GOVERNMENT SUPERANNUATION FUND AUTHORITY

Statement of Investment Policies, Standards and Procedures

4 September 2019

SIPSP

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This document is titled Statement of Investment Policies, Standards and Procedures (**SIPSP**) and is dated 4 September 2019 and supersedes all previous versions. An electronic copy is available on our website - *www.gsfa.co.nz.*

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Change without notice

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Contents

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

The SIPSP is reviewed and approved at least annually by the Board. Only the Board can approve material changes to it. A version control document is maintained.

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 all decisions relating to the Fund. The Board has all the powers necessary for managing, directing and 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 relevant law, 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 which certain functions and powers are delegated. The Investment Committee has written terms of reference and its performance is reviewed annually.

The Authority and the Board of Trustees of the National Provident Fund have formed a joint venture company, Annuitas Management Limited (**Annuitas**), to engage staff (**Management**) to provide management services to each organisation. The Management Services Agreement between the Authority and Annuitas delegates authority to Management to enable it to carry out the day-to-day activity of the Authority and the Fund. This includes the management of functions contracted out to third parties for investment management, custody, scheme administration, legal, tax and advisory services.

In relation to investments, Management is responsible for the identification and implementation of appropriate strategies for the Authority to meet its obligations and objectives under the GSF Act. The Board retains the power of appointment of investment managers, custodians and external investment advisers. Management is delegated discretion to vary the Fund's asset allocation according to prescribed criteria and within prescribed limits pursuant to a dynamic asset allocation (**DAA**) programme.

2.2 Standards

a) A custodian is to be appointed to separate investment decision-making (undertaken by the investment managers) from the holding of assets and securities, transaction settlement, recording and reporting of investment activities (undertaken by the custodian).

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

b) Cash required for operational liquidity purposes is managed by Management.

c) Third party investment managers are to be engaged to invest the assets of the Fund.

2.3 Procedures

Selection of the custodian and managers is made in accordance with the Authority's policy on procurement of services. It takes into account, among other criteria specific to the role:

- best-practice portfolio management;
- the skills and experience of the manager compared to peers;
- 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 procedures.

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

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

Managers are regularly reviewed against the criteria above to determine their ongoing suitability for their role.

Details of the current investment managers can be found on the website – *www.gsfa.govt.nz*.

3 *Statement of Investment Philosophy*

3.1 Policies

The Authority meets its responsibilities under the Act by developing and implementing:

- principles for best practice portfolio management;
- an investment strategy centred on maximising return over the long term subject to a defined risk limit; and
- responsible investment policies to meet the requirement to avoid prejudice to New Zealand's (**NZ**) reputation as a responsible member of the world community.

3.2 Standards

The Authority interprets best-practice portfolio management as:

- having a clear investment objective that reflects its statutory responsibilities and desired outcomes;
- maintaining a sound investment strategy consistent with that objective and the Authority's investment philosophy;
- having strong governance with clear assignment of responsibilities that promotes accountability, clear reporting and effective communication with the Fund's stakeholders;
- ensuring cost-effective management of investments by engaging an external custodian of its assets and managers with the requisite skills and alignment of interests with the Authority and monitoring their performance closely; and
- sharing relevant knowledge and resources with other Crown financial institutions, peer funds and experts.

The Authority's outputs and performance measures for investment must be designed to achieve these elements and measure success.

The Authority's investment philosophy must provide a foundation for its investment strategy. It must represent the Authority's views with regard to the sources of investment return and risk and how these can be captured cost effectively, having regard to the Authority's attributes:

- the nature of the GSF's pension obligations allows the Fund to take a long-term view for its investment strategy and tolerate short-term volatility in market prices and a degree of illiquidity;
- to promote the Crown's interests, the Fund's investments focus on returns after foreign taxes but before NZ taxes;
- implementation of the investment strategy is outsourced to third parties. The Authority determines investment strategy, selects and monitors external managers. Investment operational risk is managed by robust contractual arrangements with an independent custodian and the outsourced managers.

The Authority's Investment Beliefs are set out below. The Investment Beliefs are reviewed at least every four years.

Investment Beliefs	Investment Strategy
Asset Allocation	
Risk and return are strongly related. Higher returns generally require acceptance of less-certain, more-volatile cash flows and market values. Equity risk is the most pervasive and enduring source of additional return. Other investment risks provide systematic returns for bearing risk, including compensation for the risk of inflation shocks, real interest rate shocks, currency shocks, credit defaults, insurance losses and illiquidity. Other systematic returns (style premia) arise from investor behaviour, such as aversion to leverage, heavily discounted assets and going against the crowd. Investors with long horizons are better able to capture these return sources than short term investors. Asset allocation is the largest determinant of a portfolio's risk and return. Diversification generally improves a portfolio's ratio of return to risk. Significant exposure to international assets is worthwhile for NZ investors. Some foreign currency exposure also diversifies asset risk but forgoes any risk premium on the NZ dollar. Although short term returns of risky assets are largely random, they are partly predictable in the longer term and tend to revert to a mean.	The Authority seeks returns in excess of NZ Government Bonds primarily by accepting additional investment risk. Equity risk is the largest source of investment risk and excess return in the Fund. The Fund invests in other sources of systematic risk and return. Because the Fund has a long horizon and meets only part of the GSF's pension obligations it can tolerate the volatility associated with a high level of equity risk. The Fund seeks diversified exposures to rewarded non-traditional risk factors where practicable and consistent with its investment objectives. The Fund generally has some foreign currency exposure to diversify risk. Asset allocation may be varied within prescribed limits when market prices diverge widely from normal valuations.

Asset Class and Risk Factor Strategy	
Within asset classes, higher risk assets are not always rewarded with higher returns. Risk premia that are compensation for risk of loss are expected to persist but may fluctuate significantly over time. Returns derived from investor behaviour or market structure anomalies may not persist. Diversified portfolios of securities can be built to capture risk and style premia without forecasting returns. Investment strategies can be unbundled and emulated in part with derivatives to separate market risk premia from active trading strategies and their respective costs. Markets are competitive and dynamic, varying in depth and the efficiency with which news is reflected in prices. The more efficient a market is, the more difficult it is to generate returns better than the market persistently.	Passive investment in broad market representative portfolios is the default strategy to access return sources. The fund invests in risk and style premia and uses derivatives to manage risk. Active management is used where there is sufficient confidence in the ability of available investment managers to add value net of costs. Active managers are benchmarked against replicable indices, where possible, that reflect the risk factors they attempt to capture. Leverage is permissible within strategies where it can be measured and constrained within total portfolio risk limits.
Manager and investment selection	
True skill in generating additional return beyond systematic risk premia is rare and may not persist. But it is possible to identify superior active managers in certain markets or market segments. Responsible investors act in accordance with broadly accepted global standards of ethical conduct in relation to business governance, environmental and social risks. Environmental social and governance (**ESG**) factors affect the performance of companies, securities and investment portfolios presenting risks to be managed and opportunities to enhance returns.	Manager performance is monitored regularly against replicable benchmarks, where possible, net of fees and costs, to gauge added value. The Authority does not invest in entities acting contrary to NZ's laws or international agreements and excludes direct tobacco investments. It is a member of the PRI. The Authority collaborates with other investors to engage with companies that breach its standards and excludes them when engagement is unlikely to improve outcomes. The Fund's managers take account of material ESG factors in their investment processes where it adds value.
Execution	
Managing fees and implementation costs can improve the net return to investors.	Performance is measured net of fees and costs, and manager fees are compared regularly with market peers to ensure they are competitive.

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 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.

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

c) **Fixed interest** comprising interest-bearing securities issued or guaranteed by sovereign governments and agencies and issued by non-sovereign issuers.

d) **Cash and short-term securities** comprising NZ and foreign currency cash and interest-bearing securities with less than one year to maturity.

e) **Commodities** comprising futures contracts traded on recognised public exchanges.

f) **Insurance-linked** comprising securities providing exposure to natural catastrophe risks and longevity risks.

4.2 Standards

The Fund may invest in these asset classes through direct ownership of the assets, through collective investment vehicles that hold the assets (subject to section 15K of the GSF Act which prohibits the Fund having a controlling interest) 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, subject to prudent limits approved by the Board.

Private market assets and securities are generally less liquid than their public market counterparts. They include collective investment vehicles that hold assets and securities, such as unit trusts, limited partnerships, hedge funds and fund-of-funds.

Private market assets are generally valued by appraisal, as described in section 12 - Valuation.

4.3 Procedures

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 limits of investment risk which are defined in the respective agreements with each manager.

5 The Balance of 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 NZ Government Bonds (before NZ tax) without undue risk of under-performing NZ Government Bonds measured over rolling ten-year periods.

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, notional portfolio that could be managed at low cost and return more than NZ Government Bonds while meeting the Fund's risk objectives. The long-term expected excess return of the Reference Portfolio varies somewhat over time. The Reference Portfolio also provides a benchmark to measure the Authority's performance in generating value-added returns. In 2018 the Board approved an increase in the percentage of international equities, and a decrease of fixed interest to occur by 30 June 2020. The old and new Reference Portfolios are set out in Table 1.

Table 1: Reference Portfolio and Benchmarks

Asset Class	Weight as at 30 June 2019 (%)	Weight as at 30 June 2020 (%)	Benchmark
International Equities	65	70	MSCI All Country World Index
NZ Equities	10	10	S&P/NZX50 Gross Index including imputation credits
Fixed Interest	25	20	Bloomberg Barclays Global Aggregate Index
Total Assets	**100**	**100**	
Foreign currency exposure	20	20	

b) Target Portfolio

The Authority manages the Fund to a Target Portfolio that incorporates alternative risk premia and skill-based strategies and is expected to be a more efficient portfolio than the Reference Portfolio, i.e. improve risk-adjusted returns after fees and foreign tax. The current Target Portfolio is set out in **Appendix 1, Table 1**.

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

- taking exposure to sources of return not represented in the Reference Portfolio that are considered to be systematic reward for bearing risk of loss. These alternative beta sources of return include illiquidity, style premia and insurance-linked risks for example; and
- capturing returns attributable to manager skill rather than systematic risk bearing, i.e. alpha.

c) Dynamic Asset Allocation

From time to time the Authority may take temporary positions away from the Target Portfolio allocations in response to relative valuation signals. Those positions are expected to add returns as relative valuation returns to normal levels. The limits that each asset class may be tilted away from its Target Portfolio allocation are shown in **Appendix 1, Table 2.**

d) Rebalancing Limits

Rebalancing limits define the extent to which the allocation to an asset class is permitted to deviate from the intended allocation (the Target Portfolio allocation plus any temporary changes in the allocation as a result of DAA decisions) before rebalancing trades are required.

Rebalancing limits are to be expressed as deviations around the intended allocation. Asset classes are to be rebalanced once the rebalancing limits are breached.

Asset classes or components of asset classes that are not able to be readily traded are not subject to formal rebalancing limits but are to be monitored to ensure their exposure does not become excessive relative to their intended exposure.

5.3 Procedures

a) Review of Reference Portfolio

The Reference Portfolio is reviewed at least every four 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) Review of Target Portfolio

The Target Portfolio is reviewed at least annually.

c) Undue Risk

The Authority uses a number of short- and long-term risk metrics to determine ‘undue risk’, including performance under stress tests of worst rolling four quarters of historical scenarios and risk of expected under-performance versus NZ Government Bonds over the next 10 years.

d) Rebalancing

Rebalancing takes place monthly to ensure the Fund remains aligned with the intended allocation 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 intended allocation 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.

The rebalancing and reset limits (relative to the intended allocation) are shown in **Appendix 1, Table 3.**

e) Foreign exchange exposure and hedging policies

The Authority expresses its desired foreign currency exposures relative to the total portfolio. The hedge ratio for international equities is varied to deliver the desired total Fund foreign currency exposure taking into account any hedging within other asset classes and any DAA tilts.

f) Significant Asset Allocation Changes

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

g) Dynamic Asset Allocation

DAA tilts are implemented by the physical movement of assets (selling the asset to be under-weighted and buying the asset to be over-weighted) or via derivatives, where there is a well-developed market. In the case of currency tilts, forward currency contracts and basis swaps are used.

DAA decisions within limits approved by the Board are determined by Management. Those decisions and their investment performance impact are reported to the Investment Committee and to subsequent Board meetings.

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 is the Reference Portfolio. The Fund's performance is also assessed by comparing the Reference Portfolio's investment return to NZ Government Bonds, before NZ tax and after fees. The performance of individual asset classes or strategies is assessed by comparing their pre-tax performance with their respective benchmarks.

6.2 Standards

a) Actual and Target Portfolio

The investment performance of the Actual and Target Portfolio is to be monitored relative to the Reference Portfolio. The Actual Portfolio represents the Target Portfolio plus any DAA tilts and asset valuation drift permitted within the rebalancing ranges.

The expected excess return of the Reference Portfolio above the S&P/NZX NZ Government Bond Total Return Index (NZ Government Bonds) over rolling 10-year periods is to be reviewed regularly.

b) Asset Class and Strategy Benchmarks

For the purposes of assessing asset class or strategy performance, the relevant benchmarks set out in Table 2 are to be adopted.

Table 2: Benchmark

Asset Class	Benchmark
International Equities	MSCI All Country World Index
NZ Equities	S&P/NZX50 Gross Index including imputation credits
Fixed Interest	Bloomberg Barclays Global Aggregate Index
Style Premia	US 3-month Treasury Bills
Global Private Equity	MSCI All Country World Index
Natural Catastrophe Risks	Swiss Reinsurance Catastrophe Bond Total Return Index
Longevity Risk	N/A[1]
Dynamic Asset Allocation	N/A[2]

1 *No benchmark is specified for the longevity risk (life settlements) investments because there is no single, reliable measure of market performance. Instead it is monitored relative to initial return expectations and general market returns for life settlements.*

2 *The return attributable to DAA is determined based on the relative asset class benchmark returns.*

6.3 Procedures

a) The Fund's performance is assessed by comparing its return before NZ tax with the Reference Portfolio and the NZ Government Bonds. The Authority recognises that, from year to year, investment returns may not meet the expected excess return over NZ Government Bonds.

b) The Board monitors the before-tax, after fees, return of:

- the Fund's Actual Portfolio relative to the Reference Portfolio;
- the Fund's Target Portfolio relative to the Reference Portfolio; and
- the Fund's Actual Portfolio relative to the Target Portfolio.

c) Managers within an asset class may have specific benchmarks depending on their specific mandates. For example, in the case of international equities the MSCI All Country World Investible Markets Index, MSCI All Country World Index, the MSCI World Index and the MSCI Emerging Markets Index are used.

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 to be considered over periods not less than three years.

Investment performance is to be measured:

- net of any fees due to the investment managers; and
- after transaction costs (but before custodian costs).

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

For the Fund's investments as a whole, for each asset class and for each investment manager, the custodian is required to provide monthly reports to enable monitoring and review of the Fund and managers' performances. Those reports should include:

- the cash 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;
  - tax reclaims; and
  - reports of compliance with mandate specific restrictions on separately managed portfolios.

b) Reporting by investment managers

Reports from investment managers each month or quarter should cover (where applicable):

- details of securities held;
- a review of the performance and an analysis of performance factors;
- investment philosophy and strategy (if changed);
- certification that the terms of the investment contract have been met including certification that the portfolio has not been leveraged;
- annual external audit report; and
- compliance with responsible investment policies.

The Board reviews the managers' investment performances 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 will report 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 to be provided monthly of aggregate and asset class returns. Management should also report 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 annually 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 Performance Expectations.

For reference, 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 each 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's service level agreement.

Management reports to the Board on monthly rebalancing and DAA decisions.

8 Responsible Investment

Required under sections 15M (d) – Ethical Investment, including policies, standards, or procedures for avoiding prejudice to NZ'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 Philosophy (section 3.2), Responsible Investment (**RI**) encompasses more than maximising return for risk.

The Authority's RI policies encompass:

a) avoiding prejudice to NZ'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; and
- works with similar investors to enhance the effectiveness of its RI policies, which may include supporting collaborative initiatives and engagements.

8.2 Standards

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

The Authority may exclude securities issued by companies from the Fund. This may occur where companies are involved in certain activities or breaches of standards. In determining this, the Authority takes into account:

- NZ or national law
- International conventions to which NZ is a signatory
- Significant policy positions of the NZ Government
- Impact of exclusion on expected Fund returns
- Action of our peers
- Severity of breach/action
- Likelihood of success of alternative course of action (engagement).

The Fund will exclude investment in the government bonds of any nation state where there is widespread condemnation or sanctions by the international community and NZ has imposed meaningful diplomatic, economic or military sanctions aimed at that government.

The Authority may also exclude companies for 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 is prohibited by section 15K of the GSF Act from owning controlling interests in CIVs, however, and usually has little influence 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 will 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. NZ 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 the New Zealand Superannuation Fund (**NZ Super**) and the Accident Compensation Corporation, which have similar RI obligations and are 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.

With the assistance of NZ Super, 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 is 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, DAA and asset class 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 that create leverage, 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' provided the overall risk of the CIV is acceptable. (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 external 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 less than the last quoted price without any fundamental change that justifies the lower price.

f) Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.

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 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;
- consulting with other Crown financial institutions and large investment funds;
- requiring investment managers to manage their portfolios within the market exposure limits for each asset class held as defined in the agreements with each manager; and
- setting limits to which managers are required contractually to manage their portfolios, which should include:
  - limits on the expected volatility of their total portfolio or their portfolio relative to the benchmark;

- limits on concentration of 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) 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 managers (including managers of collective investment vehicles) have adequate policies and procedures relating to leverage and derivative counterparties and monitoring managers' adherence 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 agreed 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 leading credit rating agencies;
- limit exposure to individual issuers to prescribed limits; and
- maintain 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 Target Portfolio and rebalancing procedures described in section 5. In addition, liquidity risk is managed by:

- monitoring the Fund's liquidity quarterly against prescribed levels approved by the Board;
- requiring managers to invest only in securities listed on recognised exchanges, except as specifically authorised by the Board;

- 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 levels as detailed in the agreements with each manager; and
- whenever an illiquid investment is considered, the projections of Fund liquidity, projected cash flows and illiquid investment obligations will be presented to the Board; and
- future cash flows of the Fund are included in any consideration of additional illiquid asset investments.

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 a specific mandate for each investment manager, based on best practice portfolio management, except for investments in CIVs;
- separation of functions between investment management, custody, and specifying limits to the authority delegated to Management for dynamic asset allocation decisions;
- ensuring Management has sufficient resources to conduct the oversight function as part of its overall responsibilities;
- requiring fund transactions to be authorised by at least two persons; and
- requiring investment managers and the custodian to:
  - provide the Authority with 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.

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

10.2 Policies

Derivatives may be entered into by the Authority or its managers 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 counterparty to a derivative, the terms and conditions of the derivative must be specified in appropriate industry standard documentation.

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 using derivatives 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 standalone 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 NZ, or in countries with which NZ has a double tax treaty.

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

The investment management agreements for those managers actively using forward foreign exchange contracts include limits for the maximum exposure per counterparty. For other types of derivatives, there are dollar limits for the maximum exposure before collateral is required.

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 vehicle; and

d) exposures outside the rebalancing range for each asset class, including ranges permitted pursuant to the dynamic asset allocation policy (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 will have developed constraints and limits in respect of each asset class or strategy to control risks. Each investment management agreement will specify 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 will address section 15K of the GSF Act and rebalancing ranges for each asset class or strategy will be recorded in **Appendix 1, Table 3.**

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 **Table 3** of the **Appendix 1.**

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.

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 at least annually. 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 or by the application of generally accepted industry standards and subject to independent verification. 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 to be independently verified.

12.3 Procedures

Wherever possible, independent pricing measured at the most recent 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 there are adequate and timely independent valuations and audit procedures to validate underlying valuations.

Appendix 1

Table 1: Target Portfolio as at 1 July 2019

Asset Class	Weight (%)
International equities	54.75
NZ equities	9.5
Fixed interest	11.25
Style premia	10
Global private equity	5.5
Natural catastrophe risks	6
Longevity risks	3
Total Assets	**100**
Foreign currency exposure	20

Table 2: DAA Limits

Asset Class	Limit versus Target Portfolio Allocation (%)[1]
Cash vs equities vs fixed interest	+/-10
Developed market equities vs emerging market equities	+/-5
NZ equities vs international equities	+/-2
Developed market fixed interest vs emerging market fixed interest	+/-5
Foreign currency exposure	+/-15
Foreign currency majors vs NZD[2]	+/-10
High yield credit vs governments vs investment grade credit	+/-5
Commodities and/or property	+/-5

[1] *Although the ranges have been expressed as symmetric, short exposures are not permitted.*

[2] *Major currencies include USD, EUR, GBP, JPY, CHF, AUD.*

Table 3: Rebalancing

Asset Class	Rebalancing Limits (± %)
Combined Global public and private equities	5
Combined NZ public and private equities	2
Fixed interest	4
Style premia	2
Natural catastrophe risks	2
Longevity risks	2
Foreign currency exposure	5

Private Equity Limit

Total (domestic and global) invested private equities to not exceed 30% of total (domestic and global) invested private and public market equities.

GOVERNMENT
SUPERANNUATION FUND
AUTHORITY

GOVERNMENT SUPERANNUATION FUND
Te Pūtea Penihana Kāwanatanga