



ANNUAL REPORT 2005

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The Fund

Like many countries around the world, New Zealand has an ageing population, with the number of people over 65 years expected to double by 2030. Accordingly, the cost of providing retirement income – in the form of New Zealand Superannuation – is also expected to double in this period.

The Government created the New Zealand Superannuation Fund to partially provide for this future cost. The Fund is an investment fund that accumulates and invests Government contributions. The purpose is to build up a portfolio of Crown-owned financial assets over the next two decades while the cost of New Zealand Superannuation remains relatively low. As the cost of providing New Zealand Superannuation starts to escalate, the Government will progressively draw on the Fund to help smooth the impact on its finances.

Established under the New Zealand Superannuation and Retirement Income Act 2001, the Fund began investing in September 2003 with \$2.4 billion in cash. It is expected to grow to around \$120 billion in twenty years time.

The Guardians

The Fund is governed by a separate Crown entity called the Guardians of New Zealand Superannuation. While accountable to Government, the Guardians operate at arm's length from Government.

The function of the Guardians is to manage and administer the Fund in accordance with the New Zealand Superannuation and Retirement Income Act 2001. The Guardians' principal duty is to invest the Fund in a prudent, commercial manner. They must maximise investment growth without undue risk to the Fund as a whole, in a manner which avoids prejudice to New Zealand's reputation as a responsible member of the world community, and using best practice portfolio management.

All decisions relating to the business of the Guardians are made under the authority of the Board of the Guardians of New Zealand Superannuation.

2005 HIGHLIGHTS

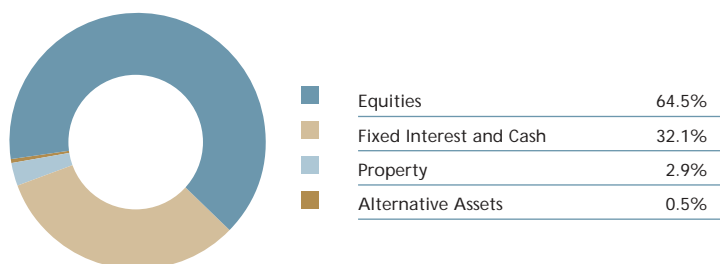
Financial Overview

- Fund assets grew from \$3,985.4 million to \$6,613.5 million*
- Net contributions of \$2,107.0 million
- Investment income of \$726.1 million (after costs, but before tax)

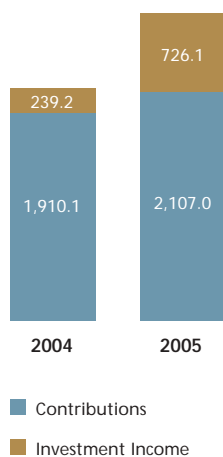
Investment Performance

- Rate of return of 14.13%, against risk free rate of return of 6.33%
- Annualised rate of return since inception of 12.50% p.a. against risk free rate of return of 5.88% p.a.

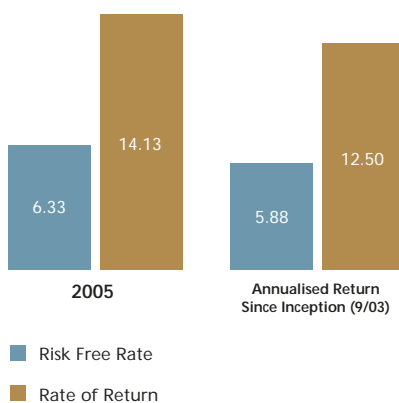
Asset Allocation as at 30 June 2005



Growth in Fund Size (NZD Millions)



Return Against Risk Free Rate (%)



* Net assets after adjustment for deferred tax liabilities and tax receivables.

OVERVIEW OF THE FUND

New Zealand Superannuation

New Zealand currently has a tax payer funded 'pay-as-you-go' retirement income system, where eligible residents over the age of 65 receive a pension irrespective of their income or assets. The pension is known as New Zealand Superannuation.

At present, in New Zealand, there is only one person in eight over the age of 65.

Longer term, the picture looks very different with a sharp increase in the proportion of the population over 65 years of age. New Zealand's ageing population means that by 2030 the ratio of people over 65 will have risen to one in four. This ageing of the population, an issue which

many countries face, is due to both increased life expectancy and lower birth rates.

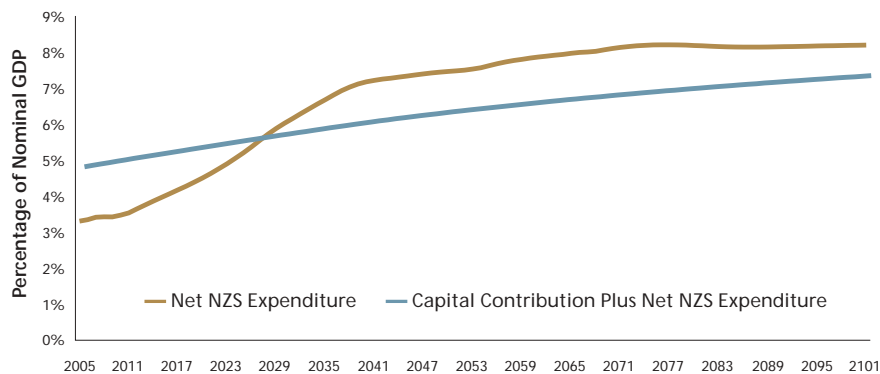
Meeting the Cost of an Ageing Population

The increase in the number of retired people relative to the working age population will inevitably lead to a significant increase in the cost of providing New Zealand Superannuation. Currently, the net cost is 3.3% of GDP. Projections indicate that by 2030 that will be about 6%, and by 2050 about 7.5% of GDP.

One way to alleviate this pressure is to move from a complete reliance on the 'pay-as-you-go' system to a partially pre-funded system, which is what New Zealand has done with the creation of the New Zealand Superannuation Fund.

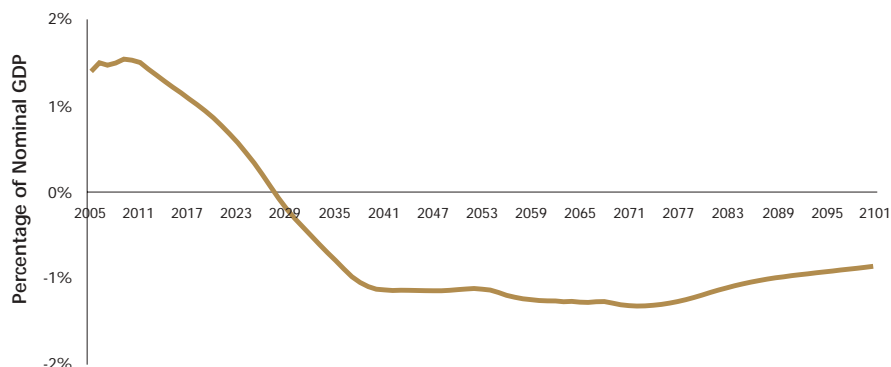
Smoothing the Cost of New Zealand Superannuation

Source: New Zealand Treasury (www.treasury.govt.nz)



Capital Contribution to Fund

Source: New Zealand Treasury



A Smoothed Pay-As-You-Go System

Established under the New Zealand Superannuation and Retirement Income Act 2001, the New Zealand Superannuation Fund is an investment fund that accumulates and invests Government contributions. These contributions, which are paid out of general taxes, are expected to average \$2.2 billion a year over the next two decades. The Fund invests the money in a way that maximises returns, without undue risk, over the long term.

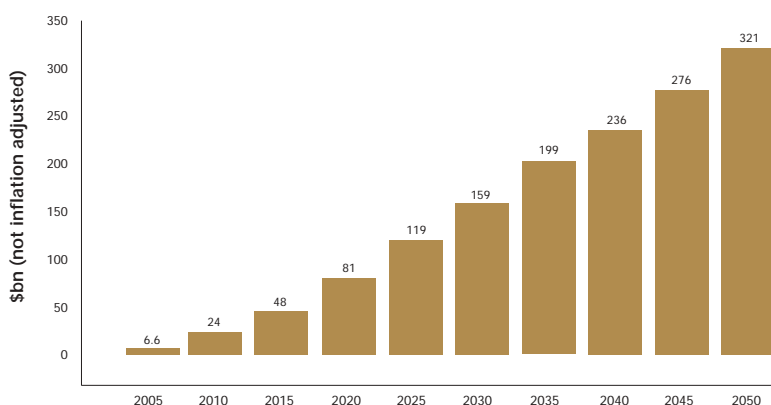
The purpose of the Fund is to build up a portfolio of Crown-owned financial assets while the cost of New Zealand Superannuation remains relatively low. Those assets will then be progressively drawn on to supplement the Government's annual budget as its finances adjust to the much higher

level of ongoing expense for New Zealand Superannuation. In effect, the Fund provides a smoothing mechanism for what remains, fundamentally, a 'pay-as-you-go' system.

Under law, no capital withdrawal is allowed from the Fund before 1 July 2020. According to current Treasury modelling, capital contributions are likely to cease around 2028, at which time the Government will start to draw on the Fund. The Fund's assets are projected to peak at around 42% of GDP sometime between 2035 and 2037, and will then gradually fall as a proportion of GDP over the ensuing decades. Because capital withdrawals are forecast to always be less than the Fund's income, the Fund is expected to continue to grow in nominal (dollar) terms.

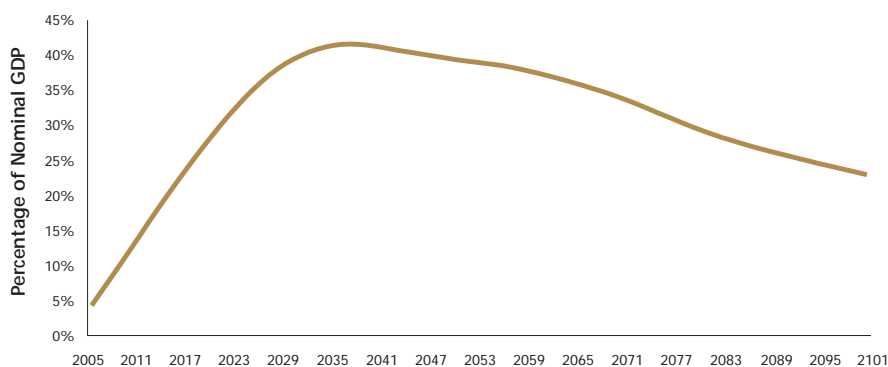
Size of Fund Assets (NZD Billions)

Source: New Zealand Treasury



Size of Fund Assets (Percentage of Nominal GDP)

Source: New Zealand Treasury



FROM THE CHAIRMAN



As a guide to the future, this year's returns should be treated with considerable caution. While the Board is confident that the investment portfolio will outperform the risk free rate over the long term, there will inevitably be years when equities perform badly and target return is not achieved.

DAVID MAY

In a little under three years, the Fund has grown to \$6.6 billion which is invested in 10 distinct asset classes by 19 specialist investment managers.

Researching, planning and implementing the structure, combined with the appointment of staff, advisers and investment managers were the key priorities and achievements in years one and two.

The third year has seen further progress in all these areas but importantly has also seen the delivery of the first full year of investment results.

Investment performance

The Board has set its investment performance objective to exceed the risk free rate of return by at least 2.5% per annum over rolling 20-year periods. For the year ending 30 June 2005, the actual return of 14.13% exceeded the risk free rate by 7.80%. This follows the first nine months of investment (from 30 September 2003 to 30 June 2004) which produced an annualised return of 10.40%. This exceeded the risk free rate by 5.10% on the same annualised basis.

The good performance in these early years has been driven mostly by rising equity markets (the international component of which was protected from the impact of a strong New Zealand dollar by our policy of hedging a large part of the currency risk). We are particularly pleased with the performance of the Fund's active equity managers in the current year who have collectively outperformed their benchmark indices by large margins.

As a guide to the future, the results should be treated with considerable caution. While the Board

is confident that the investment portfolio will outperform the risk free rate over the long term, there will inevitably be years when equities perform badly and target return is not achieved. Similarly, while our managers are expected to outperform their benchmark indices over the long term, the results in 2004/5 were exceptional and are unlikely to be consistently repeated.

Investment portfolio

During the year appointments were made for seven new investment mandates. This brings the total number of specialist mandates to 23. Considerable research is undertaken to establish confidence in the ability of external managers to add value before they are appointed.

The Fund's strategic asset allocation was reviewed for the first time since investing began. This resulted in confirmation of the broad allocation between growth and income assets, and led to a decision to increasingly diversify into asset classes such as property, private equity, infrastructure, timber and commodities. This means a move away from the current concentration of investments in listed markets.

While this diversification will take time, significant progress has already been made. We have established strategies, and appointed specialist advisers, for each area. Subsequent detailed investment analysis has led to specific allocations to the New Zealand private equity and unlisted property markets, as well as to the global infrastructure sector. Much of the work done to

date in these other asset classes will become apparent in the 2005/6.

Independent review

Our governing legislation requires that an independent review of the Guardians' performance be carried out at least every five years. The first review was completed in October 2004 by Eriksen and Associates and tabled in Parliament on 10 November 2004.

The review was timely because the Fund's structure, asset allocation and governance model, while already in place, were still at a stage where they could be modified relatively easily if the report indicated shortcomings compared with best practice.

In the event, the review concluded that the investment policies and operating model were appropriate and met best practice standards in all material respects. It stated that "The Board and Executive have succeeded in investing the bulk of the funds received in a practical, efficient way in a short timeframe and with very modest resources. In my view the Government has received excellent value for money from the Guardians to date".

This was a pleasing result for a management team who had steered the Fund through an intense period of policy formulation and implementation.

Consistent with the emerging thinking inside the organisation, the review recommended an increase in the weighting to alternative assets. Additional funding to support both this development, and the growing complexity of the Fund, was also endorsed. Both recommendations have been acted upon.

The Board

During the year, we welcomed two new Board members. David Newman is currently Chairman of Infratil Limited, and is a former Chief Executive of BP New Zealand Limited. Glen Saunders is the former UK Managing Director of Netherlands-based bank, Triodos. They have made a valuable contribution to the Board since joining.

In May, at the expiry of his term of office, Ira Bing left the Board. He is now pursuing personal business interests overseas. Ira's contribution during the demanding formative phase of the Fund is much appreciated.

My thanks go to all Board members for the diligence and robust discussion they have applied to a vast range of subjects and recommendations in helping us reach our collective decisions.

External expertise

The Fund depends on the expertise of a wide range of people - internal and external. In addition to the appointed investment managers, the Fund has a number of specialist investment advisers across a range of diverse sectors. These include private equity, infrastructure, timber, responsible investing as well as portfolio design and external manager due diligence. Operations are supported by an external global custodian, audit programme as well as tax and legal advisers.

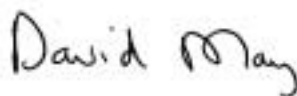
The Management team

The management of this complex flow of advice, data and funds relies on the intellect, drive and energy of a small internal team who also formulate, or review, all policy advice. While the performance in the last year reflects the contribution of the whole network of people who bring their skills to the organisation, the Board owes particular thanks to the Fund's own team of talented people for their rigorous provision and dissemination of advice as well as their management of the operating environment.

The future

The Fund's continuing rapid growth and diversification puts an increasing demand on operational integrity and risk management. This will require an increasing emphasis going forward. The move into alternative asset classes, which are inherently less well researched than public markets, brings additional challenges in maintaining high standards of selection, due diligence and disclosure. Building and monitoring an increased stable of high quality investment managers will put fresh demands on the management team.

Next year will be every bit as challenging as the past three years.



David May
CHAIRMAN

CHIEF EXECUTIVE'S REPORT



A major project during the year was a comprehensive review of the Fund's asset allocation. From the very beginning we recognised the value of the mandate we have been given – a steady stream of contributions and a very long period of time over which to invest them.

PAUL COSTELLO

Much has been achieved in the Fund's short life. In the period from September 2002, when the Board first met, to our last report in June 2004, the organisational infrastructure was established, the initial investment strategy adopted and almost NZ\$4 billion invested in a range of listed equity and fixed interest mandates around the world.

The year commencing 1 July 2004 provided an opportunity to review this early progress. We feel fortunate to have enjoyed robust markets in these formative years as this has allowed us to focus on building for the future, undistracted by market volatility.

We have been working hard on building a robust approach to identifying skilled external managers in public markets. We have been delighted with our early success in this area but acknowledge that over time the excess returns that we expect to generate from active management will be more modest. On pages 14 and 15 we discuss our approach to this task.

A major project during the year was a review of the Fund's asset allocation. From the very beginning we recognised the value of the mandate we have been given – a steady stream of contributions and a very long period of time over which to invest them.

This means the Fund is a natural investor in those markets where attractive risk-adjusted earnings can be generated in return for forgoing the need for liquidity. As a result of this review we decided to materially increase the allocation to these 'alternative assets' to around one third of the Fund. Our thinking on this issue is discussed at some length on pages 10 and 11 and a full report is available on our website.

We understand that the process of achieving this exposure without compromising returns is not straightforward and it is pleasing to have established partnerships with a range of talented specialist organisations to help us achieve this.

Our Focus

As an organisation, we believe that our efforts are best spent on managing the Fund's exposure to a fully diversified range of markets and ensuring that we have quality execution of our strategy through external investment management firms.

We have committed to building an internal team to champion these issues, but we believe that the best decisions will result from robust debate between internal and external expertise. To this end, we have deliberately sought out international advice and experience.

We have been welcomed in a number of prestigious and successful institutions around the world and the insights offered in these discussions have proved enormously helpful. Our aim is to continue to build these relationships with our global peers, and to develop a network of advisers in New Zealand and overseas who will improve our ability to manage the portfolio.

The management team is small. At 30 June 2005, there was a full-time staff of eight investment professionals and three support staff. A year earlier there was a total staff of nine. The internal capability of the organisation was strengthened with these recent appointments. Additional staff will be added over the coming year reflecting the rapidly increasing portfolio and the growing complexity of the task. The current management team is profiled on page 21.

The commitment and talent of the staff is a great asset to the Fund. We have strived for a culture which provides management with the flexibility to make decisions in a timely way to capture market advantage, but also recognises the accountability that comes with managing public savings. The Board has been supportive of this development and I believe the organisation is stronger for it.

Looking Ahead

While the 2004/5 year has seen us make significant progress in the development and implementation of an investment policy framework for the Fund, we plan to complement this with a thorough review of our operational capacity in 2005/6. This is a natural consequence of the challenges presented by the Fund's growth.

We also plan to participate in global benchmarking surveys during the year to provide perspective on how effectively, and efficiently, we are managing the Fund's assets compared to our global peers. While this has always been our intention, we have had to wait until our programme has been operating sufficiently long to provide meaningful data for comparison with our peers.

Other priorities for the year ahead include a review of how we manage our responsibilities in relation to socially responsible investing and also

how we exercise our voting rights. This is an area of growing awareness in both the pension fund and general communities. We have initiated discussions with a number of public funds elsewhere in the world on this issue with the aim of ensuring our approach in this area is contemporary.

Communicating with Stakeholders

While this annual report is an important opportunity for our organisation to communicate with the Fund's stakeholders, we are committed to providing a high degree of transparency during the year. We publish a monthly performance update on our website and provide regular reports on our key appointments and other progress through news releases. In addition, while we have always identified the Fund's largest holdings, we have recently moved to make all public equities owned by the Fund, and their market value, available on our website.

Acknowledgements

Many individuals and organisations have contributed to this year's success. My colleagues deserve special mention. The Board has provided management with wise counsel during the year and I am grateful for this. In addition, many others around the nation and the world have given generously of their time and experience. We look forward to the challenges of 2005/6 acknowledging that investment markets are likely to be more difficult but pleased to have made significant steps in diversifying the Fund to reduce the impact of this.



Paul Costello
CHIEF EXECUTIVE OFFICER

INVESTMENT PERFORMANCE

The assets of the Fund grew from \$3,985.4 million to \$6,613.5 million in 2004/5. The growth consisted of \$2,107.0 million in Government contributions and \$726.1 million in investment income.

Overall Performance

The return on Fund assets of 14.13% for the 2004/5 year was comfortably ahead of the long term minimum return objective set by the Board. This objective remains to exceed the risk free rate of return (the yield on New Zealand 90 day Treasury bills) by an average of at least 2.5% p.a. In 2004/5 the return was 7.8% above the risk free rate.

The after-fee returns for the four major asset classes, after taking into account currency hedging, were as follows:

New Zealand Equities	22.86%
Global Equities	14.85%
New Zealand Fixed Interest	8.03%
Global Fixed Interest	13.28%

This result reflects the continued recovery of global share markets since early 2003. Since that time, world equity markets have increased in value by almost 50% (excluding currency movements). In addition, our active managers produced returns substantially above long term expectations. Our policy of hedging a large proportion of the overseas investments back to the New Zealand dollar (NZD) also made a significant contribution. This can be illustrated by comparing the return, in NZD, of the MSCI World Equity index (72.5% hedged) of 10.6% with the return of 0.44% for a completely unhedged portfolio.

The returns are after investment management costs but before the payment of tax to the New Zealand Government. This reflects our view that foreign taxes are leakages to the Crown, whereas the payment of New Zealand tax is a return to the Crown of equal value to the after-tax earnings in the Fund.

Operating Costs

Fees paid to investment managers for the year amounted to 0.29% of average assets during the period. All assets are externally managed and a summary of the mandates awarded to these investment management firms is on page 13.

In addition, payments were made to the Fund's master custodian, BNP Paribas Fund Services Australasia Pty Ltd, for services performed. These include safe keeping of the assets, settlement of transactions, and a range of additional services around performance reporting and compliance monitoring. Other payments made out of Fund assets during the year include:

- Specialist services (consulting, legal and tax advice) for the alternative asset classes introduced during the year;
- Review of the portfolio for compliance with the Fund's policy on ethical investing.

Custody and these other expenses equalled 0.12% of average assets, bringing the total deduction from gross Fund earnings for all costs to 0.41% of average assets for the year. While our focus is on maximising after cost investment income, and simply operating the Fund at low cost is not an objective, this level of operating expense is competitive.

While some costs can be expected to reduce as a proportion of total assets as the Fund grows (e.g. the average fees paid to external managers will decrease as the Fund grows due to applicable volume discounts), these will be partly offset by higher costs associated with a growing allocation to alternative assets (private equity, timber, infrastructure) which are more expensive to invest in.

Under the New Zealand Superannuation and Retirement Income Act 2001 the expenses of the Guardians are not deducted from Fund earnings like those outlined above, but are covered by a separate appropriation from Parliament. Board and management expenses, office related costs and professional advice sought by the Guardians in developing policy are presently covered by this appropriation. In 2004/5 these expenses

Sector	Value in NZD Millions as at 30 June 2005	Unhedged Return for 2004/5 Year (After Fees)	Excess Return Against Benchmark (After Fees)
New Zealand Large Cap Equities <i>NZSX 50</i>	\$454.6	22.49% <i>20.42%</i>	2.07%
New Zealand Small/Mid Cap Equities <i>NZSX Mid Cap (70%) and NZSX Small Cap (30%)</i>	\$98.7	28.69% <i>21.25%</i>	7.44%
Global Large Cap Equities (Style Neutral) <i>MSCI World in NZD</i>	\$1,745.8	2.17% <i>0.44%</i>	1.73%
Global Large Cap (Growth) <i>MSCI World Growth in NZD</i>	\$552.7	1.89% <i>(2.64%)</i>	4.53%
Global Large Cap (Value) <i>MSCI World Value in NZD</i>	\$557.9	5.86% <i>3.48%</i>	2.38%
US Small Cap <i>Russell 2000 in NZD</i>	\$306.3	2.66% <i>(0.11%)</i>	2.77%
EAFE (Non-US) Small Cap <i>Citigroup Extended Markets in NZD</i>	\$309.5	11.58% <i>6.45%</i>	5.13%
Emerging Markets <i>MSCI Emerging Markets Free in NZD</i>	\$239.5	21.54% <i>22.65%</i>	(1.11%)

amounted to \$3.48 million, equivalent to 0.07% of average Fund assets. These costs are expected to reduce as a proportion of Fund assets in the future as many are fixed costs not directly impacted by the rapid growth of the Fund.

The Reward for Active Risk

We accept the premise that active management is a 'zero sum game'. This means that returns above a market benchmark generated by one investor necessarily come at the expense of another, with the total return from active management in the market netting to zero. Accordingly, allocating part of the Fund's risk budget to active management occurs only where we believe there is a high probability of securing adequate compensation for the risk involved. Our approach to identifying and selecting investment management firms in which we have this confidence is outlined on page 14.

At present, fixed income securities are primarily managed passively. This means that returns above benchmark were sought only in equity markets. The results for the year are listed in the table above. Note that returns are before the effect of any currency hedging in the portfolio is taken into account.

Investment Outlook

As most investors appreciate, investment markets tend to be cyclical. The very strong price growth in global equity markets over recent years leaves the ratio of share prices to corporate earnings high compared with historical averages. This leads us to believe that over the next few years the 'equity risk premium', or the margin above risk free interest rates paid to investors in shares, is likely to be below what has been historically enjoyed.

At the same time, yields on listed property are at 30-year lows and credit spreads for most grades of non-sovereign debt are near historic lows. This does not bode well for these sectors.

While our role is to manage the Fund in a way to limit the effect of assets declining in value, in an environment where there are relatively few sectors that seem undervalued, it is appropriate to note that total returns over the next few years are likely to be lower than long term historic averages. While the move to 'alternative' asset classes will reduce the Fund's exposure to these pressures, the increasing demand for these assets from investors suggests it will take time to build meaningful exposures of appropriate quality assets.

STRATEGIC ASSET ALLOCATION

The Fund represents an important national asset, projected to move from its current 5% of GDP to approximately 42% over the next three decades. As the liability for providing New Zealand Superannuation payments lies solely with the Government, and the Fund is only ever expected to meet part of this cost, we have decided to focus on adding value to the Government balance sheet by generating excess returns above the risk free rate.

The success of the Fund's investment strategy will therefore be measured by how much the national balance sheet has grown over and above what a risk free investment programme would have delivered.

Strategic Asset Allocation

When investing began in September 2003, the strategic asset allocation (SAA) was set at 67% to listed equities, 20% to fixed interest and 13% to a combination of property and alternative assets. This strategy resulted from a project in early 2003 aimed at determining the most efficient way to generate excess returns over the risk free rate. It reflects our belief that growth assets (equities and equity-like investments) will provide superior returns to lower risk income assets (generally fixed interest securities) over the long term. The growth: income mix was set at 80:20.

Portfolio Review

As part of a commitment to regularly assess strategy, we carried out a review of the initial SAA in late 2004. As a result we announced a revised strategy in March 2005.

In undertaking this review, our approach was to start with the proposition that a representative investor might seek to replicate the 'global wealth portfolio' (a portfolio of all readily investable assets around the world, in their relative proportions). The next step was to consider the characteristics of the Fund which distinguished it from such a representative investor, and to modify the portfolio to take advantage of these differences.

Distinguishing Features

The Fund's key distinguishing features are: the long investment horizon (30-50 years); the lack of need for any liquidity (20 plus years before any withdrawal is envisaged); and the value offered by the New Zealand equity market to a domestic investor.

The global wealth portfolio is relatively evenly balanced between growth and income assets. Given the long investment horizon, and the associated lower sensitivity to short term volatility, our analysis confirmed that an 80:20 growth:income split should provide a meaningful increase in excess returns compared to the global wealth portfolio. We recognise, however, that this comes with a considerable increase in volatility and considered whether this additional return could be achieved in a less risky way.

This led us to assess the value of the Fund's lack of need for liquidity, and the extent to which the 'illiquidity premium' in some of the alternative asset classes might be better exploited. This refers to the enhanced return for risk available to investors who are able to allocate part of their portfolio to long term investments like private equity, timber, infrastructure and property because they do not need to liquidate assets at short notice. Given the Fund's natural advantage in this area, we decided to increase the allocation to these assets from the original 13% to 35% over time. This will largely be funded by a reduction in the allocation to global listed equities and fixed interest.

The third characteristic of the Fund is that it is a New Zealand taxpayer. While the New Zealand share market is very small in global terms (less than 0.25% of total world share market capitalisation), the value of dividend imputation credits makes it disproportionately appealing for the Fund. With New Zealand equities providing comparatively high levels of fully imputed dividends, and a substantial component of the New Zealand market held by international investors who do not benefit from the imputation credits and who, therefore do not fully price in

their value, domestic taxpayers have the ability to gain exposure to tax-paid corporate earnings at an attractive price. Balancing this opportunity against the concentration of risk in a relatively small market is a judgement, but our view is that a target allocation of 7.5% to domestic equities is appropriate.

A More Efficient Portfolio

While it is unwise to place too much reliance on the results of portfolio modelling, it is interesting that over the long term the revised portfolio is expected to have a 75% probability of generating an average of at least 2.5% p.a. in excess of the risk free rate. This is superior to the expected risk adjusted return of the original SAA. In addition, we expect downside risk to be reduced, with the probability of achieving a return greater than the risk free rate standing at around 98% over the long term.

Moving to Alternative Assets

We recognise that transferring a significant proportion of the growth assets in the portfolio to unlisted markets involves significant implementation challenges. While broad exposure to listed equity and fixed income markets can be achieved quickly, and at low cost, it's the opposite for the alternative sectors. It is widely observed that the dispersion between the top performing, and median, private equity funds is significant. Returns in the timber and infrastructure sectors are generally less variable, but transactions are often lumpy and require specialist insights.

For this reason, an interim asset allocation has been established with a target date of June 2007. By this time we anticipate that the allocation to alternative assets will have increased from the current level of 0.5% (reflecting the focus during the first two years on building the exposure to listed markets) to 13%. We also expect the allocation to property to grow from 2.9% to 10% of the Fund.

The 13% allocation to alternative assets has some elasticity around it. Target allocations, and ranges around these, have been set for each sector as follows:

Sector	Target Allocation as at June 2007	Range
Infrastructure	3%	2%-5%
Private Equity	1%	0%-2%
Commodities	5%	5%
Forestry	2%	0%-5%
Absolute Return Strategies	2%	0%-3%
Total	13%	7%-20%

While these targets are a useful guide, it's important to stress that the quality of the investment programme will not be compromised by them. We have been working on implementation strategies for most of these sectors and since balance date we have made a number of commitments. These include allocations to timber, collateralised commodities futures, New Zealand private equity, and global infrastructure.

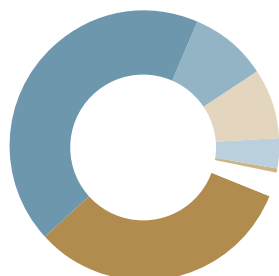
A full summary of the Fund's investment strategy review is available at www.nzsuperfund.co.nz.

Foreign Currency

As a general principle, we seek to limit the exposure to foreign currencies in the Fund. We plan to fully hedge our global fixed interest exposure back to NZD. While our general strategy is to hedge 85% of our global growth assets, we have temporarily decreased this to 72.5% in recognition of the historically high level of the NZD, and our expectation that this will return to a more sustainable level over the medium term.

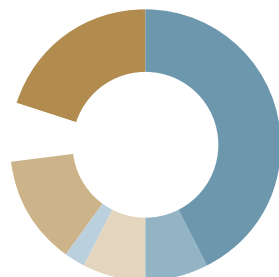
STRATEGIC ASSET ALLOCATION - CONTINUED

Portfolio as at 30 June 2005



Sector	Current SAA
Global Large Cap Equities	43.2%
Global Small Cap Equities	9.3%
New Zealand Equities	8.4%
Emerging Market Equities	3.6%
Alternative Assets	0.5%
Property (NZ and Global)	2.9%
Fixed Interest	32.1%
Total	100.0%

Target Portfolio as at 30 June 2007



Sector	June 2007 SAA
Global Large Cap Equities	42.5%
Global Small Cap Equities	7.5%
New Zealand Equities	7.5%
Emerging Market Equities	2.5%
Alternative Assets	13.0%
Property (NZ and Global)	7.0%
Fixed Interest	20.0%
Total	100.0%

Longer Term Target Portfolio (Beyond 2007)



Sector	Longer Term SAA
Global Large Cap Equities	34.5%
Global Small Cap Equities	6.0%
New Zealand Equities	7.5%
Emerging Market Equities	2.0%
Alternative Assets	25.0%
Property (NZ and Global)	10.0%
Fixed Interest	15.0%
Total	100.0%

EXTERNAL INVESTMENT MANAGERS

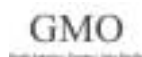
We awarded eight external investment mandates in 2004/5, bringing the total number to 23. Five of the eight mandates were listed equities, including Sterling Johnston (US small cap), Citigroup (global emerging markets), GMO (global large cap), Vanguard (global listed property), and LSV (global emerging markets).

A global emerging markets mandate was withdrawn from WestLB Asset Management during the year. This followed a number of staff departures within that organisation. LSV was appointed to replace WestLB Asset Management.

The increased allocation to alternative assets, as well as to property, coincided with the first steps we took to build the Fund's portfolio in these areas. In March, Capital Partners Pty Ltd was awarded a broad mandate to acquire infrastructure assets in a range of sectors, globally and in New Zealand. In June we appointed AMP Capital Investors (NZ) Limited to manage a New Zealand unlisted property mandate, via the AMP Property Portfolio (APP).

A schedule of the external investment managers as at 30 June 2005, and the classes of investments for which each was responsible, is set out below.

Sector	Manager	Amount Held as at 30 June 2005 (NZD Millions)
New Zealand Equities	AMP Capital Investors	\$201.8
	Brook Asset Management	\$252.8
	Fisher Funds	\$98.7
New Zealand Fixed Interest	ING (Sovereign Debt)	\$844.7
	ING (Credit)	\$123.4
New Zealand Property	AMP Capital Investors	\$78.6
	Alliance Capital	\$405.1
Global Equities (Large Cap)	Bernstein	\$275.6
	Barclays Global Investors	\$1,745.8
	Grantham, Mayo & Van Otterloo	\$147.6
	LSV Asset Management	\$282.3
	AXA Rosenberg	\$154.7
	Grantham, Mayo & Van Otterloo	\$154.8
	Goldman Sachs Asset Management	\$40.8
Global Equities (Small Cap)	Numeric Investors	\$111.9
	Sterling Johnston	\$47.3
	Thompson Siegel & Walmsley	\$106.3
	Citigroup	\$118.1
	LSV Asset Management	\$121.4
Global Equities (Emerging Markets)	Vanguard Investments	\$113.3
	Capital Partners	\$33.5
Global Listed Property	Vanguard Investments	\$1,065.8
Infrastructure	Held by BNP Paribas Securities Services as custodian	\$89.3
Global Fixed Interest		
Cash		
TOTAL		\$6,613.5



HOW WE SELECT INVESTMENT MANAGERS

Our search for managers is guided by three principles: 1) active management is difficult – the average active manager will merely match the market; 2) costs matter – we need to be confident that the expected return from active management outweighs the significantly higher costs incurred pursuing it; and, 3) successful outcomes to active management depend on a manager’s skill and the number of times they apply it.

The Starting Point

For most investors, and the Fund is no exception, it is the choice of market exposure not the choice of active management that will dominate the risk and return profile of the Fund – generally by a significant factor. Our starting point, therefore, is how we can most efficiently capture the market exposure (whether it be global equities or New Zealand fixed interest) that we desire. Fortunately, in public markets assets (particularly listed equities, fixed interest, and currencies) we can achieve our market exposure very cheaply – generally for only a few basis points (1/100ths of 1%) per year.

Identifying Skilful Managers

With that knowledge we turn our attention to considering whether active managers can, after deducting their fees, deliver us better risk adjusted returns. Because the average active manager will struggle to match the market, we focus on trying to identify much better than average managers. This is not easy. Despite the best marketing efforts of managers, past performance tells us almost nothing about future performance.

To try and identify those managers who might be genuinely skilful, we examine organisations in great detail and across a wide range of factors. We ask a number of questions: Who owns the firm – do employees have a stake? How focused is it – is it trying to be all things to all people or

does it concentrate on a specialty? How experienced is the team? How deep is the team – do they have enough people to do what they claim to do? What is the risk of people leaving the team? What is the firm’s investment philosophy – how credible is it and how consistently applied? How do they research securities – what is their insight to identify opportunities? How do they construct portfolios from these insights? How do they manage risk? How efficiently do they trade? Are they an asset gatherer or do they close strategies when adding more assets would start to diminish outperformance? Can they manage their business according to the regulatory rules they operate under and the mandate rules we impose? Finally, does their past performance give any statistically significant indication that they have been skilful?

Conviction Threshold

Across all these factors we are assessing whether what the manager has to offer is better-than-average. We apply a consistent scoring system to each manager and largely compare all active managers against the broader universe of active managers (not just their local peers). We set a score threshold (we call it our “conviction” threshold) above which a manager must score for us to consider them for an active mandate. It’s a tough threshold to pass but we spend a lot of time on it - particularly with those managers we think will make the grade. We like to spend time with them in their offices, getting to know them, seeing how they work together.

We developed our conviction process early on in 2004/5. That process was stage one of how we want to transform our thinking about active management. It is a constant work in progress as we try to build better insights into what makes a great manager.

Fundamental Law of Active Management

Stage two, which we started later in the year, is about trying to apply our conviction insight to what is known as the Fundamental Law of Active Management. That is: it is skill and the number of times that skill is applied that determines results.

‘Because the average active manager will struggle to match the market, we focus on trying to identify much better than average managers’

'The last financial year was exceptional. We don't expect to be able to generate that level of active return, particularly for that level of risk, on an ongoing basis'

We've taken the Fundamental Law and used it to estimate what excess return we think a manager can achieve. There are lots of elements to this: our assessment of skill, an estimate of breadth (the number of times skill is applied), market efficiency – some markets offer better pickings for skilful managers; transaction costs; manager fees; and, the cost of achieving the right market exposure if the manager is not giving us that. Finally we need to apply an assessment of our own skill in selecting managers. If we are not skilful then we will just get average outcomes – at a high price.

It is important to emphasise that not all our managers will achieve what we expect of them. Certainly not over a quarter, nor even a year. Some not over five years. That doesn't make them poor managers. Sometimes the tides just don't favour certain skills. Our conviction framework allows us to hold true to those managers we believe are skilful even if in the short to medium term their performance is not what we would have wished for.

Ongoing Monitoring

Our conviction work also becomes a key tool in our ongoing monitoring of managers. We can immediately assess the impact of changes within a manager. Sometimes that will lead us to downgrade our score to a level that says we no longer have conviction in a manager. In that case we will terminate their appointment. Alongside that work we are adding an increasing range of quantitative tools that enable us to examine managers' portfolios in greater depth to ensure that we fully understand the nature of our risk exposures and that the manager is staying true to style.

Towards an Efficient Risk Portfolio

Having established a framework for identifying skilful managers and then monitoring them, we need to consider the best way to put them together into an active risk portfolio. Therein lies another challenge. Just as market risk tends to dominate active risk, the composition of the market risk portfolio tends, typically, to dictate the composition of the active risk portfolio. That is certainly the case for the Fund at this point. Most of the Fund's market risk currently comes from listed equity markets - almost all of its active risk comes from stock selection decisions within listed equity markets. That needn't be the case. The two should be separable.

Our challenge is to build a genuinely diversified active risk portfolio. That would include active risk taken in equities, fixed interest, currencies and commodities. In some cases that will mean engaging managers who deliver only active risk (or with minimal amounts of market risk). In others it will mean converting the market risk that is inherent in a manager's portfolio to a market risk that we desire for the Fund. The broad principles of how we might do this are well understood in the market. The practice of implementing it is, however, much more difficult than the theory.

Return Expectations

Finally, we need to continue to be modest about the amount of active return we can generate for the Fund. The last financial year was exceptional. We don't expect to be able to generate that level of active return, particularly for that level of risk, on an ongoing basis. If, after all fees and transaction costs, we can generate 0.5% of return for every 1% of active risk we take then that would be a very satisfactory result. Experience tells us that is achievable - but it won't be easy.

REPORT AGAINST THE STATEMENT OF INTENT

The Fund's governing legislation, the New Zealand Superannuation and Retirement Income Act 2001, states the annual report must include an analysis and explanation of the performance of the Fund for the financial year under review, including a comparison with the Guardians' expectations about the performance of the Fund set out in the Statement of Intent relating to that financial year.

In the Statement of Intent issued in June 2004, the estimated rate of return for the 2004/5 year was 9.0% (after costs and the effects of hedging, but before tax). This was based on an average estimated rate over the 10 years commencing 1 July 2004, and no particular confidence was attached to the figure for the 2004/5 year in isolation. The earning rate of 14.13% in 2004/5 (after costs and the effects of hedging, but before tax) is clearly ahead of this estimate. A more detailed summary of the Fund's investment performance during the year is on pages 8 and 9 of this report.

The Statement of Intent also set out the most important expected outcomes for the year. The key objectives are outlined below, with a report on progress against them.

Investment Policy

Review of investment risk budgeting methodology to optimise return expectations for risk.

The establishment of a comprehensive risk budgeting framework for the Fund remains a major project. Building on the analysis undertaken in establishing the initial strategic asset allocation, the review undertaken in 2004/5 consolidated our approach. This was followed up with an assessment of the ability of the Guardians to forecast future earnings for asset classes by comparing current pricing against long term averages. The incorporation of this mechanism, together with a more flexible model for adding additional returns through active management, will be a focus in 2005/6.

Review current strategic asset allocation to improve diversification benefits.

This was achieved. A comprehensive review was undertaken during the year and formally announced in March 2005. This review is summarised on pages 10-12 of this report. A comprehensive report outlining the process and

conclusions is on the Fund's website www.nzsuperfund.co.nz.

Review and formalise procedures for selection and management of external investment managers to produce consistent excess returns from active management.

This was achieved. A comprehensive review of the existing procedures was undertaken and an improved process formalised. All incumbent, and a number of prospective external investment management firms, have been reviewed under this model. The approach is discussed on pages 13-15 of this Report. Excess returns above long term estimates were produced in 2004/5.

Prepare framework for the introduction of illiquid assets to the portfolio to improve risk-adjusted returns, subject to available resources.

This was achieved. Frameworks were introduced for global infrastructure, New Zealand private equity, New Zealand and global timber, collateralised commodities futures and commitments made to these sectors either before, or soon after, balance date.

Investment Operations

Formalise reporting capabilities in performance measurement and attribution, portfolio characteristics and risk analytics.

This was achieved. Significant enhancements were made in the timeliness and accuracy of performance measurement and reporting, and the incorporation of new portfolio analysis tools has improved the total risk analytics framework. This will be built on in 2005/6.

Expand procedures to enhance returns through improved efficiencies in portfolio implementation.

The procedures used to transition assets between portfolios were refined during the year. In addition, the procedures for managing the portfolio in line with the policy on foreign currency exposure were improved with the move to outsource this to an external provider. This took effect from 1 July 2005.

Implement strategies for enhancing returns through securities lending (subject to legislative approval).

This was not implemented due to a proposed amendment of taxation obligations from securities lending not yet being introduced. Once this has been passed into New Zealand law, implementation will commence.

Review and formalise procedures in relation to the investment of cash flow and portfolio rebalancing.

The procedures for managing the allocation of cash flow were reviewed during the year but no material changes made as the expansion of the number of managers and asset classes meant that new cashflow was generally deployed to fund these. The portfolio was continuously maintained within target ranges during the year.

Risk Management

Enhancement of internal control policies to improve risk management of Fund assets.

This was achieved with the first risk management plan prepared for the organisation. The appointment of a Business Risk Manager is an objective for 2005/6.

Formalise benchmarking of effectiveness and efficiency of Guardians' operations with international peers.

This was not implemented as the relevant international benchmarking survey requires submission of full calendar year sector performance and costs. As this will not be available until the end of 2005, comparisons will not be available until mid 2006.

Further develop portfolio screening capability to support compliance with ethical investment policy.

This was achieved with the screening of the portfolio taking place in line with the policy during the year. Steps to improve the efficiency of the review process were initiated during the year and will be finalised and implemented in 2005/6.

External Relations

Enhancement of public accountability through further website development.

This was achieved with a comprehensive review of the website which further increased transparency of reporting.

Organisational Development

Further recruitment as appropriate and retention and development of internal skills.

Additional staff were added during the year to meet demand. Further recruitment is envisaged in 2005/6. Professional development of staff is supported through formal education, conference attendance and contact with regional and international peers. The additional staff in each area of the Fund's activities boosts the retention of skills inside the organisation.

Further develop the regime for accessing and leveraging off international experience in institutional management.

This was achieved with international relationships deepened. Formal initiatives included an inaugural international manager panel leading to a public forum for the New Zealand funds management community, and establishment of an international reference group to contribute to investment policy development.

Ongoing development of effective governance model to promote accountability and results.

The Fund has a formal governance structure set out in the legislation which provides for an accountable, but arms length from Government, governing board. The relationship between the Board and management has further developed over the year and is providing encouraging results with responsive and informed decision making being demonstrated within an effective monitoring framework. The commitment to its further development remains.

Operating Expenditure

The operating expenses incurred by the Guardians of New Zealand Superannuation in the 2004/5 year were \$3.475 million against budgeted expenses of \$3.992 million. The shortfall related to timing differences in the appointment of employees and to lower expenditure on professional fees than anticipated. The surplus will be carried over to 2005/6 together with retained surpluses from previous periods.

Employment Policy

In common with other Crown entities, a personnel policy that complies with the principle of being a good employer, including an equal opportunities programme, has been developed. This was complied with during the year.

GOVERNANCE - THE BOARD

Board of the Guardians of New Zealand Superannuation



David May, Chairman: Currently Deputy Chairman of the Government Superannuation Fund Authority and Director of Southern Cross Medical Care Society. David has 35 years' experience in the financial services, superannuation and insurance industries, and was Managing Director of the Colonial Group in New Zealand.



Sir Douglas Graham, Deputy Chairman: Currently Chairman of the Lombard Group, Director of Watercare Services Limited, Director of OTPP NZ Forestry Investments Ltd, and the Commonwealth Special Envoy to the Kingdom of Tonga. A Member of Parliament from 1984 until his retirement from politics in 1999, Sir Douglas was Minister of Justice from 1990-1998. Prior to his distinguished political career, Sir Douglas practiced law from 1965-1984.



Dr Michaela Anderson: Currently Director - Policy and Research at the Association of Superannuation Funds of Australia (ASFA). Michaela has 20 years' experience in the superannuation industry. Prior to her ASFA appointment in 1994, Michaela was the manager of policy advice to the State Authorities Superannuation Board, a statutory board which governs the superannuation funds for employees of the state of New South Wales.



Bridget Liddell: Currently Chief Operating Officer of Fahrenheit 212, an innovation consultancy based in New York. Before moving to the USA in 2003, Bridget was Chief Executive Officer of University of Auckland Development Ltd. She has been a Director of Sky City Entertainment Group, Fisher & Paykel Appliances Holdings Ltd, and Uniservices Ltd. Bridget has also held senior executive positions at Carter Holt Harvey, and was a Director of CS First Boston NZ Ltd.



David Newman: Currently on the Boards of Infratil Limited and its subsidiaries Wellington International Airport Limited and Infratil Airport Holdings Limited. David is also Chairman of FinMedia Limited and Austral Pacific Energy Limited. Previously Chief Executive Officer of the Institute of Directors in New Zealand. Prior to this, David spent 22 years with BP, culminating in four years as chief executive and managing director of BP New Zealand Limited.



Glen Saunders: A consultant, investment banker and qualified accountant, Glen was previously UK Managing Director of Netherlands-based bank, Triodos. He is a former Director of the Wind Fund plc and the Local Investment Fund, a public-private partnership funding community-based initiatives in the UK. He has also served as Non-Executive Director of the Western Partnership for Sustainable Development and the Earth Centre Advisory Board.

The New Zealand Superannuation Fund is governed by a separate Crown entity called the Guardians of New Zealand Superannuation.

The function of the Guardians is to manage and administer the Fund in accordance with the New Zealand Superannuation and Retirement Income Act 2001. The Guardians' principal duty is to invest the Fund in a prudent, commercial manner. They must maximise investment growth without undue risk to the Fund as a whole, in a manner which avoids prejudice to New Zealand's reputation as a responsible member of the world community, and using best practice portfolio management.

Independence from Government

While accountable to Government, the Guardians operate at arm's length from Government. Under the law, the Minister of Finance may give directions to the Guardians regarding the Government's expectations as to the Fund's performance, but must not give any direction that is inconsistent with the duty to invest the Fund on a prudent, commercial basis. The Guardians must have regard to any direction from the Minister. Any direction given by the Minister must be tabled in Parliament.

Board of the Guardians

All decisions relating to the business of the Guardians are made under the authority of the Board of the Guardians of New Zealand Superannuation.

Members of the Board are appointed by the Governor General on the recommendation of the Minister of Finance. The Minister's recommendation follows nominations from an independent nominating committee.

Under the Act, the Board must comprise of at least five, but no more than seven, members. Each Board member is appointed for a term of up to five years and is eligible to be reappointed.

Board Committees

The Board has three committees – audit and governance, responsible investing and employee policy and remuneration.

The audit and governance committee comprises Dr Michaela Anderson [Chair], Sir Douglas Graham and David Newman. The objectives of

the committee are to assist the Board in safeguarding the integrity in financial reporting, to recognise and control risk, and to ensure governance systems are consistent with best practice portfolio management.

The responsible investing committee consists of Bridget Liddell [Chair], Dr Michaela Anderson, Sir Douglas Graham and Glen Saunders. The committee assists the Board in the development of policies and procedures for ethical investment and for responsible use of voting rights.

The employee policy and remuneration committee, which comprises David May [Chair] and Sir Douglas Graham, assists the Board with human resources policies and practices.

Code of Conduct

A code of conduct for Board members and employees sets out standards for appropriate ethical and professional conduct, and procedures for dealing with conflicts of interest. Matters such as relationships with suppliers, personal investments, and confidentiality of proprietary information, are covered under the code. The full code is available at www.nzsuperfund.co.nz.

Assessment of Performance

An independent review of how effectively and efficiently the Guardians are performing their function is carried out every five years. The first review was conducted in July 2004 and is available at www.nzsuperfund.co.nz.

The Minister of Finance sets the terms of reference for the review, which is conducted by an independent person appointed by the Minister. The report is then presented to Parliament. In addition to this, Treasury monitors the activities of the Guardians on an ongoing basis on behalf of the Government.

Remuneration

Board members' remuneration is summarised in Note 14 to the Financial Statements. Further information on the fees framework for members of statutory and other bodies appointed by the Crown is available at www.nzsuperfund.co.nz. The total remuneration of those employees earning more than \$100,000 p.a. is detailed in Note 13 to the Financial Statements.

GOVERNANCE - MANAGEMENT

Division of Responsibility

The division of responsibility between the Board and management team is clearly set out in the Fund's Statement of Investment Policies, Standards and Procedures. The Board is responsible for approving the Fund's investment strategy, including the statement of investment policies, standards and procedures. The Board also approves the annual business plan and budget as well as the financial statements of the Fund.

The management team plays a critical role in the development of the investment strategy of the Fund and its implementation. This role is performed in conjunction with a number of external advisers appointed by the Board.

Delegation

The Board has implemented a delegations schedule which describes the powers that have been delegated to the Chief Executive, and records the further delegation of some of these powers from the Chief Executive to other members of the management team.

Management's Core Functions

The management team's core functions include:

- Leading the review of the strategic asset allocation on at least an annual basis;
- Managing the Fund's allocation to active management risk to meet the expectations set by the Board;
- Recommending external investment managers to the Board for appointment in each of the listed asset classes (the public markets);
- Overseeing the implementation of the allocation to the alternative asset classes (the private markets) through the network of specialist advisers appointed by the Board;

- Managing the Fund's cash flow and other transactions in order to minimise both cost and operational risk;
- Managing the day-to-day relationships with the Fund's service providers including the investment managers and custodian;
- Identifying the operational risks to the organisation and implementing procedures to minimise these;
- Preparing the financial statements for the Fund and managing the relationships with the appointed auditors; and
- Managing the Fund's external communications through its website and its relationships with the media and wider community.

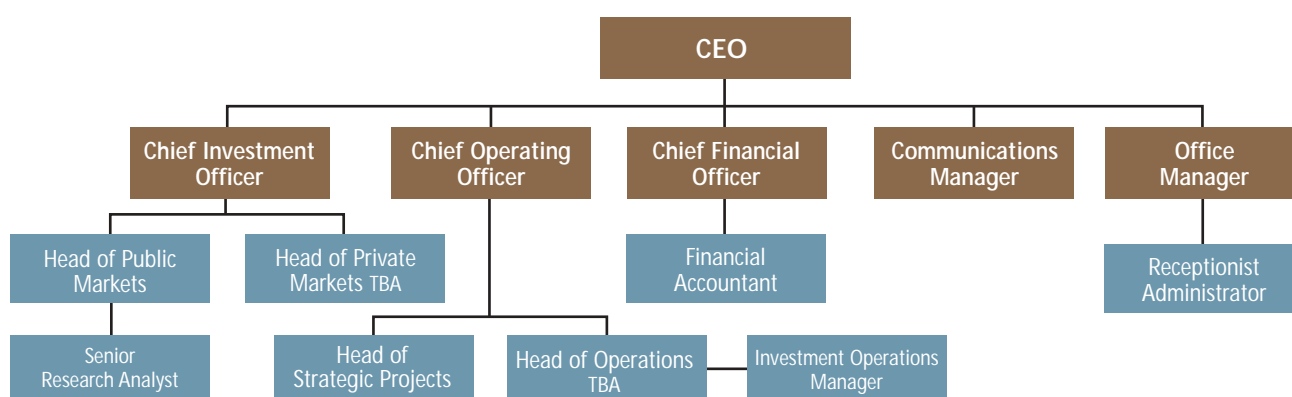
Focus on Portfolio Design

Given that the Board does not intend for day-to-day portfolio management to be undertaken in-house, management's focus is on the effective structuring of market risk (beta) in the portfolio, the seeking of excess returns on this market exposure (alpha) through the appointment of best-in-class investment management firms, and supporting this strategy through an efficient operating infrastructure.

Growth

The team is small – at 30 June 2005 there was the equivalent of 11 full time staff. This is expected to increase over coming years, recognising both the increasing complexity of the portfolio and the desire to enhance the operating capacity of the Fund's middle and back office to support this development. The organisational chart as at 30 June 2005 follows.

This chart records two positions that had been identified, but were not filled, at the reporting date.



Profiles of the Fund's management team are provided below. Full profiles of all employees are available at www.nzsuperfund.co.nz.



Paul Costello, Chief Executive Officer: Responsible for the day-to-day running of the organisation. Paul has over 17 years' experience in the superannuation and funds management industries in Australia and New Zealand. He was previously Chief Executive Officer of the Superannuation Trust of Australia. He joined the Fund in March 2003.



Paul Dyer, Chief Investment Officer: Responsible for the development of the Fund's investment strategy. Paul was previously Chief Investment Officer at AMP Capital Investors, New Zealand's largest funds manager. A former Director of Strategy at SBC Warburg (Australia), Paul was also a Chief Economist with Bettle Wilson, and Economist with the New Zealand Treasury. He joined the Fund in April 2004.



Tim Mitchell, Head of Public Markets: Responsible for developing and implementing the Fund's investment management programme in equities, fixed interest and commodities. He was previously a Principal Adviser at the New Zealand Treasury, with a focus on commercial investments and Crown financial policy. Prior to that Tim was CIO of Colonial First State Investment Managers (NZ). He joined the Fund in April 2003.



Andy Greening, Chief Operating Officer: Responsible for managing the Fund's investment operations including reporting on the performance of the Fund's external managers. Andy was previously Operations Director for UBS Global Asset Management in Zurich. Prior to that he worked for Financial Models Corporation and the HSBC Republic group of companies in London. Andy joined the Fund in November 2003.



Stewart Brooks, Chief Financial Officer: Responsible for operational risk management, financial and compliance reporting, taxation and audit. He was previously Group Company Secretary for Sterling Grace Portfolio Management. Prior to that Stewart was Financial Controller for Caltech Capital Partners and the New Zealand subsidiary of Motorola Cellular. He joined the Fund in August 2003.

INVESTMENT POLICIES

The Fund's governing legislation, the New Zealand Superannuation and Retirement Income Act 2001, states the annual report must include a Statement of Investment Policies, Standards and Procedures for the Fund.

A full copy of the Statement is available at www.nzsuperfund.co.nz. A summary is provided below.

Asset Classes and Selection Criteria

Section 61(a) – the classes of investments in which the Fund is to be invested and the selection criteria for investments within those classes

The Fund shall be invested in the following general asset classes and sub categories:

- (a) Global equities comprising separate allocations to large/mid capitalisation, small capitalisation and emerging markets equities;
- (b) New Zealand equities incorporating a constrained allocation to Australian equities;
- (c) Global fixed interest comprising separate allocations to sovereign and non sovereign debt;
- (d) New Zealand fixed interest comprising separate allocations to sovereign and non-sovereign debt;
- (e) Property comprising New Zealand and international unlisted assets and listed securities; and
- (f) Alternative assets which have less liquidity than, and/or are lowly correlated with, listed equities and fixed interest. These include New Zealand and international private equity, absolute return strategies, timber, infrastructure and collateralised commodities futures.

The strategic asset allocation identifies the mix of asset classes determined to best meet the long term performance target for the Fund. This is reviewed from time to time.

The Investment Management Agreement with each external investment manager details the constraints on security selection. Typically those

constraints include: maximum exposure to a particular company, sector, country or credit rating; maximum deviation from the manager's benchmark exposure to a particular company, sector, currency, or country; minimum and maximum number of stocks that can be held; ranges for ex-ante tracking error relative to the manager's benchmark; and maximum issued capital or debt of an individual company that can be held.

Benchmarks

Section 61(b) – the determination of benchmarks or standards against which the performance of the Fund as a whole, classes of investments, and individual investments, will be assessed

Benchmarks must be consistent with the risk and return assumptions that underpin the strategic asset allocation for the Fund.

The benchmarks for individual asset classes must be broadly representative of that asset class. The performance of asset classes will be assessed by comparing the aggregate performance of investment managers within that asset class against the benchmark for that asset class.

The benchmarks for individual managers should be either the benchmark for the asset class within which that manager is selected, or broadly representative of the universe of securities from which the manager makes its selections. A manager's performance will be assessed by comparing its performance against its respective benchmark, taking into account the amount of risk the manager has adopted relative to that benchmark.

The performance of the Fund as a whole is assessed against the risk free rate of return. Performance against this benchmark is reported monthly, and should be measured over rolling five-year periods as milestones towards achieving the stated 20-year objective of exceeding the risk free rate of return by an average minimum of 2.5% per year.

Investment performance for the Fund as a whole is measured after the deduction of fees, transaction costs and foreign taxes.

Reporting Standards

Section 61(c) – standards for reporting the investment performance of the Fund

The external investment manager and custodian reports must contain sufficient detail to enable management to make an assessment of the investment manager's performance against its mandate and its progress towards achieving its investment objectives, as well as to analyse manager, asset class and whole-of-Fund performance.

Management reporting to the Board will enable the Board to determine the effectiveness of manager selection and the Fund's strategic asset allocation decisions.

Public reporting through the website and statutory reports will be as open and transparent as commercial sensitivities allow.

Socially Responsible Investment

Section 61(d) – ethical investment, including policies, standards and procedures for avoiding prejudice to New Zealand's reputation as a responsible member of the world community

Investment in any activity that is consistent with the laws of New Zealand will be permitted. If an investment is, or maybe, in breach of the standards set out in the Statement of Investment Policies, Standards and Procedures the Guardians may elect either to engage with that entity to encourage a change to that behaviour, or to divest.

With respect to the requirement to avoid prejudice to New Zealand's reputation as a responsible member of the world community, the Guardians will regularly review the sovereign and corporate securities held by the Fund to establish whether an investment gives rise to the risk of such prejudice and, in the event that it does, the investment will be divested.

It will be a breach of policy if a sovereign or corporate issuer of securities is widely regarded internationally as having participated in any of the following: gross abuses of fundamental human rights; serious infringements of labour and

employment standards; serious infringements of environmental standards; promoting transnational organised crime or terrorism; or other conduct so reprehensible that it may prejudice New Zealand's reputation as a responsible member of the world community or its reputation as a responsible global investor in sovereign and corporate securities.

Balance Between Risk and Return

Section 61(e) – the balance between risk and return in the overall Fund portfolio

Analysis of the risk/return trade-off, over 20 years, of various asset allocation options resulted in setting a performance objective of exceeding, before New Zealand tax, the risk-free rate of return by an average of at least 2.5% per year over rolling 20-year periods.

The policy is that in order to achieve the investment objective while minimising the risk to the Fund as a whole, the mix of assets within the Fund should be as efficient as possible (that is, should offer the highest level of return for a given level of risk). Portfolio optimisation techniques are used to achieve this balance.

In addition, it is recognised that the use of active management of assets carries costs and risks, but is an appropriate policy where there is an expectation of a reward for that risk.

Fund Management Structure

Section 61(f) – the Fund management structure

The Guardians have overall responsibility for the management of the Fund. The Board of the Guardians has appointed an internal management team, supported by a range of external advisers and a global custodian. A custodian provides appropriate separation between the investing function and the settlement of transactions, as well as the recording and reporting of investment activities. The Guardians have also appointed external investment managers to manage portfolios within nominated asset classes.

Derivatives

Section 61(g) – the use of options, futures, and other derivative financial instruments

Derivatives are permitted as part of the investment strategy to manage risk, achieve or reduce exposure to asset classes, and achieve transactional efficiency. Derivatives are not to be used for investment activity where derivative exposure combined with physical exposure results in a net exposure for that asset class, or the portfolio as a whole, that is inconsistent with the investment strategy.

All derivatives must be in the form of an exposure over the same asset class as the physical instrument. Derivatives are not to be used to leverage the portfolio.

Derivatives held to increase exposure to any asset or asset class must be fully covered by cash or assets such as short-dated fixed interest securities, which are considered equivalent to cash and can be converted into cash within the settlement period. Derivatives held to decrease exposure to any asset or asset class must be fully covered by the underlying asset or asset class.

Risk Management

Section 61(h) – the management of credit, liquidity, operational, currency, market, and other financial risks

The Guardians have determined that the quality of all its risk management procedures must be of best practice standard.

Financial risks are managed through clearly specifying eligible assets in investment mandates, ensuring adequate diversification within and between portfolios, ensuring there are adequate procedures to manage operational risks including effective internal controls, separation of roles and codes of conduct, and implementing policies for the hedging of foreign currencies.

At 30 June 2005 the policy for managing foreign currency exposure was that 72.5% of the Fund's exposure in the global growth assets sector (equities, property and alternative assets), and 100% of the global fixed interest portfolio, would be hedged back to New Zealand Dollars.

Voting Rights

Section 61(i) – the retention, exercise or delegation of voting rights acquired through investments

Where an investment is made in a company in a jurisdiction where there are specific legal or codified requirements in relation to corporate governance, that law or code will be the basis for monitoring and deciding action.

In general, the Guardians voting action will be as follows. Where a proposal meets best practice and is in the Fund's long-term interests, the Guardians will endeavour to vote for the proposal.

Where the proposal does not meet best practice and is not in the Fund's long-term interests, the Guardians will endeavour to oppose the proposal.

Where a proposal raises issues which do not meet best practice, but either the concern is not regarded as sufficiently material to warrant opposition, or an oppose vote could have a detrimental impact on corporate structures, the Guardians will abstain.

The ultimate right of exercise of any voting rights attached to a security held by the Fund is to be retained by the Guardians. In general, external investment managers will be delegated responsibility to exercise voting rights in accordance with the best interests of the Fund. Investment management agreements will set out the delegation and the reporting requirements in relation to corporate governance and voting activity.

Valuation of Illiquid Assets

Section 61(j) – the method of, and basis for, valuation of investments that are not regularly traded at a public exchange

Investments not regularly traded on public exchanges will generally be held in pooled vehicles, where they will be valued by managers on behalf of all investors based on external valuation methodologies.

Where investments are neither held via public exchanges nor in pooled vehicles, fair value will be determined on the basis of independent

valuations based on accepted market practice. These valuations will be conducted at least annually by recognised professional advisers who are suitably qualified and possess appropriate experience and expertise relevant to the nature of each specific underlying asset.

Investment Constraints

Section 61(k) – prohibited or restricted investments or any investment constraints or limits

The Fund will not invest in any asset that does not fall into one of the asset classes described in the strategic asset allocation.

In addition, the Fund will not invest in any security that breaches the ethical investment policy, nor will it own any business outright.

Contractual arrangements with each external investment manager will prescribe constraints on that manager's security selection discretion that are consistent with the risk budget for that manager and the risk budget for the Fund as a whole.

In seeking to achieve the performance objective for the Fund, the Guardians will not enter into arrangements with other parties that have an intended result that diminishes the New Zealand tax base.

On behalf of the Board and Management of the Guardians of New Zealand Superannuation we hereby certify that to the best of our knowledge the investment policies, standards and procedures for the Fund have been complied with throughout the 2004/5 financial year.



Chairman



Chief Executive

FUND MILESTONES



<p>2005</p>	<p>June, 2005</p> <ul style="list-style-type: none"> • First New Zealand unlisted property mandate awarded <p>March, 2005</p> <ul style="list-style-type: none"> • First review of strategic asset allocation completed • First global infrastructure mandate awarded <p>February, 2005</p> <ul style="list-style-type: none"> • First global listed property mandate awarded • Fifth global equities (large-cap) mandate awarded • Second global emerging markets mandate awarded
<p>2004</p>	<p>November, 2004</p> <ul style="list-style-type: none"> • First independent review of the organisation conducted <p>October, 2004</p> <ul style="list-style-type: none"> • Second US equities (small-cap) mandate awarded <p>July, 2004</p> <ul style="list-style-type: none"> • Additional global equities (large-cap) mandate awarded • First US equities (small-cap) mandate awarded • First non-US equities (small-cap) mandate awarded • First global emerging markets mandate awarded <p>May, 2004</p> <ul style="list-style-type: none"> • First three global equities (small-cap) mandates awarded <p>April, 2004</p> <ul style="list-style-type: none"> • Chief Investment Officer appointed <p>March, 2004</p> <ul style="list-style-type: none"> • Further two global equities (large-cap) mandates awarded <p>January, 2004</p> <ul style="list-style-type: none"> • Additional New Zealand equities mandate awarded
<p>2003</p>	<p>November, 2003</p> <ul style="list-style-type: none"> • Chief Operating Officer appointed • First global fixed interest mandate awarded <p>October, 2003</p> <ul style="list-style-type: none"> • First New Zealand fixed interest mandate awarded <p>September, 2003</p> <ul style="list-style-type: none"> • Fund commenced investing with \$2.4 billion in cash • First global equities (large-cap) mandate awarded • First two New Zealand equities mandates awarded • Custodian appointed <p>August, 2003</p> <ul style="list-style-type: none"> • Initial strategic asset allocation announced • Chief Financial Officer appointed <p>April, 2003</p> <ul style="list-style-type: none"> • Head of Public Markets appointed <p>March, 2003</p> <ul style="list-style-type: none"> • Chief Executive Officer appointed
<p>2002</p>	<p>August, 2002</p> <ul style="list-style-type: none"> • Board of the Guardians of New Zealand Superannuation appointed
<p>2001</p>	<p>October, 2001</p> <ul style="list-style-type: none"> • New Zealand Superannuation Fund created by an Act of Parliament