purpose is to pre-fund the increasing cost of national superannuation – reducing the burden on future taxpayers. We are mandated by the founding legislation to invest on a commercial basis, consistent with best practice portfolio management in order to maximise return without undue risk to the Fund as a whole. All decisions that we make in terms of investments and our organisation are made with this purpose in mind.

As you note in your letter, the Fund's investment returns have, and will continue to, vary from year to year. This volatility, a consequence of the Fund's exposure to global markets, is expected.

The NZ Super Fund's current Reference Portfolio, which has a weighting of 80% growth assets and 20% fixed income, has been selected by the Board of the Guardians of New Zealand Superannuation ("Guardians") as the best balance of risk and return to ensure the Fund will meet its mandate. In our view, the Fund's heavy weighting to growth assets is appropriate, factoring in the endowments noted on page 1 of this letter.

These weightings will next be considered as part of the Board's five-yearly Review of the Reference Portfolio, which is one of the Guardians' key strategic activities in 2019/20. This piece of work, which focuses on ensuring that the Fund has an appropriate risk appetite for its purpose, will include a review of the Guardians' Investment Beliefs and the costs involved in operating the Reference Portfolio. We look forward to engaging with you and with The Treasury about this Review.

The way in which we complete the portfolio, and the different investment instruments we use, are chosen to meet our purpose. The Board ultimately owns the risk and we are confident that we have the appropriate capabilities within the Guardians to manage the risks involved, and the appropriate reporting approaches to allow the Board to monitor the management of the various risks.

Crown Risk

We will continue to support Treasury's efforts to help develop the Government's Crown Risk framework and scenario planning. We remain satisfied that the use of derivative instruments and leverage for the Fund is commercially sensible, consistent with our purpose, and well-run by management with good controls and regular reporting to the Board in place. Derivatives are important to manage risk for the Fund, as well as enabling the portfolio to more efficiently reflect the Reference Portfolio and to access investment opportunities.

Partnership

We will continue to work collaboratively and openly with the other Crown Financial Institutions (**CFIs**) and other parts of Government on matters of mutual interest. We place a high value on having strong relationships within the public sector. Your expectations in regards to the 'no surprises' policy and transparency over operations, expenses and communications are noted.

We provide responsible investment advice to other CFIs, and work closely with them on issues such as exclusions and corporate engagements.

Transparency is a core aspect of our approach – we are highly transparent in terms of our investment and responsible investment decisions, Fund investment returns and costs. For the Guardians, this transparency is a necessary corollary of our primary endowment – our operational independence. The ‘no surprises’ approach is a part of this overall approach and we will continue to ensure that the approach is respected.

Our existence and success is consistent with the Government’s focus on a wellbeing framework – we provide a vehicle for ensuring intergenerational equity, as well as creating resilience against shocks – in this case, the significant change in New Zealand’s population age profile.

Citizenship

We note your expectations in respect of:

- the importance of responsible investment and citizenship, particularly in the New Zealand market;
- being cognisant of second order effects in the Fund’s investment activities; and
- giving consideration to how all the CFIs can play a part making the New Zealand economy more productive and sustainable for all New Zealanders.

A founding signatory of the United Nations Principles for Responsible Investment (UNPRI), the Guardians is very active in this area and has shown domestic leadership in helping to establish both the New Zealand Corporate Governance Forum and the Sustainable Finance Forum. The Guardians was involved in the reviews of the NZX Corporate Governance Code and Listing Rules and will also be an active participant in the upcoming NZX/FMA Capital Markets Review.

As you are aware, the Guardians’ enabling legislation prohibits the Fund from taking a controlling stake in an operating company. As a result, we are a minority investor (and, in the global context, a small one). We therefore seek to collaborate with other investors to address issues of concern at both a sector and company level. We also engage directly with New Zealand company Boards and management on environmental, social and governance issues, and invest significantly in training on best practice for our staff and appointed Directors on company Boards.

Globally, we are members of a number of responsible investment initiatives including the One Planet Sovereign Wealth Fund Climate Change Working Group, the Climate Disclosure Project and the Climate Change Action 100+. Our Head of Responsible Investment is also a Commissioner on the UN Finance Commission on Modern Slavery and Human Trafficking (Liechtenstein Initiative). Our CEO is co-chair of the Sustainable Finance Forum, established under the Aotearoa Circle, with the support of Minister Shaw and the Ministry for the Environment.

In summary, your expectations in this area are well understood by the Guardians. We are confident our approach to responsible investment is world-leading, and that wider societal and economic impacts and contributions are factored into how we select and manage our domestic investments, consistent with our legislative requirement to manage the Fund in a commercial, prudent manner.

Statutory Review

We note the appointment of Willis Towers Watson and look forward to assisting them and Treasury on the Statutory 5-year Review of the Guardians and Fund. Your strong interest in ensuring our ethical policies reflect international and domestic best practice is understood and reflected in our investment strategies.

Crown Policy

We note your wishes on this topic and understand that the final decision on policy matters rests with the Crown.

As an operationally independent Crown entity, and consistent with our role as an institutional investor, the Guardians is actively engaged on various matters with a public policy dimension, both in New Zealand and internationally.

The Guardians' investment and financial market expertise, and long-term perspective, enable us to make valuable contributions on a number of policy topics that affect the investment environment, including tax, infrastructure funding and financing, overseas investment, corporate governance and climate change.

Our contributions on public policy matters are usually made as part of a public submission process and the Minister's office and Treasury are provided with advance copies of these submissions, in line with our no surprises protocol. As a matter of Guardians policy, all our submissions are publicly available at <https://www.nzsuperfund.nz/publications/submissions>.

Our aim when submitting on public policy matters relevant to the Fund is to better inform policy decisions concerning those matters. In particular, we want to ensure that the Guardians is best placed to meet its statutory purpose, which includes helping to make the New Zealand economy more productive and sustainable and promoting an efficient and predictable investment environment. In commenting on public policy issues, we adhere to a policy of strict political neutrality.

Having a public voice and advocating on such matters is consistent with best practice investment management, our independence and our organisational commitment to transparency and good stewardship. It is also required under our obligations as a responsible investor; as a signatory of the UNPRI, we have committed to:

- participating in the development of policy, regulation, and standard setting (such as promoting and protecting shareholder rights) (Principle 2);
- supporting regulatory or policy developments that enable implementation of the UNPRI (Principle 4); and
- disclosing active ownership activities, including policy dialogue (Principle 6).

It is also important that information in the public domain about the Guardians and the Fund is factually correct. We therefore answer questions, provide information and correct misinformation where necessary, consistent with our approach to transparency outlined earlier.

We have a strong view that engagement in public policy matters relevant to the Fund is part of our work as an independent investment institution and look forward to discussing this further with you.

Infrastructure Investments

Thank you for your encouragement of our work to seek infrastructure investment opportunities within New Zealand. We are continuing to build resource and capability in our direct investment team and remain committed to exploring opportunities for commercial investment in this and other sectors of New Zealand's capital markets.

Yours sincerely



Catherine Savage

Chair