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GOVERNMENT SUPERANNUATION FUND AUTHORITY

STATEMENT OF INVESTMENT POLICIES, STANDARD AND PROCEDURES (SIPSP)

AUGUST 2009

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STATEMENT OF INVESTMENT POLICIES, STANDARDS AND PROCEDURES

This document is titled Statement of Investment Policies, Standards and Procedures (**SIPSP**) and is dated 05 August 2009. An electronic copy is available via website *www.gsfa.co.nz*

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1 INTRODUCTION

1.1 The Authority

The Government Superannuation Fund Authority (**the Authority**) was established in 2001 to manage and administer the assets of the Government Superannuation Fund (**GSF** or **the Fund**) and the Government Superannuation Fund Schemes (**GSF Schemes**) in accordance with the Government Superannuation Fund Act 1956 and subsequent amendments (**the GSF Act**). The Authority is an autonomous Crown entity under the Crown Entities Act 2004 (**Crown Entities Act**).

1.2 Purpose

This Statement of Investment Policies, Standards and Procedures (**SIPSP**) records the arrangements set by the Authority's Board (**the Board**) for the governance and management of the investment assets held by the Fund. The Board's governance defines fiduciary roles and responsibilities, establishes the decision-making processes and the policies and procedures for management of the investment assets of the Fund.

1.3 The GSF Act

The Authority manages the assets of the Fund in accordance with the requirements of the GSF Act. Extracts from sections 15J (2), 15L and 15M of the GSF Act are set out below.

Section 15J (2) of the GSF Act requires that:

> *"The Authority must invest the Fund on a prudent, commercial basis and, in doing so, must manage and administer the Fund in a manner consistent with -*
> *(a) best practice portfolio management; and*
> *(b) maximising return without undue risk to the Fund as a whole; and*
> *(c) avoiding prejudice to New Zealand's reputation as a responsible member of the world community."*

Section 15L of the GSF Act requires that:

> *"(1) The Authority must establish, and adhere to, investment policies, standards, and procedures for the Fund that are consistent with its duty to invest the Fund on a prudent, commercial basis, in accordance with section 15J.*
> *(2) The Authority must review those investment policies, standards, and procedures for the Fund at least annually."*

Section 15M of the GSF Act requires that:

> *"A statement of investment policies, standards, and procedures must cover (but is not limited to) –*
>
> *(a) the class of investments in which the Fund is to be invested and the selection criteria for investments within those classes; and*
>
> *(b) the determination of benchmarks or standards against which the performance of the Fund as a whole, classes of investment, and individual investments will be assessed; and*
>
> *(c) standards for reporting the investment performance of the Fund; and*
>
> *(d) ethical investment, including policies, standards, or procedures for avoiding prejudice to New Zealand's reputation as a responsible member of the world community; and*
>
> *(e) the balance between risk and return in the overall Fund portfolio; and*
>
> *(f) the Fund management structure; and*
>
> *(g) the use of options, futures, and other derivative financial instruments; and*
>
> *(h) the management of credit, liquidity, operational, currency, market, and other financial risks; and*
>
> *(i) the retention, exercise or delegation of voting rights acquired through investments; and*
>
> *(j) the method of, and basis for, valuation of investments that are not regularly traded at a public exchange; and*
>
> *(k) prohibited or restricted investments or any investment constraints or limits."*

1.4 Review

This document is dated 05 August 2009 and supersedes all previous versions. This document is subject to regular review and amendment as the Fund's investment strategy evolves. A version control document is maintained by the Board.

2 THE FUND MANAGEMENT STRUCTURE AND GOVERNANCE

Required under section 15M (f)- the Fund management structure.

2.1 Policies

The Board is the governing body of the Authority and is responsible for making all decisions relating to the Fund. The Board has all the powers necessary for managing, and for directing or supervising the management of, the business of the Authority and the Fund. The Authority's key governance document its Corporate Governance Statement, incorporating the requirements set out in the Act, the Crown Entities Act 2004, other legislation and regulation, and policies and practices developed by the Board. A copy of the Authority's Corporate Governance Statement can be found on the website *www.gsfa.govt.nz*

The Board has established an Investment Committee and Responsible Investing Committee to perform and exercise the functions and powers of the Board delegated to each committee, as applicable. Committees have written terms of reference and ensure that their activities remain consistent with the Crown Entities Act. Each committee reviews its performance annually and is also reviewed by the Board.

The Board is supported by a Management team who act in management, operational and secretarial roles on behalf of the Authority. Clear separation of the governance and operational functions is maintained. The Board retains the power of appointment of investment managers and custodians.

The Authority has outsourced the key activities of scheme administration and investment management (including custody of the Fund's assets) as well as legal, tax and investment advisory functions and communication services.

In terms of the GSF Act, the Government Actuary is the actuary for the Fund and the Auditor-General is the auditor.

2.2 Standards

(a) A global custodian is appointed to provide the appropriate separation of functions between the investing function (undertaken by the investment managers) and the transaction settlement, recording and reporting of investment activities (undertaken by the global custodian).

All the assets of the Fund, apart from cash holdings required for operational liquidity purposes, are held under custody, unless specifically authorised by the Board.

(b) Cash required for operational liquidity purposes is managed by the Authority's Management.

(c) Third party investment managers have been engaged to invest the assets of the Fund. Details of the current investment managers can be found on the website *www.gsfa.co.nz*

The Authority and the Board of Trustees of the National Provident Fund (**NPF**) have formed a joint venture company, Annuitas Management Limited (**Annuitas**). Each organisation has entered into a management services agreement (**MSA**) with Annuitas.

The MSA between the Authority and Annuitas contains delegations of authority to enable Management to carry out the day to day management of the Authority's investment, custody and scheme administration arrangements. In relation to investments, Management is primarily responsible for the identification and implementation of appropriate strategies for the Authority to meet its obligations under the GSF Act and its objectives. This includes the management of contracted services, including investment management, custodial and external advisers, maintaining financial accounting and performance calculations and contract and compliance monitoring.

2.3 Procedures

Selection of managers is made in accordance with the Authority's Policy on Procurement of Services.

Selection of investment managers will take into account, among other criteria specific to the role:

- best-practice portfolio management;
- the skills and experience the manager brings to the role;
- the substance and viability of the manager;
- the costs that can be expected to be incurred;
- the potential for cost savings and other efficiency gains; and
- the existence of appropriate risk management structures.

Generally, unless specific circumstances require a different approach, the selection of investment managers will be contestable and conducted through a request for proposal and interview process.

Investment mandates shall include guidelines setting out eligible investments, performance measurements, constraints and exposure limits including country and issue exposures, use of derivatives, and reporting requirements.

Managers will be regularly reviewed against the criteria above to determine their suitability for their role.

3 STATEMENT OF INVESTMENT BELIEFS

3.1 Policies

The Board believes that it is essential to have a clear set of investment beliefs to communicate its values and to provide a basis for its investment actions. Accordingly the Board has adopted the following set of Investment Beliefs.

3.2 Standards

(a) **Higher returns generally require acceptance of higher risks and diversification reduces total risk**

Investors generally demand a return premium to compensate them for investing in risky assets. Total investment risk can be reduced for any given return target by investing in a diversified range of asset classes. Risk is reduced by exposure to different sources of return that are complementary or not closely related and, within an asset class, by investing across a range of industries, countries and entities. Diversification reduces risk but has a proportionately lesser effect on returns. A portfolio that is well-diversified, both across and within asset classes, will deliver more consistent returns over time than a less diversified portfolio.

(b) **Setting a strategic asset allocation appropriate to the Fund's long term objectives is the most important investment decision as it creates the majority of the Fund's risk and return**

Setting, managing and monitoring the appropriateness of the strategic asset allocation and exposures to major market risks are the key investment management functions. Although active management may be engaged to seek additional sources of return to the underlying asset class returns, the additional impact on the risk and return characteristics of the portfolio is secondary compared to the risks and returns of the underlying markets themselves.

(c) **Markets vary in their efficiency, and market inefficiencies offer skilful managers the opportunity to add value**

The more inefficient the market, the greater the opportunities for skilful active managers to out-perform the returns from a well diversified passively held portfolio, through analysis and research and by exploiting inefficiencies. It is possible to identify skilful managers by thorough research. The higher expected returns from active management should be weighed against the higher costs and any tax implications arising from active management. Rewards from active management will be maximised by engaging skilful managers with diversified investment approaches.

(d) **Market timing is not a reliable source of return in the short term because of the unpredictability of returns over short periods, but account should be taken of unusual asset price behaviour with respect to longer term indicators of relative reward for risk**

Asset values and returns are determined largely by expectations about fundamental factors that drive future cash flows, and by the discount rates applied to those cash flows. Returns are affected in the short term as new information is incorporated into asset prices and by uncertainty, temporary influences and sentiment. These random components (sometimes referred to as 'noise') make predicting returns very difficult over short periods and hence market timing is not a reliable source of return.

Asset prices deviate significantly from normal relationships from time to time increasing the risk of abnormal future returns (i.e. asset price 'bubbles' do occur). Notwithstanding the difficulty of market timing, it is appropriate to take account of this risk in implementing major investment decisions. Over longer periods, the more stable components of return become more evident.

(e) **Investment opportunities should be considered net of all costs and taxes and having regard to their contribution to total fund risk and return**

Investment returns should be considered net of all costs and taxes. Costs can be incurred in the form of fees, commissions, transaction expenses, and the impact of transactions on market prices. Costs can also arise from deviations from the strategic asset allocation that increase risk, maintenance of the management structure and unduly constraining investment managers' ability to add value.

In addition to considering the characteristics of an investment opportunity in its own right it is important to take into account its contribution to the total risk and return of the fund. Investments, whose risks are less correlated with the fund as a whole, generally have a lower return threshold for inclusion in the portfolio.

(f) **Costs and principal-agent risks should be controlled carefully, especially where managers are engaged to add value through their skill**

Active management requires an investment in research and skill or experience and is therefore more expensive than passive management, such as index tracking. When active managers are engaged to add value through their skill it is important to ensure the additional fees and costs are reasonable. Most importantly, where fees are related to performance, the manager's interests must be aligned strongly with those of the fund in terms of returns, risks and investment horizon.

3.3 Procedures

The Investment Beliefs are reviewed formally as part of the annual statutory review of the SIPSP and updated at other times as determined by the Board.

4 ASSET CLASSES AND SELECTION CRITERIA

Required under section 15M (a) – The classes of investments in which the Fund is to be invested and the selection criteria for investments within those classes.

4.1 Introduction

Investments can be divided into broad asset classes that share common return and risk characteristics. Each asset class differs materially from the others in its characteristics. These differences and the interaction among asset classes, when combined in a total portfolio, provide diversification that improves the total expected return available for any given level of risk.

4.2 Policies

The asset classes in which the Fund may invest are:

(a) **Equities** comprising equity securities and securities convertible into equities and includes partly paid ordinary and preference shares. The asset class includes large, mid and small capitalisation equities, emerging market and unlisted equity investments.

(b) **Real Estate** comprising land and premises built on land and holdings in entities that invest principally in land and premises.

(c) **Fixed Interest** comprising securities issued by sovereign and non-sovereign issuers and investments in various sub-sectors such as mortgage-backed and asset-backed securities and inflation linked bonds or products. The asset class includes government guaranteed debt securities (or guaranteed by an agency thereof) and non-sovereign debt, including deposits debentures, bonds, notes, promissory notes and other securities not convertible into equity at the issuers option.

(d) **Cash and short term securities** comprising New Zealand and foreign currency cash holdings, as specifically provided for in the relevant investment management. agreements for liquidity purposes or held as collateral against derivative transactions.

(e) **Commodities** comprising tangible products, such as metals, energy and agricultural products.

The Fund may invest in these asset classes through direct ownership of the assets or through investing in collective investment vehicles that hold the assets or through derivative securities, such as futures, forward contracts and options.

The Fund's investments may be traded on recognised public exchanges (**public markets**) or may be traded on **private markets**.

Private market assets and securities are generally less liquid than their public market counterparts. They include collective investment vehicles that hold eligible assets and securities, such as unit trusts, hedge funds and fund-of-funds that engage in active strategies trading among various asset classes and securities. Private market assets are generally valued by appraisal.

The selection of individual investments within the various asset classes is delegated by the Authority to professional investment managers selected for their expertise in particular investment disciplines. Each manager is mandated contractually to invest in a defined range of eligible investments which may cover one or more of the asset classes above and is subject to defined limits of investment risk.

5 THE BALANCE BETWEEN RISK AND RETURN

Required under section 15M (e) of the GSF Act – The balance between risk and return in the overall Fund portfolio.

5.1 Policies

(a) **Investment Objective**

The Authority's investment objective is to minimise the Crown's contribution to GSF by maximising the return on the assets of the Fund over the long term without undue risk to the Fund as a whole, within a best practice framework.

In seeking to achieve this objective over the long term, the Authority determines a level of investment risk the Fund can accept that is consistent with an expected excess return over New Zealand Government Stock (**NZGS**). The Risk Parameter defines this level of risk and the Investment Performance Measure is the expected return.

(b) **Risk Parameter**

The current Risk Parameter, adopted in May 2007 and confirmed in June 2008, is to have no more than a one in ten chance in any one year of a loss after tax greater than 6% of the total Fund.

(c) **Investment Performance Measure (IPM)**

The Authority considers that the Risk Parameter is consistent with an expected after tax return equivalent to the NZX New Zealand Government Stock Gross Return Index (after tax), plus 2.5% per annum, measured over rolling 10 year periods.

5.2 Standards

(a) **Strategic asset allocations (SAA) and rebalancing ranges**

The investment performance of the Fund will be determined largely by the allocation among asset classes in which the Fund invests. The SAA is selected by the Authority to maximise the likelihood of achieving the investment objective, limited by the Risk Parameter and the IPM.

The current allocation to each asset class or strategy and the rebalancing ranges is set out in Table 1 on the next page.

The ranges indicate the percentage the capital allocation is permitted to deviate from the SAA before rebalancing trades are required.

Table 1: Strategic Asset Allocation (SAA) and Rebalancing Ranges

Asset Class/Strategy	SAA (%)	Rebalancing Ranges (%)
Global equities	49.5	42 to 57
New Zealand equities	10	7 to 13
Property	8	4 to 12
Total growth assets	**67.5**	**60 to 75[1]**
Fixed interest	24	18 to 30
Commodities	3	0 to 6
Absolute return strategies	5.5	0 to 11
Total assets	**100**	
Foreign Exchange Exposure	20	16 to 24

[1]The rebalancing ranges for individual asset classes are subject to the total growth assets range.

(b) **Foreign exchange exposure and hedging policies**

The Authority's overall objective is to have an exposure to foreign currencies of 20% of the total Fund. To achieve that objective the Authority hedges its foreign currency exposures from the Fund's asset classes as set out in Table 2 below.

Table 2: Hedging Strategies

Asset Class	Pre tax (Post tax) Strategic Hedging Ratio	Range (Pre tax)
Global equities	103% (72%)	93% to 113%
Real estate	143% (100%)	138% to 148%
Fixed Interest	100% (100%)	90% to 110%
Commodities	143% (100%)	138% to 148%
Absolute return strategies	143% (100%)	138% to 148%

5.3 Procedures

(a) **Review of Objectives and SAA**

The IPM and the Risk Parameter are reviewed at least annually, taking into account the investment and taxation environment in which the Authority operates. The trade-off between risk and return is reviewed based on analysis of the prospective risk and return characteristics of each asset class in which the Fund might invest and their combinations.

(b) **Rebalancing**

Rebalancing takes place monthly to ensure the Fund remains aligned with SAA taking into account known cash flows for the following month. The asset exposure ranges are set as a trade-off between the costs of being exactly at the SAA with variations in exposures that do not compromise the Fund's investment objectives. Rebalancing takes into account private market investments that are relatively illiquid, such as equity interests in collective investment vehicles that are not traded and have contractual restrictions on redemptions.

(c) **Implementation**

Implementation strategies for significant asset allocation changes or the addition of new asset classes may include a staged entry or exit programmes to achieve investing and disinvesting goals.

6 BENCHMARKS

Required under section 15M (b) – Determination of benchmarks or standards against which the performance of the fund as a whole, classes of investment, and individual investments will be assessed.

6.1 Policies

The benchmark for the Fund as a whole (and for individual asset classes) is selected to be consistent with the risk and return assumptions that underpinned determination of the strategic asset allocation for the Fund. The Fund's performance is assessed by comparing its investment return with the IPM, Risk Parameter and individual asset class or strategy benchmarks (see sections 5.1 and 5.2).

6.2 Standards

(a) **Investment Objective**

The Authority's investment objective is to minimise the Crown's contribution to GSF by maximising the return on the assets of the Fund over the long term without undue risk to the Fund as a whole, within a best practice framework.

(b) **Investment Performance Measure (IPM)**

The IPM is an expected after tax return equivalent to the NZX New Zealand Government Stock Gross Return Index (after tax), plus 2.5% per annum, measured over rolling 10 year periods.

(c) **Risk Parameter**

The current Risk Parameter, adopted in May 2007 and confirmed in June 2008, is to have no more than a one in ten chance in any one year of a loss after tax greater than 6% of the total Fund.

(d) **Multi-asset Class**

The Fund has an investment with a multi-asset class manager who manages a diversified range of both public markets' and private markets' assets including global equities, fixed interest, property and private equity, and absolute return strategies The asset allocation for reporting and monitoring purposes is set out in Table 3 on the next page. For the strategic asset allocation set out in Table 1 on page 9 the economic exposures of the multi-asset class are re-allocated amongst the Fund's asset classes according to the multi-asset manager's long-term asset allocation targets.

Table 3: Fund Asset Allocation with Multi-asset Manager

Asset Class/Strategy	Allocation (%)
Global equities	47
New Zealand equities	10
Property	7
Fixed Interest	23
Commodities	3
Absolute return strategies	3
Multi-asset	7
Total Assets	**100**
Foreign currency exposure[1]	20

[1]The foreign currency exposure arising from the multi-asset class manager's investments is not hedged, rather the hedge ratio for global equities is adjusted so give the required Fund foreign currency exposure.

(e) **Asset Class and Strategy Benchmarks**

For the purposes of assessing asset class or strategy performance, the benchmarks set out in Table 4 below are adopted.

Table 4: Asset Class and Strategy Benchmarks

Asset Class/Strategy	Benchmark
Global equities	MSCI All Countries Index
New Zealand equities credits	NZX 50 gross index including imputation
Global listed real estate Return – collective portfolio	UBS Warburg Global Real Estate Total Investors Only Index
US unlisted real estate	NCREIF Property Index
International fixed interest	Barclays Global Aggregate Index
Commodities expressed (Collateralised Commodities Futures)	Dow Jones – AIG Commodity Index in US dollars
Absolute return strategies (that are not part of the Multi-asset class manager's portfolio)	US 3 month Libor + 6%
Multi-asset Class	70% MSCI World Index and 30% Barclays Global Aggregate Index

Generally, managers within an asset class have the same benchmark as the asset class. Managers may have specific benchmarks depending on their specific mandates, for example in the case of global equities the MSCI All Country World Index, the MSCI World Index, the MSCI Emerging Markets Index and the Standard and Poors ex-Australia Developed Markets Small Cap Index are used.

6.3 Procedures

(a) Any investment returns above the return for NZGS will reduce the Crown's contribution to the Fund (NZGS is a proxy for the rate at which the Crown could otherwise borrow money to pay entitlements). Performance against the Investment Objective can be measured by comparing the after tax return of the Fund with the after tax return from investing in NZGS over the same period.

(b) The Fund's performance is assessed by comparing its investment return with the IPM over rolling 10 year periods. The Authority recognises that, from year to year, investment returns may not meet the IPM.

The Board also monitors the performance of the Fund's SAA relative to the Risk Parameter and IPM and the performance of the Fund relative to its SAA. The first measure gauges the appropriateness of the SAA while the second measure gauges the effectiveness of implementation, primarily selection of active managers or strategies.

(c) The performance against the Risk Parameter is monitored by comparing the variance of the Fund's actual return with the variance consistent with a loss of 6% occurring not more than one year in ten.

(d) The performance of asset classes or strategies is assessed by comparing the actual performance of the investment managers with the benchmarks relevant to their respective mandates, plus any excess return target expected for active managers. Investment managers' performances are generally considered over periods not less than three years.

Investment performance is generally measured:

- Before and after the deduction of any fees due to the investment managers; and
- After transaction costs have been deducted (but before custodian costs are deducted).

Investment managers are evaluated **after** taking into account their investment management fees and the degree of risk incurred to achieve expected return targets. Investment managers are also compared to other managers in the same asset class or strategy.

7 STANDARDS FOR REPORTING

Required under section 15M (c) - standards for reporting the investment performance of the Fund.

7.1 Policies

A comprehensive and timely reporting framework enables the Board to analyse the performance of the Fund, asset classes and investment managers.

7.2 Standards

(a) **Reporting by the custodian to the Board**

For the Fund's investments as a whole and for each investment manager, the custodian provides the reports required by the Authority to enable monitoring and review of the Fund and managers' performance. Those reports include:

- the overdraft position of each portfolio;
- accounting matters including portfolio valuation;
- reconciliation of portfolio values and cash flows with the investment managers;
- investment performance measurement and comparisons with benchmarks;
- taxation matters; and
- reports of compliance with mandate specific restrictions on separately managed portfolios.

(b) **Reporting by investment managers**

Reports from investment managers each month may cover (where applicable):

- details of securities held;
- a review of the performance and an analysis of performance factors;
- investment philosophy and strategy;
- certification that the terms of the investment contract have been met including certification that the portfolio has not been leveraged;
- reconciliation of portfolio accounts with the custodian;
- a statement of any voting rights issues;
- annual external audit report; and
- compliance with responsible investment policies.

The Board reviews the managers' investment performance quarterly and investment managers are required to meet with Management, on behalf of the Authority, on at least an annual basis.

(c) **Reporting by Management to the Board**

Management reports investment performance quarterly to the Board including aggregate returns and returns analysed by asset class and by manager. In each case actual returns are compared to benchmarks, expected risk measures, any active return targets and, in appropriate cases, peer returns. Summary reports are provided monthly of aggregate and asset class returns. Management also reports on responsible investment developments.

Management liaises regularly with the Treasury which represents the Minster of Finance.

(d) **Public Reporting**

The Fund's investment performance is reported quarterly on the Authority's website *www.gsfa.govt.nz* and published each year in the Fund's Annual Report, which is tabled in the House of Representatives. Forecasts for investment performance are published each year in the Authority's Statement of Intent.

The Treasury also reports to the Minister quarterly, following consultation with the Authority, on the Fund's investment performance and on key operational issues.

7.3 Procedures

The investment management agreements contain reporting provisions to enable the Board to determine a manager's compliance with the agreement and mandate, and success in meeting investment targets set for the manager. Similarly, the reporting functions provided by the custodian, including standards for timeliness, are described in the custodian contract.

8 RESPONSIBLE INVESTMENT

Required under section 15M (d) – Ethical Investment, including policies, standards, or procedures for avoiding prejudice to New Zealand's reputation as a responsible member of the world community and 15M (i) – the retention, exercise or delegation of voting rights acquired through investments.

8.1 Responsible Investment Policies, Standards and Procedures (RI Policies)

The Authority has developed RI Policies for:

(a) ethical investment, including avoiding prejudice to New Zealand's reputation as a responsible member of the world community;

(b) environmental, social, and governance considerations; and

(c) the retention, exercise, or delegation of voting rights acquired through investments.

The Authority may take other factors into account in its investment processes, provided they do not conflict with its responsibilities under the GSF Act and can be implemented in a practicable and cost effective way. The Authority takes a broad range of other factors into account in its investment processes including:

- information or advice that a corporate entity or country, on the basis of credible evidence from publicly available sources, has participated in serious infringements of relevant international standards relating to human rights, labour and employment, the environment or international security and disarmament;
- any action by the corporate entity or country which is of such a nature that the Board considers that ongoing investment may give rise to a risk of prejudice to New Zealand's reputation as a responsible member of the world community; and
- information and advice obtained by the Authority that the entity is subject to economic or other sanctions that New Zealand applies.

The Authority's RI Policies are regularly reviewed by the Board.

8.2 Procedures

The Board is accountable for, and maintains oversight of, the Authority's RI Policies. The Board has established the Responsible Investing Committee to oversee the development of the RI Policies, monitor their implementation, and make recommendations to the Board, as required.

The Authority has signed a collaborative agreement with the Guardians of New Zealand Superannuation (**GNZS**), the Accident Compensation Commission and the Earthquake Commission as all parties have similar RI obligations and all are signatories to the United Nations Principles for Responsible Investment. The purpose of the agreement is to minimise costs and duplication of research effort for all parties.

The Board has delegated the implementation of the RI Policies to the General Manager - Investments, the Chief Executive and the Board's Responsible Investing Committee depending on the level of action required.

A copy of the Authority's **RI Policies** and the delegated authorities for their implementation can be found on the website *www.gsfa.govt.nz*

9 RISK MANAGEMENT

Required under section 15M (h) – The management of credit, liquidity, operational, currency, market, and other financial risk.

9.1 Policies

The Authority has developed comprehensive risk management policies for the management of various investment, operational and financial risks. The Audit and Risk Review Committee assists the Board in fulfilling its responsibilities with respect to internal controls, accounting policies, financial statements approval and risk management. Risk management is further supported by the Corporate Governance Statement, acceptable conduct policies for Board members and Management, Board expenditure policies and procedures, defined roles and responsibilities, performance accountability processes and timely disclosure and communication.

The level of investment risk in the Fund is defined by the Risk Parameter and the Authority's risk management procedures described in section 9.3. A description of the major risk categories are set out below.

9.2 Standards

(a) **Market risk**

Market risk is the risk of adverse movements in investment markets (including asset prices, volatility, changes in the yield curve or other market related variables) that affect the value or income of the portfolio. Market risk is outside the control of the Authority. The volatility of investment markets means that the return from the Fund is inherently uncertain. Actual returns from each asset class may vary significantly each year from the mean returns assumed in determining the investment strategy appropriate to the long term.

Major structural changes to investment markets and/or taxation environment are not within the control of the Authority. However, the Authority takes into account changes in these risks in its reviews of the SAA and investment strategy.

(b) **Borrowing or leverage risk**

The Fund is not permitted to borrow money or charge any of the property of the Fund, directly or through financial instruments, without the Minister of Finance's consent. The Authority has sought and obtained the Minister's consent to enter into financial instruments, where the use of those is consistent with the Authority's SIPSP. The Authority has also obtained the Minister's consent to enter into temporary overdrafts with its banks.

Collective investment vehicles

The Fund may own equity securities or invest in collective investment vehicles that borrow or grant charges on their own assets provided that owning these equity securities does not cause undue risk to the Fund as a whole, as expressed in the Risk Parameter. Particular investments or strategies within collective investment vehicles may be leveraged or include leverage or be invested 'short'. (Short positions arise when securities are sold while not yet owned, in anticipation of being bought after the price falls. Short positions may be created physically by borrowing the securities and selling them or through derivative contracts.)

Derivatives held directly by the Fund

To avoid undue risk to the Fund as a whole, derivative positions held directly by the Fund are required to be collateralised. In general this means the Fund must hold sufficient cash or securities corresponding to the derivatives to be able to meet any obligations arising from closing out the derivative transaction at current market prices.

(c) **Manager risk**

The Authority retains professional managers to implement its investment strategy and, in many cases, deliver superior returns through skilled active management. Managers' returns may vary from expected levels.

(d) **Credit risk**

Credit (or counterparty risk) is the risk of default by a counterparty to a particular transaction or an issuer of a security held in the portfolio.

(e) **Liquidity risk**

Liquidity risk is the risk that a security cannot be sold when required or that the price achieved is significantly different from the quoted price.

(f) **Operational risk**

Operational risk is the risk of financial loss due to mismanagement, error, fraud or unauthorised transactions.

(g) **Currency risk**

Currency risk is the risk that the foreign currency denominated assets will lose value due to the effect of an adverse exchange rate movement.

9.3 Procedures

(a) **Market risk** is managed by:

- specifying the total risk budget of the Fund and its various major exposures consistent with the Risk Parameter and best practice assumptions in relation to exposure risks and correlations among them;
- diversifying the asset classes in which the Fund invests by adopting the SAA described in section 5 and a range of investment management techniques for the Fund;
- seeking professional advice on the investment strategy and SAA;
- carrying out peer reviews of advice, and consulting with other Crown Financial Institutions and large investment funds;
- requiring investment managers to manage their portfolios within defined market exposure limits for each asset class held; and
- setting limits to which managers are required contractually to manage their portfolios which may include:
  - limits on the expected volatility of their total portfolio or their portfolio relative to the benchmark;
  - limits on exposure to any single issuer of securities;
  - limits on particular exposures in the manager's benchmark; and exposures not represented in the benchmark.

(b) **Borrowing or leverage risk** is managed by:

- requiring any derivative transactions held directly by the Fund to be adequately collateralised with cash or corresponding securities, valued at current market prices;

- entering into commercial arrangements for any charges against the Fund in accordance with industry best practice, such as the use of agreed counterparty settlement limits and temporary overdrafts for forward currency con-tracts, swaps and other contracts for difference;
- requiring settlement of amounts outstanding from any derivative transactions due to short term price fluctuations that exceed levels agreed in advance with counterparties;
- the Authority satisfying itself that potential managers (including managers of collective investment vehicles) have adequate policies and procedures relating to derivative counterparties and, if selected, monitoring that managers adhere to their policies; and
- using appropriate industry standard documentation.

(c) **Manager risk** is managed by:

- robust selection process for investment managers based on demonstrated ability and independent expert opinion;
- diversification among managers;
- setting mandates for active managers based on best practice portfolio management that prescribe acceptable risk limits;
- regular assessment and review of manager performance against the benchmark and peers; and
- putting in place management agreements or other satisfactory contractual terms that separate Fund assets from managers and protect against manager errors, omissions and wrongful actions.

(d) **Credit risk** is managed by requiring that managers of the Fund's credit investments:

- maintain the credit quality of their portfolios within agreed contractual guidelines and specified according to approved independent credit ratings;
- limit exposure to individual issuers to prescribed limits; and
- maintain appropriate policies and procedures relating to derivative counterparty selection and management and appropriate industry standard documentation.

(e) **Liquidity risk** is controlled by implementing the Fund's SAA and rebalancing procedures described in section 4. In addition, liquidity risk is managed by:

- requiring, except as specifically authorised by the Board, managers to invest only in securities listed on recognised exchanges;
- limiting investment in securities that are not traded on recognised markets as authorised by the Board;
- requiring managers, within the terms of their individual investment management agreements, to hold diversified portfolios; and
- limiting the credit rating of the fixed interest and cash investments to approved levels.

(f) **Operational risk** is managed by:

- engaging an independent global custodian to record transactions, report on performance and monitor compliance of investment managers with mandates;
- having in place a specific mandate for each investment manager, based on best practice portfolio management;
- clear separation of functions between investment management, custody, and overall supervision;

- ensuring the Management team has sufficient resources to conduct the oversight function as part of its overall responsibilities; and
- requiring investment managers and the custodian to:
  - provide the Authority with third party covenants or assurances against operational risk events
  - have in place insurance arrangements to cover claims in those events
  - have in place and regularly confirm the existence and efficiency of internal policies and controls to address those risks
  - provide compliance reporting, and
  - reconcile the Fund's recorded positions regularly.

(g) **Currency risk** is managed by:

- maintaining a foreign currency hedging policy for the Fund and individual asset classes;
- engaging currency managers to manage the various hedging programmes;
- specifying the bounds within which investment managers may take on currency exposures relative to their benchmark; and
- specifying the instruments that managers may use and the credit worthiness of the counterparties in the investment management agreement with each manager.

10 THE USE OF DERIVATIVES

Required under section 15M (g) – The use of options, futures and other derivative financial Instruments.

10.1 Introduction

Derivatives are financial instruments whose value and characteristics are derived from underlying assets, indices or reference rates. Derivatives cover a broad range of financial instruments and include futures contracts, forward currency contracts, swaps, forward interest rate contracts, options and credit default swaps.

There is a variety of purposes for which it may be appropriate for the Fund to use derivatives. These include risk management, value adding investment strategies and transactional efficiency.

Derivatives provide another means for an investment manager to obtain market exposures and can be more liquid than the assets from which their value is derived.

10.2 Policies

Derivatives may be entered into by the Authority or its managers and custodians on behalf of the Fund. Their use must be entered into as specified in each investment management agreement, or where consistent with the terms governing collective investment vehicles.

Section 15C of the Act requires the consent of the Minister of Finance to enter into derivative transactions. Accordingly the Authority has sought and obtained the Minister's approval to use derivatives subject to certain conditions.

The use of derivatives is permitted only where it results in market exposures appropriate to the Fund as a whole; the resulting counterparty exposures are adequately controlled and the Fund can meet any liquidity requirements arising from their use.

Derivatives, relating to foreign exchange, may be used for the purposes of managing and hedging currency exposures held within the Fund and for the purposes of purchasing or selling foreign currencies required for the settlement of foreign exchange transactions.

10.3 Standards

Derivative instruments may be traded on recognised exchanges or issued by a counterparty over-the-counter. Each such counterparty must meet the Fund's general requirements in terms of credit rating and contractual arrangements.

The net exposure to foreign currencies (after taking into account hedging positions) in the relevant portfolios is to be in accordance with the Authority's hedging policy for the asset class. If required, appropriate parameters for hedging using proxy currency will be established with the currency managers as well as appropriate operational ranges.

The effective exposures to underlying securities or assets arising from any derivatives are taken into account for the purposes of determining compliance with the prescribed exposure limits of portfolios.

10.4 Procedures

All investment managers are required to provide the Authority with a copy of their policies relating to derivative securities trading and counterparty risk and to manage their derivative exposures in accordance with those policies. The Authority recognises that, where it invests in collective investment vehicles offered by investment managers, those vehicles may be investing in derivatives and takes that into account in determining the appropriate level of investment for the Fund.

The risk of derivatives is measured by their effective exposure to underlying assets as well as on a stand alone basis. The value of derivatives is measured according to generally accepted industry best practice.

Over-the-counter foreign exchange hedging derivative contracts may be entered into only with counterparties that have credit ratings approved by the Board and measured by a recognised rating agency for counterparty risk and domiciled in New Zealand, or in countries with which New Zealand has a double tax treaty.

The currency exposure associated with international investing will be managed using forward foreign exchange contracts relating to the currencies in which the securities that comprise the portfolio are denominated, or their close proxies.

Derivative policies and practices, including foreign exchange hedging are in accordance with any selected manager's derivatives policies, set out in their offer documents, or as otherwise specified in an investment management agreement. Selected managers are required to maintain policies and procedures relating to derivative counterparty selection and management accordingly and use appropriate industry standard documentation.

11 INVESTMENT CONSTRAINTS

Required under section 15M (k) – Prohibited or restricted investments or any investment constraints or limits.

11.1 Policies

Prohibitions and constraints imposed by the Authority can be categorised as follows:

(a) asset classes or strategies which do not form part of the asset allocation;

(b) investments excluded under the Authority's RI Policies;

(c) investments outside the permitted investments of any investment mandate, or not included in the offer document of a collective investment; and

(d) exposures outside the rebalancing range for each investment class (to ensure the investment objective of the Fund is not compromised by excessive deviation from the Fund's SAA).

In addition, the Authority is precluded from controlling any other entity or from holding such a percentage of the voting rights of another entity that would require it to seek control of that entity. See section 15K of the GSF Act.

11.2 Standards

The Authority has developed constraints and limits in respect of each asset class or strategy to control risks. Each investment management agreement specifies those investments that constitute authorised investments and managers may not invest other than in those permitted investments.

Limits on the maximum holding that can be held in each issuer address section 15K of the GSF Act and rebalancing ranges for each asset class or strategy are recorded in Section 5.2

11.3 Procedures

Specific written authorisation from the Authority is required to invest outside of the prescribed permitted investments. The Board will consider such investments as they arise on application from the investment manager.

Procedures for rebalancing are set out in section Table 1, page 9.

12 VALUATION

Required under section 15M (j) – The method of, and basis for, valuation of investments that are not regularly traded at a public exchange.

12.1 Policies

Many of the investments of the Fund are securities regularly traded on recognised exchanges and are valued independently and reported publicly. These investments are valued at current market value by the independent custodian in accordance with accepted industry best practice.

Where investments are not traded on recognised exchanges but can be independently priced by the custodian, the Authority, in conjunction with the custodian, determines fair valuation on these investments through an objective or independent process where possible. Examples of investments that are not traded on recognised exchanges but that can be independently priced are: some collective investment vehicles, some non-sovereign bonds and over-the-counter derivative transactions.

Where a valuation discrepancy arises between an investment manager and the custodian, the Authority generally accepts the custodian's valuation.

For private market investments, that are not able to be independently priced by the custodian, the Authority relies on the valuation undertaken by the investment manager. In these cases the valuation is required to have been undertaken by a reputable, suitably qualified professional valuer who is independent of the investment manager.

12.2 Standards

In the case of listed assets, fair value is determined by reference to prices traded on recognised exchanges. For unlisted securities, where quoted market prices are not available, fair value will be determined on the basis of independent valuation. Investments in collective investment vehicles will be subject to external valuation processes and valued according to accepted market practice. In the case of over-the-counter derivatives, the mark-to-market method for determining the value is independently verified.

12.3 Procedures

Wherever possible, independent pricing measured at subsequent reporting dates will form the basis of the Board's fair value estimate, using the Standards in 12.2. In cases where an independent valuation is unable to be obtained, the Authority uses the closing price released by the relevant investment manager. Investments in collective investment vehicles, where underlying assets are not publicly traded, are subject to the Board being satisfied that there are adequate and timely independent valuations and audit procedures to validate underlying valuations.

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