



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 2014

Dear Member

On behalf of the Government Superannuation Fund Authority Board (the **Board**), I am pleased to present the annual reports 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 2014.

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 2014 Year

- A strong year in investment markets with a total Fund return of 10.8% after tax, well ahead of the Fund's long term average expected return.
- A pre-tax surplus of \$459 million and after tax surplus of \$363 million saw the Fund grow in size from \$3,382 million to \$3,677 million after entitlements paid and contributions received.
- Better than expected investment returns and the change in discount rate assumption used by the Actuary in the gross liability calculation has seen the unfunded liability fall over the year to \$9,149 million from \$10,476 million.
- Returns from international and New Zealand equities were strong.
- Insurance-related assets performed well, diversifying the Fund's return sources and risk.
- Active managers added 0.9% of return overall, notably in domestic and global equities.
- The New Zealand Dollar (**NZD**) was exceptionally strong, resulting in the Fund's lower-than-normal hedge ratio subtracting 2.7% from the Fund return.
- Completion of the three yearly review of the Reference Portfolio has resulted in removal of Commodities exposure from 1 July 2014.
- During the fiscal year \$861 million was paid out to members of the Schemes.
- Progress on the new business system for the administration of the Schemes has been slower than planned due to the complex nature of the Schemes. The Authority is fully committed to having a fit for purpose system which will enable the Schemes to operate efficiently and accurately.



Investment Activity

From the next financial year the Fund is switching to a before tax investment objective. This reflects the fact any New Zealand tax incurred by the Fund is paid to the Crown. The Fund's risk profile will not change and the objectives will still be expressed relative to New Zealand Government Stock but in before tax terms over a ten year rolling period.

The Fund relies largely on equities to provide the target return over New Zealand Government Stock but is always looking for more efficient ways to capture alternative return sources. Almost 20% of the Fund is invested in alternative asset classes such as insurance-linked assets, less liquid private equity and real estate funds, and skill-based trading strategies.

Following a review of the Reference Portfolio it was decided in August 2013 to remove commodities (5% to 0%) and increase the exposure to international equities (55% to 60%) from 1 July 2014. The Fund sold out of its exposure to commodities futures on 30 September 2013. The majority of this investment was reinvested into international equities and further allocations were made to private equity, in New Zealand and overseas, and the allocation to insurance-linked assets was increased.

Early in 2014 a more flexible approach to asset allocation was adopted to allow limited tilts when market prices diverge significantly from long term value.

Considerable attention is paid to the cost of active management relative to the extra risk and expected enhancement. Two active investment mandates were revised to eliminate expensive performance fees. A full review of active managers of New Zealand equities resulted in the incumbent managers being retained.

Schemes

Datacom Employer Services Limited continues to perform well 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. The detailed requirements for the project were completed in December 2010.

The construction phase is scheduled to be completed and the transition phase will commence in 2014. Work on initial planning for transition from the old system to the new system is already underway.

Outlook

Heading into the 2015 financial year, global economic conditions are improving in response to continued extraordinary monetary stimulus and, as yet, no sign of incipient inflation that might cause early withdrawal of policy support. The US has largely corrected its imbalances apart from large accumulated government debts but the Federal Reserve has indicated it will not try to reduce these in the near term. Japan is still pursuing aggressive monetary stimulus but requires structural reform to sustain economic growth. The United Kingdom is recovering but Continental Europe has been unwilling or unable to provide enough stimulus to avoid painful unemployment and is struggling to pull out of deflation. Emerging markets are in a cyclical trough but look healthier from a medium term perspective. China has avoided a disruptive transition from investment-led to consumption-led growth to date but still faces a testing period of economic management.

Financial markets are remarkably calm despite the high risk that a deflationary debt spiral could reassert itself. They are anticipating that Europe will do what is necessary to ensure financial stability and eventually recover, and that geopolitical events will not be dangerously disruptive to market valuations. Bond yields remain low, perhaps discounting a very prolonged continuation of low interest rates and contained inflation. Equity markets are no longer cheap after several years of expanding price-to-earnings ratios but they are not unusually expensive either.

Market volatility is extremely low, which has foreshadowed modest returns historically. In the most likely scenario of persistent slow growth and low interest rates, equities are priced to deliver a reasonable return premium over bonds, appropriate to their greater risk.

New Zealand assets, notably shares and the NZD, look fully priced compared to global counterparts. The relative strength of the New Zealand economy is likely to abate somewhat looking forward and high external debt levels remain a risk.

Absolute returns across all asset classes are expected to be modest, continuing the temptation to reach for additional yield. Like this time last year, economic and financial risks remain that could trigger instability.

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 half yearly 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 2013/14 and there were eight full Board meetings held during the financial year. The Board has two permanent committees, an Investment Committee and an Audit and Risk Review Committee. These were chaired by Steve Napier and Toni Kerr respectively and each committee met three times during the year.

Last year Steve Napier retired from the Board effective 30 June 2014 and his position was filled by Shelley Cave from 1 July 2014. Shelley has been a partner of Simpson Grierson law firm and amongst her other roles is a Board member of the Financial Markets Authority. It is great to have her on the Board and we look forward to her contribution.

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