State Street Global Markets Research Retreat

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The Road Less Travelled:
Investment and Culture at the NZ Super Fund

About the NZ Super Fund

New Zealand has a universal national superannuation scheme and, like much of the western world, we have the problem of an aging population.

Superannuation – how we pay for it, the level and age of entitlement - has been a political football for governments going back for generations.

After many false starts, the NZ Super Fund was set up in September 2003 to reduce the burden on future taxpayers of the rising cost of New Zealand superannuation.

We are a buffer fund. Saving today for a cost that will come a long way into the future.

The first withdrawals are not expected until the early 2030s and the Fund will continue to increase until the 2080s.

The Guardians of NZ Superannuation was set up to manage the fund. In Maori, the concept we represent is kaitiaki, which means caring, looking after something precious for the future.

We are blessed by the mandate that was set out in our founding legislation.

As the Guardians, we are required to invest the Fund on a prudent, commercial basis and to manage it in a manner consistent with:

- Best-practice portfolio management
- Maximise return without undue risk to the Fund as a whole
- Avoid prejudice to New Zealand's reputation as a responsible member of the world community

We have a double arms-length Governance framework. We are an autonomous Crown entity, legally separate from the Crown, and we operate independently.

The Fund grew rapidly. We started with a contribution of $2.4 billion from the New Zealand Government and a plan of regular contributions – unfortunately, suspended since the GFC.

It grew to nearly $15 billion in the space of five years, using a traditional investment model of strategic asset allocation.

I joined as CEO in February 2007 - just in time for the GFC.

The Fund recovered rapidly because we were able to take advantage of our long-term horizon. Not being spooked by the short-term state of the markets, we invested counter-cyclically.

Reference Portfolio approach

The most important job that a Board, Chief Executive, and Senior Management does is to look at the big picture.

After I joined, we put a lot of thought into identifying our endowments, or advantages, and our core investment beliefs.

These beliefs now flow through into all aspects of our investment decision-making process.

Because of our defining endowments, we are a truly long-term investor:

- We can ride out short term volatility
- We can be a genuine contrarian investor
- We can invest in private market and illiquid assets
- As a sovereign fund, we pay lower tax in some jurisdictions
- We are favourably regarded as a potential co-investor or partner

Until 2010, we used a traditional strategic asset allocation approach: we invested according to a set of target asset class weights, specified by our Board.

We reviewed the Strategic Asset Allocation every two years, but between reviews the weightings afforded to each asset class stayed the same.

This approach meant our allocation choices were mostly static.

And active investment strategies were - by and large - left to external managers.

We began to question whether that approach was consistent with our fundamental endowments.

I joined the Fund from an economics background. When I looked around the staff that we employed at the time, people operated in silos based on asset classes.

We only had one lens to look at the portfolio through. That was asset classes.

The problem is that if someone is head of property, then property is the only thing they look at - Not at the best investment compared with all other opportunities available.

The focus on asset classes meant we were back-filling. Whether it was good or bad at the moment, we needed to fill that particular bucket of assets.

Asset classes seemed more like access points to risk.

We rapidly came to the view that we needed to have a whole of fund approach. That we needed to focus on the whole Fund, and not to view it as the sum of asset classes.

That we needed to be more nimble to take advantage of our truly long horizon and liquidity profile.

We developed an ambition to work together as one team, managing one whole fund, pursuing a collective goal.

And we wanted to be more opportunistic - to take advantage of opportunities that would add value.

We began to look at other ways to manage our portfolio and we decided that the Reference Portfolio approach was a better way to meet our goals.

In 2010, we changed the operating model. It was a multi-year, re-engineering project.

I don’t need to explain to this audience how a Reference Portfolio works. It is a simple, passive, listed portfolio – a portfolio that will deliver the returns we want at the lowest cost.

It is how we invest when we cannot identify a better way to add value, looking at the risk-adjusted returns.

The Reference Portfolio forms both the core of the Fund's actual portfolio, and its passive benchmark.

It is a hurdle that active investments have to surpass to add value. And it clearly establishes the opportunity costs of all of the Fund's active investment decisions.

Any decision to move away from the allocation set in the Reference Portfolio becomes an active one: a decision that we will only undertake if we possess a high level of confidence that it will, over time, be better than investing passively.

One team/One Fund

The shift to the Reference Portfolio was a big change for our staff.

For example, in a deliberate move to reinforce our new structure, we took away our team’s asset-class specific job titles.

This was challenging on a lot of levels. For many, the asset class title had come to act as an anchor, a reference point that informed professional identity.

But it helped us to articulate the reality of our new model: an actual investment portfolio with no fixed allocations. Investment opportunities existing irrespective of asset class.

It also helped to encourage thinking on the underlying economic drivers of risk, returns and correlations.

In practice, the change has allowed our investment team more freedom to research across disciplines and to pursue promising ideas, regardless of asset class.

This is not to say that adopting an asset-class agnostic approach to investing did not come without its challenges.

We talked at length about how we could allocate risk more efficiently across the Fund's portfolio.

We had to be clear in our own minds just how much exposure we were willing to assign a given risk so as to afford individual investment heads enough autonomy in their decision-making.

For this we established the risk-allocation process (RAP), a process that allows us to rank opportunities by financial attractiveness and consistency with our endowments, beliefs, target operating capabilities, and responsible investment commitments.

Our culture

But we needed more than just those tools – we needed a culture that supported the approach.

So we began work on understanding the culture of our organisation, starting with some in-depth surveying to find out what we were really like.

Ours is an industry driven by results. And at times, this 'drive to deliver' mind-set promotes behaviours that are competitive, aggressive, and ultimately self-serving.

This was reflected in our survey results. We realised we needed to make a big change to our culture.

To start with,

We changed our human resources strategy to make culture the number one priority.

In practice, this meant that our culture became the foundation on which we based all of our interactions and activities.

Just as we envisaged a desired state for our portfolio, with the reference portfolio, we envisaged our desired culture: collaborative and constructive.

We started by asking our people to tell us what they wanted out of a culture, and in particular – what a 'constructive' style of behaviour means to them.

These were our initial building blocks, the pieces we put together to form an understanding of what our optimal culture might look like.

There was scepticism – people would say you'll never change the character of the kid in the school yard.

But you can have much greater awareness of what your own characteristics are, how they affect others, and how you can moderate those characteristics to deal most effectively with others.

1. <u>We set ambitious targets for improving our culture.</u>
2. <u>We also introduced a new 360 degree feedback and performance review system.</u>
   And, to align incentives:
3. <u>We changed our remuneration scheme.</u>

So, potential bonus payments are linked to the demonstration of constructive behaviour. That is now worth 20% of base salary. This piece is entirely focused on *HOW* people operate, not what they do.

The remainder of our bonus structure for front office staff is paid on a whole of Fund basis, based on both relative and absolute returns on a rolling four year basis.

No staff are remunerated solely on the performance of "their" part of the portfolio.

And how did we do?

We met, and exceeded, the targets we set.

This initiative has delivered tangible value across the organisation.

Our ongoing culture surveys have found that the improvement in constructive styles delivered marked improvements in employee satisfaction, effort, cooperation, adaptability, innovation, quality and motivation.

And overall, our culture focus has:

1. Given us a longer term view of team capability and planning;
2. Supported 'whole of Fund' as opposed to individualistic, culture;

3. Helped establish a succession bench that does not rely heavily on external talent.

And, again, it feeds back into our overall strategy to link all our decisions back to our fundamental purpose, with a view to the long-term.

One Fund approach affects relationships with external managers

The shift to a Reference Portfolio is also a fundamental change for external managers and advisers.

We focus more on the opportunity. The investment opportunity that will outperform the Reference Portfolio.

We want to truly understand the context and the risk.

Only then do we look at the best access point for the investment.

We use external managers only when there is a case to: where we don't have the in-house capability, or capacity, or there is a reason such as being close to a specific geography.

We have a preference to manage active investments ourselves.

This approach changes the relationships we have with the external managers and advisors.

They have to talk about their opportunity rather than their skill or the asset class. They have to share their intellectual property.

It's a fundamental change.

Our investment strategy is based on getting better alignment between the Fund's investment approach to its long-term investment objectives.

In the same way, we are looking for better alignment with external parties.

We want to be sure we are both working towards the same goal.

What this means in practice is that we have fewer, but deeper, relationships with external managers. We want to be sure that we are on the same page.

But where we do work with external managers, the size of the mandate is bigger – reflecting our confidence and conviction.

We are looking to build partnerships that will last.

Governance

Now I will return to where I started – the issue of Governance

In recent years, I have taken on roles as Chair of the International Forum of Sovereign Wealth Funds and now of the Pacific Pension Investment Institute.

I have done that because we have a great deal to learn from our peers internationally.

There is also potential for partnership opportunities.

So those international relationships and connections are important for us as an organisation and for our staff.

What I have learned from our peers is the importance of the clarity of mission, clarity of purpose, good governance and transparency.

At the start, I mentioned that we at the Super Fund are blessed with our mandate.

I mean that sincerely.

It means we have a clear purpose, we are independent and there is little interference.

This is hugely enabling.

The trade-off is transparency. I call it our licence to operate.

It's not always a convenient thing, but transparency is the check and the balance to our independence.

I have seen other SWFs globally subject to political interference, or to changes in purpose and direction when the economic going gets tough.

Internationally, IFSWF is important because it is building the first community of SWFs and that is now being recognised.

The Santiago Principles embody this commitment to good governance, sound investment practices, transparency and accountability – and they are becoming more widely recognised. It's very pleasing that nearly all members are publishing self-assessments.

We have been through a phase where the organisation has been building itself, developing, and now it can move to more substantive work.

As this happens, SWFs will gain more credibility as the important global investors they are, and be better understood.

The focus now is not just on messaging, but on action and co-operation between members. Current work streams include, for example, co-operation on BEPs (Base Erosion and Profit Shifting), understanding private equity models, mandate design and climate change.

PPI is a community of long-term investors. It's an excellent forum for fund leaders to talk informally about working on the business as well as in the business.

It's a great forum for knowledge sharing, with a heavy focus on Asia, political and geopolitical issues, and emerging issues of global import.

Trends and issues affecting long-term investors

Both of these organisations are valuable forums for learning how long-term investment works in practice.

Some of the opportunities are:

- New models of partnership and engagement – between funds and with external managers
- Designing new performance benchmarks for the longer term
- Designing new risk metrics for long-term performance evaluation
- And, in terms of working with external managers, relating fees to the duration of investments.

Both IFSWF and PPI also provide a great sounding-board for new or changing investment themes.

Three investment themes have struck me from recent international meetings:

- Big data - How do we make use of big data to develop big findings? By this I mean what can large data sets tell us about

portfolio design, investment beliefs or the fundamental nature of markets and asset returns over the long term?

- Emerging and frontier markets – Have EMs lived up to their promise? Are there new options for investing on a greater scale? How can long-term capital find new domestic institutions to partner with?
- How we develop new models of finance for public sector goods?

How we are managing climate

But the biggest investment theme at the moment is climate change.

This is regardless of whether President Trump pulls the US out of the Paris Agreement on Climate.

The politics of climate change may continue to be debated. Some people still might try to debate the science…..although, personally, I believe that particular bus has left the station.

Climate change has undeniably become an investment issue. It's a financial issue. It's a risk issue.

It is material to investment returns.

It's an issue that a prudent investor has to consider.

The fact of the matter is that in coming years the global energy system will transition away from fossil fuels.

Some assets we invest in today may become uneconomic, made obsolete or face a dwindling market.

There will be a transition to a low-carbon energy system and that will present investment opportunities for long-term investors - which we, at least, intend to capture.

We started to look at climate issues as part of our Responsible Investment strategy.

I take you back to our mandate. We are required to manage the fund in way to "avoid prejudice to New Zealand's reputation as a responsible member of the world community".

That was our impetus.

The core of our RI approach is to integrate RI into our investment decision process – it's not an add-on at the end, but an embedded factor we consider at every stage of an investment.

As part of our RI approach, we have a small number of ethical exclusions, such as cluster munitions and tobacco.

Many funds have opted for an exclusion approach as a way to deal with climate risk.

We have chosen a more nuanced path.

Why?... Because exclusions are a blunt instrument.

Some fossil fuel companies may be a part of the solution in the long run.

And the transition to a lower carbon economy may throw up technologies or processes we can't envisage yet. These may be investment opportunities that we want to be a part of.

In October last year, we announced a multi-faceted climate strategy. We are in the process of implementing it now.

It includes a commitment to significant reduce the Fund's exposure both to fossil fuel reserves and to carbon emissions.

This will be achieved through:

- Measuring our carbon footprint and reporting it annually;
- Building carbon measures into our investment model, including valuation models and risk assessment;
- Incorporating climate change considerations into manager selection;
- Ongoing engagement with companies on their carbon exposure;
- Targeted divestment of high-risk companies;
- Reduction of other relevant portfolio exposures;
- Seeking new investment opportunities in alternative energy, energy efficiency and transformational infrastructure.

Our strategy is in line with current global best practice investors and has been developed after a great deal of research.

It will evolve over time as investment markets become more sophisticated on climate issues, and more tools and data become available.

We are in the process right now of implementing the strategy.

In the first stage, we will announce will be a new Reference Portfolio, a new version of the Reference Portfolio that takes account of carbon risk.

I'm pleased to say that the latest Global Climate 500 Index gave us the top AAA rating for our climate strategy. We rank 15th among the top 17 global asset managers.

Results

In developing our climate strategy, we have followed our own path - taken the road less travelled. Just as we have done with the Reference Portfolio approach, we've done it our way.

The results so far speak for themselves.

At the end of March this year, the fund stood at $34 billion.

Since the fund was set up, we have achieved an annual growth rate of 10%. Over the past five years to March, the annual rate of growth was nearly 15%.

Since inception, we have added nearly $18 billion to the fund, compared with the Treasury Bill return.

Over that time, our active investment strategies have added nearly $6 billion to the fund, compared to the passive Reference Portfolio benchmark.

Global outlook

At times in the last few years since the GFC, it has felt like we are operating in an unanchored world.

We've been in unchartered territory in terms of global economics.

We seem to be in unchartered territory politically.

It has always been a problem in financial markets to separate the signal from the noise. That seems to be the case now in the geopolitical sense as well.

The global economy appears to have stabilised. Some growth momentum is apparent – or at least IMF forecasters have stopped revising their projections downwards.

For investors and for asset prices, it's still an uncertain time, with low yields and prices looking around fair value.

These are challenging times.

But for the NZ Super Fund, but I have no doubt that our clear purpose and our strategy of a one team/one Fund approach will serve us well.