GOVERNMENT SUPERANNUATION FUND AUTHORITY

Our Mission

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

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

www.gsfa.govt.nz

Further information

If you have any queries regarding your GSF membership or would like a free copy of the annual report, please contact Datacom Employer Services, GSF Schemes Administration, PO Box 3614, Wellington 6140, Freephone 0800 654 731.

Chairman's Letter 2015

Dear Member

On behalf of the Government Superannuation Fund Authority Board (the **Board**), I am pleased to comment on the activities of the Government Superannuation Fund Authority (the **Authority**) and the Government Superannuation Fund (**GSF** or the **Fund**) for the year ended 30 June 2015.

The Authority was established in October 2001 as a Crown entity by section 15A of the Government Superannuation Fund Act 1956 (**GSF Act**) and became an autonomous Crown entity under the Crown Entities Act 2004 (**Crown Entities Act**) in January 2005.

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.

The Authority is responsible for interpreting the provisions of the GSF Act relating to the GSF schemes and exercising discretionary provisions. Management, appointed by the Board, carries out these functions under delegation from the Board.

Features of the 2015 Year

- Strong return on investments for the year of 13.3% before tax and after investment fees. This was 2.6% ahead of the Reference Portfolio and 4.7% ahead of the return on New Zealand Government Stock.
- Fund investment returns were boosted 2.1% by above normal exposure to foreign currency when the New Zealand dollar declined sharply late in the financial year. Active managers added 0.7% of return overall, notably in global equities and the multi-asset class strategy.
- Over the last 3 years the Fund investment return averaged 15.0% pa, 1.0% pa above the Reference Portfolio and 8.9% pa above New Zealand Government Stock.
- Over the last 10 years, which spans the global financial crisis, the Fund investment return was 7.1% pa, compared to 7.0% pa for the Reference Portfolio and 6.2% pa for New Zealand Government Stock.
- An after tax surplus of $511 million saw the Fund grow in size over the year from $3,677 million to $4,087 million after entitlements paid and contributions received.
- Better than expected investment returns, together with the Government contributions, has seen the unfunded liability fall over the year from $9,149 million to $8,592 million.
- During the year $877 million was paid out to members of the GSF schemes.
- Progress on the new Business System for the administration of the GSF schemes has been slower than planned. The Authority is fully committed to having a fit for purpose system which will enable the GSF schemes to operate efficiently and accurately.

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Investment Activity

The Fund switched to a before tax investment objective this year. This reflects the fact any New Zealand tax incurred by the Fund is paid to the Crown. While the Fund's risk profile did not change, the investment objective is now expressed relative to New Zealand Government Stock over a ten year rolling period.

The Fund relies largely on equities to provide the target return over New Zealand Government Stock returns and is always looking for more efficient ways to capture alternative return sources. Around 20% of the Fund is invested in alternative asset classes, such as insurance-linked assets, private equity and real estate funds, and skill-based trading strategies. The Fund's private equity investments are now well into their 8-10 year lifecycles and have started to produce very good returns, both in New Zealand and offshore. Insurance-based investments have provided worthwhile diversification of fixed interest investments.

During the year the Fund's foreign currency exposure was reduced from 40% to 20% in after tax terms in response to the significant decline in the New Zealand dollar to more normal valuation levels. A small position was also established in commodity futures because global bonds were considered to be over-valued whereas commodity prices are at multi-year lows.

Considerable attention is paid to the cost of active management relative to the extra risk and expected enhancement. The investment team has been investigating a lower cost approach to active equity management that captures part of the active returns provided by skilled managers using systematic exposure to risk factors that offer a distinct risk premium. This work is ongoing. A third global bond manager was added to diversify the fixed interest manager risk. A further small commitment was made to global private equity funds managed by Makena Capital.

Collaboration with other Crown Financial Institutions (**CFIs**) continues, notably with the Guardians of New Zealand Superannuation. As well as discussing common investment issues, the Authority joined with the CFIs in hiring a global engagement service company to co-ordinate engagements with global companies that have serious issues around environment, human rights and corruption. The Authority also participated in the launch of the New Zealand Corporate Governance Forum to promote good governance among listed New Zealand companies.

Schemes

Datacom Employer Services Limited continues as the scheme administrator.

Work continues on the development of a new and more sustainable Business System for use in the administration of the GSF schemes.

Outlook

Global economic conditions are improving in response to continued extraordinary monetary stimulus and, as yet, there is no sign of incipient inflation. However there is a big divergence among countries in terms of economic performance and monetary policy. The US is recovering and will be raising interest rates but only very gradually and from very low levels. Europe has followed Japan with aggressive monetary stimulus but both economies require structural reform to sustain economic growth. This will be hard to achieve politically, increasing the risk of continuing destabilising events in Europe in particular. Emerging markets are in a cyclical trough related to commodity prices but some of these economies have good medium term growth prospects. China faces a testing period of economic management as it tries to transition from investment-led to consumption-led growth without causing major disruption.

After an impressive bull run, global bond and equity markets are pricing a continuation of the very low interest rates for several more years notwithstanding the imminent prospect that US interest rates will start to rise before the end of 2015. This means government bonds, the safest long term asset class, are likely to return an average of only 2-4%pa over the next few years, near zero in real terms. Global equities are moderately more expensive than normal and assuming only moderate growth, implying a return of 6-8%pa. Although modest, this is good value relative to bonds. With slowing revenue growth, profitability is being maintained by increasing corporate leverage and, hence, risk. The significant realignment of the US dollar versus other global currencies over the last year relieved some of the tension in markets arising from the divergent monetary policies of the US compared to the rest of the world.

The asset classes looking most extreme in terms of valuation are commodities, which are at multi-year low prices, and global listed real estate and infrastructure, which is expensive compared to equities in general. The extremely low interest rates on offer have encouraged investors to chase other sources of yield, notably lower risk equities with stable and high dividend payouts, real estate and infrastructure trusts. Emerging markets have been poor performers in contrast but several now look under-valued relative to their longer term growth prospects.

The New Zealand dollar is no longer grossly over-valued, which will facilitate a shift of resources towards global-facing firms, other than dairy producers. The New Zealand share market, which is dominated by lower risk yield stocks, is likely to be more challenging after several very good years.

Global economic adjustment is continuing broadly in a positive direction towards a 'new normal' with low growth and low interest rates. Market volatility had been low, foreshadowing low future returns, but could easily jump. Divergent monetary conditions among the major economies remain a risk and geopolitical events can always trigger disturbance in markets. After a very strong run of investment returns, the next year or so is likely to be more difficult.

Website

The Authority's website – *www.gsfa.govt.nz* – continues to be an important part of our communications strategy and contains comprehensive information on both the Authority and the Fund. It explains how the Authority operates and gives all stakeholders access to our annual investment results, as well as any changes the Authority makes to its policies, investment strategy and personnel.

The Board

The Board has worked effectively and efficiently in 2014/15, with eight full Board meetings being held during the financial year. After serving on the Board for 6 years, as both a Board member and as Chair of the Audit and Risk Review Committee, Toni Kerr retired effective 30 June 2015. Toni's position as a Board member was filled by Ainsley McLaren from 1 July 2015. Ainsley brings with her a wealth of investment experience. She has previously held executive roles including Head of Investment Management at ASB Group Investments and Executive Director at First State Investments (NZ) Limited.

The Board has two permanent committees - an Investment Committee chaired by Craig Ansley and an Audit and Risk Review Committee chaired by Cecilia Tarrant. In 2014, the Board also established a committee to provide governance oversight to the project developing the new Business System for the administration of the GSF schemes. This Committee is chaired by Michelle van Gaalen.

Conclusion

The Board thanks the Minister of Finance and government officials for their support, and the Management team and staff for their high level of work and commitment to meeting the Authority's objectives.

I also thank my fellow Board members for their expertise and commitment during the year.

Keith B Taylor
Chairman
Government Superannuation Fund Authority Board

2 September 2015

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