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The New Zealand Superannuation Fund and the Guardians of New Zealand Superannuation were established by specific legislation for a specific purpose.

### The big picture

Between 2005 and 2050 Government data predicts that the number of New Zealanders eligible to retire (aged 65+) is expected to double. The associated cost of providing their retirement income New Zealand Superannuation (NZS) is also expected to double.

What this means is that there will be fewer 'working-age' people whose productivity can be tapped, through taxation, to fund NZS for a greater number of retired New Zealanders than ever before in New Zealand's history. This has clear implications for future Governments' ability to fund other vital areas such as health, welfare, education and law enforcement.

This is a situation with clear relevance for you, your children and your grandchildren.

### How does the Fund and the Guardians respond to this?

The establishment of the Fund and the Guardians recognises New Zealand's ageing population as a significant, multigenerational issue. The Fund attempts to address this situation by 'smoothing' the tax burden between generations of New Zealanders, of the future cost of NZS. It does this by investing Government contributions received during the early period of the Fund and, through returns generated over decades of investing, by growing the size of the Fund. At a certain point - currently from 2031 - the Government then begins making withdrawals from the Fund to help to meet the cost at that time of NZS.

'Pre-funding' the future cost of NZS in this way means that future Governments do not have to seek as much from future New Zealand taxpayers (or from other sources, such as through raising debt) to meet the cost of NZS when it is increasing most sharply.

In the 2009 Budget the Government decided to reduce contributions to the Fund until the Crown operating

balance returns to surplus sufficient to resume contributions. The Treasury estimates this to be in 2020. The Treasury has explained that this means the Fund will be smaller in size when withdrawals begin in 2031 and so the 'buffer' effect of the Fund will also be less.

Regardless, the focus of the Guardians on adding the maximum possible economic value is unchanged.

### How do we reflect this context in our Statement of Intent?

We think of it this way – the **Fund** is expected to add to Crown wealth over the long term by earning more for the Government in investment returns than the Government would save in debt servicing i.e. adding to Crown wealth and improving its ability to meet increased Superannuation commitments in the future.

For our SOI we wanted to state that impact in a way meaningful to all New Zealanders. That is why we have described the Fund's ultimate outcome as "Reducing the tax burden on future New Zealand taxpayers of the cost of New Zealand Superannuation". We believe that if the Fund improves the Crown's financial position, it will have reduced the tax burden.

The **Guardians** are expected to manage the Fund according to a legislated mandate. The mandate requires us to manage the Fund in a commercial, prudent fashion comprising

- Best-practice portfolio management
- Maximising return without undue risk
- Without prejudicing New Zealand's reputation in the world community

For our SOI we have simply expressed this as 'managing the Fund'. It comprises our work to manage the investments, costs, risk, governance and our own organisational growth and ultimately to add value to the Fund and its intended outcome.

It is obvious that this is a long-term outcome. Our SOI sets out in detail how we plan to achieve that outcome, and how we intend to measure our progress toward it.

If you are interested in further information about the reason why the Fund and Guardians exist, more on the ageing population issue and how the Guardians and Fund are designed to respond to it, there is a significant volume of information on our website [www.nzsuperfund.co.nz](http://www.nzsuperfund.co.nz). On the front page of the website you can find our Introduction to the Guardians and Fund. At various places in our SOI we refer you to specific sections of the website for more information.

## BOARD STATEMENT

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On behalf of the Guardians of New Zealand Superannuation we are pleased to present our Statement of Intent (SOI) for the five-year period commencing 1 July 2010.

As is appropriate, this SOI builds on the five-year plan we set out in 2009. That plan reflected lessons learned from the global financial crisis (GFC). It was also impacted by the Government's decision, announced in the 2009 Budget, to suspend contributions to the Fund until the operating balance of the Government's accounts was sufficient in terms of cash flow to resume those contributions.

The Fund is large and has an important task. As Guardians we remain determined to add economic value and to develop organisational characteristics to ensure our ongoing success. We maintain a long-term perspective on investing and developing our organisation. During the 2009/10 financial year we temporarily increased our weighting toward some classes of growth assets because we believed they were undervalued and presented an excellent opportunity. Subsequently, since the lowest point of the crisis in March 2009, we have experienced significant growth in returns as global markets have returned closer to more 'normal' conditions.

### 2010 Statement of Intent

The purpose of the Fund is to reduce the tax burden on future New Zealand taxpayers arising from the cost of providing New Zealand Superannuation. The purpose of the Guardians is to manage and administer the Fund to best achieve its purpose. The management activities set out in our 2010 SOI reflect this desired outcome.

#### **Risk continues to be appropriate to our purpose and to our mandate**

The risk in our portfolio is calibrated to our mandate, to maximise returns without undue risk, and to our long-term purpose. Consequently, our portfolio is weighted largely toward growth assets. Each of the investment strategies we pursue to develop our portfolio fits clear investment beliefs and our competitive advantages in location, our Government ownership, investment horizon, and liquidity requirements.

#### **Costs are similar to what was forecast in the 2009 SOI and are rigorously benchmarked**

The expected cost of managing the Fund in 2010-11 is similar to what was forecast in our previous SOI. We project actual costs to increase compared to those in 2009-10 (when our costs were lower than forecast), largely because of an anticipated increase in our investment activity.

Our investment decisions are based on expected net return, which requires us to weigh up the certainty of incurring cost against expectations of higher long-term returns. In doing so, we are mindful of the Government's desire for fiscal prudence and our statutory duty to invest on a commercial, prudent basis. As such, we place considerable emphasis on relevant peer benchmarks:

- a. Our absolute costs are assessed in the annual CEM Survey, which benchmarks our costs against peer funds (see page 12). We publish the results in our Annual Report.
- b. Our Reference Portfolio provides a transparent benchmark against which to measure the net value added by our active investments (i.e. our returns relative to a simple, low-cost, passively managed portfolio) over relevant periods of time (see page 9). Fund performance relative to the Reference Portfolio is also published in our Annual Report.




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**We are mindful of the Government's desire for fiscal prudence and our statutory duty to invest on a commercial, prudent basis.**

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**BOARD STATEMENT (continued)**

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- c. We incur external manager fees only when we firmly believe that the manager is: operating in an environment conducive to generating returns above the Reference Portfolio; utilising a good investment strategy; and satisfying our due diligence hurdles.

**We are pursuing a full suite of New Zealand investment strategies**

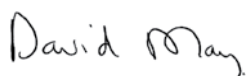
In May 2009 we received a direction from the Minister of Finance relating to investment in New Zealand, subject to our duty to invest on a commercial, prudent basis. Our analysis indicates that market conditions following the GFC were conducive to the Fund achieving an expected return in New Zealand, sufficient to compensate for the additional asset concentration risk. This was true in a few specific areas and we have established strategies accordingly. We expect to make progress on each of these strategies in 2010/11 with market conditions more conducive to such activity. The strategies agreed to date include:

- NZ Direct strategy providing capacity to make a small number of significant investments;
- Expansion Capital strategy aimed at small to mid-sized businesses with capital constraints and genuine growth potential;
- Cornerstone investment in Public Infrastructure Partnerships (PIP) Fund aimed at direct investment in public infrastructure; and
- A rural land strategy (a global strategy but with clear potential for applicability to New Zealand).

**We are focussed on driving commercial benefits from our international relationships**

Over time we have established a network of relationships with peer funds around the world. This network has sufficient strength for us now to focus on driving commercial and reputation benefits. Our goals in this regard are detailed in our Forecast Statement of Service Performance on page 16 but, in particular, as suitable opportunities arise we may be in a position to bring in other responsible, long-term sources of investment capital to the New Zealand economy.

We believe that the Guardians and Fund are well positioned to achieve our outcome of reducing the tax burden on future New Zealand taxpayers of the cost of New Zealand Superannuation. With an organisational backbone tempered by the global financial crisis and its aftermath, we have developed internal capabilities and clear investment strategies to capture favourable investment opportunities.

**DAVID MAY**

Chairman  
12 May 2010

**DAVID NEWMAN**

Deputy Chairman  
12 May 2010

## OUTCOME FRAMEWORK

This framework sets out what we are trying to achieve and how we plan to achieve it.

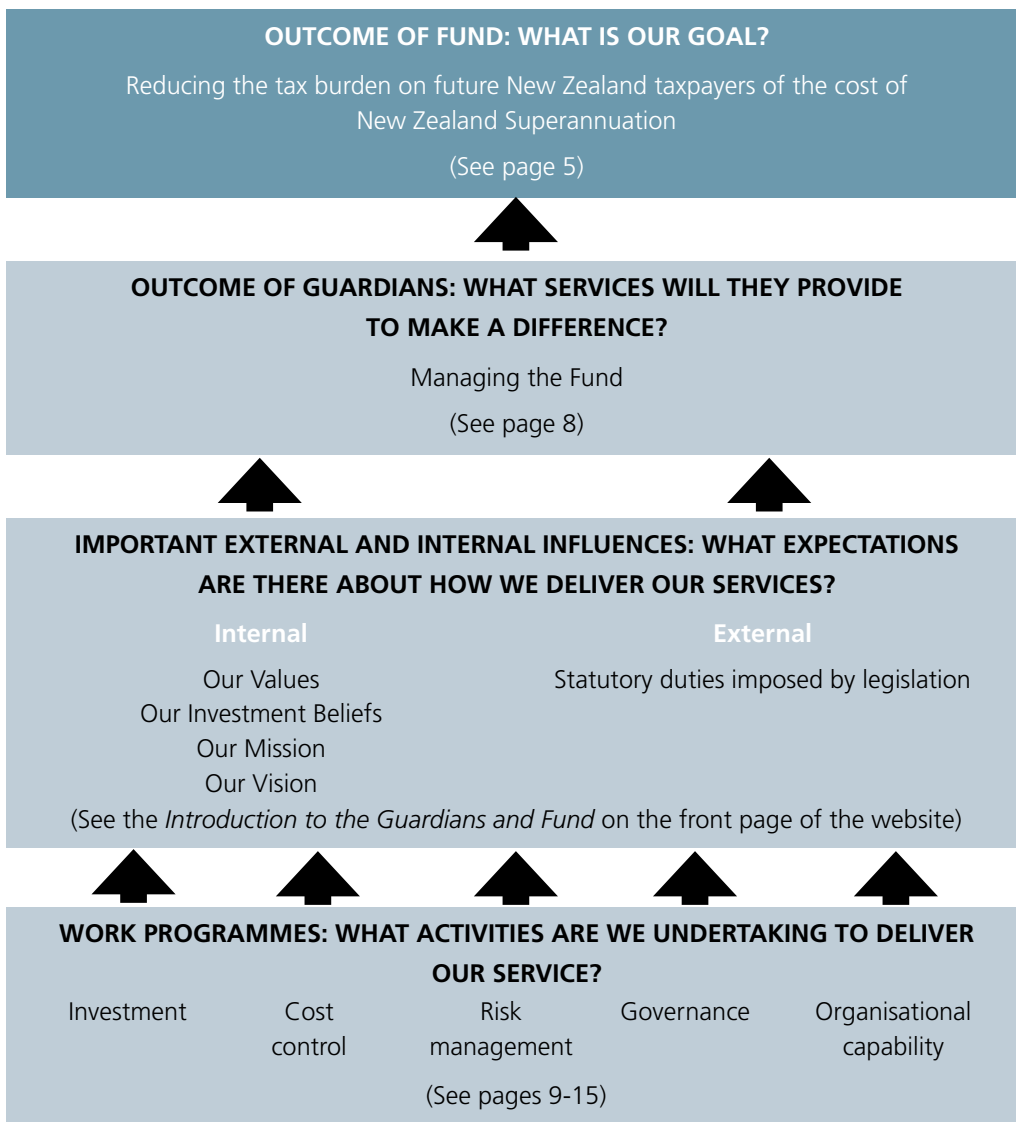
Our **outcome** is reducing the tax burden on future New Zealand taxpayers arising from the cost of New Zealand Superannuation.

Our single output is the management of the Fund. This output comprises the following **work programmes**: investment, cost control, risk management, governance, and organisational capability.

We have set out our key initiatives under each work programme and how their success will be measured in the short and medium term. We will report on progress against those measurements in our Annual Report.



**Our single output is the management of the Fund.**



## OUTCOME

*Reducing the tax burden on future New Zealand taxpayers arising from the cost of New Zealand Superannuation*

Where to go for more information: See the *Why We Exist* page on our website

On current Treasury projections the Government begins capital withdrawals in 2031. Those who are eligible to first receive New Zealand Superannuation in 2031 are now aged 44.

Setting targets in a five-year SOI for such a long-term outcome presents a challenge. To illustrate: at current policy settings, the reporting period for the 2027 SOI will be the first to cover actual withdrawals from the Fund. Internally, we use rolling 20-year periods to assess the performance of the Fund against our objective.

However, we acknowledge that there is considerable interest in the Fund's progress and that most observers would not expect to wait until 2027. In fact, there are waypoints short of 20 years' time which have significance for the performance of the Fund and for our management of it. These can be seen in Table 1.

Tables 1-3 on this and the following pages set the context for the one, five, and 20-year periods we have established for our outcome and our output measures.

**Table 1 – Significant time periods for the Guardians and Fund**

Horizon period	Why does it matter?	Relevant SOI measurement period
1 year	Monitoring of short term investment manager performance. Financial reporting to the Crown.	1 year
Minimum 5-10 years	Core period for review of Reference Portfolio (see page 10) and to assess value-add and excess return. Interval for Independent Review	5 and 10 years
10-20 years	Key period for judging the impact of Fund returns on the Fund's objective and of our long-term value-add strategies.	10 and 20 years
>20 years	Withdrawals begin. Consistent with longer-term mandate of the Fund	20 years

**Table 2 – Outcome measures**

	Measure	Guardians One year horizon	Fund Five year horizon	Fund 20 year horizon
<b>Maximising returns....</b>	Reference Portfolio Returns relative to T-Bills	+3.20%	+3.20% per annum	+ 2.35% per annum
	Actual Fund returns relative to Reference Portfolio (after costs)	+0.55%	+0.80% per annum	+0.95% per annum
<b>....without undue risk</b>	Expected worst case downside return <sup>1</sup>	-31% (per annum)	-5% per annum	-3% per annum

1. We define a 'worst case' scenario as one with a 1 in 100 chance of occurring within the specified timeframe. It is based on a 30-year investment horizon. See page 7 for further explanation.

## OUTCOME (continued)

**Explanation of measures chosen****One-year Guardians' estimate**

We are legally required to outline our expectations for the performance of the Fund over the next financial year. Predicting short-term financial market returns with useful accuracy over such a near-term horizon is, however, impossible. To reflect this we use a longer-term forecast – over five years – and then interpolate this forecast into annual figures. How we have calculated the five-year forecast is set out in detail on page 19.

**Five and 20-year Fund estimates**

These measures are based on movement toward long-run equilibrium for each asset class<sup>2</sup>. This involves two assessments:

- first, an estimate of what we would expect each asset class to return over certain periods, if their actual market values started at 'equilibrium' levels; but then incorporate
- an estimate of what the impact would be of a move from current market value toward those equilibrium levels.

**Why use Treasury Bills as a measurement of 'maximising returns'?**

**If the Fund outperforms Treasury Bills over time it adds value to the Crown's financial position. We believe this impact can be expressed as reducing the tax burden on future New Zealand taxpayers.**

The Fund is a pool of financial assets held by the Crown. As such, contributions to the Fund make no difference to net Crown assets/liabilities. However, contributions can impact the level of the Crown's gross debt.

Accordingly Treasury Bills proxy the 'opportunity cost' to the Government of contributing capital to the Fund, instead of using the money to retire debt. This is because Treasury Bills represent the interest cost to the Government of raising debt.

Over time, the Fund is expected to earn more for the Government in investment returns than it would save in debt servicing i.e. it is expected to add to Crown wealth, putting future governments in a better position to meet increased Superannuation commitments.

**Why use the Reference Portfolio as the measurement of 'maximising returns'?**

**If the Fund outperforms the Reference Portfolio over time we as managers are adding value to the Fund. This impact represents an additional contribution to reducing the tax burden on future New Zealand taxpayers.**

The Reference Portfolio is our estimate of the best simple, low-cost, passive portfolio we could invest in to achieve our mandate. It therefore represents a benchmark for our ability to add value with more complex, expensive, active investment strategies such as strategic tilting, investing in private and/or illiquid assets, and investing in specific skills. We see these active investment strategies as consistent with our statutory duty regarding best-practice portfolio management; our investment beliefs and our competitive advantages. We discuss them in more detail on page 10.



**If the Fund outperforms Treasury Bills over time it adds value to the Crown's financial position. We believe this impact can be expressed as reducing the tax burden on future New Zealand taxpayers.**

2. Taking global equities as an example, we assume that earnings yields (adjusted for the economic cycle) will move half-way towards our assessment of equilibrium value in five years and essentially all the way in 20 years. Because annualised returns are more widely dispersed over shorter periods, we have greater confidence in a 20-year estimate than we have in a five-year estimate.

## OUTCOME (continued)

### Why use a worst-case downside return as a measure of 'undue risk'?

#### The volatility of the Fund returns over time shows the level of risk present in the investment path we have chosen for the Fund.

Our Act requires us to maximise returns without undue risk to the Fund as a whole. This is the trade-off all investors must consider and maximise. The term 'undue risk' is not defined in our Act; rather, it is up to us to interpret. Accordingly in establishing the Reference Portfolio we weigh up the amount of expected return per unit of risk that comes with different combinations of assets. The resulting combination of risk and return is that which we think best meets our statutory obligations.

Financial market returns are inherently volatile. In any given period actual returns will fall somewhere within a wide range of possible returns. For the estimated 'worst case' downside return we look at lowest percentile expected return (or a 1-in-100 event) for the period. If actual returns are worse than this then either a rarer-than-expected event has occurred or we have taken more risk than we assumed.

In Table 2, our modelling work, which has taken into account the additional potential for downside risk following the GFC, suggests there is a 1-in-100 chance of Fund returns being worse than: -31% in any one year; -5% in any consecutive five-year periods; or -3% in any consecutive 20-year period. In any such case, we need to explain what has happened (and will do so in the relevant period's Annual Report).

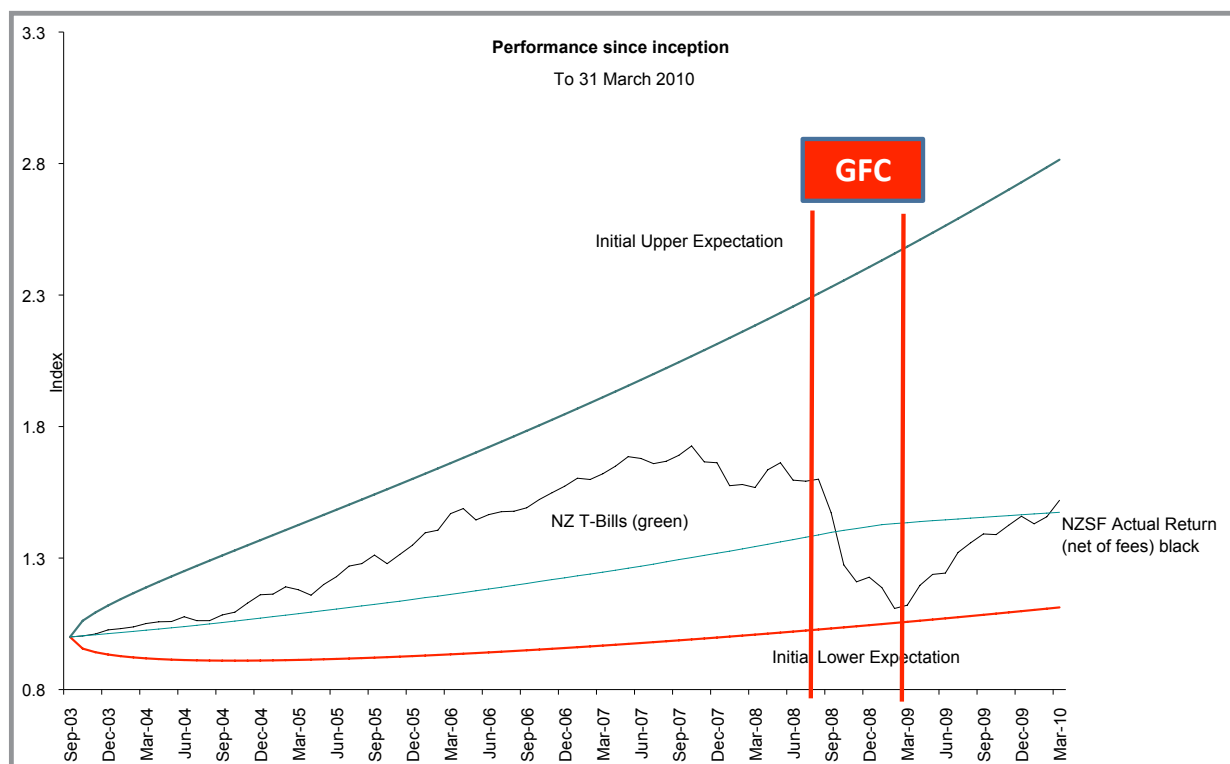
Our Reference Portfolio is designed with a 30-year investment horizon in mind. The 'worst-case' estimates are therefore also modelled on this time horizon.

#### Cumulative Fund return over time

This graph sets out the Fund's performance (the black line) relative to Treasury Bills (the green line) since inception. The graph also sets out the initial extreme upper and lower expectation ranges for the Fund's returns over time.

Most clear from this graph is the impact of the Global Financial Crisis (GFC). It is also clear from performance prior to the GFC that, while our focus is on minimising the risk of worst-case outcomes, returns can also exceed expectations on the upside.

Perhaps most important, this graph shows that the Fund has been in existence for less than seven years which is a very short time relative to its long-term purpose.



## OUTPUT

### Managing the Fund

For more information on our Values, Investment Beliefs, Mission, Vision and statutory duties see pages 4-6 of our *Introduction to the Guardians and Fund* on the front page of our website.

There are a number of important external and internal influences on how we manage the Fund:

- the internal influences - our Values, Investment Beliefs, Mission and Vision – are our own conception of how we should manage the Fund; and
- the external influences are statutory duties embedded in our establishing legislation.

Consistent with our outcome measures we have used one, five and 20-year periods for measuring our outputs. These are set out in table 3 below. We explain what each work programme encompasses, set out any key developments in each programme for 2010 and explain the measures we have chosen for each.

**Table 3 – output measures**

Contributing work programme	Measure	Guardians One Year Horizon	Fund Five Year Horizon	Fund 20 Year Horizon
<b>Investment programme</b>	<b>Measure and targets are same as for outcome</b>		<b>Measure and targets are same as for outcome</b>	
<b>Cost control</b>	<b>1. Costs relative to peers in CEM survey</b>	Rating of 'median cost, value-adding'	Ongoing	Ongoing
<b>Risk management</b>	<b>1. Expected worst case downside return<sup>3</sup></b>	Better than -31%	Better than -5% p.a.	Better than -3% p.a.
	<b>2. Transparency ratings over time (at least Linaburg Maduell)</b>	10/10 Linaburg, results as appropriate to other surveys	Ongoing	Ongoing
	<b>3. Annual updating of response to 'Santiago' Principles</b>	Completed	Ongoing	Ongoing
	<b>4. UNPRI Assessment over time</b>	Top quartile	Ongoing	Ongoing
	<b>5. Published records of voting, RI in practice</b>	Published	Ongoing	Ongoing
<b>Governance</b>	<b>6. Outcome of independent reviews</b>	N/A (done five-yearly)	Good review, review and response published	Good review, review and response published
<b>Organisational capability</b>	<b>7. Key person risks identified and covered</b>	Achieved	Ongoing	Ongoing
	<b>8. Key performance indicators achieved</b>	Achieved	Ongoing	Ongoing

3. 'Worst case' means a 1 in 100 chance of occurring within the specified timeframe. See page 7 for further explanation.

## WORK PROGRAMMES

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### Investment programme

#### What is encompassed

This programme encompasses all of our investment activity. For more information on our investment process, asset allocation, significant holdings and how we assess and select investment managers please see the What We Do and Structuring the Fund sections of our website.

#### Key influences on 2010 SOI

##### 1. Having regard to the New Zealand Investment directive

In May 2009 we received a direction from the Minister of Finance which stated 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.*

The full direction and our response are available via the *Investing in New Zealand* section of our website. In brief, we undertook to examine a range of investment opportunities allowing us to comply with the direction and with our statutory duties to invest on a prudent, commercial basis. We report our progress against the direction in ensuing Annual Reports. The first such report is on page 36 of our 2009 Annual Report.

While we remain optimistic that a number of value-adding investments will come to fruition over the period of this SOI, there is no guarantee that they will. Each opportunity must be weighed against our statutory duty to maximise returns without undue risk. We have built capacity to invest directly in large assets in New Zealand. We also believe that there is an opportunity to provide expansion capital to small and medium-sized growing businesses in New Zealand. We have also committed capital to an externally managed New Zealand infrastructure fund. For more information on our New Zealand investment strategies see the *Investing in New Zealand* section of our website.

##### 2. The Reference Portfolio

The composition of the Reference Portfolio is currently being finalised and will be disclosed on our website and in our 2010 Annual Report.

#### Why are we using the Reference Portfolio?

The Reference Portfolio is important for a number of reasons, but primarily because:

- it represents a balance of risk and return which, because of our long-term investment horizon, is necessarily weighted in favour of growth assets;
- it underpins our expectations of the returns the Fund should produce over the long-term; and
- because it represents a low-cost way to invest, it establishes an important performance benchmark for the additional value-adding investment activities we undertake within the Fund's actual portfolio.




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**We have built capacity to invest directly in large assets in New Zealand.**

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**WORK PROGRAMMES (continued)**

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**What is in the Reference Portfolio?**

We will disclose the detail of its composition once it is finalised. Very basically, the Reference Portfolio comprises exposures which are

- low-cost, simple (i.e. listed asset classes) and passive
- representative of the investable market
- appropriate to the risk profile of the Fund and
- relevant to a New Zealand investor.

**How does it differ from our current passive benchmark?**

Like the Reference Portfolio, the passive benchmark comprises passive public markets exposures (e.g. listed equities). However it also includes 'non-equilibrium' and 'active' investment concepts such as set allocations to illiquid assets such as infrastructure. The Reference Portfolio includes only low-cost, simple, passive exposures. It does not contain proxies for illiquid assets.

In Table 4 on the following page we illustrate the basic difference between the previous structure and the structure based on the Reference Portfolio.

**Is the Reference Portfolio 'set and forget'?**

The Reference Portfolio is an 'equilibrium' concept. This means that it is structured based on our assumptions of what the long-term value of various asset classes **should** be, regardless of what is actually happening to those values in any given market conditions. Therefore the Reference Portfolio's composition will only change if:

- our assumptions change about what long-term equilibrium return-for-risk should be; or
- aspects of the Fund's purpose or endowments change; or
- market developments mean that a narrower or wider set of representative market exposures can be obtained passively and at low-cost.

The Reference Portfolio will be augmented for practical purposes with asset-class ranges for the purpose of managing the Fund i.e. to ensure a regular benchmark against which we rebalance our investments.

**How do we add value to the Reference Portfolio?**

The actual Fund at any one time can – and very likely will – deviate from the Reference Portfolio based on what additional activities we believe will add value. This is underpinned by our recognition that investment opportunities come and go and, to benefit from this fluctuation, the active portfolio must be more dynamic. There are also investment strategies that can be anchored to our investment endowments (tolerance for illiquidity, long-term investment horizon, our location and Government ownership) our competitive advantages (the knowledge we have e.g. about New Zealand markets) and our investment beliefs.

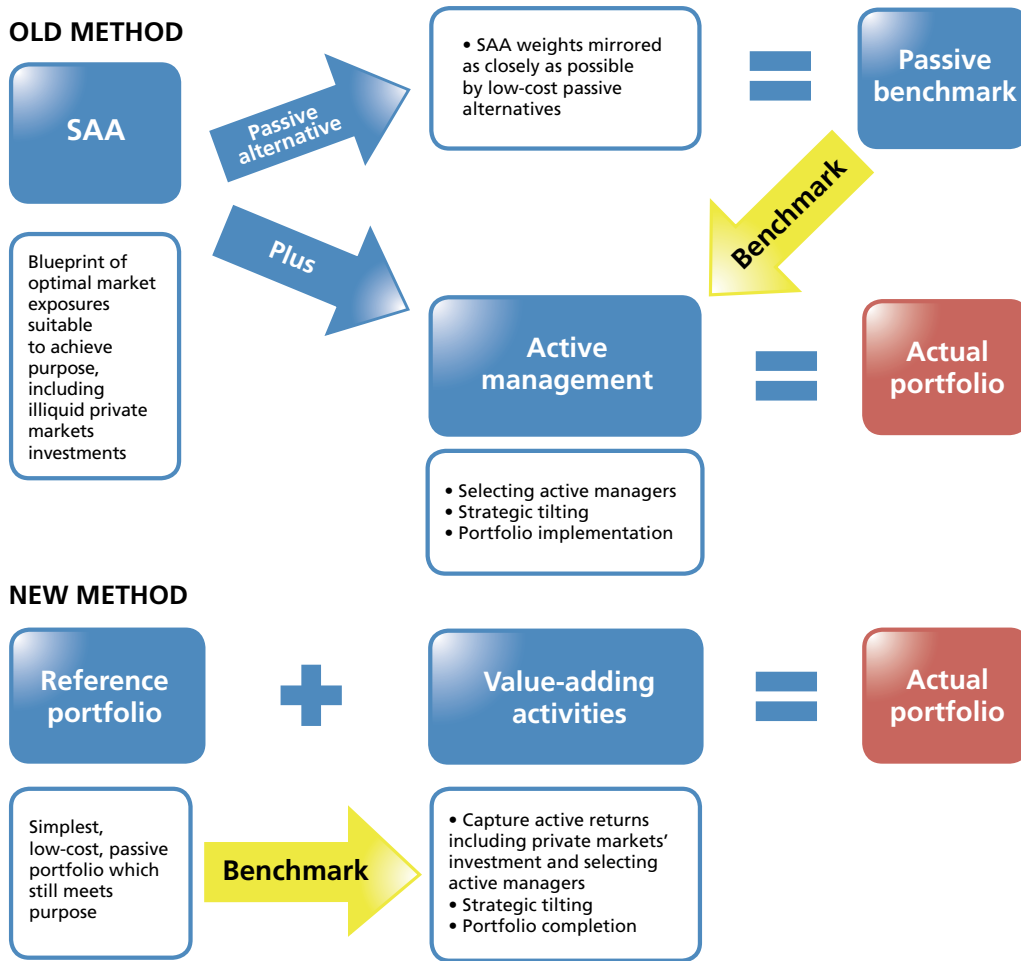



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**The Reference Portfolio represents a low-cost way to invest and so establishes an important benchmark for our value-adding activities.**

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Table 4 - Comparing portfolio construction methods



**Explanation of measures**

The measures for our investment programme are the same as for our outcome.

## WORK PROGRAMMES (continued)

## Cost control programme

## What is encompassed

This programme encompasses all activity aimed at making our management and administration of the Fund as cost-effective as possible.

## Key influences on 2010 SOI

## Cost expectations

For the period covered by the 2010 SOI we expect total costs to be similar to the previous SOI. They are above our actual costs for 2009, as those costs were lower than budgeted for given the prevailing market conditions.

The increase in forecast costs for 2010 reflects a return to more 'normal' market conditions and is a direct function of the more 'normal' corresponding level of investment activity we expect to be able to undertake. We believe the following points are important to understand about this:

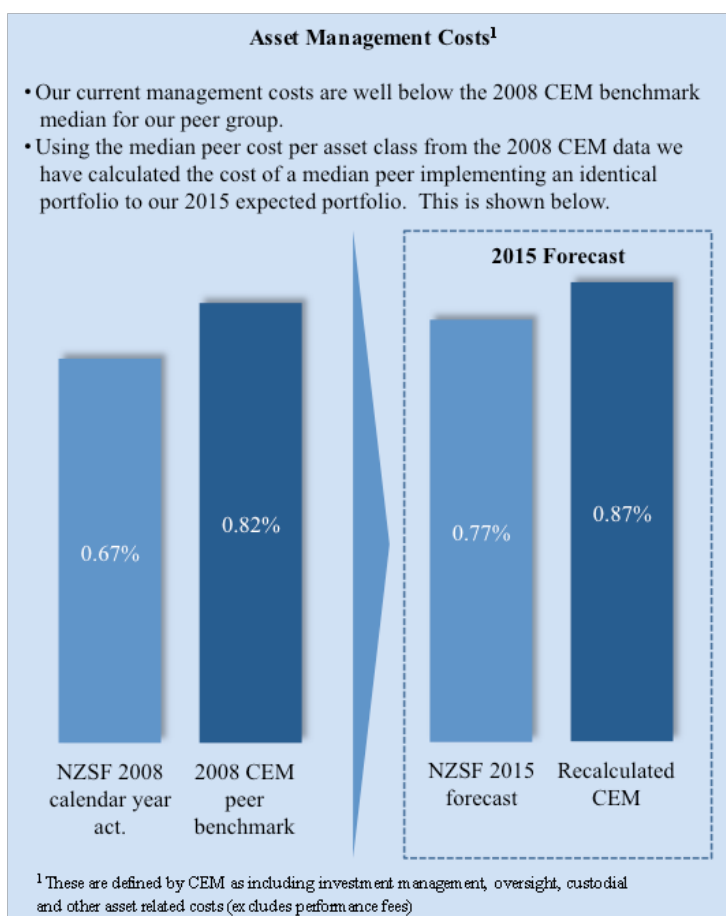
- All the expenses we incur as part of our investment activity are subject to two important checks and balances: the low-cost principle underlying the Reference Portfolio; and the annual benchmarking of the costs we incur and the value we add, relative to peer funds, via the CEM survey (see below).
- Our expenditure includes investment in our own capabilities to manage the Fund efficiently i.e. in people and processes.
- Investment manager costs are an important component of our overall cost. We believe that pursuing certain active investment strategies will produce excess returns, and that some of these strategies are best managed by external experts.
- Peer group collaboration is a focus of this SOI, as can be seen in particular in our Statement of Service Performance on page 16. Its relevance to cost control will be through joint investments with other funds and, in the New Zealand context, through actively pursuing joint initiatives with fellow Crown Financial Institutions.

## Explanation of measures

The Guardians participate in the annual cost structure benchmarking survey by CEM Benchmarking Inc. (CEM). The survey assesses the cost structure of the Fund against nearly 300 funds from around the world, focussing on 20 with similar risk profiles who also use active management strategies.

In the most recent survey, for the four years ended 31 December 2008, our Fund was rated low cost relative to our peer funds.

We disclose CEM survey results in each year's Annual Report. The most recent results are on page 42 of the 2009 Annual Report.



## WORK PROGRAMMES (continued)

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### Risk management

#### What is encompassed

Managing risk is of fundamental importance to our governance of the Fund. Failing to appropriately identify, assess and manage risk has potentially significant financial, operational and reputational consequences. The risk management programme therefore encompasses our activities in those three risk-management areas. For more information on our risk management approach please see the Managing Risk section of our website, under What We Do.

#### Key influences in 2010 SOI

Following on from the lessons learned in the Global Financial Crisis our risk management focus is, internally, on enhancing our processes on managing risk and, externally, on ensuring we are as transparent as possible about our activities. In practice, this involves:

1. a thorough review of our policy frameworks to ensure that all of our policies – whether governing investment, operational, human resources or governance matters – are simple to understand and that all our staff are clearly aware of their responsibilities under each;
2. reviewing our significant disclosure channels including the website, Annual Report and SOI to ensure that our stakeholders and the public in general can easily understand why we exist, what we do, how we invest and why and how we are progressing against our objective; and
3. a focus on collaboration with peer funds (as set out in our Forecast Statement of Service Performance) to develop and share best practice, including in risk management and Responsible Investment. Peer funds are global funds (e.g. other sovereign wealth funds).

#### Explanation of measures

##### Financial

The Fund's key financial risk is that it will not meet its ultimate objective. We have already explained above, in discussing our Outcome Framework, that financial market returns are inherently volatile. We also discussed what, in this context, constitutes an 'undue risk'.

Consequently it is appropriate for our measurement of financial risk to be the same as that for undue risk i.e. a 'worst case' downside return worse than the lowest percentile expected return for the period.

##### Reputational

We are conscious that the Fund has as its ultimate beneficiaries future New Zealand taxpayers. We acknowledge that internationally we have status as representatives of New Zealand and this is reflected in our statutory duty to invest so as not to prejudice New Zealand's reputation in the world community. We believe that transparency is crucial to the formation, preservation and enhancement of our reputation and that transparency is best judged by external parties. Our chosen measures reflect that.

##### Transparency ratings

Currently there are not many third-party mechanisms rating the transparency of Sovereign Wealth Funds. One such rating is compiled by the San Francisco-based Sovereign Wealth Fund Institute and published on a quarterly basis. The rating is out of 10 and based on the Institute's




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**We believe that transparency is crucial to the formation, preservation and enhancement of our reputation and that transparency is best judged by external parties.**

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**WORK PROGRAMMES (continued)**

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conception about what the average person would expect to find out, easily, about a Sovereign Wealth Fund. Our Fund has been rated 10 since the inception of the index and our target is simply to remain a 10. The Institute's website is [www.swfinstitute.org](http://www.swfinstitute.org)

We have published our ratings in ad hoc transparency surveys by other organisations, in the *How Transparent Are We?* section under the Performance heading on our website.

We will report how we are rated by other such mechanisms as we become aware of them (and regard them as relevant) and we aspire to a top-quartile, or higher ranking, as is appropriate to the mechanism.

**Santiago Principles**

The Santiago Principles are essentially principles for best practice by Sovereign Wealth Funds, drawn up by the International Forum for Sovereign Wealth Funds (IFSWF), which was established under the auspices of the IMF, and, of which New Zealand is a member. The principles are explained, and we at least annually review and publish our response to them, on our website under the *How Transparent are We?* section mentioned above. Consistent with Santiago Principle #24 we will continue to do so, publicly, at least annually.

**UNPRI Assessment**

This is the assessment by the secretariat of the United Nations Principles for Responsible Investment as to the extent to which, and how effectively, UNPRI signatories are actually carrying out the principles in their investment activity. Achieving a top quartile rating is our aspiration as it is a moving target and requires a constant process of improvement in Responsible Investment policy and practice to maintain. More information on UNPRI is on our website under the *Responsible Investment* heading.

**Voting and Responsible Investment in practice reports**

A simple transparency measure of the extent to which interested parties can see and understand how we have voted on Responsible Investment and governance issues with respect to investee companies; and more generally the Responsible Investment initiatives we have undertaken. All reporting on Responsible Investment matters is on our website under the *Responsible Investment* heading.

**Governance****What is encompassed**

We believe it is important for our stakeholders to be aware that our management and administration of the Fund is subject to regular and ongoing external assessment, and that those assessments are made public.

**Key influences in 2010 SOI****Progress against Independent Review recommendations**

In November 2009 the Minister of Finance was presented with the conclusions of an Independent Review into our management and administration of the Fund. The review, which is required every five years, was conducted by Mercer, a global financial advisor. We welcomed the conclusions of the review as overall being supportive of our governance. The vast majority of the recommendations were endorsements of actions already being undertaken. The full review




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**...our management and administration of the Fund is subject to regular and ongoing external assessment... those assessments are made public.**

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## WORK PROGRAMMES (continued)

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and our response to it are available via the *Performance* section of our website under *How Transparent Are We?* We have already implemented 70% of these recommendations and we anticipate that most remaining action items will be addressed by the end of 2010/11.

The Leadership Team and Audit Committee review progress in implementing outstanding External Audit and Independent Review recommendations on a quarterly basis, to ensure completion of action items associated with these recommendations within expected timeframes.

*Explanation of measures*

### **Independent review**

An independent review of our governance of the Fund is required every five years. The terms of reference, and funding, for the review are provided by the Minister of Finance. The Fund has had two such reviews since inception. They are both available via the *Performance* section of our website under *How Transparent Are We?*

### **Organisational capability programme**

#### **What is encompassed**

This work programme encompasses ensuring that the Guardians' have appropriate internal capabilities to deliver our output of managing the Fund, in service of our outcome. Organisational capability includes the recruitment, retention, development and remuneration of our people. We expect the completed HR Strategy to produce further performance measures for this work programme.

#### **Key influences in 2010 SOI**

In 2010 we will conclude the implementation of our HR Strategy. The key elements of this are a tool for identifying the working culture our people want from the Guardians, including an annual survey of whether they are actually experiencing that culture working here; and new programmes for performance based remuneration and talent retention.

*Explanation of measures*

#### **Key person risk**

This measure is essentially an indicator of how well we attract and retain the best people relative to our assessment, given the purpose of the Guardians and Fund, of our capability requirements.

#### **Achieving Key Performance Indicators**

Each staff member must achieve KPIs which cover desired behaviours and their achieving key projects, all of which are driven by the staff member contributing to our overall outcome. This measure is therefore an indicator of the extent to which our people are performing.

## STATEMENT OF SERVICE PERFORMANCE

### Statement of Service Performance for 2010/11

In this section we set out the important initiatives which will occur under each work programme within the financial year to 1 July 2011. All of these initiatives are sourced directly from our Strategic Plan. We note that most of the initiatives identified will also apply to 2012.

- Table 5 sets out the broad initiatives together with the relevant work programme performance measure (see page 8) for each.
- Table 6 identifies in greater detail the specific activities encompassed by each initiative (and makes clear some activities are relevant to more than one initiative) as they are set out in our Strategic Plan.

**Table 5 – Statement of Service Performance for 2010/11**

Initiative	Explanation	Relevant work programme measure(s)
Peer collaboration project	We have an extensive network of strong global peer relationships over recent years. We see significant benefits from working more closely with peer funds to access skills and investments advantageous to the Fund. Our plans to do so comprise the peer collaboration strategy.	<ul style="list-style-type: none"> <li>• <b>Investment</b></li> <li>• <b>Cost control</b></li> <li>• <b>Risk management</b></li> <li>• <b>Governance</b></li> <li>• <b>Organisational capability</b></li> </ul>
Excellence in investment opportunity search, evaluation and selection	Seeking opportunities to invest jointly with other funds and fellow Crown Financial Institutions (CFIs) as contribution to value add (excess return)	<ul style="list-style-type: none"> <li>• <b>Investment</b></li> <li>• <b>Risk management</b></li> <li>• <b>Organisational capability</b></li> </ul>
Capturing the illiquidity premium	Improving processes for identifying opportunities with appropriate (or potentially appropriate) liquidity premiums from private and public markets investing; ensuring passive alternatives are identified and assessed; and, if proceeding, structuring such opportunities to ensure the premium is delivered.	<ul style="list-style-type: none"> <li>• <b>Investment</b></li> </ul>
Excellence in portfolio completion	Improving our ability to identify and address potentially unnecessary investment costs.	<ul style="list-style-type: none"> <li>• <b>Investment</b></li> <li>• <b>Cost control</b></li> </ul>
Complete HR Strategy implementation	Review of organisational design, new performance-based remuneration programme, key talent management and ongoing capability development.	<ul style="list-style-type: none"> <li>• <b>Organisational development</b></li> </ul>

Table 6 – Strategic Objectives and key planned activities

Five strategic objectives for the year ahead:		Key planned activities in fiscal years 2011 and 2012							
Excellence in investment opportunity search, evaluation and selection	Investment strategies	Portfolio Completion	Counterparty and transition panel development; implement liquidity framework; refresh funding model; refine/develop benchmarks	✓	Excellence in search & eval	Capture illiquidity prem	Excellence in completion	Collaboration with peers	Complete HR strategy
		Strategic Tilting	Broaden range of asset classes & scope; refine forecasting & integration with hurdles; increase maximum limits	✓					
Capturing the illiquidity premium	Investment strategies	Private Markets Active Return	Develop opportunity map; enhance systematic monitoring; review infrastructure strategy; build PE, private property & NZ Direct	✓					
		Public Markets Active Return	Revise mandate set & build target exposure; develop opportunity map; enhance systematic monitoring; investigate internal NZ active	✓					
Excellence in portfolio completion	Investment strategies	Portfolio Level Change	Macro themes; peer collaboration strategy (including working with other CFIs); RI strategy implementation; risk management	✓					
		Governance	Review of governance budget against best practice; Board learning & growth plans; develop risk mandate map; policy review	✓					
Collaboration with peers	Organisational development	Risk Management	Establish an enterprise risk model; enhancing risk measurement and monitoring systems; improving risk preparedness	✓					
		NZ Hallmark	Implementation of a Hallmark plan aimed at building a strong domestic reputation for having a positive impact in NZ	✓					
Complete HR strategy implementation	Organisational development	People	Cultural development programme; review organisational design; new bonus programme; key talent management programme	✓					
		Processes & Technology	Process improvement; migrate to new IT framework; assess long term IMS requirements; cost of ownership benchmarking	✓					
	Organisational development	Physical location	Investigate overseas representation	✓					

## CONSULTATION AND REPORTING TO THE MINISTER

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We strive to be as transparent as possible about our management of the Fund and its consequent performance. Our important stakeholders, including the Minister of Finance, and any other interested party can easily access a wealth of current, detailed information on our website.

In addition we provide a quarterly report on the progress of the Guardians and the Fund to the Minister. This sets out the performance of the Fund and key investment and other operational developments during the preceding quarter.

Section 50 of our Act sets out a limited number of borrowing activities we cannot undertake without prior approval from the Minister. From time to time we have sought approvals, together with exemptions from restrictions in broader public sector legislation, and the Minister has given those approvals. An example is the ability we have to use derivatives as part of our investment strategy.

Section 58 of our Act sets statutory duties for our investment approach but gives the Guardians the responsibility for setting and executing the investment strategy of the Fund. Accordingly we would not expect to consult the Minister on the development or implementation of that strategy.

Section 64 of our Act states that the Minister may, after consulting with us, give directions regarding the Government's expectations as to the Fund's performance, including the Government's expectations as to risk and return. Such a direction cannot be inconsistent with our statutory duty to invest the Fund on a prudent, commercial basis. We must have regard to the any such direction and must notify the Minister how we propose to do this. We must also report how we are having regard to the direction in our Annual Report.

As part of the 2009 Budget we received a direction from the Minister on investing in New Zealand. We have disclosed the following:

- the wording of the direction and our response is on our website under the *Investing in New Zealand* section; and
- progress reports on the directive are in our Annual Report and in the *News and Reports* section of our website.

In common with other Crown entities we have also received from the Minister a Letter of Expectations, setting out the Minister's general requirements for prudent expenditure given the broader economic and fiscal environment.

## ACQUISITIONS

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We have no intention in respect of our own activities to acquire interests in companies, trusts or partnerships. We do however undertake such acquisitions in respect of the Fund.

Section 59 of our Act requires us to use our best endeavours to ensure that the Fund does not control any other entity or hold a percentage of the voting rights in any other entity that would require us to seek control of that entity. Consequently the investment guidelines we have in place with external managers place strict limits around the portion of a company's issued capital each manager can own. We monitor the portion of issued capital present in the Fund to ensure it is not deemed to represent a controlling interest. We also ensure that where the threshold for publicly reporting the Fund's holding in a company is reached, we do so promptly.

Opportunities to purchase privately traded assets carry associated obligations to take over operating entities specific to that asset. In these cases we need to balance the benefit to the Fund of going ahead with the transaction, against the Section 59 restriction.

Our approach is to continue to consider transactions on their commercial merit and then aim to change the ownership structure of the operating entities 'as soon as practicable', as required by the Act, to comply with Section 59. We seek and follow appropriate legal and taxation advice on these transactions and ensure that the Minister of Finance is kept informed.

## Required Statement of estimated returns for the Fund

We are legally required to outline our expectations for the performance of the Fund over the next financial year. Predicting short-term financial market returns with any useful accuracy over such a near-term horizon is, however, impossible. At best, we can use our modelling techniques to provide a range of likely outcomes for the year ahead and identify amid-point of this range.

Specifically, we begin with our expectation for market returns over the next five years and use this to form the mid-point of the range for the estimated Reference Portfolio Return for 2010/11. To that we add our expectations of returns from added-value activities to arrive at the mid-point for the Actual Fund. Finally, we estimate a range of possible Fund returns for 2010/11, given our estimate of the volatility of market returns. Using this approach we have estimated as follows:

Component of Return	Explanation
Risk-free rate <b>4.9%</b>	Our estimate of the return on 90-day Treasury Bills, reflecting that T-Bill yields are currently below equilibrium levels.
<b>PLUS</b> Reward for market risk (after costs) <b>3.2%</b>	<p>We define the reward for market risk as the margin between the risk-free rate and the return that would be generated on the Reference Portfolio (after assumed costs of 0.3%). We estimate this number over a five-year horizon, allowing for movement towards equilibrium valuations (see page 6) and treat this as representative for 2010/11.</p> <p>Over a 20-year horizon our estimate on the same basis is 2.35%. Although we expect similar returns from the Reference portfolio over five and 20-year horizons, we expect T-Bill returns to rise closer to equilibrium levels over the 20-year horizon. Hence we expect the margin between the Reference Portfolio return and the return from Treasury bills to be smaller over 20 years than over five years.</p> <p>Our estimate of the reward for market risk has a very wide range over a one-year horizon, although this range is tightens over longer horizons. Around the mid-point the 90% probability range is around +/-20% for one year, +/- 8% for five years and +/- 3.5% for 20 years.</p>
<b>PLUS</b> Reward for value-adding activities <b>0.55%</b>	Our estimation of the return from the investment activities we undertake to add value. We describe those activities as part of the explanation of the Reference Portfolio on page 9.
<b>EQUALS 8.65%</b>	<p><b>The mid-point of our estimated range for the Fund return over 2010/11 is 8.65%</b></p> <p>This estimate is below our corresponding estimate of 10.70% in the 2009 SOI. This reflects the very strong market returns since the end of 2009/10. Higher starting prices for the various asset classes in which the Fund invests imply lower projected returns for the near future.</p> <p>As for the reward for market risk, the 90% probability range around the mid-point return is around +/-20% for one year, +/-8% over five years and +/-3.5% over 20 years.</p>

## Financial projections for 2010/11

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### Cost Allocation Model

Our Cost Allocation Model is made up of two main components – The Guardians and the Fund.

#### Cost of the Guardians

The costs incurred by the Board of the Guardians (comprised of Board fees, the cost of travel to and from Board meetings, and the cost of external audit for the Guardians) are met from Parliamentary appropriation. These expenses amount to \$0.52 million p.a. (GST exclusive) in 2010/11.

The majority of the Guardians' costs are met from the Fund. The costs are those incurred in the establishment and implementation of investment policy, the management of the organisation, and the financial and risk management of Fund assets. These costs are recovered from the Fund and include remuneration, staff expenses such as office services, travel, and professional development. These costs amount to \$21.07 million in 2010/11.

Together, the total costs of the Guardians in 2010/11 are expected to be \$21.70 million (GST exclusive). This is equivalent to 0.13% of expected average funds under management over 2010/11.

All operating costs, irrespective of whether they are sourced from appropriations or Fund assets, are consolidated in the financial statements of the Guardians and subject to the reporting and disclosure obligations of the Crown Entities Act.

The Guardians have prepared prospective financial statements for the Fund. The estimates assume that earnings will be broadly in line with their medium-term estimate (i.e. 8.65% p.a. after costs but before New Zealand tax). Some costs are fixed (e.g. audit costs and most advisory services) and can be easily estimated, but the majority are variable (i.e. base and performance fees paid to investment managers or transaction fees paid to the custodian). The Guardians have prepared estimates of these variable costs based on their expectations of the portfolio over the year.

#### Overall costs of managing the Fund

Overall, the cost of managing the Fund over 2010/11 – which includes the above costs plus such costs as fees paid to investment managers – is forecast to represent 0.54% of expected average funds under management. This is lower than we expect it to average over time, largely due to timing of compositional changes to our public and private markets investment programmes. We forecast that by 2015 these costs will have risen to 0.77% p.a. This would still be below the median established in the CEM cost-effectiveness benchmarking survey of peer funds (see page 12).

We note that estimating with any accuracy these costs in advance is difficult given the range of factors with potential to influence our expenditure e.g. market conditions and how we execute our investment programmes. For example, our actual costs in 2009/10 are estimated to be some 0.25% of funds under management below what was budgeted, primarily due to a change in the composition of both our private and public markets investment programmes.