

Statement of Investment Policies, Standards and Procedures

at 6 August 2014



**GOVERNMENT
SUPERANNUATION FUND
AUTHORITY**

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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 (**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 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 is its **Corporate Governance Statement**, incorporating the requirements set out in the Act, the Crown Entities Act, 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 to perform and exercise the functions and powers of the Board delegated to the committee. The committee has written terms of reference and ensures that its activities remain consistent with the Crown Entities Act. The committee review its performance annually and is also reviewed by the Board.

The Board is supported by a Management team (employed by Annuitas Management Limited (**Annuitas**) - see below) 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 until 30 September 2011 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.govt.nz

The Authority and the Board of Trustees of the National Provident Fund (**NPF**) have formed a joint venture company, 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 are regularly reviewed against the criteria above to determine their ongoing suitability for their role.

3 *Statement of Investment Beliefs*

3.1 **Policies**

The Authority has established a set of Investment Beliefs to provide a robust foundation for its investment strategy and to communicate shared values about investment. These Beliefs comprise the Authority's views about the sources of investment risk and return and how these can be captured cost effectively. They are reviewed annually.

3.2 **Standards**

- a) Because the Crown guarantees the Schemes' pension obligations and meets the major share of them, the Fund can adopt a higher risk profile than otherwise to improve returns and the Crown's economic position.
- b) The Fund expects to earn higher returns for investing in markets or assets with higher risks of loss.
- c) The aggregate degree of exposure to higher risk sources of return is the most important investment decision as it creates the majority of the Fund's additional risk and return.
- d) Diversification among various uncorrelated return sources improves the Fund's reward-to-risk ratio. Conversely, concentration of risk requires sufficient additional return to compensate.
- e) Although closed to new investors, the Fund's long horizon means it can afford to invest in some illiquid assets when the expected return is attractive.
- f) A large proportion of most return sources can be captured by investing passively in low-cost, market-representative baskets of securities.
- g) Some investment markets are more efficient than others and their relative efficiency varies over time and it is possible to exploit this using skilled managers.
- h) Moderate market timing is appropriate because risk premia vary over time and there is some evidence they are mean-reverting.
- i) Investment opportunities should be considered net of all costs and taxes and having regard to their contribution to total fund risk and return.
- j) Costs and principal-agent risks should be controlled carefully, especially where managers are engaged to add value through their skill.
- k) Responsible Investment encompasses not only maximising return for risk, but also broadly accepted global standards of ethical conduct in relation to business governance, environmental and social risks.



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. The Fund may also lend its equities securities with the intention of earning extra return.
- b) Property 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.
- f) Insurance-linked assets, including securities providing exposure to natural catastrophe risks and longevity risks.

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, options and swaps.

The Fund's investments may be traded on recognised public exchanges, 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

Investment Objective

Maximise the Fund's excess return relative to New Zealand Government Stock (before New Zealand tax) with a one in four chance of under-performing New Zealand Government Stock by 10% cumulatively measured over rolling ten year periods.

Under current assumptions, the expected excess return of the Reference Portfolio over the next 10 years is 2.5% per annum. The Board will monitor investment performance against that expected excess return as well as against the Reference Portfolio.

5.2 Standards

a) Reference Portfolio

The Board has adopted a Reference Portfolio for accountability and performance measurement purposes. The Reference Portfolio is a simple portfolio that could be managed at low-cost and meet the Fund's return and risk objectives. The Reference Portfolio also provides a benchmark to measure the Authority's performance in generating value-added returns. The Board reviews the composition of Reference Portfolio at least every three years.

With effect from 1 July 2014, the Reference Portfolio will comprise:

Table 1: Reference Portfolio and Benchmarks

Asset Class	Weight (%)	Benchmark
International equities	60	MSCI All Country World Index
New Zealand equities	10	NZX50 Gross Index including imputation credits
Fixed interest	30	Barclays Capital Global Aggregate Index
Total Assets	100	
Foreign currency exposure (after-tax)	20	

b) Target Portfolio

The Authority seeks to out-perform the Reference Portfolio on a net of fees basis in two main ways:

- By taking on exposure to sources of return that are considered to be systematic, are rewarded for bearing risk of loss and are not represented in the Reference Portfolio. These 'better beta' sources of return include property, private equity and insurance-linked risks for example; and
- By capturing returns, attributable to manager skill rather than systematic risk bearing, ie, 'alpha'. Alpha does not add materially to systematic risk.

The Authority manages the Fund to a Target Portfolio that incorporates better beta and alpha strategies and is expected to be a more efficient portfolio than the Reference Portfolio, ie, improve



risk-adjusted returns after fees and tax. The Target Portfolio is also expected to deliver the Fund's Investment Objective.

The current Target Portfolio is set out in Table 2.

Table 2: Target Portfolio Allocation

Asset Class/Strategy	Target Allocation (%)
International equities	54.7
New Zealand equities	9.3
Fixed interest	16.3
Global tactical asset allocation	3.0
Multi-asset class	7.0
Natural catastrophe risks	6.0
Longevity risks	3.7
Total Assets	100.0
Foreign currency exposure (after-tax)	20.0

The actual weightings of the asset classes/strategies are based on the valuations of those assets/strategies determined using the policies, standards and procedures set out in Section 12.

c) Rebalancing and Reset Ranges

Rebalancing ranges define the extent to which the capital allocation to an asset class is permitted to deviate from the target allocation (set out in Table 2) before rebalancing trades are required.

Reset ranges show the extent to which an asset class is rebalanced having breached the rebalancing ranges.

Some asset classes (for example, the multi-asset class) or components of asset classes (eg, private equity within New Zealand equities and private property within property) are not able to be readily traded. Those assets are not subject to formal rebalancing ranges but are monitored to ensure the exposure does not become unacceptable.

The rebalancing and reset ranges are shown in Table 3.

Table 3: Rebalancing and Reset Ranges

Asset Class	Rebalancing Range (%)	Reset Range (%)
International equities	49.7 to 59.7	52.7 to 56.7
New Zealand equities	7.3 to 11.3	8.3 to 10.3
Fixed Interest	12.3 to 20.3	14.3 to 18.3

d) Foreign exchange exposure and hedging policies

The Authority addresses its foreign currency exposures in a total portfolio context. The Authority's overall objective is to have an after-tax exposure to foreign currencies of 20% of the total Fund.

The hedge ratio for International equities is varied to deliver the desired total Fund foreign currency exposure and takes into account any foreign currency tilting as discussed further below in Section 5.3 (d). Before tax hedge ratios depend on the tax treatment of the currency hedge and is determined by the tax treatment of the underlying assets, which may be on a comparative value or fair dividend rate basis.

5.3 Procedures

a) Review of Investment Objective and Reference Portfolio

The Reference Portfolio is reviewed at least every three years taking into account the investment 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 the Target Portfolio taking into account known cash flows for the following month. The rebalancing ranges are set as a trade-off between the costs of being exactly at the Target Portfolio against the risk that variations in exposures will compromise the Fund's investment objectives. Rebalancing takes into account 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.

d) Foreign Currency Tilting Strategy

The Authority adjusts the Fund's foreign currency exposure periodically in accordance with its Foreign Currency Tilting Strategy. This Strategy moves the Fund's foreign exchange exposure according to defined tilting rules that reflect the prevailing valuation of the NZD. The Strategy is implemented by adjusting the before-tax hedge ratio on the International equities' portfolio so that the total Fund foreign currency exposure is at the required after tax level.



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 Reference Portfolio and Target Portfolio for the Fund. The Fund's performance is assessed by comparing its before New Zealand tax investment return with its expected excess return compared to New Zealand Government Stock. The performance of individual asset classes or strategies is assessed by comparing their pre-tax performance with their respective benchmarks (see sections 5.1 and 5.2).

6.2 Standards

a) Actual Portfolio

Under current assumptions, the expected excess return of the Reference Portfolio over the next 10 years is 2.5% per annum. The investment performance of the actual portfolio is monitored relative to that expected excess return as well as against the Reference Portfolio.

b) Asset Class and Strategy Benchmarks

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

Table 4: Asset Class and Strategy Benchmarks

Asset Class/Strategy	Benchmark
International equities	MSCI All Countries World Index
New Zealand equities	NZX50 Gross Index including imputation credits
Global listed property - collective portfolio	FTSE EPRA / NAREIT Global Property Index
US unlisted property	NCREIF Property Index
Fixed interest	Barclays Global Aggregate Index
Commodities (Collateralised commodities futures)	Dow Jones UBS Total Return Commodity Index
Global tactical asset allocation	US 3 month Libor + 6%
Multi-asset class ¹	Reference Portfolio (unhedged)
Natural catastrophe risks	Swiss Reinsurance Catastrophe Bond Total Return Index

¹ A single portfolio comprising a diversified range of both public markets' and private markets' assets including global equities, fixed interest, property and private equity, and absolute return strategies.

No benchmark is specified for the longevity risk (life settlements) investments because these are long term, idiosyncratic investments for which there is no reliable benchmark.

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 International equities the MSCI All Country World Index Investible Markets Index, MSCI ACWI, the MSCI World Index and the MSCI Emerging Markets Index are used.

6.3 Procedures

- a) The Fund's performance is assessed by comparing its return before New Zealand taxes with the New Zealand Government Stock index return. Under current assumptions that excess return is expected to be 2.5%pa, over a ten year horizon. The Authority recognises that, from year to year, investment returns may not meet that expected excess return.
- b) The Board monitors the before-tax after-fees return of:
 - (1) The Fund's actual portfolio relative to the Reference Portfolio;
 - (2) the Fund's Target Portfolio relative to the Reference Portfolio; and
 - (3) the Fund's actual portfolio relative to the Target Portfolio.
- c) 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, for each asset class and for each investment manager, the custodian provides the reports required by the Board 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 on 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 Minister 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. A forecast for investment performance is 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 service level agreement.



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 Policies

As noted in the Authority’s Investment Beliefs (section 3.2) Responsible Investment encompasses more than maximising return for risk.

The Authority’s RI Policies encompass:

- a) 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.

Where an investment is found to contravene the Authority’s RI Policies, the Board may engage with the issuer, exercise its voting discretion, or exclude or divest it from the Fund. Exclusion or divestment decisions may be reversed where subsequent advice indicates that the investment complies with the RI Policies.

In addition to the application of its RI Policies to the investments held in the Fund, the Authority:

- encourages the adoption of good corporate governance practices, including exercising voting entitlements consistent with maximising shareholder value and RI policies where possible;
- encourages investment managers to consider its RI policies and to integrate environmental, social and governance (**ESG**) factors into their investment analysis and/or engage with corporate entities as part of their investment process, where it improves investment performance; and
- works with similar investors to enhance the effectiveness of its RI policies, which may include supporting collaborative initiatives.

8.2 Standards

Standards encompass direct investment in corporate securities (equity and debt), public debt and collective investment vehicles (**CIVs**).

The Authority excludes from the Fund direct interests in companies that are involved in the:

- manufacture of cluster munitions
- testing of nuclear explosive devices
- manufacture of anti-personnel mines
- manufacture of tobacco; and
- processing of whale meat.

These activities either contravene New Zealand law or international agreements to which New Zealand is a signatory or are clearly inconsistent with Government policy.

The Authority may also engage with or exclude investment in entities believed, on the basis of credible evidence from publicly available sources, to have participated in serious infringements of relevant international standards relating to human rights, labour and employment, severe environmental damage, bribery and corruption or infringements of international security and disarmament accords.

The Authority may also exclude companies for severe breaches of the Fund's RI standards where engagement was unlikely to be effective due to the context of the company's operations or to a lack of responsiveness from the company to the issue.

Investment in CIVs may be a practicable and cost effective way of achieving exposure to some investment opportunities. The Authority usually has little influence, however, over the structure of the CIV, the individual securities it holds or its individual voting decisions. In applying the RI Policies to a CIV the Authority assesses value to the Fund of the CIV as a whole rather than each security it may hold. The Authority communicates its RI policies to managers of CIVs in which it invests and encourages them to consider whether its policies are appropriate for the CIV. In addition, the Authority may review its investment if there is a material change in its mandate or strategy.

Investment managers are delegated responsibility to exercise voting rights on behalf of the Authority but the Authority retains the ultimate voting right. Managers are required to vote in the interests of the Fund and their voting record is monitored. New Zealand managers are required to advise the Authority of their voting intent where the issue is likely to be publicly contentious, against the recommendation of an approved proxy voting service or give rise to a conflict of interest. In such cases, Management may direct the manager's votes under delegation from the Board. Managers' voting record is summarised on the website every six months.

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

8.3 Procedures

The Board is accountable for the Authority's RI Policies. The Authority has a collaborative agreement with the Guardians of New Zealand Superannuation (**GNZS**) and the Accident Compensation Corporation, which have similar RI obligations and are all signatories to the United Nations Principles for Responsible Investment². The agreement encompasses policy development, identification and analysis of high RI risks, co-ordination of engagement and exclusion activities, engagement of research providers, research sharing and communications. The parties to the agreement meet regularly to review current engagements and exclusions, high risk securities, research and policy development.

² The UN principles for Responsible Investment can be viewed at www.unpri.org.

With the assistance of GNZS, the Authority implements its RI policies by:

- monitoring high risk issues and securities;
- monitoring portfolio investments against the RI policies;
- analysing RI issues and appropriate responses;
- excluding securities as appropriate;
- communicating the Authority's policies and decisions to investment managers;
- participating in collaborative engagements with other investors;
- monitoring managers' voting records; and
- publishing its RI policies and exclusion decisions (individual company engagements may be confidential).



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 Investment Objective 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 Reference Portfolio, Target Portfolio 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 Investment Objective. 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 at current and prospective market prices to ensure the Fund remains within permitted risk limits at all times.

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 Investment Objective 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 Reference Portfolio and Target Portfolio described in section 5 and a range of investment management techniques for the Fund;
- seeking professional advice on the investment strategy, the Reference Portfolio and the Target Portfolio;
- 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; and
 - 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 contracts, 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 Reference Portfolio and Target Portfolio 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 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 benchmarks; 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. Where managers or custodians use derivatives, their use must be specified in each investment management agreement, or be consistent with the terms governing collective investment vehicles. Where the Authority is a counter-party to a derivative, the terms and conditions of the derivative must be specified in appropriate industry standard documentation.

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 Reference Portfolio and Target Portfolio).

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.

Rebalancing ranges are set out in section Table 3, page 8.

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 custodian in accordance with accepted industry best practice. Investments that are not regularly traded at a public exchange are valued according to the policies, standards and procedures in this section 12 at least annually.

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 either:

- not able to be independently priced by the custodian; or
- can be priced independently by the custodian but at a cost, determined by the Authority to be unreasonable, the Authority relies on the valuation provided by the investment manager using generally accepted industry standards that has either:
 - been undertaken by a reputable, suitably qualified professional valuer, who is independent of the investment manager; or
 - been determined by reference to observable market variables obtained from sources independent of the manager.

The Authority may seek independent advice from a suitably qualified professional valuer to verify or confirm the reasonableness of any valuation provided by an investment manager.

12.2 Standards

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 generally accepted industry standards. 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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