Equities & Strategic Tilting Boost Returns at NZSF

On November 19-20, 2015, the OECD/Euromoney Long-term Investment Financing Conference took place in Paris. Matt Whineray, Chief Investment Officer at the New Zealand Superannuation Fund was scheduled to speak at the event, taking part in a panel discussion on long-term investment in a volatile market but was subsequently unable to due to the events in Paris just before the conference. This interview was taken prior to this occasion.

Key points:

- With a large equity exposure, the New Zealand Superannuation Fund (NZSF) has reaped the benefits of an equity bull market: Its returns for the last five years are in the 93rd percentile; “On only 7% of occasions would you expect to see better returns. That tells you that we have had an extremely favourable environment for the last few years”, commented NZSF Chief Investment Officer Matt Whineray.

- Strategic tilting also helped its performance: Shorting the Kiwi dollar, while going long on foreign currency, has contributed to its performance, Whineray said, along with investments in timber and some hedge funds. And it is also short bonds, which it sees as expensive.

In the run-up to the Paris conference, Matt Whineray spoke to IIN's Matt Craig and Joel Paula of the OECD on his views on the investment outlook and return expectations, NZSF’s investment beliefs and its recent strong performance, and a number of other issues, from greenfield infrastructure to using currency to add value.

Matt Craig, European Content Director, Investor Intelligence Network (IIN): There is a view that future return expectations are low, do you share this view?

Matt Whineray, Chief Investment Officer, New Zealand Superannuation Fund: The last six months have been a bit ugly but for the last five years and more, we have had very strong returns from buying the big bounce of equity markets coming out of the GFC. When we look at our five year performance and think about that, versus our expectations for any particular five years, and our returns are in the 93rd percentile. So on only 7% of occasions would you expect to see better returns. That tells you that we have had an extremely favourable environment for the last few years. In addition, the fact is that you are now at a higher starting point now and given that valuations have risen, we would expect to have lower returns in the future. Our expectation, going forward, is still that our median returns are about 8% or so, rather than around 17%, which we have seen recently. You cannot expect to get a 17% return all the time. If your median is 8%, you are going to expect to have something somewhat lower than that over time.

Matt Craig, IIN: We talk about a low return expectation but then on IIN, when we ask investors about recent performance, in one asset class or another, someone has got a return of 25% or 30%.

Matt Whineray, NZSF: Yes, you will get that in an individual asset class. All we are saying is that our median expectation over the long run is 5% cash, plus 2.7% of risk premium, plus some value add. That gets you to 8%, maybe 8.5%. Now that looks hard at the moment because, cash rates are closer to zero and risk premiums are compressed and in some cases very compressed, for example in bonds. So on a forward-looking basis, you would expect returns to be lower.
**Matt Craig, IIN:** Is the outlook for lower returns having an impact on your portfolio?

**Matt Whineray, NZSF:** The way we express our portfolio level view is through strategic tilting - which other people might call dynamic asset allocation. If we think markets are somewhere away from fair value, then we will buy, if we think markets are cheap, or sell, if we think markets are expensive. At the moment, our largest positions, in terms of strategic tilting, continue to be short bond positions; we continue to think that bonds around the world are very expensive. We think that ultimately rates will be higher than where they are now and they have been low for a while now, so we have had some short bond positions for a while and that has cost us. We continue to think that the rates are south of fair value, so that probably represents our bigger position. We do have some long equity positions with a tilt towards Europe and also in emerging markets. That reflects the fact that we think that markets are more pessimistic about the prospects for Europe and some emerging markets than we are over the long term. They might be right about them in the near term, but the strategic tilting policy or strategy is a long-term, mean reversion strategy. We think that over time those markets will return towards the median in terms of the way they are priced.

**Matt Craig, IIN:** Do you still expect to see attractive growth in certain markets? If so, which?

**Matt Whineray, NZSF:** Our base portfolio, which is what we call our reference portfolio, is tilted towards growth assets. The core for reference portfolio construction is 80% growth assets, which is comprised of 75% global equities, 5% New Zealand equities and then 20% sovereign bond and credit. In our reference portfolio, we have a strong growth bias and that reflects our mandate, which is to maximise returns over a long period of time, without undue risk and that reflects the risk tolerance of the board. Away from that, over and above the reference portfolio, we are longer equities than in the reference portfolio, so we own a bit more in emerging markets and a bit more in Europe. We are short bonds versus the reference portfolio; those are our tilts. We have a strong growth bias in the reference portfolio and are a little bit above that in the actual portfolio at the moment.

**Joel Paula, OECD:** Can you describe what has led NZSF’s strong performance in the near term?

**Matt Whineray, NZSF:** A big chunk of it is driven by the asset allocation that we choose in the reference portfolio. Having a strong weighting for equities has, over the last few years, driven a strong performance in the reference portfolio. Over and above that, we have added quite a lot of value from our active strategies. Those include strategic tilting, which has been a big contributor to fund returns, but also some of our other unlisted strategies. Timber has been a big contributor and a couple of our hedge fund investments have been strong contributors over time as well. Last year, for example, we had a total portfolio performance of slightly over 14.5%, so we had a value add of roughly 4% or slightly more. We outperformed the reference portfolio, which is our benchmark portfolio by a significant margin. That was largely driven by that tilting strategy, where we take broad market positions. A good chunk of that came from our currency tilting last year, driven partly by weakness in the New Zealand dollar and strength in the US dollar. We have made money because the markets have been good and we have also because we managed to add a bit of value over and above that market performance.

**Matt Craig, IIN:** How much of an issue is volatility to you?

**Matt Whineray, NZSF:** We don’t have any explicit liabilities and our mandate and our legislation is to maximise return without undue risk, so we deliberately choose to have a big growth exposure in the reference portfolio. We know that when we make that decision, there’ll be a lot of bouncing around from month to month. We have seen that in the last three months and we are a highly transparent fund; you can read all about us on our website and we publish monthly results. Monthly results for a
very long term fund are going to have a lot of noise in them, but it is just part of our commitment to transparency. We have just published them today for September and we saw a -2% or so figure. We often have discussions with local media here, Adrian [Adrian Orr, NZSF CEO] had one last month, when the fund was down 1.4 billion and they said ‘isn’t that terrible and what are you doing about it?’ Our response is, ‘Well, apart from perhaps buying some more equities, because equities have got cheaper, we’re not changing our asset allocation in response to that’. That’s the noise we would expect from a fund with this much equity exposure. We are certainly conscious of it but that short-term noise doesn’t affect our long-term investment decisions.

**Matt Craig, IIN**: Can you describe some of your investment beliefs as a long-term investor and also how you think about the definition of being a long-term investor?

**Matt Whineray, NZSF**: We take a simple approach to that and say a long-term investor is one that can hold an investment strategy for as long as they want. The key point is that you are never forced to sell something.

There are a couple of components that go into being a long-term investor. One is that you have a long time horizon from a fund prospective and we do. We expect to start paying money back to the New Zealand government in about 2030. The way that the formula works, we would still expect to grow through to about 2080, so we are going to continue to grow for another 65 years. The other key thing is that we know what our liquidity requirements are. Those two things are really important to be a long term investor.

In terms of our beliefs, as a result of the combination of those two endowments, the long horizon and the certainty of our liquidity needs, we’re able to withstand month to month, or even year to year volatility, if we think that over time we’re going to get paid for taking that risk. That informs the reference portfolio with a significant growth component in it, but it also informs the strategic tilting strategy, which relies on that long-term horizon, because what we say with that is that we expect markets to return to the mean over time, even it if takes a number of years. So we may underperform our benchmark by a significant margin while we wait for markets to return to the mean expectation that we have. That strategic tilting strategy is a very important manifestation of our long horizon.

Some other manifestations of our long horizon are our investments in forests and farms. We think they are good diversifiers but we wouldn’t want to sell them in a hurry if there was a downturn. That’s been another focus for us in terms of exploiting that long term horizon.

**Matt Craig, IIN**: What other assets do you hold where you are providing capital over the long term?

**Matt Whineray, NZSF**: We have some infrastructure assets, held directly and through funds as well. At the moment, we think that infrastructure, particularly core or brownfield infrastructure, is a bit expensive. That’s largely driven by our view on bonds being expensive and there being a significant fixed income factor in infrastructure returns.

The key criteria is, is it going to improve the performance of the portfolio? Are we getting compensated for the risk that we’re taking on? We do have some emerging market exposure in the portfolio, mostly in listed assets but we do have some unlisted fund exposure, both in real estate and in infrastructure. We have some other domestic infrastructure assets. Regulation and regulatory changes can have a big impact on infrastructure returns. More broadly in infrastructure, there are some interesting opportunities but there is a fairly limited supply of what investors would think of as easily investable structure. More and more investors are saying, ‘Yes, we’d like a bit of infrastructure
in our portfolio. Let’s add it in’. As a result of that, you have seen prices move quite a lot in the infrastructure space for brownfield, core infrastructure assets.

**Matt Craig, IIN:** *Have you ever come under government pressure to invest in areas like infrastructure?*

**Matt Whineray, NZSF:** No, we have not and that is a great benefit to us, that independence is really important. It is part of our legislation, we have an independent board and make investment decisions on a purely commercial basis. That independence of governance is really important. We don’t get told by the government ‘go and have a look at this or that’. That’s critical because we’ve got a mandate and you can’t serve two masters. If you try and do that you’ll disappoint both of them. However, there is a desire around the world, and New Zealand is not alone, in terms of getting more money in to infrastructure. One of the difficulties is that what governments want is new infrastructure, but what investors find easiest to price is old infrastructure, that has already constructed and doesn’t have any construction risk. Infrastructure where the demand levels are already established so, for example, on toll rolls, you don’t have any risk around how many people are going to drive on them once they open. You know, it’s getting money in to the greenfield infrastructure which is where it’s really needed whereas investors find it easier to go in to the brownfield stuff. That’s the challenge for, sort of, governments around the world, I think which is being able to channel invested money in to greenfield infrastructure and that’s a tougher thing to do.

**Matt Craig, IIN:** *Does the fund invest in greenfield infrastructure?*

**Matt Whineray, NZSF:** We made a commitment to a New Zealand fund which was established a few years ago to focus on what was called social infrastructure. PPPs focused on providing, for example, roads or schools or prisons and that is invested in some New Zealand school projects. It is invested in a new prison that’s being built and also in a convention centre. We found a structure that we were comfortable with, in terms of being able to direct some money in to those greenfield opportunities. We haven’t done it offshore, it depends a lot on the nature of the manager and the structure that is put in place. One of the difficulties with infrastructure assets is that they often are in private equity fund structures where, in order to pay an infrastructure investment manager, you have to sell an asset that you’d like to own for quite a long time, to be able to pay them their performance fee. The fund structure is inconsistent with the underlying asset. Trying to find structures that are consistent or coherent with the underlying asset is a problem for infrastructure investors generally.

**Matt Craig, IIN:** *Are you getting more interest in the ethical or environmental social and governance aspects of investing? Is that becoming more prominent on the radar?*

**Matt Whineray, NZSF:** It is something that is increasingly being integrated into the whole investment process. It’s not just a, ‘let’s have a look at it at the back end of an investment due diligence process’ and saying, ‘do the responsible investment people like this or not?’ Rather, it is a question of ‘where should we be allocating our risk and how do we take in to account the risks that are presented by environmental, social governance issues?’ You are increasingly seeing investors develop investment beliefs specifically around ESG which is an important way of formalising it in to a strategy and putting more demands on managers in terms of how they are thinking about and managing these risks.

**Joel Paula, OECD:** *You mentioned an overweight now in emerging markets but looking at regions, there’s a big diversion in terms of performance. Maybe a lot of that’s related to commodity prices. What has your strategy been in general for dealing with a lot of volatility in emerging markets?*
Matt Whineray, NZSF: We are overweight emerging markets as a group. We think about them in our tilting strategy as emerging markets rather than separating them into individual markets. We have definitely seen a difference in performance between commodity exporters and importers and we’ve seen it in their currencies as well. We understand that there will be volatility, but we think they are, in a long-term sense, cheap versus other assets that we look at, but we know that we are going to get a lot more volatility in both currency and markets themselves. One of the things we are thinking about though is, how would we tailor our tilts or our overweights to try and take in to account some of those differences? Assuming that you can sensibly make those differences on a forward-looking basis, as opposed to a backward-looking one. It’s easy to identify those that have performed badly now, but it’s not always easy to identify those on a longer term, forward-looking basis. That’s why at the moment, those exposures are broader than being rifle shots.

Matt Craig, IIN: With currency, do you take an active position and try to capture value, or do you just try to hedge currency to try and remove the currency risk?

Matt Whineray, NZSF: At our reference portfolio level, our benchmark, the assumption there is we hedge all of our foreign exchange exposures back in to New Zealand dollars. Where we express our currency views is in our strategic tilting strategy and we are reasonably active there. We have positions in a number of currencies. We trade the Kiwi, the Aussie, the Canadian, the US dollar, the Pound, the Euro and the Swiss Franc and the Yen. We have short and long positions in those currencies that change from time to time, depending on where we think relative value is, or the price versus the long run equilibrium value. We had a reasonably big short position on the Kiwi over the last year, so a big contributor to that value add for the year ended was long foreign currency, short the Kiwi dollar. The Kiwi dollar has fallen significantly over the course of the last year. We definitely take some views in the currency markets. We express them in that, if you like, medium term strategic tilting strategy.

Matt Craig, IIN: In terms of an investment belief, presumably you see currency as a way of adding value?

Matt Whineray, NZSF: Yes, the investment belief is that returns or currency levels are, at least partly, predictable and that they will mean revert over time. The key investment belief, if you like, is the mean reversion belief, these things can depart from their long run equilibrium value. That long run equilibrium value will be dictated by the economic forces and the different countries, the relative growth rates, the relative interest rates, the relative inflation rates. You can estimate a long run equilibrium value for the exchange rate, and then you can compare that with the current price. We look at currencies in that sense as being similar to other markets, where we can say there is a long run equilibrium value and then we will apply risk to them, according to how far we think they deviate from that value and how confident we are. We do have more confidence in some currency pairs, compared to others and that gets reflected in how big our positions are.

Matt Craig, IIN: Looking ahead for investors such as yourselves, what do you think are the next steps in governance and how structure the fund?

Matt Whineray, NZSF: In terms of governance, I think we have a really good governance structure. We’ve got an independent board, clear legislation, a commercial mandate and no interference.

One of the things that we think about from a strategic perspective is scalability. That is something that we will be discussing with the board. In fact, we’re having a strategy day in about a month’s time and one of the questions is, ‘as we continue to grow, how do we get scalability in the key strategies that
we think that will add value to the fund over time?’ That will become a real focus for us. Last year, we implemented a new risk budget structure that detailed a framework for how we allocate active risk across the fund and we agreed a new overall risk budget for the fund with the board. We are still developing the way in which that operates internally. We have largely got it there in terms of how it operates in respect of the board, so we report on the different risk budgets, how much risk we’ve allocated to each of those over time, and that’s been in place for about a year. That’s a newer thing for us in terms of a governance perspective but one that seems to be working well so far.

With governance, you go back and review the investment beliefs with the board every so often. Have we had any changes in our beliefs? If we’re happy with our beliefs, are we still happy that our strategies are based on those beliefs? That’s a really important question to ask, because you can have a number of beliefs, but then you can go into different investment strategies that bear no relation to those beliefs. Then the test is, do we have the capability internally to be able to run those strategies? That doesn’t mean that we can do them ourselves, but that we are also able to access them externally. Those are the three things that we test all the time and the board should always be testing. Are our beliefs reasonable ones for an investor like us? Do we have strategies that are based on those beliefs? Do we have the capabilities internally to manage those strategies?

Joel Paula, OECD: As a relatively new fund, I was wondering how you’ve been able to educate the people of New Zealand and the beneficiaries of the fund to how you function? Also, how you have got to the level you have, relatively quickly and in a short period of time.

Matt Whineray, NZSF: It’s probably easier to answer the second question first, which is because we’re so young we were able to get to that where we are now quickly. We weren’t starting from a position of having done things the same way for 30 years, or having asset allocations that have largely been developed over a long period of time. We are a relatively small fund. We had plenty of scope for innovation. We had a board that was really happy to be part of thinking about new ways of doing it. We spent a lot of time getting on planes, because New Zealand is quite a way from everywhere, and going out there and talking to people who we thought were smart in the space and who could help us. We’ve benefited a great deal from that, being able to talk to really smart funds around the world. We think of these peer funds, they might be a lot bigger than us but they have got similar mandates. We ask them, ‘how are you doing this?’ They’ve been very helpful to us in developing our thinking. Collaboration is a really key part of our strategy. Comparing what we do with other funds, collaborating with them and if we can, co-investing with them. We have started from a clean sheet of paper and we have been able to get assistance from a lot of smart people and that’s helped us develop.

On the first question about how we communicated that, it is just by doing a lot of communication. We spent a lot of time thinking about how we invest and then telling people how we invest. Telling people what they should expect to see and explaining things in great detail. Providing a lot of detail about the transactions that we’ve done and the asset allocation approach that we take. Over time, our picture has got quite simple but it’s only got to that point by spending a lot of time thinking about how to communicate it. What the key issues are that people should care about and trying to get them focused on those. In a way, going through the GFC was helpful for that because having a big negative year really flushes out some of those questions. Do you have the right beliefs? Do you have the right strategies? Do you have the right people? You rarely get as much opportunity to explain why you are doing things the way you are, why you hold as many equities as you do, as when they’ve just gone down by a massive amount and everyone, with the benefit of hindsight, says you should have been holding government bonds the whole time. We really had to get quite good at explaining what we are doing and we’ve published a series of white papers on our website. They are on what we think about different aspects of strategy, how we think about all aspects of our business and all of our policies.
We’ve spent a lot of time and put a lot of effort into that communication, to get people to understand what it is that we do. That challenge continues. It’s a really important focus for the whole thing.

**Matt Craig, IIN:** Is co-investing something you favor? It seems to be popular in principle but not always easy to do in reality.

**Matt Whineray, NZSF:** We love to co-invest if we can find people with the right alignment. The same horizon as us, the same need for liquidity as us, the same way of thinking about investments and that can be a real challenge. You never really get to know your co-investment partner, how they think and how they operate, until you take part in a transaction. We like the idea of co-investing, we spend quite a lot of time talking to people about it, we have done some of it and we’d like to do more of it.