NEW ZEALAND SUPERANNUATION FUND

ANNUAL REPORT 2011

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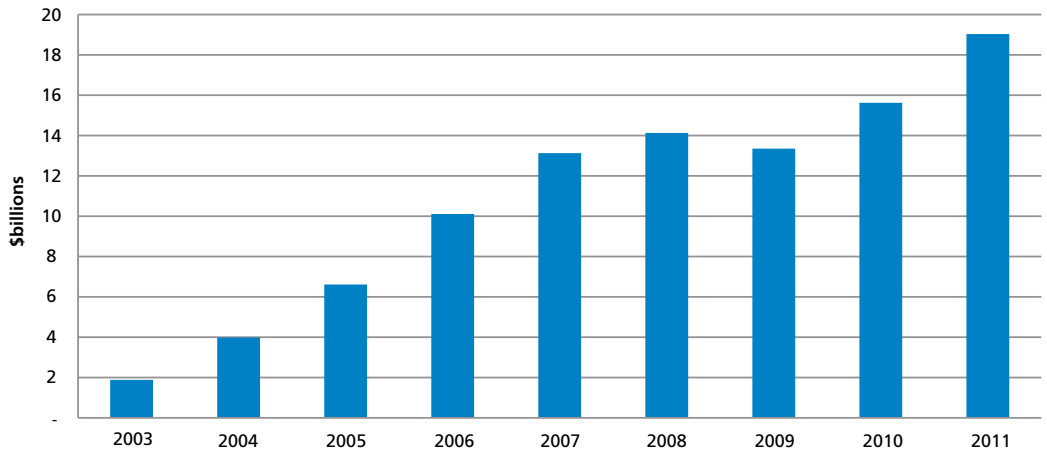
The Fund is less than eight
years into a task that will span
generations of New Zealanders.

Performance Summary

Fund size at 30 June 2011 (does not include NZ tax paid since inception, see below)		**$19.03[1] billion**
Returns	**Financial year to 30 June 2011**	**Since inception**
Actual Fund Return (includes NZ tax paid, see below)	25.05%	7.83% p.a.
$ increase in net asset position[1]	$3.4 billion	$19.03 billion
NZ Treasury Bill Return (T-Bill)	2.89%	5.60% p.a.
Absolute Net Return (Actual Return – T-Bill Return)	22.17%	2.23% p.a.
$ earned relative to Treasury Bills	**$3,483m**	**$1,750m**
Reference Portfolio Return	19.48%	7.44% p.a.
Value Added (Actual Return – Reference Portfolio Return)	5.58%	0.38% p.a.
$ earned relative to Reference Portfolio	**$887m**	**$539m**
NZ income tax paid	**$487m**	**$1,915m**

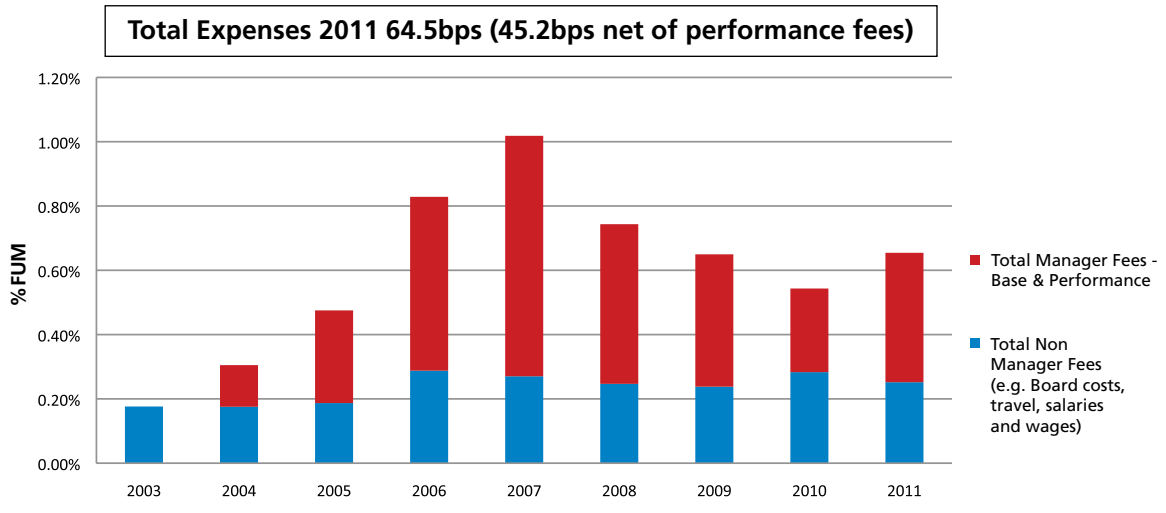
1. Excludes provisions for NZ tax

Fund size since inception



Data covers financial years to 30 June
Does not include NZ tax paid of $1.9 billion since inception

Fund Expenses as a Percentage of Funds Under Management (FUM)



The big picture

The New Zealand Superannuation Fund and the Guardians of New Zealand Superannuation were established by an Act of Parliament to reduce the tax burden on future New Zealand taxpayers of the cost of New Zealand Superannuation (NZS).

What is the effect of New Zealand's ageing population?

Statistics New Zealand data projects that, between 2005 and 2050, the number of New Zealanders eligible to retire (aged 65+) will double. The associated cost of providing their retirement income, NZS, will more than double. This means New Zealand will have:

- more people of retirement age, as a proportion of the population, than ever before; and
- fewer 'working-age' people whose productivity can be tapped, through taxation, to fund the greater cost of retirement income.

These projections have significant implications for future Governments' ability to fund other vital areas such as health, welfare, education and law enforcement. This information is therefore relevant for all New Zealanders, now and in the future.

How do the Guardians respond to New Zealand's ageing population?

The NZ Superannuation and Retirement Income Act 2001 (the Act) established:

- the Fund, as a pool of assets on the Government's balance sheet
- the Guardians, as a Crown entity charged with managing the Fund

Together, the Fund and Guardians exist to 'smooth' the tax burden between generations of New Zealanders arising from the higher future cost of NZS.

The tax smoothing occurs through the Government making contributions to the Fund and then, at a future date (currently from 2031) withdrawing money from the Fund to help to meet the cost, at that time, of NZS.

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

This is reflected in our Mission Statement which frames the purpose of the Fund and Guardians:

'Maximise the Fund's return over the long term, without undue risk, so as to reduce future New Zealanders' tax burden'

Note that in the 2009 Budget the Government decided to suspend contributions to the Fund until the Crown operating balance returns to surplus sufficient to resume contributions. At present the Treasury estimates this to be in the 2016 financial year.

Six things to remember about the Guardians and Fund

1. We are required to invest the Fund so it makes as much money as possible, without incurring undue risk, for as long a period as possible; and the Government is not scheduled to make withdrawals from the Fund until 2031.

2. This means that the asset mix of the Fund is weighted toward growth assets, such as equity in companies.

3. It also means that we can and do invest in asset classes (e.g. timber) which cannot be realised quickly – they are 'illiquid' – and require a longer-term commitment of capital. This does not suit many investors' portfolios, often because they have high demands for cash (perhaps because they have to pay dividends or must cover the eventuality of investors selling up and leaving their fund).

4. We pursue 'atypical' investment options – such as investing in 'illiquid' asset classes – only when we are confident of being rewarded, over time, with superior returns relative to more standard options such as passive investments in fixed interest or equities.

5. Having a portfolio weighted toward growth assets tends to generate short-term volatility – up or down. However it is very important to keep in mind that the purpose of the Fund is long-term and so its success must be measured over time by future taxpayers who will benefit (the oldest of whom is 21 years away from retirement and many of whom have not yet been born). Single-year snapshots have very limited relevance other than as a small contributor to a much larger pattern of returns, which the Fund is only seven years into establishing.

6. Finally, we are very aware that the circumstances which make our Fund special relative to many other investors also make it quite difficult to objectively assess its performance and, as important, whether we are adding value to it. Accordingly, we carefully and publicly benchmark both its performance, and our role in that performance.

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.** On the front page of the website you can find our *Introduction to the Guardians and Fund.*

Board Statement

David May
CHAIRMAN

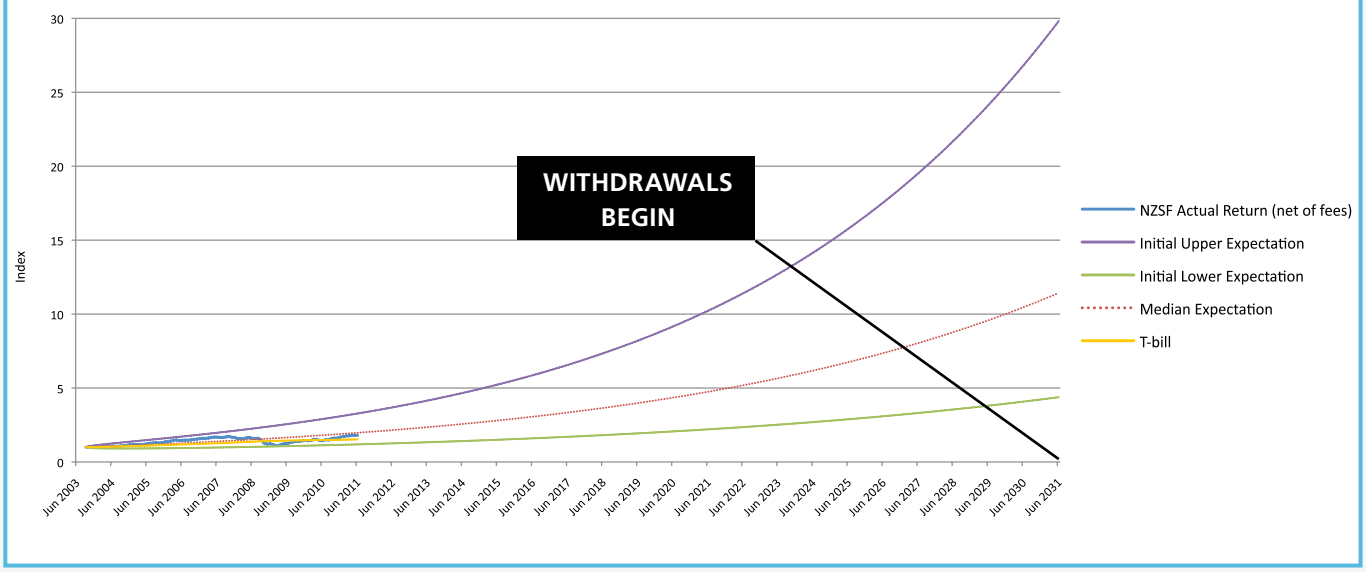
This financial year builds on the rebound that occurred post the 2008/09 Global Financial Crisis.

The strong return of 25% for the year reflected the continued maintenance of our investment discipline following the GFC and particularly strong results flowing from some of our value-add activities. The return over one year should, however,be kept in perspective. The Fund is less than eight years into a task that will span generations of New Zealanders (shown in the graph below). It's inevitable that, over such a long time, the Fund will have good years and bad. As illustrated by the past three financial years having encompassed the best and worst annual results for the Fund, the exceptionally good and bad can occur close together.

Of perhaps more importance is the work we have done to try to ensure we can sustain a strong performance into the future. Following the strategic objectives identified in our 2010 Statement of Intent (SOI) and derived from our Strategic Plan, we have:

- widened and deepened our framework for Strategic Tilting to ensure that we maximise the return from the strategy (see page 27);
- embedded the Investment Framework we introduced in our 2011 Statement of Intent (see page 12 for an example of how it has been applied);
- deployed capital into some new value-add strategies including New Zealand investments (see page 29 for a summary);
- reviewed our policy framework, including our Statement of Investment Policies, Standards and Procedures;

We are a short way into a long-term purpose



We expect and accept volatility. On some occasions, we can take advantage of it.

- conducted a number of stress tests to gauge the impact on the Fund's liquidity and long-term performance, of extreme investments shocks;
- continued to build a team capable of adding value in an extremely competitive global investment market (see from page 55).

DEALING WITH MARKET STRESSES

The past three financial years and the market unrest prevailing at the time this report was written have been an excellent test of the resilience of the Fund and of our ability to maintain investment discipline.

The investment mandate contained within our legislation demands a long-term structure for the Fund and a long-term perspective from us as the Guardians. This long-term focus translates to a weighting toward growth assets in the Fund and a tolerance from us for the short-term volatility that such a weighting creates. By tolerance for volatility, we mean that we expect and accept it. On some occasions, we can take advantage of it.

Any period of market activity will encompass various reactions to actual or perceived stresses. Some stresses are simply short-term shocks and some do not actually eventuate. It is the impact of volatility on long-term valuations that we care about. These impacts are sometimes far less pronounced than the short-term reactions in market pricing.

The fact that stresses have negative impacts on short-term investment returns is fundamental to the markets. It is why you can earn more, on average over time, on an investment in equities relative to an investment in cash. Equities are more volatile than cash and therefore offer a larger risk premium to compensate investors for accepting more volatile returns.

We do not try to predict short-term market reactions, but we do try to prepare for them in order to avoid being forced into unplanned response. We prepare for them by:

- diversifying the passive exposures in the Reference Portfolio;
- stress testing the Fund for the possible impact of extreme shocks, and;
- ensuring strong governance of our active asset allocation activity which deviates from the Reference Portfolio.

Diversifying the Reference Portfolio

The Reference Portfolio is a diversified set of passive investments weighted toward growth assets so that, over time, it benefits from the expected risk premiums. It is diversified primarily by asset class (currently equities, property and fixed income) and within those by geography and sector.

Ensuring strong governance of our value-add investments where we deviate from the Reference Portfolio

The governance we apply is anchored to our fundamentals: the Fund's endowments, our investment beliefs and our risk appetite (see the box *Investing in all Conditions* on the next page).

Against the context of our fundamentals, we put considerable effort into assessing the fair-value price of assets, based on long-term fundamental factors. That allows us to form a view of the intrinsic value of an asset class at any point in time. We can then put money on the table when markets have moved far enough below that fair value, to represent the best possible reward at that point in time for the risk we are accepting (we illustrate that idea further in our discussion of Strategic Tilting on page 27). This discipline is often applied because of market responses to a stress event (or, conversely, where there is no stress event but we nevertheless judge the assets are mispriced).

Similarly, we can take money off the table if markets move above that fair value. In both cases we limit the size of our tilts so they do not represent a major departure from our long-term policy position of being predominantly oriented toward growth assets.

Board Statement (continued)

STRESS IN THE PAST FINANCIAL YEAR

A good example of how we dealt with short-term stress is the market impact of the terrible earthquake and tsunami in Japan. There was a clear negative effect on the Japanese economy and a knock-on effect on global production which is still being felt. However, we assessed that the impact on the drivers of fair value of Japanese and global equities was likely to be negligible (namely, the earthquake had not altered the long-established trend rates of global growth and profitability; neither had it changed the equally established expectation that there is a risk premium for holding equities). Therefore, while the market's aggressive response was to sell global

INVESTING IN ALL CONDITIONS

There are three important influences on our investment approach in all market conditions: the Fund's endowments, our investment beliefs, and our risk appetite.

Endowments

The Fund benefits from a number of endowments which allow us to tolerate short-term volatility. These include the Fund's long investment horizon and its certain liquidity profile.

Having a long investment horizon allows us the flexibility to make investments with longer-term return characteristics (i.e. they are likely to produce higher returns over time because of the various risk premiums involved). As has been discussed in this section, this long horizon is the crucial factor in the Fund being tolerant to market volatility and able to endure market cycles.

Having a certain liquidity profile means that the flow of cash into and out of the Fund is known – in fact it is subject to a legislated formula. This certainty gives us the confidence to invest in assets (in particular, assets that are not simple to sell quickly) where other investors may be constrained by their own less predictable liquidity demands. It also means that we can buy assets at attractive prices when other market participants are forced to sell to meet their liquidity demands.

It is evident that in reacting to market stresses, the Fund's endowments work hand-in-hand. The first endowment means that we do not need to overreact to market disruptions; the second means that we can benefit directly from others' reactions.

Investment beliefs

Our investment beliefs guide all of our investment decisions. Collectively, the beliefs guide our value judgements about how markets work, and about how a long-term investor should behave to maximise its returns.

The belief most relevant to dealing with market stresses is: expected returns are partly predictable within asset classes and returns can revert toward a mean over time. This is the foundation of our Strategic Tilting strategy, which we discuss further on page 27.

The final influence is our risk appetite

This is a crucial element of how we approach investment during stress events. We have interpreted the investment mandate established in our legislation and have set parameters for our investment activity. The main output of this is the weighting to growth assets in the Fund; another is how much volatility we are prepared to accept in a given period (this is discussed in detail beginning on page 20). Others involve controls on how much of the Fund can be concentrated in a single asset or investment manager. Setting these parameters naturally guides how we apply our investment beliefs and the Fund's endowments.

Could we insure against the negative impacts of volatility?

Even in volatile markets the likelihood of a substantial downward movement, with a corresponding impact on the Fund, remains small. However, the impact of that movement if it does happen can be substantial. Nevertheless, we do not seek to actively insure the Fund against those impacts (other than what is possible as a secondary effect of hedging the Fund's returns to the New Zealand dollar).

Insuring the Fund in this way would be expensive. It would also require us to make investments which are aimed at mitigating volatility rather than maximising our risk-adjusted returns over time. Ultimately, it would give away the advantages we've discussed of being a long-term investor.

Our strongly preferred response is to tilt the Fund away from what we believe is overvalued, thereby hopefully avoiding its eventual – or rapid – return towards intrinsic value. And if we believe there is a serious case for intrinsic value to be reconsidered, portfolio insurance would still not be our primary response. Rather, we would consider reducing the growth assets in the Fund – a more effective and less expensive way of reducing the Fund's exposure to a market movement of that order.

The past three financial years and the prevailing market unrest have been an excellent test of the Fund's resilience and our ability to maintain investment discipline.

equities – thereby driving their price to a level below what we regarded as fair value, and which therefore represented an attractive reward for the risk accepted – we responded by buying more equities for the Fund.

A more recent response to market stress has been to reduce the NZD hedging of our foreign currency exposure below our long-term policy position of 100%. This policy position has paid off well over the life of the Fund but, while we remain predominantly hedged, our current view of the high NZD has prompted us to scale back the hedging quite considerably.

BOARD CHANGES

I'd like to note some changes in the Board of the Guardians during the financial year. In 2011 Professor John Evans and David Newman left the Board. Both made enormous contributions during the Fund's formative years with David providing strong support to me in his role as Deputy Chairman and Chair of the Audit Committee.

I would also like to note the reappointment of Mark Tume for a further five year term and welcome the appointment to the Board, on 1 September 2011, of Dr Craig Ansley. Finally, I would again like to thank my colleagues and the team at the Guardians for their work during the year. There has been a strong focus, and a considerable amount of work completed, on further refining our investment approach. We are confident that these refinements will allow us to get the most out of our investment beliefs, and the Fund's endowments, in order to best serve the Fund's purpose.

David May
CHAIRMAN

CEO's Statement

What work have we done to add value to the Fund?

Adrian Orr
CHIEF EXECUTIVE OFFICER

The Board Statement has set out how the Fund is structured to navigate, and to benefit from, stormy market conditions.

In this section, I'd like to go into more detail on what we have done in the past financial year to ensure that we are best-placed to add value to the Fund over the horizon that matters for our purpose. This seems timely in the current climate, which we anticipate still prevails as this report is published, as we are applying the preparatory work we have done in the preceding financial years.

As discussed in the Board Statement, the Fund's endowments are key to driving our approach to investment. They are particularly important in adding value as, collectively, they represent the Fund's competitive advantage. A long investment horizon, certain liquidity, our sovereign status and independent investment responsibility mean that we have a very wide set of investment choices. We have significant latitude – subject to our mandate; to the constraints we put on ourselves through the Board's risk appetite; to our Statement of Investment Policies Standards and Procedures (SIPSP), and to our Responsible Investment Framework – to invest in what we want, for whatever term suits the Fund and with whatever other parties we regard as desirable and appropriate.

That puts us in a very attractive position, relative to many other investors, for maximising the risk-adjusted returns on the Fund over the long term. In the past financial year we have done a lot of work to ensure that we are using the Fund's competitive advantages as well as we can. We have done so in three main ways:

First, by decoupling our investment approach from the Strategic Asset Allocation (SAA). A critical first step was establishing the Reference Portfolio, which we discussed in our 2010 Annual Report. More information about the Reference Postfolio is on our website.

In the past financial year, however, we have further decoupled from the SAA and, as set out in our Statement of Intent for 2011 (and discussed in detail on page 24), we have shifted to an Investment Framework. The Investment Framework builds on the Reference Portfolio by refining the process we follow if we deviate from it and how we do so (our value-added investment activity).

We are positioned to maximise the risk-adjusted returns on the Fund over the long term.

The Investment Framework works by being indifferent to asset class and to how an investment is accessed (e.g. accessed through a manager, by direct investment, or held passively in listed markets). Instead, it focuses on applying to all investment opportunities a common analytical framework to robustly assess the expected risks and return of each.

This enables an investment approach which is more flexible and, once we have identified potential investment opportunities, a more rigorous assessment of whether it represents the best possible use of the Fund's capital, relative to all other opportunities. We have provided an actual example of how the framework is applied in the case study on the following page.

The language, and the thinking process, which underpins the Investment Framework has been reflected in all of the internal policies that contribute to the governance of our investment activity. This includes our Statement of Investment Policies, Statements and Procedures (SIPSP), which is required by our Act. The revised SIPSP and all of our other policies are on our website.

Second, by continuing to ensure that potential co-investors – in particular, those we regard as our peer funds (discussed in some detail in this section of the 2010 Annual Report) – are aware of our endowments. We do this passively, by making a considerable amount of information available publicly on our website and through our public documents (including Annual Reports). But we also actively engage with our peers. We do this at forums where our peer funds go to learn from and benchmark ourselves against each other, to co-operate on issues of common interest and – our prime focus – to work toward co-investment.

Co-investment is a prime objective of our peer relationships because it further broadens our potential investment choices. It also usually provides more cost-effective access to the investment in question. Because our peers have time horizons and investment approaches similar to our own, we also have close alignment of interest in how we manage the investment. Importantly, we can share and benefit from each other's investment expertise. We can be part of opportunities we might otherwise be unable to consider by ourselves, because the opportunities are too large, or because we would simply not otherwise have access to them.

Third, by applying an ongoing focus on identifying and then developing an ideal team culture. Having endowments, investment beliefs and a robust governance framework is irrelevant if the organisation lacks a culture which values, uses and develops these things. In the past financial year we have concluded an exercise where we have decided on the culture we want and assessed the extent to which we provide it. We will be using the results of that survey in the coming financial year (we discuss this further on page 57) to further develop our great team.

CEO's Statement (continued)

Case study

Below we provide an example from the past financial year, of how our revised approach works in practice. This example deals with a $20 million investment in a Paris-based Private Equity fund, Astorg Partners, at the end of 2010. The investment involved taking over the commitment to the fund of an existing investor who wished to exit.

Investment	Astorg Partners – private equity fund specialising in midsized privately owned French companies
Sources of investment risk	Risk relates to the French and broader European economy in general and, likely, sector risk depending on the nature of the companies invested in.
Sources of investment return	Our confidence in returns is based on our conviction about Astorg Partners and its strong record of prior returns.
Sources of opportunity	We believe it is difficult to get reliable, high-quality information about the performance of small to midsized privately owned French companies. Consequently, there is a lack of capital available to those companies to facilitate their growth. The opportunity is therefore to use a rare source of quality information – our manager – to make attractively priced investments in companies with sound business models and excellent growth prospects.
Access point (how do we make the investment)	We do not believe it is possible to adequately replicate the expected returns from privately owned French companies with a listed exposure. Given its track record of returns, there is some evidence of Astorg's persistent skill and, crucially, that this skill is rewarded by outperformance. This skill appears to relate to the Manager's ability to create economically viable deals from companies with complex private ownership and then to apply a broad set of operational and strategic skills to improve business performance and create investment value.

Thanks

Finally, I would like to thank the team and the Board for maintaining and increasing their discipline in what has been a pleasing and constructive 12 months. I believe the work we have done this year to further refine our investment and organisational processes will provide the platform for a significant and positive step-change in our ability to manage the Fund in the service of its important purpose.

Adrian Orr,
CEO

Overview of financial statements

HEADLINE RESULTS

- **$3.0 billion increase in Fund's net asset position compared to the prior year**
- **A net return of 25.05% on the Fund's assets**
- **A 12.5 bps increase in overall expenses, driven mostly by performance fees, as a proportion of funds under management[1]**

FUND REVENUE

The 2010/11 financial year saw further growth for the Fund, continuing on from the gains made in the previous year.

This increase in returns reflects the continued recovery of both global and local asset prices following the GFC. The Fund has seen significant gains across a number of different areas including listed equities, private market holdings and derivative financial instruments.

In particular, the Fund's revenue arising from derivatives is reflective of further increases in use of this asset class to gain cost-effective exposure to investments. This is also reflected in the increased holdings of these financial instruments at the year end. Share of profits from the Fund's associate, Kaingaroa Timberlands Partnership, have also increased, in part due to a revaluation increase that was higher than in the previous year. We discuss the revaluation process on page 30.

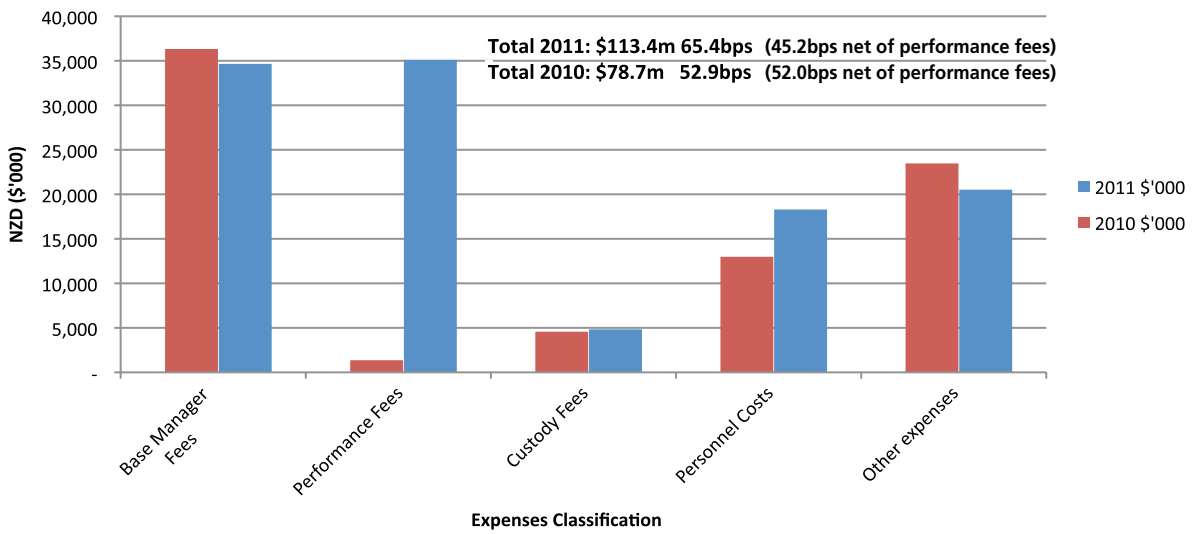
FUND EXPENSES

The Guardians' and Fund expenses are accounted for separately. Both are met from the Fund (with all returns net of all costs), although the Board of the Guardians costs are funded through an annual appropriation from Parliament as required by our Act. Regardless, we include all costs in the expenses analysis graph presented below.

The Fund's overall expenses have increased over the year, primarily driven by an increase in manager performance fees (net of performance fees, expenses actually decreased from 52.0bps to 45.2 bps as a proportion of funds under management). The levels of these fees are determined by the positive net returns generated by assets overseen by our external managers.

Base manager fees have continued to decrease largely due to a continued increased use of derivatives, rather than holding of physical securities.

Expenses Analysis for the Year Ended 30 June 2011



[1] To reconcile the expenses discussed in this section with the expenses in the financial statements (note 2), please note that the graph does not include timber expenses or farm operating costs. While for accounting purposes they must be treated as expenses, economically they form part of the net return of the Fund.

Overview of financial statements - continued

Custody fees have increased in line with the increase in the size of the Fund.

Personnel costs have increased due to the payment of incentives, linked to the overall performance of the Fund, as well as a small increase in headcount (see pages 55 and 57 for discussion of both).

Other operating expenses (containing trading and brokerage expenses, depreciation and amortisation, audit fees and advisor costs) have reduced marginally, driven primarily by a reduction in trading and brokerage expenses in the year.

The Fund has recognised a tax expense for the year of $907 million, an increase on the previous year, largely due to the fair value gains on investments as noted above.

Managing expenses

The ultimate measure of the success of the Fund will be its absolute return net of all costs over rolling 20-year periods. So the overall focus is on ensuring that when we incur expenses we do so because we expect to add value to the Fund. Cost efficiency is central to all of our investment decisions. Within that overall absolute return focus we seek to ensure that the cost we incur is optimal by:

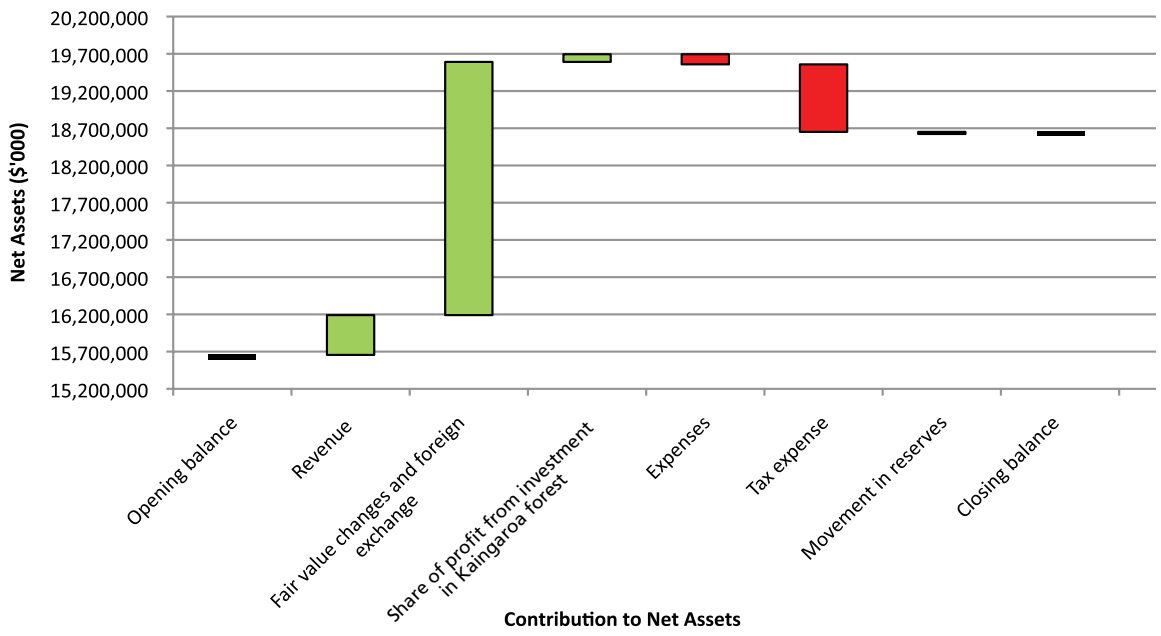
- ensuring that any fees paid to external managers of our investments are commensurate with the complexity of the investment and with the market standards for fees at the time. We also seek to use our negotiating ability – arising from our attractiveness as a genuine long-term investor, including our ability to tolerate illiquidity – in this regard.
- assessing whether portfolio management activity, such as cash management, should be done internally rather than externally.
- including the cost of due diligence in our assessment of whether the investment opportunity we are evaluating adds better risk-adjusted value than would another opportunity. This then becomes part of the key decision about whether the opportunity is worth pursuing.
- choosing cost-effective access points for all investment opportunities we decide to pursue e.g. managed by our staff, by investment managers, through derivatives.
- comparing our cost structure with our peers, via the CEM survey and in the general course of business. This includes comparing the cost of internal and external management and the fees we pay our Custodian. Comparisons are not simple because cost structure is always a function of an investor's purpose, which drives their appetite for risk, the structure of their portfolio, what investment styles they seek and the level of skill internally and externally they need to access. In comparing costs we are conscious that higher relative costs are not automatically bad and lower costs are not automatically good – what matters is why and how they are incurred and the value added after costs are taken into account. So while we want to avoid paying above market costs, it would be self-defeating to indiscriminately prune costs relating to important tasks such as adding value, due diligence and research.
- acknowledging that while the CEM Survey is the best available external assessment for cost structure and value add, it is not perfect. We are looking to develop additional cost efficiency benchmarks and measures to reinforce those present in the CEM survey (as discussed in our 2011 SOI, which we report on in our 2012 Annual Report).

We note that cost management is an important part of the independent review of our governance of the Fund that happens every five years. Certainly it was a focus – in particular fees paid to external managers – of the latest review in 2009. In that review Mercer concluded that our investment management fee levels and structures were competitive for a fund of our size and type and that most external investment mandates were at or below Mercer's expected median levels for the relevant assets classes.

CHANGE IN NET ASSETS UNDER MANAGEMENT

Total net assets increased during the year by $3.0 billion, comprised primarily of gains on investments. The figures below highlight changes in our expenses (the expenses bar includes those of the Board) and our net asset movements.

Movement in Net Assets (post-tax) for Year Ended 30 June 2011



Performance

In this section we have set out what the Fund is invested in and how the investments have performed in the financial year to 30 June 2011. We also compare that performance to our two key benchmarks: 90-day Treasury Bills and the Reference Portfolio. Finally, we set out the work we have done during the financial year to refine our understanding of the sources of risk in the Fund and therefore the sources of volatility in its returns.

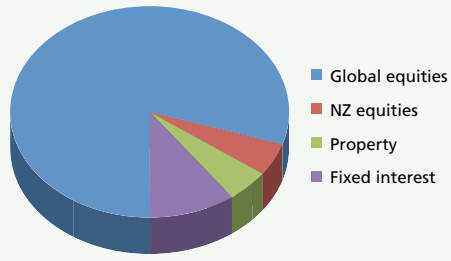
Exposures in the Fund

We believe it is useful to briefly recap the concept of the Reference Portfolio as it is the foundation of our portfolio construction. The Reference Portfolio is our best effort at a 'shadow' portfolio which is appropriate to the Fund's long-term investment horizon and associated risk profile, and which is capable of achieving the Fund's objective with simple, low-cost investments (they are all passive, listed asset classes). These characteristics make the Reference Portfolio an important benchmark of whether we are adding value with investment activities – 'active' investment activities – which are more complex and/or more expensive.

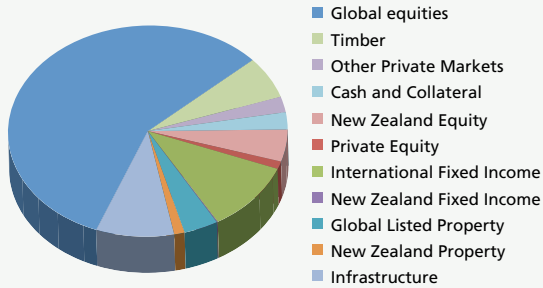
Because the Reference Portfolio is limited to listed passive asset classes, we regard it as being constrained. We believe we can better serve our mandate by considering and pursuing additional investment activities. We define all such activities as value-adding investments and they are the difference between the Reference Portfolio and the Actual Portfolio. We pursue them only when we strongly believe that, over time, the Fund will be better off – relative to the Reference Portfolio – for doing so. By 'better off' we mean it will achieve larger returns, or the same returns for less risk (we discuss this key assessment further in this section. The Sharpe Ratio explained in the sidebar is central to that assessment).

Our belief that the Fund will be better off as a result of our value-adding investment activity is constantly tested by the performance of the Reference Portfolio. And it is a public test; in each Annual Report we publish the performance of both.

Reference portfolio at 30 June 2011



Actual portfolio at 30 June 2011



IMPROVING THE SHARPE RATIO OF THE FUND

All of our active investment aims to improve what is known as the Sharpe Ratio of the Fund.

The Sharpe Ratio of the Fund is

$$\frac{\text{Total Return - risk free return}}{\text{Risk}}$$

'Total Return' is a combination of Excess Return and Active Return

Excess Return = the return premium earned on financial assets such as equities and property over and above what would be possible to earn investing in cash (a 'risk-free' investment). This is the contribution of the Reference Portfolio and is why cash is netted off.

Active Return = the additional return earned by deviating from the Reference Portfolio. This is the contribution of our value-adding strategies.

Risk = the level of risk collectively brought into the Fund by the sum of all investment activity in the Actual Portfolio. Risk is measured by the volatility (standard deviation) of returns.

The formula above makes clear that if the risk denominator is high, the returns must be higher. So each active investment we undertake must raise the sum of the top line, reduce the sum of the bottom line, or do both.

Fund return

In this section we analyse the performance of the Fund in the year to 30 June 2011 and set that performance in the context of how the Fund has performed since its inception.

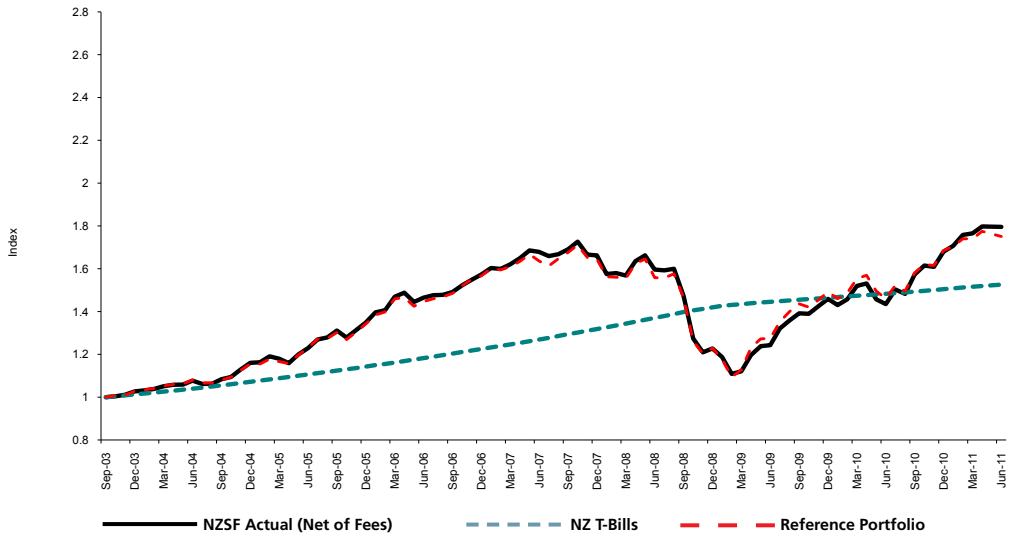
Performance since inception relative to 90-day Treasury Bills and Reference Portfolio

We compare the performance of the Fund to 90-day Treasury Bills because they 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 borrowing.

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 the increased cost of New Zealand Superannuation commitments.

We have explained on the previous page why the Reference Portfolio is an important performance benchmark for the Fund.

Cumulative Fund Return relative to T-Bills and Reference Portfolio to 30 June 2011



Financial year	Fund Return	Treasury Bills	Excess return relative to risk-free rate	Reference Portfolio return	Value Added by active investment
2004	7.69%	3.76%	3.76%	8.07%	-0.38%
2005	14.13%	6.33%	7.80%	13.88%	0.25%
2006	19.21%	6.77%	12.43%	17.56%	1.65%
2007	14.58%	7.21%	7.37%	13.07%	1.51%
2008	-4.92%	7.97%	-12.89%	-4.73%	-0.18%
2009	-22.14%	5.49%	-27.63%	-18.25%	-3.89%
2010	15.45%	2.60%	12.85%	14.62%	0.83%
2011	25.05%	2.89%	22.16%	19.48%	5.58%
Since inception	7.83% p.a.	5.60% p.a.	2.23% p.a.	7.44% p.a.	0.38% p.a.

Performance - continued

Value-add in 2010/11

This section details the contribution that active investments made to the Fund in the financial year.

	Value-added activities				
Reference Portfolio return	Capturing active returns	Strategic tilting	Portfolio completion	Actual portfolio return	Value added by active investment
19.48%	5.63%	(1.55%)	1.49%	25.05%	5.57% (+$887 million)

CAPTURING ACTIVE RETURNS +5.63%

- **Active investment managers +1.56%.** This pleasing result continues to build on the positive returns from the prior financial year. The Fund's overall stable of investment managers again beat their individual investment benchmarks and the main contributors to this were managers using multistrategy approaches (an approach hit particularly hard during the Global Financial Crisis) and market neutral approaches.
- **Private markets relative to public markets +3.94%**. The main contributions to this strong performance were 'Z' Energy – as the Shell network was rebranded during the year – and Kaingaroa Forest. Both assets performed well during the year and consequently had strong valuation uplifts. These are dealt with in further detail in discussion of our New Zealand investments on pages 29 and 30. This was offset by poorer returns from NZ property and private equity.
- **Benchmark mismatch (or using alternative tracking indices) + 0.02%.** This is where we choose to have index – i.e. passive – exposures that are not exactly the same as those specified in the Reference Portfolio.
- **Internally executed arbitrage + 0.11%.** This is where we take advantage of pricing differentials between two things that are economically the same e.g. a security may be dual-listed and we can generate returns by buying it on one exchange and selling it on the other for a higher price.

STRATEGIC TILTING -1.55%

We have provided a case study of Strategic Tilting on page 27. The main factor in this result was currency tilting due to our position on the NZD (as discussed elsewhere the Reference Portfolio is 100% hedged to the NZD) and its ongoing strength relative to most other currencies. This outweighed returns from tilts into equity and away from sovereign debt (which returned +0.41%) and credit tilting (which returned +0.24%). It's important to recognise that tilting is undertaken with a long-term horizon. We do not expect to precisely time the top or the bottom of markets.

PORTFOLIO COMPLETION +1.49%

This refers to activities we undertake with the objective of avoiding unnecessary cost. We seek to capture the most cost-effective means of gaining access to, and managing, investments.

- **Portfolio completion + 0.75%.** This reflects our efforts to add value through using passive investment managers and derivatives to gain equity market. Derivatives can be very attractively priced relative to physical exposures. We have provided more detail on our use of derivatives in the side bar on the facing page.
- **Currency return +0.83%.** This reflects the return generated from how we implement our currency hedging.
- Other portfolio completion activities together contributed **-0.09%**

What are derivatives?

Derivatives are financial instruments that replicate the behaviour and performance of certain types of investments. Typically, they are linked to:

- individual securities such as equities
- indexes on bonds and equities, such as the MSCI world, which aggregate the performance of a group of securities
- reference rates (such as exchange rates or interest rates)

There are many types of derivatives and many reasons to use them, including to manage risk and liquidity; to lower transaction costs and as added-value investments in their own right.

Using derivatives to manage risk and liquidity

The foreign exchange component of our Reference Portfolio is, generally, 100% hedged back to New Zealand dollars. We do this to get the benefits of New Zealand interest rates being higher than offshore interest rates. We are indifferent to fluctuations in the NZD relative to other currencies. Currency derivatives, such as forward contracts, allow us to manage this hedging position efficiently.

In addition, the actual portfolio tends to "drift" away from its target exposures through time due to differential performance of the asset classes we own and also due to changes in exchange rates. In other words, the portfolio's actual risk can drift away from the desired risk. Derivatives are a convenient way of re-balancing the portfolio back to its targeted risk level.

Derivatives can also help us to manage our liquidity. When we enter into a derivative contract, we sometimes are not required to make any deposit on this exposure. Where we are required to set aside a deposit, it is often a relatively small percentage of the underlying exposure. This means we hold a pool of collateral within the Fund, while maintaining the desired market exposures through the derivative. In instances where we require liquidity at short notice, closing the derivative position allows us to access an immediate source of cash.

Using derivatives to lower transaction costs

Derivatives can lower transaction costs because index derivatives are often cheaper to buy than the individual physical securities making up the index; and commissions are generally negligible.

Using derivatives to add value to investment

Derivatives allow us to add value to the Fund in some instances. For example, derivative counterparties may offer attractive terms to the Fund for entering into certain types of derivative contracts. Total return swaps on global equities, for example, involves us contracting to receive the total return on the global equity index and to pay an interest rate back to the counterparty. The interest rate we pay, is to compensate the counterparty for the cost of funding the equity position.

In some total return swap transactions, value derives from a combination of the counterparty quoting us an interest rate below the market standard interest rate and us being being able to earn a return on the cash collateral that we hold, that is above the standard interest rate. The net effect of the swap transaction is for the Fund to receive the return on global equities plus an additional margin reflecting the difference between the relatively high interest rate we earn on our collateral and the relatively low interest rate we pay to the counterparty. The alternative way of obtaining global equity exposure, through physical purchase of the equities, generally involves the Fund generating the same return on the index but having to pay all the associated expenses of buying and managing the securities.

Performance - continued

Risk in the Fund

Any picture of the performance of the Fund is incomplete without understanding the risk taken in the course of trying to capture that performance.

Our mandate requires us to maximise return without undue risk, so the analysis we do to optimise the balance of the returns we seek, relative to the risk we believe it is prudent to accept, is crucial. Hence, improving the Fund's Sharpe Ratio (see the sidebar on page 16) is at the core of our value-added investment activity.

As that sidebar says, when we say risk in this context we mean our expectation of the volatility – i.e. differences both up and down – of the Fund's returns over time.

Because the Reference Portfolio requires a weighting toward growth assets to achieve the Fund's purpose, and growth assets bring market risk, a certain amount of market volatility is present within the Fund. We accept this, as the Board and CEO Statements have discussed in depth.

However in the past year our Portfolio Design team has been working to deepen our understanding of the components of that market risk. That allows us to further enhance our understanding of all sources of risk within the actual Fund and how each investment, and various combinations of investments, are likely to impact the total volatility of the Fund over any given period.

This includes being able to assess the likely volatility of the Reference Portfolio over time.

Importantly, it also assists our analysis of what other risks (for example illiquidity risk arising from certain types of unlisted assets, such as timber) we bring into the Fund by deviating from the Reference Portfolio with value-adding activities. By doing so we understand:

- what impact value-adding activities have on the volatility of the Fund; and
- what compensation we are getting for the additional volatility.

It is worthwhile revisiting the Sharpe Ratio on this point. Any value-adding investment must:

- reduce the overall level of intrinsic risk in the Fund, or;
- increase the overall level of expected returns for the Fund, or, preferably;
- do both.

The Reference Portfolio plus our value-added activities equals our Actual Portfolio. At any one time, the composition, and therefore the volatility, of the Actual Portfolio could deviate considerably from the Reference Portfolio (volatility in the Actual Portfolio could actually be less than that which is hardwired into the Reference Portfolio).

What volatility is acceptable?

Management understanding the risk implications of any given investment is only part of the process. It is also very important to establish our appetite for risk. That is a decision for the Board.

We have a long-term investment perspective so we accept that volatility is part and parcel of a portfolio designed consistent with that perspective. However, the Board has set a number of risk limits – all of which are disclosed in our Statement of Investment Policies, Standards and Procedures on the Fund's website – which govern how the Fund is invested, including the volatility the Board is prepared to tolerate.

A number of judgements are involved, but their effect is that the Board will accept that returns will fluctuate within a range around our average expected return over time. The breadth of this range is the crucial judgement for the Board.

The breadth of the range of expected returns of an investment reflects its risk. Low risk investments like Treasury Bills have a very narrow range of likely returns. Higher risk investments like venture capital have a very wide range of possible returns.

The common measure of volatility of investments is a statistical measure called 'standard deviation'. Usually when we talk about risk or volatility we are talking about the standard deviation of expected returns.

If we look at a table of returns over a very long term we can measure the average return and the standard deviation of returns. Approximately two-thirds of returns will lie within a range of +/- one standard deviation of the average return. Approximately 95% of returns will lie within a range of +/- two standard deviations. So by looking at standard deviations we can get a good idea of where most return outcomes will fall.

By using statistical modelling techniques we can refine these estimates and examine more closely the expected distribution of returns. Importantly, we can examine what happens in events beyond two standard deviations. We know that these '1 in 100' outcomes actually occur more often than that and our modelling gives us a better feel for what to expect in reality.

Risk analysis

On the following pages we use illustrative figures to demonstrate for interested readers how the risk analysis works. We will be using these graphs to enhance how we forecast investment risk in our Statements of Intent, and report on actual investment risk in our Annual Reports. The 2012 Statement of Intent and 2013 Annual Report will be the first to have this additional information (which will include measurement and discussion of the impact of investment risk on the Sharpe Ratio of the Fund).

For the graphs we have assumed certain illustrative levels of returns over time. It is important to note that, as we explain carefully in each SOI, the figures we use are derived from long-term forecasting and so have far more relevance over longer time periods. For the purposes of this exercise we have assumed as follows:

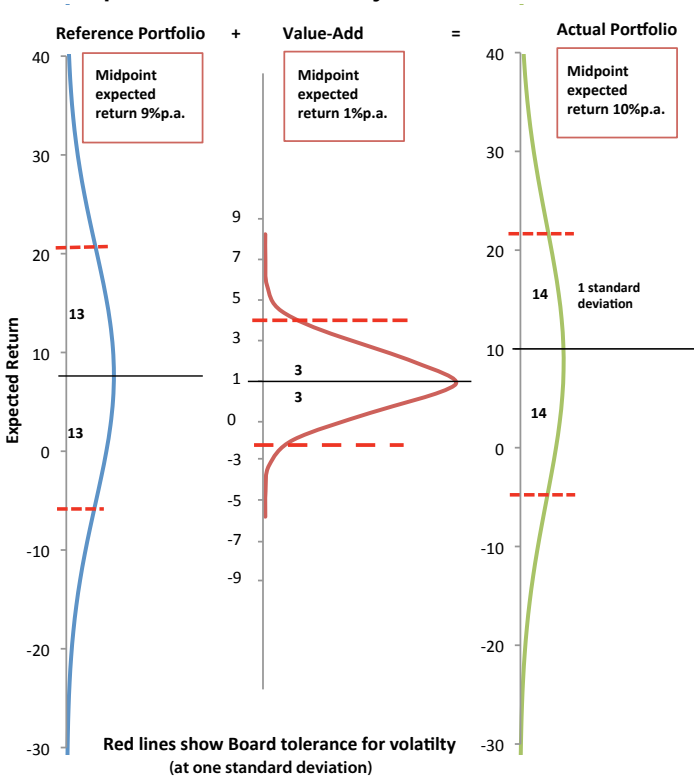
- expected average annual returns over time for the Reference Portfolio of 9% p.a. (this return comprises Treasury Bill returns plus an excess return for the market risk within the Reference Portfolio);
- expected average annual returns over time for our value-added activities of 1% p.a., and;
- expected average annual returns over time for the Actual Fund of 10% p.a. (Reference Portfolio + Value Add).

These expected returns all come with expected risk, which we explain further on the following pages.

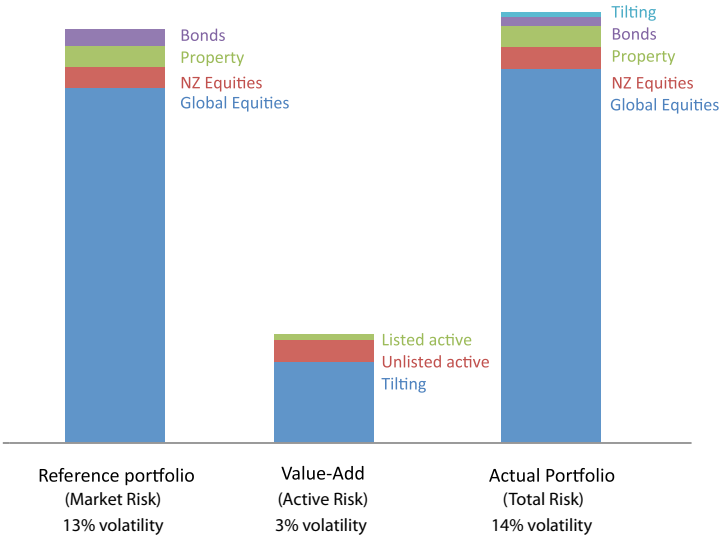
Performance - continued

Risk and Volatility

Impact of risk on volatility of Fund returns



Sources of risk



What the graphs show

It is important to note:

1. the graphs use illustrative figures
2. the graphs show what applies at a certain point in time. So, for example, while tilting might be a primary influence in one graph, it is unlikely to be in most graphs because the nature of the activity means it is most effective in stressed market conditions (see page 27 for more information)
3. the risk in the Reference Portfolio and within our value-added activities behaves separately. So it is quite feasible for our Reference Portfolio to perform toward the top of its range (or even outside that) and for our value-added activities to perform towards the bottom of their range – and vice versa – in the same period.

Reference Portfolio

- our exposure to equities is the main source of risk in the Reference Portfolio in this snapshot
- the resulting expected annual average volatility of the Reference Portfolio returns is 13%. Remembering that the acceptable range of volatility is one standard deviation away from the midpoint, that means we expect returns to vary up to 13% either side of our expected return for the Reference Portfolio much (about two-thirds) of the time (i.e. they range from -5% p.a. to +21% p.a.) and to vary up to 26% most (about 95%) of the time.

Value-added activities

- active risk makes up only 3% of total risk
- the main source of active risk is Strategic Tilting in this snapshot
- the expected annual average volatility of returns from our value-added activities is 3% either side of our expected return for value-adding activities (i.e. 1% p.a.) much of the time and up to 6% most of the time.

Actual Portfolio Total risk

- equities and strategic tilting are the main sources of risk in this snapshot
- the resulting expected annual average volatility of the returns from the Actual Portfolio is 14% much of the time and by up to 28% most of the time
- in our illustrative graph the overall impact of our value-added activities does not materially increase the overall risk of the Fund. This is usually the case and the reason is that the returns of value-added activity usually behave differently to the returns of the Reference Portfolio. For example, the value added by a timber manager through good selection of forestry assets and timing of harvesting relative to market prices for logs, is usually independent of the ups and downs of the sharemarket. In some of our strategic tilting positions we will add value when the sharemarket goes down (and vice versa). In those instances active risk might actually reduce total Fund risk.

Making investment decisions

Given the importance of the Fund's purpose to multiple generations of New Zealanders, having a robust investment decision-making framework is crucial. Consistent with the strategic priorities we identified in our 2010 Statement of Intent – and continued in our 2011 Statement of Intent – we have focussed this year on further strengthening our investment decision-making processes. We believe that doing so enables us to:

- make investment decisions that represent the best returns, net of costs and adjusted for the risk accepted into the Fund; and which therefore maximise the value added to the Fund;
- have the capability and flexibility to have and use a dynamic approach to investing;
- organise our team and financial resources to focus on activities which add the most value; and
- monitor, assess and where appropriate report the results.

In particular, we have focussed on developing and rolling out an Investment Framework.

The Investment Framework

The Investment Framework was an initiative of our investment teams and refines our existing investment approach. The Framework itself was completed this year and establishes a common investment language so that when any of our team members are discussing concepts such as risk, opportunity and value-add; they are talking about the same thing. This has value when team members' employment backgrounds are diverse and when different asset classes may have specific terminology for the same basic ideas.

Most important, it seeks to use a common internal understanding of the important concepts as the foundation for a common approach to how they are applied to each investment proposal regardless of the asset class, geographical location or how it is accessed (for example, directly or through an investment manager).

This common approach is tuned to take account of the characteristics particular to the Fund: its New Zealand location, Government ownership, long horizon and that the responsibility for investing it is independent of the Government.

The Framework gives us a consistent platform for assessing

1. what risk we are bringing into the Fund with each investment proposal (the work done by our Portfolio Design team on this, as discussed from page 20, is an important part of this assessment)
2. the returns we expect for the risks – the 'Sharpe Ratio' assessment (see page 16)
3. our level of confidence in the expected returns, a judgement based on some or all of whether:
    a. the proposal assists with the diversification of the Fund
    b. the proposal is built around a genuine investment opportunity. Opportunities generally involve mispricing and examples include vendor distress, market failure, the impact of regulatory reform and exclusivity (which may arise because of the Fund's sovereign status)
    c. the proposal is built around a genuine skill, either our own skill or that of an external investment manager
4. whether we are accessing the opportunity in the ideal way

As discussed in our 2011 Statement of Intent, work will be continuing in the 2011/12 financial year to develop the necessary tools and systems to support the Investment Framework (for example, to enhance our valuation models).

We have already developed a number of tools to support the Investment Framework. The following two tables illustrate two of these:

1. the 'heat map' we use to establish whether a potential investment represents a genuine opportunity
2. the five-step process an investment proposal must go through to be approved under the Investment Framework

We have already shown in the CEO Statement how the Investment Framework was applied to an actual investment.

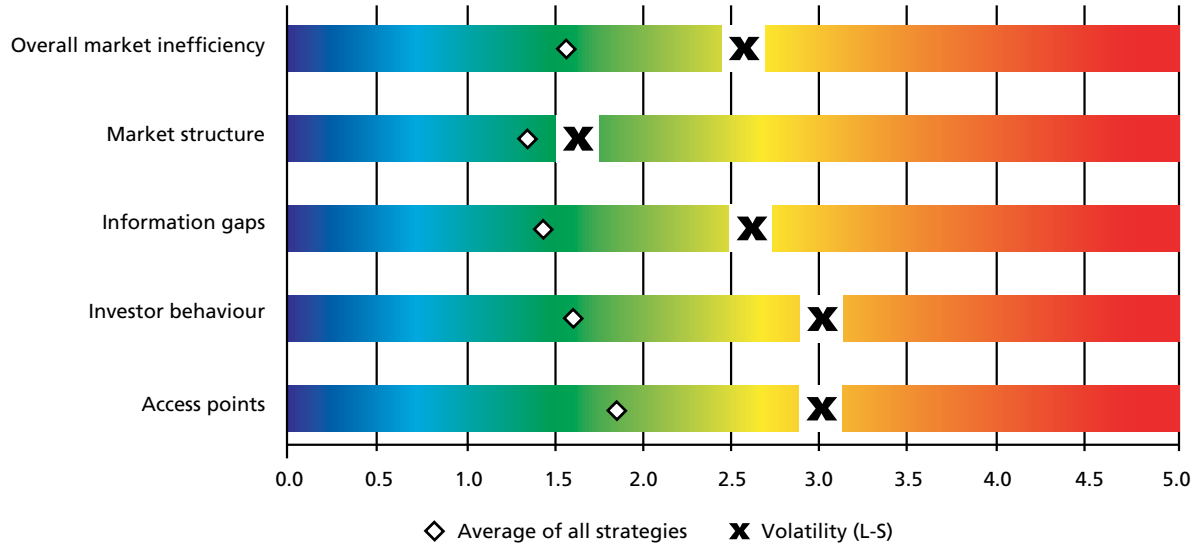
Heat mapping

This is a tool used by our investment teams to demonstrate the level of confidence they have in the potential of an investment opportunity (with zero being low and five being high). A decision to invest can be made on a stand-out rating in a single category, or a consistently good rating across several or more categories.

As per the heat map below which was used for an actual investment, opportunities can arise because of an inefficient market (where knowledgeable participants can outperform). Opportunities can also arise from diversification (what the investment returns rely upon is sufficiently uncorrelated to equity market returns); or high conviction in a manager (where the skills, experience, track record and other qualities of the investment manager persuade us that they are likely to outperform over time). Individual heat maps are used for each class of opportunity.

Assessing the existence and extent of opportunity is key to the approval process described on the following page.

Sample Investment 'heat map'



Making investment decisions - continued

The five-step approval process

If our investment teams wish to pursue an investment proposal – or wish to spend time and money establishing whether it is worth pursuing – they must follow a five-stage approval process.

Stage	What happens
1 - Strategy approval	We have a number of existing strategies including NZ Direct Investment, Rural Land, Timber, Direct Arbitrage, Private Equity and Property. If the opportunity is consistent with an existing strategy, then the process moves immediately to Stage 2. However if the opportunity is sufficiently different to what we have invested in previously, it will likely require a new strategy setting out the why, what and how of the investment type (not just the specific investment being considered). Only if and when the strategy is approved (some require approval by the Board, some do not) can the opportunity progress.
2 - Investment 'Heads Up'	This is the most important stage for considering a specific investment opportunity. The heat map discussed on the previous page is a key part of this. At this stage approval is given (or not) for due diligence – which typically incurs cost – on the proposal and/or on any investment managers involved. If a manager is involved, a screening process will likely have been completed to get the opportunity to this point. The investment team member recommending the opportunity will also have to identify the organisational and resource implications – how much legal time? How much operational time etc? – of making and managing the recommended investment. The heads up is considered by the Investment Committee. The decision to approve or decline proceeding with due diligence on the investment/investment manager is made by the relevant General Manager, following the Investment Committee discussion.
3 - Approval	The focus of this stage is the findings of the due diligence approved at Stage 2. The key features of this are: • that the proposed investment actually reflects the originally identified opportunity • a final, financial estimate of the value and risk expected to be added to the Fund by the investment • confirmation that we have conviction in any investment managers involved • confirmation that the assessment of organisational and resource and risk implications made in Stage 2 is robust This stage is managed by the Investment Committee and, based on their recommendation, is approved (or not) by the General Manager of Investments or of Asset Allocation (depending on the proposal). This stage may also require Board approval.
4 - Completion	The investment team member confirms to the Investment Committee that the investment deal has been made (or not), and the status of any matters raised at stage 3 but not yet resolved.
5 - Implementation Review	All investment strategies – and therefore the investment made under them – are reviewed on a regular, ongoing basis by teams of non-investment staff. The reviews are overseen by our Risk Committee and focus on whether the results produced match what we expected.

Strategic Tilting – how it works

Strategic Tilting is an investment strategy which will often be deployed in times of market stress or market excess. It is based on our investment belief that investment returns revert to our mean expectations over time.

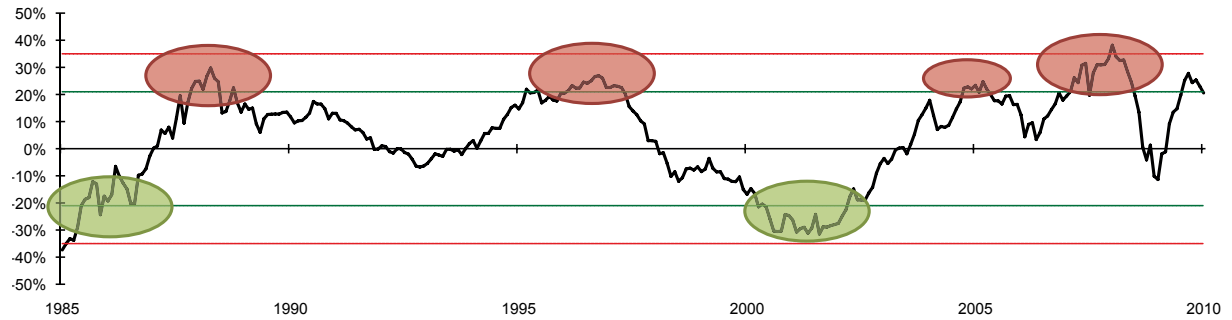
For Strategic Tilting, the mean is the intrinsic long-term expected return of an asset class. Investment opportunities arise when the market value of a particular asset class is materially different to that mean; the returns arise when the market value begins to revert to the mean.

In the below graph we illustrate how tilting works; in this example, currency tilting. Broadly, it should be clear from the graph that when we tilt we are not trying to time the market. Rather, we are positioning the Fund over the long-term relative to our views of where fundamental value lies. In relation to currency, the graph shows the NZD:USD exchange rate over time, where the middle line is the average exchange rate over that time. The green lines either side of the middle line illustrate where the exchange rate differential has entered extreme territory – when the tilting 'signal' would be activated. The red lines at the top and bottom of the graph show the maximum tilt possible.

The circles show logical tilting signals in the period covered by the graph. The red circles above the line denote periods where we would have shorted – sold – the NZD and bought USD because in our view the NZD is overvalued and, in the long term, we will make more money for the Fund by holding more USD as its value relative to the NZD returns to the average. The green circles below the line show periods where we would have gone long on – bought – NZD and sold USD because in our view the NZD is undervalued and that holding more NZD will position the Fund better as the value of the NZD relative to the USD returns to the average.

Because it demands a long-term perspective and an ability to weather the short-term volatility in returns – up or down – that often accompanies long-term positions, Strategic Tilting is almost perfectly suited to us. An additional attraction of the strategy is that it is relatively inexpensive to execute – we manage tilts internally. Accordingly, we expect Strategic Tilting to be a significant contributor to the value our active investment activity adds to the Fund over time.

Tilting signals: NZD vs. USD over time



Investment activity

Non-New Zealand investment activity

The table below shows the investments we have made outside New Zealand in the past 12 months, either directly, through a third party fund, or through giving a mandate to an investment manager (the full list of our investment managers is on page 31). It also shows where we have committed funds, but those funds have not yet been drawn down to make actual investments, as at 30 June 2011.

New commitments or investments made to 30 June 2011	**Opportunities under consideration at 30 June 2011**
Commitment to Paris-based private equity fund managed by Astorg Partners specialising in midmarket and expansion capital buyouts in France.	
Investment in passive, fixed-income mandates managed by BlackRock Investment Management (UK) Ltd.	
Commitment to Hong Kong-based private equity property fund managed by Gaw Capital specialising in commercial and residential real estate in second-tier cities in mainland China.	
Commitment to London-based private equity property fund managed by Mountgrange Investment Management specialising in adding value to commercial real estate.	
Investment in active equities mandates managed by QS Investors, LLC.	
Commitment to New York-based private equity property fund managed by Savanna specialising in real estate investments in the major markets surrounding key east-coast US cities.	
Commitment to Sweden-based private equity property fund managed by Sveafastigheter AB specialising in property investment across the Nordic region.	
Commitment to a California-based fund managed by Canyon Capital Advisors specialising in opportunities in distressed fixed income securities, including debt.	
Commitment to US-based timber fund managed by Global Forest Partners, LP, specialising in timber plantations in New Zealand, Australia, Asia, Africa and South America.	
NZD$1.4 billion invested **NZD$196.7 million committed but not yet invested**	**NZD$242.1 million under consideration**

New Zealand investment activity

We are required to report annually on our progress on the New Zealand Investment Directive received from the Minister of Finance in 2009. This section of the Annual Report meets that requirement.
The following table updates the table from our 2010 Annual Report. It summarises what we have done to identify, consider and make investments in New Zealand assets.

Opportunities reviewed to 30 June 2011	**New commitments or investments made to 30 June 2011**
We consider a large number of opportunities to invest in New Zealand. In this column we count only those opportunities we seriously reviewed and/or proceeded with in the financial year.	Commitment to New Zealand rural land (eight dairy properties, Southland, Otago, Canterbury and the Waikato). Mandate managed by FarmRight Ltd.
	Commitment to private equity property fund managed by Willis Bond specialising in New Zealand commercial real estate.
	Commitment to consortium led by Direct Capital to acquire 79.7% of Scales Corporation Limited[2].
	Appointment of Devon Funds Management Ltd to manage an active New Zealand equities mandate.
TOTAL 25	**NZD$50.2 million invested** **NZD$79.8 million committed but not yet invested**

SNAPSHOT: Value of NZ investments at 30 June 2011

We note that this table shows only what financial reporting standards would regard as New Zealand investments (i.e. investment value and cash flows in and out of investments); it does not include funds committed but not drawn, debtors' and creditors' balances and other items. It also omits swaps, FX and other influences as they are noise in the balance sheet at one point in time and so provide little of analytical value.

	30 June 2011	**1 July 2010**	**1 July 2009**
Auckland Airport	292.2m	248.8m	191.2m
Listed equities	826.5m	804.9m	690.4m
Private equity	35.1m	47.3m	47.8m
Property	238.1m	267.6m	292.2m
Timber	1,115.8m	1,026.6m	991.1m
Fixed income	88.3m	347.2m	145.6m
Shell NZ 'Z' assets	560.6m	209.8m	n/a
Rural land and associated assets	32.9m	n/a	n/a
TOTAL INVESTMENTS	**3,189.5m**	**2,952.2m**	**2,358.3m**

2 With our investment in Scales approved by Scales Shareholders past balance date, this commitment is now an investment.

Investment activity - continued

Z and Kaingaroa

We have a 40% holding in the Kaingaroa forest (specifically, the tree crop) which is our largest single investment. We also have a 50% holding in what was Shell's NZ business, which during the financial year was rebranded Z Energy.

Both assets performed well during the year. Log prices have been strong, largely courtesy of high appetite from China (we note that in the table setting out the value of NZ investments on page 29 the increase in valuation is hidden somewhat by the effect of the strong NZ dollar at the time the 2011 valuation was made).

Z Energy has performed above initial expectations and has been revalued from its acquisition cost (which was significantly below where we percieved value to be at the time we bought it). We also note that Z Energy received the Energy Company of the Year Award at the Deloitte Energy Excellence Awards in August 2011.

How we assess the fair value of private market assets

Both assets are private market assets, which – very basically – means that they are not listed on the stock exchange and therefore we do not have a 'market' price for them. We are required to value unlisted assets on an annual basis. We use a 'mark-to-market' approach to do this, which means we assess their fair value based (among other things) on the price for similar, listed assets. Clearly, this valuation reflects market price at one point in time.

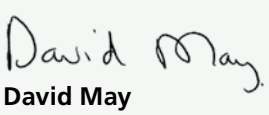
It is important to note that the fair value assessments are done by independent valuers. Further, before the independent valuation is booked, the methods used to obtain it are checked by our internal Valuation Working Group, comprising senior members of our Investments and Finance teams. The Working Group liases with our external auditors.

Managers and custodians

We are required to show our full stable of investment managers and custodians, and to identify where new managers or custodians have been appointed or existing managers or custodians terminated, for the past 12 months. Note that this table does not show investments made (which has been summarised in the tables on pages 28 and 29).

Managers appointed during financial year	**Mandate**
BlackRock Inc	Fixed income, passive
Direct Capital	NZ private equity, active
FarmRight Ltd	New Zealand rural land, active
QS Investors, LLC	Large-cap global equities, active
Devon Funds Management Ltd	New Zealand equities, active
Managers/mandates terminated during financial year	
Vanguard Investments Australia Limited	Global credit, passive Global listed property, passive
Numeric Investors, LLC (one mandate only)	US small-cap equities, active (note Numeric retains a multistrategy equities mandate, as set out below)
Managers retained during financial year	
AMP Capital Investors	NZ equities, active NZ property, active
AQR Capital Management	Multistrategy equities, active Convertible bonds, active
CP2	Global infrastructure, active
Elementum Advisors, LLC	Catastrophe-linked securities, active
Global Forest Partners	Global timber, active
GMO Renewable Resources	NZ timber, active
Hancock Timber Resource Group	NZ timber, active US timber, active
LSV Asset Management Limited	Global equities, active Emerging markets equities, active
Milford Asset Management	NZ equities, active
Morrison & Co Funds Management Limited	Global infrastructure, active
Numeric Investors LLC	Multistrategy equities, active
State Street Global Advisors	Global large-cap equities, passive
Thompson, Siegel & Walmsley, Inc.	US small-cap equities, active
Western Asset Management	Global credit, active
Custodians during the financial year	
Direct Capital	Holding shares in Scales Corporation Limited as custodian
Northern Trust Company	Master Custodian for the Fund's public market assets.
From time to time the Guardians appoint custodians for a particular purpose. Details of these custodians are set out below.	
Wells Fargo and Bank of New York Mellon	Holding collateral associated with our investment in insurance-linked securities (including catastrophe bonds).
Euroclear Bank NA/SV	Holding collateral required under sale and repurchase (repo) transactions
The New Zealand Guardian Trust Company of New Zealand Limited, the Public Trust Limited and Perpetual Trust Limited	Trustees for holding money relevant to tax pooling arrangements.

Note: A Statement of Investment Policies, Standards and Procedures (SIPSP) is published on our website www.nzsuperfund.co.nz. On behalf of the Board and Management of the Guardians of New Zealand Superannuation we hereby certify to the best of our knowledge that the SIPSP has been complied with throughout the 2010/11 financial year.



David May

Adrian Orr

Statement of Service Performance

This Statement of Service Performance (SSP) measures our progress against objective and measurements set out in the Forecast Statement of Service Performance in our 2010/11 Statement of Intent (SOI). As set out in our SOI, the single output of the Guardians is managing the Fund. That output comprises five work programmes covering expected investment returns; risk management; cost control; governance and organisational development. For each work programme we have set performance measures which, collectively, are performance measures for our output. While Government cash contributions to the Fund are suspended, we receive no funding from the Crown other than an appropriation to meet the cost of our Board (an appropriation required by our legislation). Our cost control therefore relates to the management of costs met from within the Fund.

OUTCOME MEASURES

The Fund's outcome is an investment outcome: reducing the tax burden on future New Zealand taxpayers arising from the cost of New Zealand Superannuation. That is a long-term outcome, the tangible results of which will be when the Government starts withdrawals from the Fund (currently in 2031). For the shorter term, we focus on maximising return without undue risk, which facilitates the Fund's ultimate impact on future New Zealanders' tax burden.

Measure	Expected outcome	Actual result	Comment
Reference Portfolio returns relative to Treasury Bills (per annum)	+3.2%	+16.59%	See page 2
Actual Portfolio returns relative to Reference Portfolio (after costs)	+0.55%	+5.57%	See analysis on page 18
Expected worst-case downside return[4]	-31%	+25.05%	See page 2

OUTPUT MEASURES

Work programme	Measure	Expected outcome	Actual result	Comment
Investment	Measures and targets are the same as for Outcome measures across this programme			
Cost control	Costs relative to peers in CEM survey	Rating of 'median cost, value-adding' in CEM survey	See comment	The CEM document was not available when this report went to print. We will disclose our rating on the website as soon as possible
Risk management	Expected worst-case downside return	Measures and targets are the same as under Outcome		
	Transparency ratings over time (at least Linaburg-Maduell)	10/10 Linaburg, results as appropriate to other surveys	10/10 Linaburg	See our website and the website of the Sovereign Wealth Fund Institute
			Top-rating Sovereign Wealth Fund in Santiago Compliance Index 2011 edition	See our website and the website of Geoeconomica
			Top three for transparency in Sovereign Wealth Fund Scorecard 2011 edition	See our website and the website of the Petersen Institute for International Economics
	Annual updating of report on implementation of 'Santiago Principles'	Completed	Completed	See our website and the website of the International Forum of Sovereign Wealth Funds
	United Nations Principles for Responsible Investment assessment	Top quartile	Top quartile	See page 44
	Published records of voting and Responsible Investment Report	Published	Published	See our website
Governance	Outcome of independent reviews	Positive review	N/A – done five yearly	See our website for the results of the two reviews done since our inception
Organisational capability	Key persons risks identified and covered	Achieved	Achieved	See page 57
	Key performance indicators achieved	Achieved	Achieved	See page 58

4. A scenario with a 1 in 100 chance of occurring within the specified timeframe. It is based on a 30-year investment horizon

Statement of Service Performance - continued

SPECIFIC INITIATIVES FOR 2010/11

This table reports progress against the important initiatives contributing to the various work programmes, and ultimately to the Fund's purpose, in the 2010/11 financial year. We note that, as set out in our 2010/11 SOI, most of these initiatives also apply to 2012 (therefore to be registered in the Achievement column as 100% Achieved, an initiative must either have been completed in the 2010/11 financial year or, where it is a multi-year initiative, be on-track relative to our expectations). The initiatives are derived from our Strategic Plan, which we have closely aligned to our Service Performance reporting.

Strategic Long-term Initiatives	Work in 2010/11 (and 2011/12)	Relevant SOI work programmes	Achievement	Comment
Peer collaboration project	Working more closely with peer funds to access skills and investment opportunities advantageous to the Fund. Incorporates comparison and benchmarking, co-operation on issues of mutual interest (e.g. Responsible Investment) and co-investment.	Investment Cost control Risk management Governance Organisational capability	**100% Achieved** • Agreed co-investment protocol with selected peers • Developed peer group prioritisation and plans, implementation well underway • Invited members of key international groups e.g. Public Funds Forum, World Bank Advisory Group • Established and chaired the Crown Financial Institutions Collaboration Forum	Retained as an ongoing objective. See 'Collaboration with peers' in the Forecast Statement of Service Performance (FSSP) in 2011 Statement of Intent (SOI).
Excellence in investment opportunity search, evaluation and selection	Refining our ability to identify, assess and capture investment opportunities; including jointly with other funds and fellow Crown Financial Institutions.	Investment Risk management Organisational capability	**100% Achieved** • Widened tilting ranges for Foreign Exchange, equity and credit • Progressed assessment of 3 investment themes • Reviewed 7 active return opportunity sets • Invested with 2 managers, restructured 2 existing managers, divested 1 investment as returns achieved and opportunity narrowed • Established a common language framework • Established an "investment framework"	Retained as an ongoing objective. See objective of same name in FSSP in 2011 SOI.

Initiative	Explanation	Relevant work programmes	Achievement	Comment
Capturing the illiquidity premium	Refining our processes for identifying opportunities with appropriate rewards for accepting illiquidity risk. Ensuring low-cost, passive alternatives are identified and assessed and, if proceeding, to structure illiquid investments to ensure the illiquidity premium is delivered.	Investment	**100% Achieved** • Updated the infrastructure strategy • Reviewed the private equity, private real estate and timber strategies • Increased capacity and investments in unlisted assets, including NZ Direct • Made commitments to a further $650m of unlisted assets	Retained – and broadened – as an ongoing objective. See 'Significantly progress implementing value-add strategies' in FSSP in 2011 SOI.
Excellence in portfolio completion	Improving our ability to identify and address potentially unnecessary investment costs.	Investment Cost control	**100% Achieved** • Implemented a liquidity framework • Moved to Fund-level hedging • Developed a rebalancing tool • Increased the number of active counterparties from 11 to 17 • Appointed a transition panel of 4 members	Sufficiently embedded to now be a business-as-usual contributor to cost control and investment programmes.
Complete HR Strategy implementation	Review of organisational design, new performance-based remuneration programme, key talent management and ongoing capability development.	Organisational development	**100% Achieved** • Reviewed and revised organisational structure • Implemented new bonus plan • Developed key person risk mitigation • Extended leadership development • Established target organisational culture	The completion of a succession plan has been carried over into 2011/12. Overall objective retained and broadened. See 'Building and maintaining a Great Team' in FSSP in 2011 SOI.

Responsible Investment

What is Responsible Investment?

Like many institutional investors, we invest with a long-term focus. We recognise that environmental, social, and governance (ESG) issues are long-term factors that can be highly relevant to investment performance. ESG issues present regulatory, market, reputational, and operational risks and opportunities which shareholders should consider to fully understand the companies in which they invest.

Responsible Investment (RI) is, therefore, the integration of ESG considerations into investment management practices in the belief that these factors can have an impact on financial performance.

Revising our Responsible Investment Framework

As discussed in the CEO Statement, in the past financial year we reviewed our policy framework including those which contribute to governing our Responsible Investment approach. The Act states that our overall Statement of Investment Policies, Standards and Procedures (SIPSP) must cover:

- ethical investment including policies, standards and procedures for avoiding prejudice to New Zealand's reputation as a responsible member of the world community; and
- the retention, exercise or delegation of voting rights acquired through investments

Previously, we met this requirement with a separate statement of Responsible Investment Policies, Standards and Procedures (RIPSP) which was published on our website. Subsequent to the review of our policy framework, we now meet this requirement in two ways:

1. Responsible Investment policies, standards and procedures are now incorporated within the relevant investment policies. Additionally, there is a Responsible Investment section within the SIPSP itself. We regard that as a further important step toward truly embedding the assessment and management of ESG factors within our investment processes, and;
2. To ensure there is public visibility of how we approach Responsible Investment, we continue to publish the SIPSP on our website. We have also published a separate document, a Responsible Investment Framework, which is part of the SIPSP and brings together everything that we do in one place.

What does the Responsible Investment Framework cover?

The Framework sets out the various work streams that we follow under our Responsible Investment programme. Importantly, it also closely aligns those work streams with the UN Principles for Responsible Investment (UNPRI). These include six broad principles as guidance on how to best integrate ESG issues in the management of the Fund. We have adopted the UNPRI as the internationally accepted benchmark of how institutional investors should manage ESG issues in a manner consistent with improving long-term investment returns.

The table below demonstrates the alignment between our work streams, the different UNPRI principles, and what activities come under each.

Our RI workstream	Relevant UNPRI principle(s)	Typical activities covered
Integration Developing guidelines to integrate ESG considerations across different types of investments Effective engagement with the external investment managers and manager selection advisers we use and the companies we invest in Considering investments which provide positive social returns in addition to the required financial return	**Principle 1** We will incorporate ESG issues into investment analysis and decision-making processes	Integrate RI guidelines across asset classes Apply exclusions Positive Investment & social rating Investment manager due diligence; monitoring and conviction
Ownership Being an active owner of securities in which we invest by exercising our voting rights Maintaining a robust analytical and decision making process in responding to investee companies breaching our Responsible Investment standards	**Principle 2** We will be active owners and incorporate ESG issues into our ownership policies and practices.	Direct and collaborative engagements with companies Voting - reducing agency risk NZ Corporate Governance Governance guidelines for other asset classes
Disclosure (by investee companies) Raising investee companies awareness of good practice reporting standards and encouraging their own efforts in this regard	**Principle 3** We will seek appropriate disclosure on ESG issues by the entities in which we invest.	ESG Reporting standards for companies Carbon Disclosure Project Encourage good practice reporting by NZ companies
Best practice and collaboration Benchmarking our performance against the Responsible Investment standards to which we aspire	**Principle 4** We will promote acceptance and implementation of the Principles within the investment industry. **Principle 5** We will work together to enhance our effectiveness in implementing the Principles.	Participation in Forums & working groups (e.g. UNPRI) Engagement with regulators and advisors Collaboration with Crown Financial Institutions and global peers Asset and co-investment guidelines
Communication Reporting on our activities across all workstreams including the benchmarking of those activities	**Principle 6** We will each report on our activities and progress towards implementing the Principles.	Public reporting of RI activity and benchmarking Internal reporting Stakeholder engagement

Responsible Investment Report

This report uses the structure set out on the preceding page.

Principle 1 - Integration

Typical activities

- Integration of Responsible Investment (RI) guidelines across asset classes
- Applying exclusions
- Positive Investment and social rating
- Investment manager DD; monitoring and conviction

Activities in 2010/11

The revision of the RI Framework itself was the main activity in this workstream. That is discussed in more detail on page 36. We have also developed RI guidelines for our private market (unlisted) assets as a key step toward full ESG integration. The objective is to have these guidelines implemented across all Private Market asset classes such as Private Equity, Property, Timber, and Rural Land.

During the year we also examined the risks and opportunities of climate change, and how this may impact our portfolio. Our integration of climate change risk issues into our investment approach was used as a case study for the Global Investor Survey on Climate Change report. The report was published in a joint effort by Mercer, the Institutional Investors Group on Climate Change (a body representing European institutional investors), the US-based Investor Network on Climate Risk and the Australian-based Investor Group on Climate Change (IGCC) (of which we are a member). The case study is below.

Box 3 The Guardians of New Zealand Superannuation

Assessment of existing and potential managers

The Guardians of New Zealand Superannuation (Guardians) is an operationally autonomous agency of the New Zealand Government, charged with managing the New Zealand Superannuation Fund. The Guardians annually review the actions taken by investment managers with respect to RI, including climate change issues.

The Guardians' RI policy applies to all asset classes and procedures for each become more detailed as best practice standards are developed. ESG requirements are integrated in investment due diligence including assessment of climate change risks where this is particularly relevant. For property investments, climate change guidelines focus on energy efficiency; for the New Zealand direct investments, and forestry holdings, the focus is on the risks and opportunities associated with the Guardians liability to the New Zealand Emissions Trading Scheme.

When appointing property, rural or forestry managers, climate change is incorporated into due diligence of the manager and mandate. As part of its RI requirements more broadly, the Guardians include ESG requirements in all private market manager agreements. Where it is not possible to include an ESG clause directly in the head agreement, especially in the case of a limited partnership, the Guardians use a side letter. The side letter sets out the Guardians' ESG requirements and sometimes specifically requires the manager to address climate change as part of environmental risk in the execution of their mandate.

In addition to inclusion of climate change considerations within formal processes and documentation, the Guardians have established an internal climate change "think tank" group. The group's role is to assess climate change risks and opportunities for the Fund, and comprises members of the Asset Allocation, Investment, Treasury, Communications and RI teams.

Principle 2 - Ownership

Typical activities

- Direct and collaborative engagements with investee companies
- Voting - reducing agency risk
- NZ Corporate Governance
- Governance guidelines for other asset classes

Activities in 2010/11

Voting

Voting rights are important for maintaining shareholder oversight of directors, boards and company policies. We aim to use our voting rights to promote best practice corporate governance in the long-term interests of the Fund and to meet our obligations under our governing legislation. We exercise our voting rights globally across the Fund's segregated equity portfolio.

We regularly publish a record of how we have exercised our voting rights, on the Responsible Investment section of our website.

Engagement

Engagement is when we communicate with companies, either by ourselves or collaboratively with other investors, to encourage them to address poor ESG performance. We publish to our website the engagement process we follow. Below we have provided a table of our engagement activities during the financial year (note that there are instances of the same company appearing under more than one issue. We nevertheless regard each issue as a separate engagement).

# of companies	ESG issues engaged on	Objective	Direct or Collaborative	
			Direct	*Collaborative*
27	**Human Rights**			
	Conflict zones	Developing and implementing the United Nations 'Guidance on responsible business in conflict affected and high risk areas: A Resource for companies and investors".		7
	Health and safety (Labour practices inc child labor)	Improving Working conditions and health and safety of employees/workers and banning child labour.	4	2
	Supply chain risks	Ensuring supply chain management procedures and policies exist, and are transparent and sufficiently robust to address risks of poor labour practices, human rights infractions or environmental damage.		14
19	**Severe Environmental Damage**	Improving the company's management and reporting of environmental risks (inc crisis management).	3	16
24	**Bribery and Corruption**	Seeking significant improvements in anti-bribery policies and practices, following significant incidents at the company.	3	21
5	**Cluster Munitions**	Seeking clarification if a company is a producer or manufacturer of cluster munitions or of key components of cluster munitions.		5
390	**Best Practice Reporting**			
	Climate change	Increasing the number of portfolio companies reporting on climate change risk management.		250
	ESG risks	Encouraging public reporting on ESG risks amongst emerging market companies (South Korea).		10
	UN Global Compact Standards	Comply with reporting requirements under the UN Global Compact.		130
3	NZ Corporate Governance	Improving Corporate governance at specific NZ companies.	3	
	Palm oil	Research into sustainable certification (research stage)		
Total: 468 companies			**13**	**455**

In addition to the above, there are 12 companies we have on our monitoring list. Analysis concluded ESG concerns addressed with no engagement required.

Responsible Investment Report (continued)

Engagement case studies

Engagement to improve governance on the Board of Guinness Peat Group (GPG)	This engagement sought improvements in the governance of GPG, In particular, to the independence of the GPG Board, to the structuring of the bonus scheme and to the employment contracts of Executive Directors.	Jointly with other shareholders, including AMP and Milford Asset Management, we engaged directly with the GPG Board. We succeeded in getting changes to GPG's Board and therefore to the business strategy and the company. We believe these changes will benefit all shareholders.
UNPRI Engagement on Anti-Corruption - this focuses on 21 global companies with operations in sectors or countries exposed to high level of corruption risk	This engagement seeks disclosure from major companies, notably in the defense and construction sectors, of their management policies on bribery and corruption. The investors involved believe it is very important for companies, in which they are invested to provide sufficient information and reassurance on the material risks, including corruption risks, that they face in the course of their business activities.	We are a signatory to a letter to 21 companies. The investors ask companies that have not developed relevant policies to do so as a matter of urgency. Where policies are in place we ask the company to report on how these are implemented – i.e. in the area of anti-corruption management. Such disclosure should be sufficient to enable investors and other key stakeholder to make informed judgments about the effectiveness of the company's anti-corruption measures. As of July 2011, 11 companies replied to investors' letters. Of these 11 companies – the following companies substantially improved the way they report on anti-corruption management: Dominion Resources, Tesco, AT&T, Belgacom, Eiffage and Schneider Electric. Communication is continuing between investors and the other companies on the list (with follow up engagement with those companies that have not responded). Progress is closely monitored.
UNPRI engagement – targeting 130 companies who are participants to the UN Global Compact	This engagement targets companies that are participants of the UN Global. Being a participant requires companies to report on their progress - Communication on Progress (COP) annually. Those that do not produce a COP are taken off from the UNGC as a participating company. Every year, more and more companies are taken off the UNGC list due to their lack of reporting. The objective of the engagement is to: welcome particularly good practice, or, conversely, challenge non-conforming companies to regain full participant status	The targeted companies in 2010 included 44 leaders and 86 laggards (non-conforming companies). These companies received letters, emails, and phone calls regarding their inactive UNGC status. As a result, 40% (up from 33% in 2008) of the companies submitted a COP and regained active status as UNGC participants. Investors in collaboration also held a joint webinar with laggard companies in concert with the COP team at the UNGC.

Principle 3 - Disclosure by investee companies

Typical activities

- ESG Reporting standards for companies
- Carbon Disclosure Project
- Encourage good practice reporting by NZ companies

Activities in 2010/11

We continue to support the Carbon Disclosure Project (CDP) as an investor participant, The CDP seeks information on climate change management and carbon emissions from the world's largest companies, including those listed on the NZX 50. Together with Investor Group Climate Change (IGCC), we encouraged listed companies in New Zealand to respond to the CDP request. The responses from these companies are still to be publicly released. Nevertheless our active participation in CDP has nevertheless helped to ensure that NZX 50 companies have some presence in the global universe covered by the CDP project. We believe that our participation in the CDP has been important in raising awareness amongst NZ companies that investors globally are interested in the economic impacts of climate change and its potential effects on long-term shareholder value.

Principle 4 and Principle 5 - Best-practice and collaboration

Typical activities

- Participation in Forums and working groups (e.g. UNPRI, the IGCC and the RIAA)
- Engagement with regulators & advisors
- Collaboration with CFIs and global peers
- Asset and Co-investment guidelines

Activities in 2010/11

We seek to promote and encourage best practice management of ESG matters by our stable of investment managers. A key part of this effort is an annual survey of our investment managers to gauge what progress they are making.

For the past financial year we reviewed 33 managers (22 managing unlisted assets and the remainder managing listed assets). We were pleased to see that 11% of our managers are also UNPRI signatories, compared to 5% of our managers in 2009/10.

Key findings included:

- Managers of listed assets have an increasing appetite to include ESG factors in their investment analysis, largely because of their perception of a link between good governance and good risk management practices and company performance. Many are passive investors (where the composition and performance of their portfolios is determined by what companies are included within particular market indices, rather than by stock picking which is active). That means that the performance of their portfolios relies on a high common standard of management across the relevant index as a whole.
- There is more work to do on encouraging managers of listed assets to engage on ESG matters. Many companies identified by screening agencies, such as MSCI, as breaching ESG standards are unlikely to be sold from passive portfolios unless they are removed from the index tracked by the portfolio. Therefore, managers can play an important role in screening their portfolios and engaging with companies to improve ESG performance.
- Managers of unlisted assets are becoming increasingly active in integrating ESG factors. Of the 22 who responded to our survey, 18 have ESG or related policies or are in the process of developing them.
- Property managers identified environmental factors, such as energy efficiency, as key issues for their portfolios.
- Private equity managers identified governance issues as being most material.
- Managers of unlisted assets said that, where their investment in a company was not of sufficient size to give Board representations, they often found it difficult to influence company conduct on ESG matters.

The agreement we have with our fellow Crown Financial Institutions (CFIs) to collaborate on our Responsible Investment programmes was the subject of a case study by the UNPRI (see below). The agreement, which we have referred to in previous Annual Reports, has now been successfully operating for two years. The other CFIs are the Accident Compensation Corporation, the Earthquake Commission and the Government Superannuation Fund Authority.

7 Investor Group on Climate Change
8 Responsible Investment Association of Australasia

Responsible Investment Report (continued)

New Zealand Superannuation Fund

Principle 5: Developing agreements among responsible investors to share resources

Signatory type: Superannuation fund

Country: New Zealand

Established: 2001

AUM: US$11.26 billion

Collaborating with other investors can help smaller investors improve the effectiveness of their responsible investment strategies. This case study examines the Responsible Investment Agreement between the Guardians of New Zealand Superannuation and three other Crown Financial Institutions (CFIs) in New Zealand. The agreement has helped all four funds save resources by sharing information and research and collaborating on engagements. The four Funds are:

- Accident Compensation Corporation
- Earthquake Commission
- Government Superannuation Fund Authority
- Guardians of New Zealand Superannuation.

The Responsible Investment Agreement

The Guardians and the three other CFIs all have similar mandates: to maximise returns without undue risk and avoid investments that may harm New Zealand's reputation as a responsible member of the world community. The Guardians manage the New Zealand Superannuation Fund, which is the largest of the four CFIs. While the Guardians have an internal RI team to implement its strategy, the other three CFIs cannot justify having their own dedicated RI resource.

NEW ZEALAND SUPERANNUATION FUND

As PRI signatories, a degree of collaboration was developing naturally between the other CFIs. The organisations decided to formalise a resource-sharing arrangement and were encouraged in this endeavour by the Minister of Finance. This led to the signing of the CFI RI Agreement in February 2009.

In this Agreement, the Guardians act as a Secretariat for the CFI group and provide a series of outputs related to implementing responsible investment. These outputs are based on their RI Policies, including the six principles of the PRI as follows:

- Research and policy development
- Integration of ESG factors in investment including investment manager selection and monitoring
- Portfolio monitoring, which involves updating exclusion lists, identification, analysis and prioritising high RI risks with investments and issues, and proposing actions
- Active share-ownership activities through developing a framework and implementing an engagement programme with companies and other investors
- Assisting the CFIs with communication and collaboration. All the CFIs are responsible for their own communication but the Guardians help them report internally and externally on common RI activities. The Guardians also share information such as presentations, research report press releases, letters, and media articles as appropriate.

The CFI Agreement in practice – how it works

During the first few meetings of the CFI group, discussions focused on agreeing ESG priority issues for engagement. As ESG issues are broad, creating a feasible work plan required the group to narrow the priority issues to severe environmental risks and concerns, human rights, and bribery and corruption. These were seen as issues particularly relevant to New Zealand's reputation as a responsible investor.

"Banding together with other investors with similar characteristics and priorities can enhance the cost-efficiency and effectiveness of responsible investment activities."

Anne-Maree O'Connor and Arti Prasad-Naidu
Guardians of *New Zealand Superannuation Fund*

From Back left (facing you): *Earthquake Commission (EQC), Michael Daly (Manager, Investment Strategy), Annuitas, Government Superannuation Fund (GSF), Paul Bevin (General Manager, Investments), Accident Compensation Corporation (ACC), Atholl Law (Manager, External Managed Funds)* Front left to right (facing you): *New Zealand Superannuation Fund (GNZS), Anne-Maree O'Connor (Head of Responsible Investment), Arti Prasad-Naidu (Responsible Investment Analyst)*

The group also set some principles on how it should prioritise its approach to engagement with companies. The CFIs also agree on recurring agenda items, such as integration and research, portfolio monitoring, engagement and communications.

The CFIs pay the Guardians an annual fee as part of the Agreement. This fee contributes to the cost of the time the Guardians spend on the Group's RI activities and reflects the cost savings the other CFIs enjoy by not needing dedicated staff for this function. Furthermore, the CFI group saves on the total costs of buying ESG research by selecting common RI suppliers. This has roughly halved total costs.

The fee provided by the CFIs helps support their Principle 4 and 5 activities through the Guardians' participation in working groups, conference-speaking and other wider industry activities on their behalf.

The group meets quarterly with a set agenda and papers. Outside of these meetings, the group is in regular contact via phone and email. The Guardians use the PRI assessment results as one way to oversee group performance.

Key takeaways

The Guardians recommend three places to start for signatories interested in creating a similar agreement. Signatories should:

- Have similar objectives. It is important that signatories have similar mandates or objectives. Being part of the PRI may be enough. For funds already involved with the PRI, begin direct discussions with senior management.
- Identify what they have in common. For example, on prioritising corporate engagements, common holdings are a logical place to start.
- Have a streamlined approval process for engagements. In the establishment phase, focus on signoff and delegated lines of approvals and responsibility. This will help the group to meet deadlines. It is also beneficial for the signatories to develop a standard reporting template for RI meetings and activities.

More information:
www.nzsuperfund.co.nz

Responsible Investment Report (continued)

Principle 6 - Communication

Typical activities

- Public reporting of RI activity & benchmarking
- Internal reporting
- Stakeholder engagement

Activities in 2010/11

The UNPRI conducts an annual survey of signatories' progress against the UNPRI's six principles for Responsible Investment. We report annually on our performance and on the ratings subsequently awarded by the UNPRI. The ratings assess the extent to which signatories are actually delivering against the principles they have signed up to; and how well they are doing relative to other signatories.

Scores are calculated based on a self-assessment (a full version of which is published on the Responsible Investment section of our website) and using the scoring methodology approved by the PRI Assessment Group[9]. Each year some self-assessments are subject to a limited verification exercise, but responses are not independently audited. We note that in 2009 we were included in the group of signatories subject to verification, which resulted in the UNPRI raising the scores we had given ourselves.

Our results for the 2011 survey are set out in the below table, which shows how we have progressed since 2008 (and how the number of asset owner participants in each survey has also grown significantly). We continue to be one of the top performing funds globally across all six principles.

As the number of participants grows, and the policies and practices mature, it will be harder to maintain top quartile rankings. We are focused on this, however, as a key external measure of the quality of our Responsible Investment programme and an important indicator of whether we are consistent with best-practice.

Our performance against all asset owners, 2008-2011

Quartile summary

	2008	2009	2010	2011
GPS	n/a	1	1	1
Principle 1	3	3	1	1
Principle 2	1	1	1	1
Principle 3	2	3	1	1
Principle 4	1	1	1	1
Principle 5	2	1	1	1
Principle 6	2	1	1	1
Number of peers	**74**	**128**	**168**	**198**

Top quartile 1 (green), quartile 2 (yellow), quartile 3 (orange), bottom quartile 4 (red)

9. Consistent with UNPRI requirements we note that scores have been calculated based on signatories' self-assessment and using the scoring methodology approved by the PRI Assessment Group. Although a limited verification exercise was undertaken with a proportion of signatories, responses have not been independently audited by the PRI Secretariat, PRI Assessment Group, or any other third party. Individual results including comparisons to the overall results (quartiles) are indicative and do not imply an endorsement of signatory activity. While this information is believed to be reliable, no representations or warranties are made as to the accuracy of information presented, and no responsibility or liability can be accepted for any error, omission or inaccuracy in this information.

Implementation of our Environmental Policy

We have published an assessment of the environmental footprint of our organisation in our two previous Annual Reports. We expressed this as the emissions of greenhouse gases, per person, arising from our overall consumption of energy and resources arising from our office buildings and our travel. The footprint uses power bills, taxi receipts and travel data to produce baseline data which we have updated for the past financial year. Our task then is to try to reduce our per person emissions, reflecting that our organisation is growing and that Team member has a role in implementing the Environmental Policy.

New premises

On 13 June 2011 we moved into new premises at 21 Queen Street. This means that the report for this year is based mostly on our former premises but partially also on our new premises. It also means that we have to establish new baselines for the new building, not least because the new building carries a 5-star Green rating from the New Zealand Building Council. This is particularly relevant for the waste recycling programme.

Footprint

There has been an increase in the overall per person emissions of greenhouse gases[10] from 12.41 to 13.46 tonnes per FTE. Again, this is entirely due to increased airline travel, which is an inevitable consequence of being an international investor. We note that despite an increase in FTE our taxi usage has remained essentially flat and our power usage has decreased. We also note that if actual staff numbers at 30 June 2011 are used i.e. 70 people (as opposed to FTE which measures full-time working hours) the total emmissions per person drops to 12.88 tonnes per person.

ACTIVITY	Greenhouse gas emissions to 30 June 2010	Emissions per person to 30 June 2010	Emissions to 30 June 2011	Emissions per person to 30 June 2011
Power usage	31.5	0.49	31.6	0.47
Taxi usage[11]	6.0	0.09	6.5	0.10
Flights[12]	757.0	11.83	863.8	12.89
TOTAL	**794.5**	**12.41**	**901.9**	**13.46**

Relevant activities and information

- Our FTE increased from 64 at 30 June 2010 to 67 at 30 June 2011
- We moved to our new premises on 13 June 2011 which means that the data above contains 17 days of data from the new building (which is most relevant to the power usage). We note that the green practices followed by the building management at the new premises, together with new printers which permit enhanced power and paper saving, are already having an impact on the data we are recording for the 2011/12 financial year and which we will disclose in the 2012 Annual Report.

Portfolio footprint

In the 2010 Annual Report we said that we would report on work we are doing to assess the broader footprint of our portfolio – i.e. of the companies and enterprises in which we are invested. We have identified a number of work streams:

- Implications for our local holdings and investments of the proposed New Zealand Emissions Trading Scheme
- What useful guidelines for our reporting exist in global tools such as the Climate Disclosure Project

10. All emissions calculations via Climate Friendly at www.climatefriendly.com
11. Taxi data represents 3.9 tonnes in 5-litre cars and 2.6 tonnes in four-litre cars
12. All domestic and international travel

Implementation of our Environmental Policy (continued)

- A broader analysis of our direct and indirect exposures to climate change risks and opportunities
- What climate change mitigation actions are being undertaken by our peer funds.

Part of the outcome for assessing and managing our portfolio footprint from climate change risk and opportunity has been published as a case study for the Global Investor Survey on Climate Change report (see page 38). This will further be supplemented by the implementation of our RI guidelines across private market assets.

We are continuously working with our peers in sharing ideas and strategies. This was particularly beneficial in the area of climate change, especially in understanding how this theme would impact our portfolio. Seeing what others have done has lead us into establishing an internal climate change "think tank" group. This comprises members of the Asset Allocation, Investment, Portfolio Completion, Communications and RI teams. The group's role is to assess climate change risks and opportunities for the Fund.

Waste

As we have moved into new premises we will be conducting a waste audit which will establish a new baseline. In the new building we separate food/organic waste, recyclables such as glass, cans and certain types of plastic and landfill rubbish. We already have some preliminary information which indicates that we produce close to 500kg of waste a month.

We will aim to recycle the majority of that through a combination of the building's recycling programme and our existing paper shredding and recycling programme which we transferred from the previous premises.

Governance

In this section we report on how the Guardians observed each of the Securities' Commission's corporate governance principles in the year to 30 June 2011.

Principle 1 Directors should observe and foster high ethical standards

The Board has adopted a Board Charter incorporating a Code of Conduct for Board members. The Charter is available on our website under *Who We Are/Our Board.*

Employees also have a Code of Conduct. The Code provides Board members and employees with clear expectations of ethical standards expected at the Guardians. The Codes of Conduct address:

- professional conduct and duties of Board members and employees;
- conflicts of interests;
- confidentiality;
- securities markets legal obligations;
- use of Guardians' information and assets;
- receipt of gifts and entertainment;
- political participation; and
- whistle blowing.

A copy of the Code of Conduct for employees is available on our website under Who We Are/Our Management.

For Board members, actual or potential conflicts of interest are managed in accordance with the requirements of the Guardians' governing legislation. Codes are reviewed regularly as part of the Guardians' Legislative Compliance Framework.

Principle 2 There should be a balance of independence, skills, knowledge, experience and perspectives among directors so that the Board works effectively

The skills and attributes required to be a Board member are set out in the Act. Board members are chosen for their experience, training and expertise in the management of financial investments, as well as their mix of complementary skills.

Board members are appointed by the Governor-General on the recommendation of the Minister of Finance. The Minister's recommendation follows nominations from an independent nominating committee established by the Minister. On receiving those nominations, the Minister consults with representatives of other political parties in Parliament before recommending the Governor-General appoint a person to the Board.

The Board must comprise of at least five, but no more than seven, members. Each Board member is appointed for a term of up to five years and is eligible to be reappointed. The first Board members were appointed in August 2002.

The Board composition at 30 June 2011 with details of individual Board members' background is set out in the table below. We note that Gavin Walker joined the Board in July 2010, Professor John Evans retired in May 2011, David Newman left after completing his second term and Dr Craig Ansley joined the Board after the end of the financial year, in September 2011.

Governance - continued

Name	**David May, Chairman**
Term of office	Appointed August 2002 for five years and reappointed September 2007 for five years.
External directorships	Deputy Chairman, Government Superannuation Fund Authority and Annuitas Management Limited.
Skills, experience, and expertise	David has 43 years' experience in the financial services, superannuation, and insurance industries, including 31 years with Colonial Group, most recently as Managing Director of Colonial Life NZ Ltd (1995–2000).
Standing Board committee membership	Chairman of the Employee Policy and Remuneration Committee.

Name	**David Newman, Deputy Chair**
Term of office	Appointed September 2004 for five years and reappointed November 2009 until September 2011. Completed term and left Board in September 2011.
External directorships	Chairman of Infratil Limited and its subsidiary Wellington International Airport Limited and a Director of Infratil Airports Europe Limited. David is also Chairman of Loyalty New Zealand Limited, operator of Fly Buys loyalty card programme, and of the Centre for Biodiversity and Restoration Ecology at Victoria University of Wellington.
Skills, experience, and expertise	David was previously Chief Executive Officer of the Institute of Directors in New Zealand. Prior to this, David spent 22 years with BP, culminating in four years as Chief Executive and Managing Director of BP New Zealand Limited.
Standing Board committee membership	Chairman of the Audit Committee.

Name	**Professor John Evans**
Term of office	Appointed December 2006 for five years and retired in May 2011.
External directorships	John is Chairman of Vertex Capital Ltd and is Managing Director of PGE Australasia Pty, an actuarial company specialising in the application of quantitative techniques to investment business. He also holds a number of directorships, including Emerging Leaders Investment Ltd, and is actively involved with various Committees at Fiducian Portfolio Services, a specialist financial services organisation.
Skills, experience, and expertise	John holds a Master of Business Administration from the University of Sydney. He is also Associate Professor in actuarial studies at the University of New South Wales and Director of the Centre for Pensions and Superannuation.
Standing Board committee membership	Member of the Audit Committee.

Name	**Mark Tume**
Term of office	Appointed April 2006 for five years. Reappointed August 2011 for five years.
External directorships	Director of the New Zealand Railways Corporation (KiwiRail), Infratil Limited and The New Zealand Refining Company
Skills, experience, and expertise	Over his 20-year career, Mark has held a variety of senior roles within the finance sector, in areas such as investment banking, capital markets, asset and liability management, and risk control.
Standing Board committee membership	Member of the Audit Committee[5]

Name	**Catherine Savage**
Term of office	Appointed November 2009 for five years.
External directorships	Managing Director of CMS Capital Limited, Director of Todd Family Office Limited, Comrad Holdings, NZX Incognito and Pathfinder Asset Management. Chairman of the National Provident Fund.
Skills, experience and expertise	Catherine was Treasurer of the National Gas Corporation from 1991-1993 prior to moving to AMP Capital Investors (NZ) Ltd where she worked in various senior management roles to 2000 when she became the Managing Director - AMP's youngest and only female country manager.
Standing Board committee membership	Member of Employee Policy and Remuneration Committee.

Name	**Stephen Moir**
Term of office	Appointed November 2009 for five years.
External directorships	Stephen is a non-executive director of the Bank of New Zealand and a member of the NZX Discipline Panel
Skills, experience and expertise	Stephen has more than 25 years of experience in financial services, including being the General Manager of the Westpac Institutional Bank from 1998-2001, preceded by senior positions with Credit Suisse in Singapore and Citibank in Singapore, Bangkok and Sydney.
Standing Board committee membership	Member of Audit Committee until July 2010. Member of Employee Policy and Remuneration Committee from July 2010.

Governance - continued

Name	**Gavin Walker**
Term of office	Appointed July 2010 for three years.
External directorships	Gavin is Chairman of ASB Bank and Sovereign Insurance and also chairs the Boards of Commonwealth Securities Pty Ltd and Australian Investment Exchange Ltd. He has been a director of Lion Nathan National Foods (formerly Lion Nathan Ltd) since 2000 and is also a director of Rimu SA.
Skills, experience and expertise	Gavin has extensive experience in investment banking and funds management including being CEO of the Banker's Trust in both New Zealand and Australia. He is a past chairman of the Foreign Direct Investment Advisory Board and a past director of BT Investment Management Limited, the Southern Cross Building Society and of Goodman Fielder Limited. Gavin has a BCA from Victoria University. He is a member of the New Zealand and Australian Institutes of Directors and the Institute of Financial Professionals.
Standing Board committee membership	Audit Committee from July 2010

The Guardians' governing legislation and the Board Charter define Board responsibilities, responsibility of individual Board members, as well as matters reserved for the Board and matters delegated to management.

While the day-to-day responsibility for the operation of the business is delegated to the executive, there are a number of matters which, either because it is required by law or because the Board has decided it is in the interests of the Guardians to do so, are decided only by the Board as a whole.

The Board regularly reviews its delegations and governance priorities. This year a full review of the Guardians' policies including those relating to Human Resources, outsourcing and risk management was carried out, jointly by the Board and management. The Board also completed a self-assessment, with the assistance of an international expert, to gauge where it stood in relation to international best practice in investment governance.

The Board also hear directly from a range of external experts on investment markets and regularly visit international peer funds for the purpose of assessing developments in best practice. We have significantly progressed a Board member education programme in the 2010/11 financial year. We actively identify further education opportunities for our Board members. In the coming year four Board members will take part in a joint International Centre for Pension Management/Rotman course relating to governance of long-term investment funds.

Principle 3 The Board should use committees where this would enhance its effectiveness in key areas while retaining board responsibility

The Board had two standing Board committees during the 2010/11 financial year:

- **Audit Committee:** Oversees financial reporting, internal and external audit, the operational risk management and management of legislative risk, compliance (including tax compliance), accuracy of financial statements, and other governance systems.
- **Employee Policy and Remuneration Committee:** Oversees the development and operations of employment and remuneration policies.

The roles and responsibilities of the Board committees are set out in the respective Committee's Terms of Reference. Copies of the Terms of Reference are available on the Fund's website. Minutes of the Committee's meetings are provided to the Board. In addition, all Board members are able to attend any Committee meeting.

In addition, from time to time, the Board may establish specific sub-committees to address a particular matter or for a particular purpose. This allows the Board to function effectively and to apply its conflicts of interest policy.

The Board committees meet either quarterly or are convened as necessary. Each committee is entitled to the resources and information it requires to operate effectively. The Chief Executive Officer and senior executives are invited to attend committee meetings as necessary.

The Board met 6 times during FY 2010/11, and its standing committees held nine meetings. Table 4 below reflects the number of meetings attended by each Board member relative to the total meetings that Board member could have attended.

Meeting Type	Board	Audit Committee	Employee Policy and Remuneration Committee
Number of meetings	6	5	3
David May	6	n/a	3
David Newman	5	4	n/a
Mark Tume	6	5	n/a
John Evans*	3	4	n/a
Gavin Walker	6	4	n/a
Catherine Savage	6	n/a	3
Stephen Moir	6	n/a	3

*John Evans left the Board during the financial year.

Principle 4 The Board should demand integrity both in financial reporting and in the timeliness and balance of disclosures on entity affairs

As a Crown entity the Guardians must meet all its obligations in respect of the Guardians and the Fund under the Act, the Crown Entities Act 2004, and the Public Finance Act 1989, including tabling the Annual Report for the Guardians and the Fund in the House of Representatives. The Annual Report is available to the public in hard copy and on our website. The financial statements for the Guardians are signed by the Chairman of the Board and the Chairman (or nominee) of the Audit Committee. The Financial Statements for the Fund are signed by the Chairman of the Board, and the Chief Executive Officer.

The Guardians are required by the Crown Entities Act 2004 to prepare a Statement of Intent. Our Statement of Intent for the five years from 2011 to 2016 was tabled in the House on 23 May 2011. The Guardians also report quarterly to the Minister with a written report on progress of the Fund and the Guardians.

Principle 5 The remuneration of directors and executives should be transparent, fair, and reasonable

The remuneration of Board members is set by the Minister of Finance operating in accordance with the Fees Framework for Members of Statutory and Other Bodies Appointed by the Crown.

Members' remuneration is disclosed in Note 13 to the Guardians' financial statements.

The objective of the staff remuneration strategy is to provide competitive remuneration aimed at attracting and retaining competent people and aligning rewards with achievement of financial and non-financial targets. Staff remuneration comprises base or fixed remuneration and a long-term incentive scheme based on the achievement of organisation and financial performance targets.

Further details concerning staff remuneration are disclosed in Note 13 to the Guardians' financial statements. We also note a new discretionary bonus scheme applies from 1 July 2010 onward, this is outlined on page 57.

Governance - continued

Principle 6 The Board should regularly verify that the entity has appropriate processes that identify and manage potential and relevant risks

The Board is responsible for reviewing and approving the Guardians' risk management strategy. The Board delegates day-to-day management of risk to the Chief Executive Officer and, as appropriate, other staff. Inherent in this delegation is the belief that responsibility for managing risks at the Guardians is the domain of the relevant business unit.

The Audit Committee reviews the reports of management and the external and internal auditors on the effectiveness of systems for internal control, financial reporting, and operational and legislative risk management. The Committee reports to the Board on changes to the risk management framework and to those risk records overseen by the Audit Committee. To assist in discharging this responsibility, the Board has in place a number of strategies designed to safeguard the Fund's and Guardians' assets and interests and ensure the integrity of reporting.

Principle 7 The Board should ensure the quality and independence of the external audit process

The Audit Committee is responsible for overseeing the external audit of the Guardians and the Fund. Accordingly, it monitors developments in the areas of audit, and threats to audit independence, to ensure its policies and practices are consistent with emerging best practice in these areas.

The external auditors are not permitted to perform non-audit work assignments.

The Auditor-General appoints the external auditors of the Guardians and the Fund. The Guardians' external auditor is Brent Penrose of Ernst & Young who audits the Fund and the Guardians.

Principle 8 The Board should foster constructive relationships with shareholders that encourage them to engage with the entity

The Guardians are a Crown entity and its assets, and the assets of the Fund, form part of the Crown's assets. The Guardians are accountable to Parliament, through the Minister of Finance, for those assets. The Guardians' Statement of Intent for the five years from 2011 to 2016 is published on our website and will be reported against in the Annual Report next year. The Guardians report to the Minister on the Fund at those intervals that the Minister may require and currently the Guardians provide a quarterly written report on the Fund's progress.

Under the governing legislation, the Minister may give directions regarding the Crown's expectations as to the Fund's performance, including its expectations as to risk and return. However, the Minister may not give any direction that is inconsistent with the duty to invest the Fund on a prudent, commercial basis. The Guardians must have regard to any such direction and must notify the Minister how it proposes to do this, as well as report the direction in the Annual Report. Any direction given by the Minister must be tabled in Parliament. We received a direction in May 2009 but have received no directions in the current financial year.

The Act and the Crown Entities Act 2004 provide more information on the role and responsibilities of the Minister and are available on the Fund's website.

Principle 9 The Board should respect the interests of stakeholders within the context of the entity's ownership type and its fundamental purpose

The Guardians published its Statement of Intent under the Crown Entities Act 2004 in May 2011. This set out the broad parameters of work for the five years from 2011 to 2016 and a detailed plan for FY2011/12.

Objectives set out in the Statement of Intent for the 2010-11 financial year are reported against from page 32 of this report.

Adrian Orr

Neil Williams

Matt Whineray

MANAGEMENT TEAM

To ensure high-quality decision-making, our management team operates through a series of internal executive committees. These committees include the:

- Leadership Team: dealing with the business operations of the Guardians;
- Investment Committee: advising on the investment decisions of the Guardians; and
- Risk Committee: advising on the performance of the Fund and the Guardians' service providers.

In planning for growth, we have refined our organisational structure to support the overall business strategy. In particular, we have designed the structure to deliver:

- alignment to the Guardians' strategies and mandate;
- focus on driving performance and accountability;
- clarity around processes within the organisation;
- additional capability;
- support of clear governance;
- leverage of economies of scale and skill across the Guardians; and
- assurance the cost of doing business is managed appropriately.

Below are brief profiles of the Leadership Team.

Adrian Orr, Chief Executive Officer: Responsible for general management of the Guardians under delegation from the Board. Adrian joined the Guardians in February 2007 from the Reserve Bank of New Zealand where he was Deputy Governor and Head of Financial Stability. Adrian has held the position of Chief Economist at Westpac Banking Corporation, Chief Manager of the Economics Department of the Reserve Bank of New Zealand, and Chief Economist at the National Bank of New Zealand. Adrian is New Zealand's representative on the International Forum of Sovereign Wealth Funds and a member of the investment council for the World Economic Forum and of the Expert Advosory Group for the World Bank's Treasury.

Neil Williams, General Manager Asset Allocation: Responsible for investment in listed markets and for the overall Fund investment completion (i.e. the use of derivatives, cash management and rebalancing). Neil joined the Guardians in May 2008 from UBS Global Asset Management in London where he was Global Head of Asset Allocation and a Managing Director in Global Investment Solutions. Neil was previously Chief Global Strategist, Executive Director for Goldman Sachs International (London).

Matt Whineray, General Manager Investments: Responsible for investment activity in alternative assets and the appointment of investment managers. Matt joined the Guardians in May 2008 from Credit Suisse (Hong Kong) where he was Head of Financial Sponsor Coverage for non-Japan Asia. Prior to this, Matt was a Managing Director of First NZ Capital and a Vice President at Credit Suisse First Boston (New York). Matt began his career as a Barrister and Solicitor with Russell McVeagh.

Governance - continued

Tim Mitchell, General Manager Corporate Strategy: Responsible for the Guardians' overall strategy in best-practice activities, including best-practice portfolio management, responsible investment, legal, and communications. Tim joined the Guardians in April 2003. He was previously a consultant to the Board with responsibility for establishing the Guardians' infrastructure and policies. Prior to that, Tim was a principal advisor at The Treasury. Before moving into the public sector, he spent seven years with Colonial First State Investment Managers, most recently as Chief Investment Officer.

Tim Mitchell

Mark Fennell, General Manager Operations: Responsible for developing and overseeing investment operations and information technology. Mark joined the Guardians in July 2007 from The Warehouse Group where he was the Company Secretary and Chief Risk Manager. Mark also has significant public sector experience, working in a senior finance position for the Ministry of External Relations and Trade and for State Owned Enterprises (Forestry Corporation and NZ Railways Corporation).

Mark Fennell

Stewart Brooks, General Manager Finance: Responsible for financial control, tax, and external audit. Stewart joined the Guardians in August 2003 from Sterling Grace Portfolio Management Group, where he was Group Company Secretary. Stewart was previously Financial Controller for Motorola Cellular and worked in private equities for seven years. Prior to this, he worked for a computer multinational in the UK.

Stewart Brooks

Janet Gallagher, General Manager Human Resources: Responsible for people, performance and culture. Janet joined the Guardians in May 2007 after eight years managing her own HR consultancy business. Previously Janet held senior HR positions with Lion Nathan, NZI Life and New Zealand Dairy Foods.

Janet Gallagher

Our Team

We recognise the benefits to our organisation of having a breadth of skills and experience among our employees. We also recognise the benefits of being able to recruit, retain and develop high-quality people. To us this means our people must enjoy and feel safe in their workplace; trust the processes and procedures around their development, recognition, promotion and exit; and be enthused about and professionally satisfied by their roles.

If we can consistently achieve this for our people we believe that we will succeed in achieving our long term business goals, and continue to improve our Good Employer and Equal Employment Opportunity practices.

EEO Statistics

As part of regular reporting requirements, we monitor and report on the profile of our workforce. We have presented our FTE equivalent numbers and the numbers of people whose work comprises the FTE hours in the table below. As at 30 June 2011, our workplace profile is as follows:

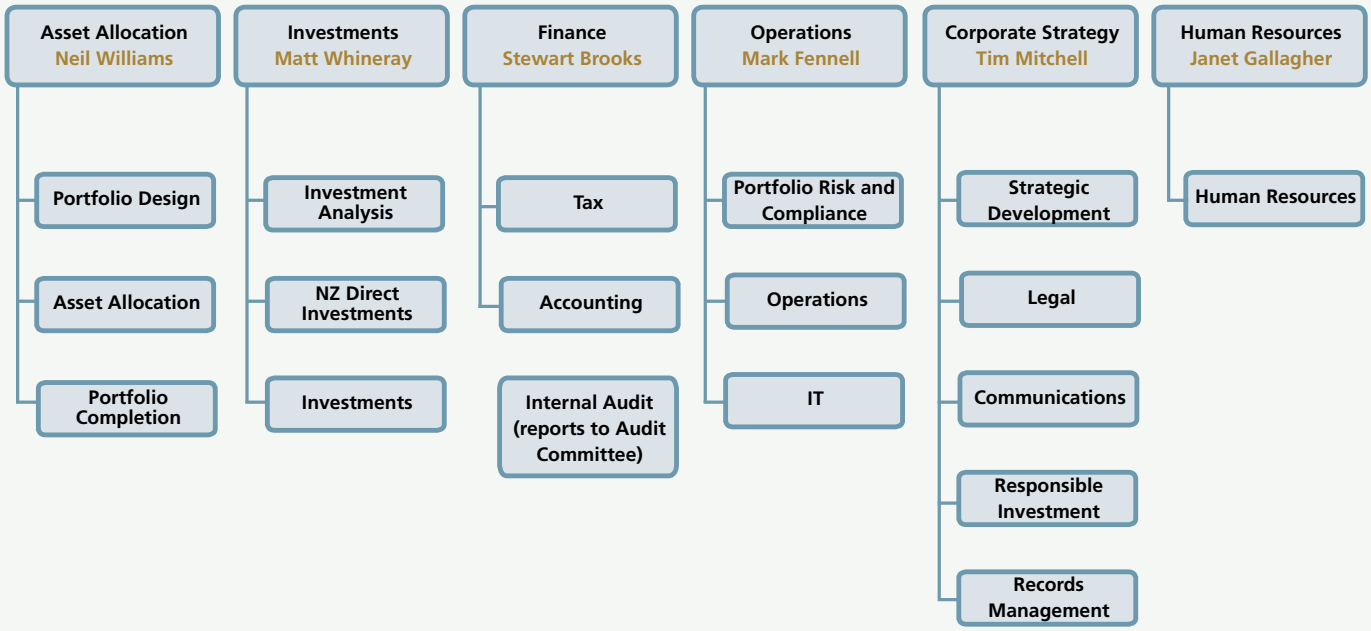
Headcount (FTE)	**66**	
Full-time (FTE)	61	92%
Part-time (FTE)	5	8%
Gender (Number of people comprising FTE working hours)		
Women	24	34%
Men	46	66%
Senior Management (Number of people)*		
Women	11	37%
Men	19	63%
Age (Number of people)		
Under 20	0	0%
20 – 29	5	7%
30 - 39	27	39%
40 – 49	31	44%
50 – 59	7	10%
Over 60	0	0%
Undeclared	0	0%

* senior management includes General Managers, Heads of Departments and Senior Investment Analysts

Our Team - continued

Guardians of NZ Superannuation Organisation Chart

Operating Units and Leadership Team General Managers (direct reports to CEO)



1. Completing HR Strategy implementation

Cultural development programme

We have an ongoing focus on developing an investment team culture. Any single investment involves a lot of our team members' knowledge and experience. So we need to function as an integrated team to maximise our investment potential. Our culture is crucial to that.

In the past year we surveyed, our board, leadership team, and staff on their desired culture. They were unanimous that they preferred a culture strongly oriented toward achieving our goals in a supportive and constructive workplace.

Subsequently, we have included clear guidelines in all of our position descriptions on how to achieve our goals as a team, and will be holding each other accountable to these on an ongoing basis.

Key person risk identified and covered

We have developed a key person risk framework to ensure that we identify, obtain, keep and develop the talent that we need. The framework is reviewed twice a year by our Employee Policy and Remuneration Committee (EPRC) and is designed to identify the roles within the team that are critical to the purpose of the Fund and any risk to those roles not being performed as we require them to be. That includes identifying potential succession gaps and setting out the planning required to develop and promote talent from within the team. The framework also identifies those people outside the organisation who we believe have the skills and experience that would add value to the Fund.

EPRC has concluded that we are currently well positioned to provide internal cover for any mission-critical position, should it become vacant at short notice, for at least a three-to-six-month period.

2. New discretionary bonus scheme

Guardians' Remuneration Framework

Our remuneration framework was revised in July 2010 and has two components: base remuneration and an incentive. The framework is benchmarked to relevant New Zealand salary comparisons using third-party data.

The incentive element

The incentive element is based on two components (corporate staff e.g. those in operations and corporate strategy are eligible only for the first component; the CEO, GMs and investment staff are eligible for both):

1. Individual performance against targets specific to their role.

These targets are derived from an agreement between an employee and their manager as to what measurable, tangible efforts they can make over and above their standard role, but relevant to that role, to contribute to the relevant period's strategic objectives. As such, the targets are directly relevant to, and are controllable by, the employee.

2. The medium-term financial performance of the Fund.

This portion of the incentive element is based on the rolling four-year financial performance of the Fund relative to the same two public benchmarks we use for the performance of the Fund itself. The four-year benchmarks are:

- relative to return on 90-day Treasury Bills. The payment is capped when this return is ahead of 90-day Treasury Bills by 4 percent. If the return is below 90-day Treasury Bills the payment is zero, and;
- relative to the Reference Portfolio or the 'value add' return. This is a key measure of the value we're adding to the Fund through taking active investment decisions. The payment is capped when this return is 0.75% ahead of the Reference Portfolio. If value-add is zero or negative, the payment is zero.

How does the framework work?

In the below table we have set out the three categories of eligibility and the maximum bonus payments available to each (as a percent of gross remuneration):

Scheme since July 2010	Corporate Staff	Investments Staff	CEO and General Managers
Short-term	20%	30%	20%
Long-term Financial Performance	n/a	30%	20%

Prior to July 2010, all staff were eligible for a 7.5% short-term and a 22.5% long-term bonus. The long-term bonus was similarly based on Fund performance relative to benchmarks and was also paid on a rolling four-year basis.

Our Team - continued

Results

Individual KPIs

Employees agree individual targets which are relevant to their role and are therefore controllable by the employee. Each employee is then rated according to what they achieved, and how they went about doing it.

Across all employees, 71% of individual targets were achieved for the financial year. This reflects that the targets are not designed to be simple to achieve. We believe this is a positive start to the new incentive scheme.

Fund Financial Performance

Given that the long-term incentive is based on a rolling four-year period, there are currently a number of bonus 'vintages' in operation. Below we have shown the effect of these vintages which also shows that two different bonus schemes are in force.

Vintages Financial Year	**Maximum Payment** % average base gross remuneration	**Actual Payment** % average base gross remuneration	Comment
1. 2006-2009	22.5% all staff	8.6% all staff	Completed last year
2. 2007-2010	22.5% all staff	11.7% all staff	fully vested this year
3. 2008-2011	22.5% all staff	14.7% all staff	¾ vested
4. 2009-2012	22.5% all staff	11.3% all staff	½ vested
New bonus scheme in force from 1 July 2010			
5. 2010-2014	20% CEO/GMs 30% Investments	5% 7.5%	¼ vested

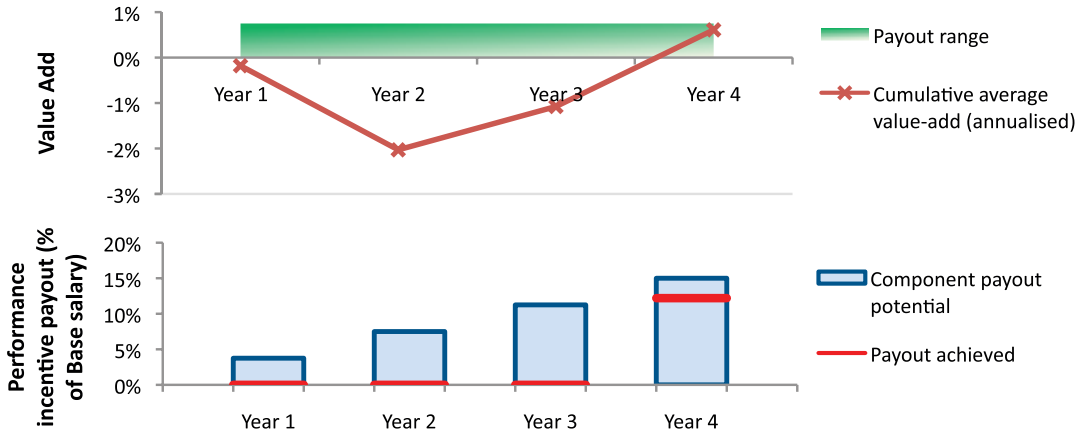
Catch-up effect

Where Fund underperformance or negative performance has meant that there has been no payment within a vintage, it is possible for subsequent strong performance within the same vintage to cancel out some or all of that underperformance. This could be sufficient for performance to 'catch up' on the relevant benchmark and for a bonus payment to be triggered for that portion of the vintage which has outperformed the benchmark.

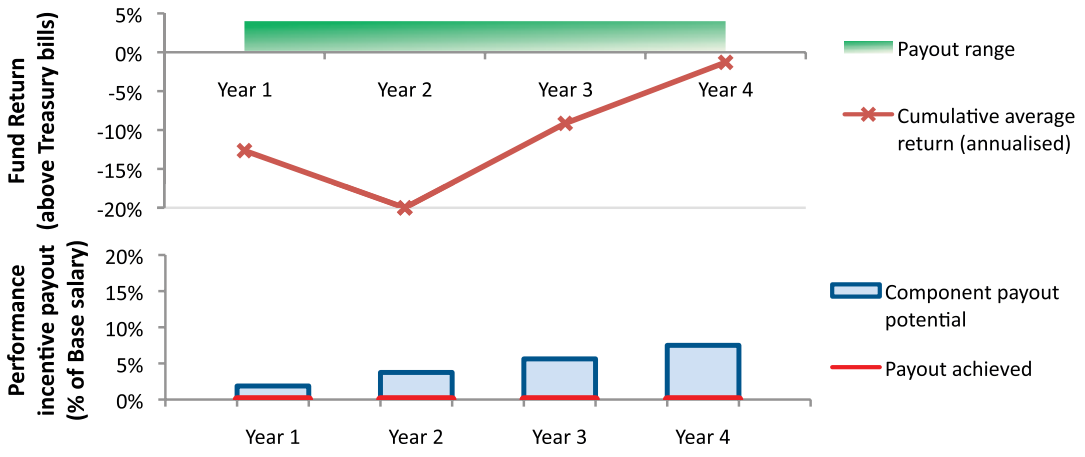
This has occurred for the 2007-10 vintage. For the first three years of that vintage, which included the Global Financial Crisis, the Fund's underperformance was such that no long-term incentive payments were made. However, the Fund's performance in 2010/11, the final year of that vintage, was of sufficient scale to lift the entire period's performance to a position triggering a payment of the value-add component of the long-term bonus. The effect of this was that all payments of the value-add component for the four-year period were made in the 2010/11 year, rather than being spread over the full four-year period. However, no payments were triggered for the Total Return component, which remained out of payment range.

This is shown in the graphs on the facing page.

Value-add Component



Total Return Component



Our Team - continued

3. Review of Human Resources Policy and Staff Code of Conduct

During the year we reviewed our policy framework and this included the Human Resources Policy – which sets out how we attract, retain, remunerate, develop and exit staff – and the Staff Code of Conduct, which sets our expectations of staff conduct.

As a result the two are now combined, with the Code of Conduct a schedule to the Human Resources Policy. Both are available on our website.

4. New premises

Shortly before the end of the financial year we moved in to new premises at 21 Queen Street in Auckland's CBD. We made the move because space was getting too tight for us at our previous home in the AMP Building on the next block; and with a weak commercial property market the timing was right to move within AMP's stable of properties.

We needed additional space because of our recent efforts to bring more of our investment activity in-house to manage our costs effectively, widen our investment capability, and continue to meet our mandate including direct investment capability in NZ. Doing so has had, and will continue to have, a favourable impact on cost control and net return of the Fund.

We believe the new tenancy more effectively future-proofs our space requirements than did the tenancy in the AMP Building.