



26 September 2008

Dear Member

Following release of the annual reports of the Government Superannuation Fund Authority (*the Authority*) and the Government Superannuation Fund (*GSF* or *the Fund*) for the year ended 30 June 2008, I am pleased to provide you with this update on the management of GSF.

Features of the 2008 Year

- Investment performance impacted by the global credit crunch and rising inflation.
- Shift from passive to active management of international equities.
- Introduction to the Fund of a multi-asset class, incorporating investments in listed equities, private equity, real estate and hedge funds, and a global tactical asset allocation strategy.
- Exclusion of direct investment by the Fund in companies involved in the manufacture of tobacco and anti-personnel mines, in terms of the Authority's Responsible Investment Policies, Standards and Procedures (*RI Policies*).
- Scoping of the schemes' administration system as the first step in developing a new more sustainable system.

Tributes

The previous Chairman, Basil Logan, retired when his term of appointment ended on 31 May 2008. Mr Logan was the inaugural Chairman of the Authority Board, appointed when the Authority took over responsibility for managing the Fund and administering the GSF Schemes in 2001. He was previously Chairman of the GSF Establishment Board.

As Chairman, Mr Logan directed the transition of the Fund's investment assets from fixed interest to a fully diversified investment portfolio in line with best practice. He also oversaw the successful and seamless change of the scheme administrator from AXA to Datacom, with entitlements continuing to be calculated accurately and paid on time.

Board member Colin Blair also retired on 31 May 2008. Mr Blair was first appointed in 2001 and during his terms he was the Chairman of the Board's Audit and Risk Review Committee. The Authority and the Fund benefited from Mr Blair's wide experience in accounting, audit and tax matters.

The Board expresses its appreciation and thanks for the significant contributions made by Mr Logan and Mr Blair and wishes them well for the future.

Yours sincerely



Tim McGuinness

Chairman

Government Superannuation Fund Authority Board

Investment Markets

The performance of the Fund during the financial year was severely impacted by a number of factors. These included the financial crisis in the United States, which turned into the global “credit crunch”, rapidly rising inflation around the world, caused by surging food and energy prices, and high interest rates in New Zealand.

These, in turn, led to nervousness among investors, a sharp slowdown in global economies, double-digit falls in stock markets and much weaker property markets.

In New Zealand, the NZX 50 Index fell 23% from its peak level as investors retreated from the market, house prices weakened and companies faced rising costs. In addition, the collapse of a number of finance companies, with the accompanying loss of funds, combined with the freezing of other funds and assets, led to increasing nervousness and further retreat by investors to the safety of larger banks.

Changes made by the Authority have been helpful in responding to these adverse events. There has been a move from passive to active management of international equities, a reduction in the allocation to New Zealand equities and the introduction to the Fund of a multi-asset class, incorporating investments in listed equities, private equity, real estate and hedge funds, and a global tactical asset allocation strategy. The changes to the asset allocation for the Fund are set out in the table below.

Asset Class	Asset Allocation at 30 June 2007 (%)	Asset Allocation at 30 June 2008 (%)	Strategic Asset Allocation at 30 June 2008 (%)
Fixed interest	30.4	23.0	23.0
New Zealand equities	16.2	9.5	10.0
International equities	42.6	46.5	47.0
Property	7.4	6.6	7.0
Collateralised commodity futures	3.4	4.0	3.0
Multi-asset	–	7.1	7.0
Global tactical asset allocation	–	3.3	3.0
	100.0	100.0	100.0

Despite these changes, the Fund has experienced a negative return for the year. It is not alone in this position; many other comparable funds have been similarly affected.

Another factor, which has had an adverse impact on the results for the year, is the new international tax regime which came into force for the Fund last October. Even though the Fund made a loss on its international equities portfolio, tax was still payable at the rate of 5% of the opening market value on 1 October 2007. Also, under the new tax rules, losses on Australasian equities and listed New Zealand property securities are no longer deductible for tax.

The Authority remains confident that, over the long term, its investment strategy is soundly based. Volatility is a feature of equity and property markets worldwide and their values will increase again at some future point. The performance of the Fund is best assessed over the long term and not in any one year in isolation.

Investing in a wide range of assets globally is prudent and responsible and the Authority remains committed to that approach. Diversification and active management of investments should enhance investment performance over time.

Investment Returns

The Fund’s deficit after tax for the year of \$260.9 million represents a return of -6.7% of average net assets. The negative return was caused primarily by the sharp decline in international and New Zealand equities over the year.

The following table compares the Fund’s investment returns against the Investment Performance Measure and the after tax returns from the NZX New Zealand Government Stock Gross Index over 1, 3 and 5 year periods ended 30 June 2008.

	1 year %	3 years annualised %	5 years annualised %
Fund	-6.7	5.1	6.5
Investment Performance Measure*	8.8	6.1	6.0
NZX New Zealand Government Stock Gross Index (after tax)	6.3	3.6	3.5

**The NZX New Zealand Government Stock Gross Index return (after tax) plus 2.5% per annum measured over rolling 10 year periods.*

The table demonstrates the need to assess the investment performance of the Fund over the long term.

Responsible Investing

The Government Superannuation Fund Act 1956 (the GSF Act) requires the Authority to manage and administer the Fund in a manner consistent with (among other requirements) avoiding prejudice to New Zealand's reputation as a responsible member of the world community.

The Authority has developed RI Policies, which can be viewed on the Authority's website

www.gsfa.govt.nz

In terms of the RI Policies, the Authority has resolved to exclude direct investment in the securities issued by companies understood to be involved in the manufacture of tobacco and anti-personnel mines. The companies' activities are inconsistent with the RI Policies and with international conventions to which New Zealand is a party. Background on this decision and a list of the companies excluded from direct investment can be viewed on the Authority's website.

The Authority also invests in a number of collective investment vehicles (CIVs), which are a practical and cost effective way of achieving exposure to some markets and managers. The Authority has little or no influence or control over the structure of the CIVs, the securities held or individual voting decisions. The managers of the CIVs have been made aware of the RI Policies, and the decision to exclude certain direct investments, and have been encouraged to consider whether these are appropriate for the CIVs.

Schemes

The Authority commenced work last year on fully scoping the operations and functions of the GSF Business System, used in the administration of the GSF Schemes. This was the first step in determining the specification for a new and more sustainable administration system.

The scoping work was completed in July 2008. The next step was to invite expressions of interest to undertake the development, using the Government Electronic Tenders Service. Organisations needed to demonstrate they had the resources, experience and capability to undertake the work. A short list of interested parties has been developed and these parties will be invited to tender.

Key tasks for the Board next year will be to consider the tenders received and decide whether to proceed with the development. If the Authority decides to proceed, the development of a new system could take up to two years.

During the year 344 GSF Police Scheme members elected to transfer to the Police Superannuation Scheme (PSS). This brought the total number of transfers since August 2005 to 1388 and the total amount transferred to PSS to \$522 million. The transfer facility ended on 1 August 2008.

The high number of Police transfers and staff shortages put pressure on the scheme administrator, Datacom, resulting in some slippage against performance standards. The Authority and Datacom have developed and put in place plans to bring administration performance up to required levels.

In the Budget 2008 the Government announced that the minimum cost of living adjustment for GSF annuities will be increased from 90% of the increase in the consumer price index to 100% from 2009. The Authority will work with the scheme administrator, to ensure the increase can be implemented on the due date.

Features of the 2008 Year

Our Mission

The Authority's mission is to use best practice to manage the Fund and administer the GSF Schemes, in accordance with the GSF Act, with the prime objectives of enabling:

- returns to be maximised without undue risk,
- the Crown's contribution to GSF to be minimised, and
- the needs and reasonable expectations of stakeholders to be met.

Website

The annual reports are available on the Authority's website – www.gsfa.govt.nz The Authority's website continues to be an important part of our communications strategy and contains comprehensive information on both the Authority and the Fund.

Further Information

If you have any queries regarding this letter, please write to the Authority at PO Box 3390, Wellington. Please continue to address any queries you may have on your membership to Datacom, GSF Schemes Administration, PO Box 3614, Wellington, *Freephone 0800 654 731*. Free copies of the annual reports can also be obtained by contacting Datacom.