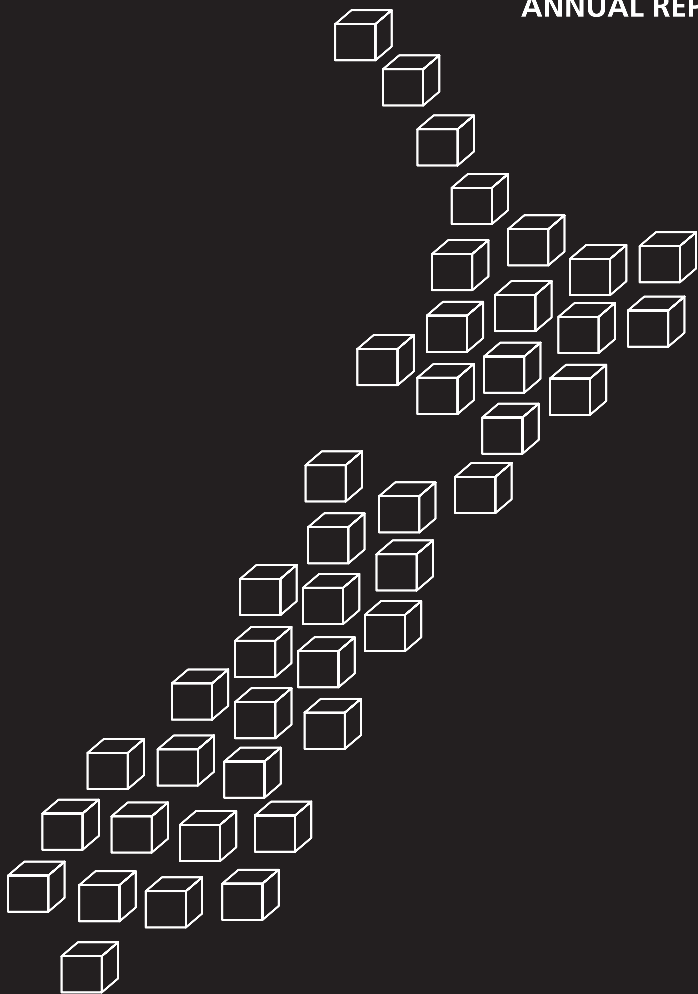
LAYING THE FOUNDATIONS

ANNUAL REPORT 2004



NEW ZEALAND
SUPERANNUATION
FUND

...FOR THE FUTURE.

CONTENTS

STATEMENT OF PURPOSE

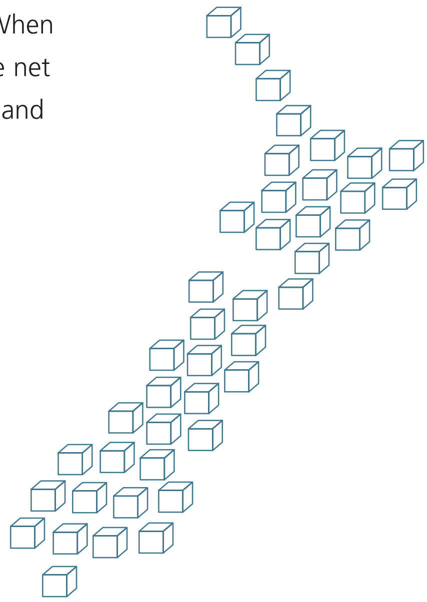
THE FUND

The New Zealand Superannuation Fund was established by the New Zealand Government, under the New Zealand Superannuation Act 2001, on 12 October 2001.

The Fund, which began investing at the end of September 2003, is designed to partially provide for the future cost of New Zealand Superannuation. An ageing population means the cost of providing New Zealand Superannuation is expected to double over the next 50 years. To prepare for this, the Government is allocating, on average, $2.2 billion a year to the Fund over the next 20 years while the cost of superannuation is relatively low.

As the cost of superannuation escalates, the Government will progressively draw on the Fund to help smooth the impact on its finances. On current Government modelling, contributions will cease in 2025 and from 2026 the Government will start to draw the equivalent of between 15-20% of the annual cost of superannuation. When income tax payments on the Fund's earnings are also taken into account, the net fiscal impact of the Fund is expected to exceed 30% of the cost of New Zealand Superannuation for several decades.

The Fund is expected to grow to around $100 billion by 2023.



THE GUARDIANS

The Guardians' mission is to assist in the provision of New Zealand Superannuation by maximising the long-term investment returns (gross of New Zealand tax) of the New Zealand Superannuation Fund. This will be achieved without taking undue risk for 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 principles.

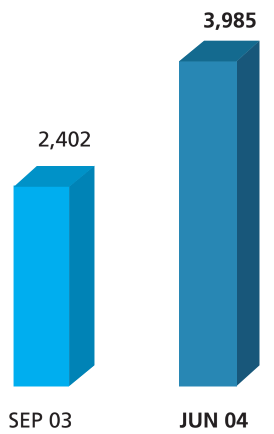
The Guardians of New Zealand Superannuation was established, under the New Zealand Superannuation Act 2001, as a separate Crown Entity to manage and administer the Fund.

The Guardians conducts its activities through a Board that was appointed on 30 August 2002. The Board recognises that the effectiveness of the Guardians will be judged on the long-term return on the assets under its management. The long-term performance target of the Board is to generate a time-weighted average return, over rolling 20-year periods, in excess of 2.5% pa above the risk-free rate (measured as the yield on 90-day Treasury bills).

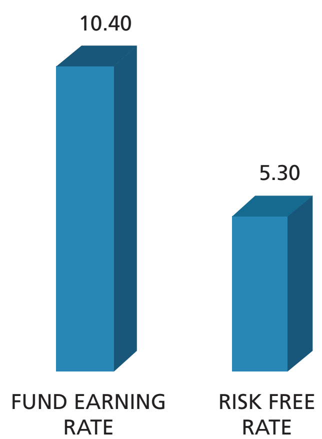
2004 HIGHLIGHTS

- FUND ASSETS TOTALLED $3.985 BILLION AT 30 JUNE 2004 (BEFORE NET TAX PROVISION)
- FUND ASSETS FULLY INVESTED OVER NINE MONTHS TO 30 JUNE 2004 IN LINE WITH BOARD POLICY
- 15 INVESTMENT MANAGERS APPOINTED FOR 16 DISTINCT MANDATES
- OPERATIONAL STRUCTURE ESTABLISHED THROUGH APPOINTMENT OF INTERNAL MANAGEMENT TEAM, CUSTODIAN AND FOREIGN CURRENCY MANAGER
- STATEMENT OF INVESTMENT POLICIES DEVELOPED AND IMPLEMENTED
- NET INVESTMENT EARNINGS (I.E. AFTER COSTS BUT BEFORE TAX) AMOUNTED TO $239 MILLION FOR NINE MONTHS FROM 30 SEPTEMBER 2003 (WHEN INVESTMENT BEGAN) TO 30 JUNE 2004
- NET INVESTMENT EARNING RATE OF 7.69% FOR THE NINE MONTHS (10.40% ANNUALISED) AGAINST THE BENCHMARK RISK FREE-RATE OF 3.94% FOR NINE MONTHS (5.30% ANNUALISED)

Total Assets $m



Annualised Investment Return Since Inception (%)



CHAIRMAN'S REPORT

ON BEHALF OF THE GUARDIANS OF NEW ZEALAND SUPERANNUATION I AM PLEASED TO PRESENT THE ANNUAL REPORT FOR THE YEAR ENDING 30 JUNE 2004. IT HAS BEEN A YEAR OF SIGNIFICANT PROGRESS WITH THE FOCUS MOVING FROM PLANNING TO IMPLEMENTATION.

Following the intense research and planning of the first ten months, the Board's objectives were to fully invest the Fund across the major listed asset classes and to put in place the structure and people to ensure that would be achieved in a manner consistent with international best practice.

I am pleased to say those objectives have been met. The Fund is fully invested and the Board is confident that the framework and processes established will support strong growth in the future.

INVESTMENT IMPLEMENTATION

In August 2003, the Board announced the strategic asset allocation for the Fund. This set out the asset classes in which the Fund will invest, and the number and type of managers to be appointed. A summary of the process followed and the considerations leading to those decisions were contained in last year's annual report.

On 30 September 2003, Treasury transferred $2.4 billion to the Guardians. Since that date this amount, and the additional Crown contributions received during the year, has been invested with 15 external managers across 16 distinct investment mandates. At 30 June 2004 almost $4 billion was invested with those managers in the fixed interest and listed equity markets.

Putting this in place has been a major focus for the year. The work, which has been carried out in conjunction with Mercer Investment Consulting, has required the analysis and screening of a significant number of investment managers followed by detailed interviews with, and due diligence on, short-listed candidates. Throughout, the Board has reviewed the results and processes to ensure they meet best practice standards.

POLICY DEVELOPMENT

During the year the Guardians developed a Statement of Investment Policies, Standards and Procedures to govern its investment operations. These included standards for measuring performance, for the management of credit and other financial risks, for ethical investment and for the use of derivatives. A summary of the Statement is on pages 24 to 28.

These policies have been implemented through the establishment of detailed performance analysis, through compliance reporting and verification, and through their inclusion in each of the investment mandates established with each investment manager. The Board has received external confirmation that those mandates meet best practice standards.

The Board has also adopted the policy that reporting of the Fund's activities to the New Zealand public should be as full and transparent as commercial sensitivities allow. This objective is being met through the Fund's website which was launched in August 2003. It covers a wide range of material, including strategy, research, governance and investment policies, as well as information on investment managers and performance.

STAFF

While day-to-day investment management and much advisory work are outsourced to specialist firms, the role of the management team in the success of the Guardians is crucial.

Skilled and experienced staff are essential in order to manage the selection and monitoring of investment managers, to manage the efficient implementation of policy and risk management in a manner consistent with best practice, and to provide additional checks and balances on the information provided by external providers.

Additionally, the staff are required to evaluate and distil a vast amount of advice and research on a wide range of investment issues and, following this, to develop policy recommendations.

The Board set the recruitment of a high-quality internal management team as a priority. Over the last year we have been singularly fortunate in attracting quality people with the right mix of skills and experience. Staff numbers have grown from two to nine. The Board is confident that the team in place provides a solid infrastructure for the Guardians, and will continue to set standards of excellence that will serve as a yardstick for the years to come.

GOVERNANCE

As a Crown entity, the Board also sets the propriety and integrity of its operations as a high priority. During the year the Guardians developed and introduced its internal governance policy to prescribe the roles and responsibilities of management and Board committees, and to detail those decisions reserved for the full Board. The Guardians also introduced Codes of Conduct for all Board members and employees. During the year the Board also carried out a comprehensive internal "Board Effectiveness Review" in conjunction with an external specialist.

The Act requires that an independent review of the Guardians' performance be carried out at least every five years. In August 2004 the Government announced the appointment of an external consultant to carry out the first review.

The Act also requires the Guardians to operate largely at arm's length from Government. While the Act gives the Minister of Finance limited powers of direction on the Government's expectations of Fund performance, no such directions have been received.

INVESTMENT PERFORMANCE

The Board has set the Fund's investment performance objective as exceeding the risk-free rate of return by 2.5% per year over rolling 20-year periods. The 20-year period is important. Because of the long timeframe before money can be withdrawn, the Fund can, and will, tolerate short-term volatility including periods when the performance target is missed by a substantial margin and periods when it is well beaten.

In the first nine months of investing, the objective was comfortably exceeded, thanks to rising equity markets. However, while it is a good start, it is just too short a period from which to draw any conclusions. It is just as wrong to claim one good year as proof of success as it is one bad year as proof of failure.

The investment policy of the Guardians, with its strong weighting to growth assets, has been selected to perform over the long haul, and it is over that long haul that performance should be judged.

LOOKING FORWARD

The considerable progress of the last year has resulted in a fully invested and operational Fund. However, neither the Fund nor investment markets are static. The Fund receives $80 million of new monies to invest each fortnight and will double in size over the next two years. Much remains to be done.

To date, investments have been restricted to fixed income and listed equity markets in New Zealand and around the world. The plan is also to invest in alternative assets (private equity, infrastructure, forestry, commodities) and property, which will all be important sources of return and risk diversification as the Fund grows.

Because effective implementation and manager selection are both more crucial and difficult to get right in these sectors than in listed markets, the Board has held back from investing in these areas until it is able to secure and devote adequate resources to the job. This will be a major focus over the next two years.

In the next twelve months the Board's aims will be to strengthen the operational and risk management functions further to handle the strong growth in the Fund, to refine the strategic asset allocation in the light of market developments, and to seek further risk diversification opportunities through property and alternative assets.

ACKNOWLEDGEMENTS

I would like to thank the Board members, including Brian Gaynor who resigned to pursue further interests in March 2004, for their strong commitment to best practice and sense of determination and purpose. This was particularly evident during the hectic phase when the Fund was getting up and running. I would also like to thank the vast array of advisors who have helped us meet our demanding standards and timetable as well as the many local and overseas investment organisations who have given us the benefits of their knowledge and experience.

However, this year the main thanks must go to the staff who have steered the Fund through an enormously complex nine-month implementation phase, under the eye of a Board continually demanding demonstration of best practice. The team has come together very rapidly and achieved an enormous amount in a short space of time.

David May

David May
CHAIRMAN

CEO'S REPORT

PAUL COSTELLO

WITH THE TRANSFER OF RESPONSIBILITY FOR THE MANAGEMENT OF THE ASSETS OF THE NEW ZEALAND SUPERANNUATION FUND, THIS HAS BEEN A YEAR OF OPPORTUNITY AND CHALLENGE FOR THE MANAGEMENT TEAM.

The opportunity to contribute towards the establishment of this exciting and important initiative for New Zealand has already proved a significant drawcard for talented investment professionals.

The Guardians' management team is outlined on page 22 of this report. Collectively, the team brings many years of insight into the effective operation of investment institutions and is committed to building on this experience by learning from the approaches of highly successful organisations around the world. One of management's clear objectives is to ensure that the Guardians is regarded as a best practice organisation from as early as possible in the Fund's life.

Management's current responsibilities are divided between the development of investment policy in conjunction with external advisors; implementing this once approved by the Board; managing the risks around this implementation; and reporting progress both in financial and non-financial terms.

During this first year, a significant proportion of management time has been directed towards researching, selecting and contracting with 15 investment management firms granted investment mandates by the end of the year. Now that this round of appointments has been completed, comprehensive processes for ensuring that these managers maintain the features that led to their appointment are being developed. In addition, there is an ongoing focus on identifying talented investment management firms who can be closely monitored to determine the merit of their addition to the portfolio.

The process of transitioning almost $4 billion to these managers over the last year has involved establishing robust systems for managing transaction costs in both equity and foreign currency markets. The efficiency with which this has been done has resulted in significant value being added to the Fund. This has involved reducing the cost of transactions as well as managing the market impact of this trading. The development and implementation of these arrangements, as well as bedding down a partnership with the Fund's custodian, BNP Paribas Securities Services, has also been a priority during this period. The accurate and timely valuation of the investment portfolio is crucial for monitoring performance and this has been fully implemented during this year in conjunction with BNP Paribas.

In addition, the implementation of the Fund's policy of hedging the majority of foreign currency exposure back to New Zealand dollars has involved managing significant flows through this market. The partnership with the New Zealand Debt Management Office has resulted in this being done efficiently with appropriate management of trading costs.

The establishment of a new entity managing an increasing component of the Crown's balance sheet brings with it the responsibility to ensure there are very tight controls around the movement of funds. Management of potential risks involved in building these diverse portfolios of assets in New Zealand and around the world has been an early success of the Fund. These will be built on further over the coming year as the Board has prioritised the establishment of a comprehensive risk management plan, together with establishing an internal audit programme.

The finalisation of broad policies for ethical investing, in line with the governing legislation, and the first screening of the portfolio to ensure that its securities comply with the policy, have also been achieved during the year.

As the implementation of the initial asset allocation neared completion, attention turned to ensuring that the combination of assets in the portfolio was optimal. The generation of an expected rate of return over time, for the lowest level of risk, is a core aim for the organisation and enhancing insights into the most efficient use of this risk/reward trade-off is a key component of management's role.

Priorities for 2004/5 include:

- Formalising procedures for the management of external investment managers to raise the probability of sustainable excess returns from active management;
- Preparing the framework for the introduction into the portfolio of "alternative" asset classes;
- Further developing performance measurement and attribution capabilities;
- Introducing a range of strategies to increase transactional efficiencies in the management of the portfolio; and
- Formalising benchmarking services to measure the operating efficiency of the Guardians against international peers.

In common with other Crown entities, the Fund has established a personnel policy that complies with the principle of being a good employer, including an equal employment opportunities programme. These policies were complied with during the year.

The experience, insight and commitment of the management team have been invaluable during this exciting but demanding period. I am confident the Fund is well placed to meet its objectives.

Paul Costello
CHIEF EXECUTIVE

THE YEAR IN REVIEW

INVESTMENT PERFORMANCE

Following a number of years of declining prices on world equity markets, the strong recovery during the first year of the Fund's investment programme resulted in a time-weighted return of 7.69% for the nine months to 30 June 2004 (equivalent to 10.4% for the full year). This was ahead of both the risk-free rate of return (measured as the yield on 90-day Treasury bills) and the long-term performance target of the risk-free rate plus 2.5% per year.

In measuring investment returns against such benchmarks, it is common practice to use the "time-weighted" rather than "money-weighted" return. Equal weighting is given to each month's returns, regardless of the asset base. By contrast, a money-weighted return is affected by the amount of assets under management for each month. As the Fund is growing, this means that recent performance, when the assets under management are greater, will have more impact on the investment income generated than performance in earlier months when the Fund was smaller. For this reason, the Guardians' focus is on the time-weighted earnings of the Fund.[1]

Recognising the challenge of establishing a new institution, and the many operational risks in moving a substantial cash portfolio to market, the Board resolved to move steadily from a portfolio of Treasury bills to a diversified portfolio over the nine months to June 2004. This transition was achieved on schedule with the portfolio fully invested with 15 investment management firms by June 2004.

With investment managers appointed and funded progressively during the year, many held their mandates for only very short periods. This makes meaningful comment about their performances difficult. While the performance of individual managers varied, the return for each asset class for the nine months was very close to the relevant benchmarks (after fees). The 2004/5 year will provide a much clearer insight into the effectiveness of the investment managers in each sector of the Fund.

ASSET CLASS	NZD MILLIONS	SECTOR RETURN (AFTER FEES)*	BENCHMARK RETURN*
New Zealand Equities	$396.1	13.25%	12.96%
New Zealand Fixed Interest	$472.6	3.03%	3.06%
Global Equities	$2,546.7	10.92%	10.55%
Global Fixed Interest	$560.5	3.94%	3.94%
Cash	$9.5	3.95%	3.94%
Total	**$3,985.4**		

* Sector returns and benchmarks have been adjusted for the appointment of each manager during the period

The Board estimated a return of $182 million in pre-tax income for the Fund for the period from 30 September 2003 to 30 June 2004. The total return during this period, measured on the same basis, was $239 million. This was due to returns from equity markets over the nine months being ahead of long-term estimates.

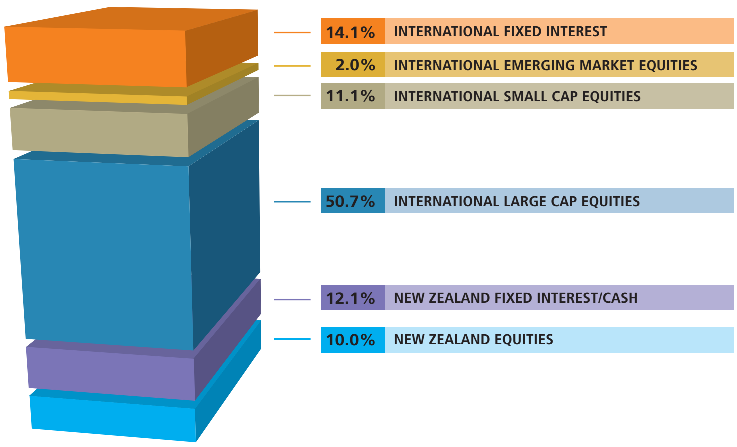
[1] For the nine months to 30 June 2004 the "money-weighted" return was 6.49%.

ASSET ALLOCATION

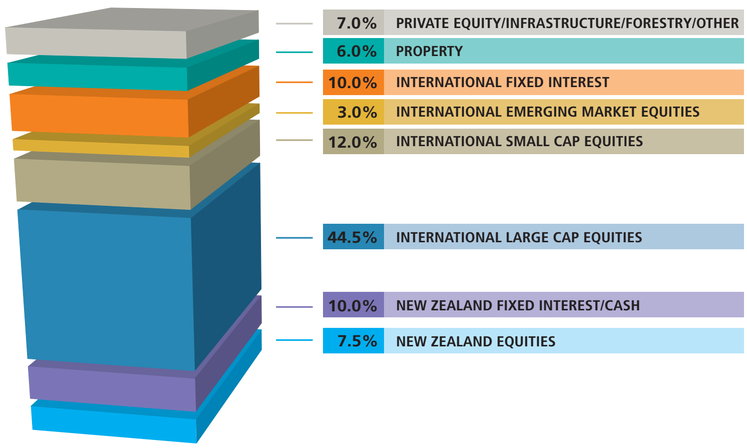
The initial strategic asset allocation for the Fund was announced in August 2003. While the research undertaken at that time is expected to shape the long-term direction of the investment portfolio, it is appropriate that this be reviewed regularly to ensure it remains appropriate. The first comprehensive review of the asset allocation is underway and is expected to be completed and announced by the end of calendar 2004.

A comparison of the initial strategic asset allocation as at 30 September 2003, when investing began, and the actual asset allocation at 30 June 2004, is set out below.

ASSET ALLOCATION AT 30 JUNE 2004



STRATEGIC ASSET ALLOCATION AT 30 SEPTEMBER 2003



The current strategic asset allocation has a weighting of 6% to property and 7% to largely illiquid assets (e.g. private equity, infrastructure and forestry). During the first year the priority was to allocate funds to listed equities and fixed interest securities. The combined 13% allocation to these "other growth assets" was placed with equity and bond managers to approximate the returns that might be expected from these assets. It is expected that allocations to these sectors will begin in 2004/5.

INVESTMENT MANAGERS

The Board decided that the challenge of building a stable of quality investment managers for the listed assets was the most appropriate area on which the organisation should focus its resources during 2003/4.

As at 30 June 2004 a total of 15 external investment managers and one custodian had been appointed. There is significant exposure to foreign currencies through these managers and much of this is hedged back to New Zealand dollars. The New Zealand Debt Management Office acts as the Fund's agent to achieve this. The Custodian, BNP Paribas Securities Services, was appointed in July 2003. The role of the Custodian is to provide safekeeping of the Fund's assets and to settle all transactions by the investment managers.

Considerable effort has been expended in identifying and selecting top-quality managers within each asset class. This involves distilling research on an extensive database of managers to a shortlist for further analysis. Intensive due diligence is then conducted on those managers that have appealing characteristics, including a thorough examination of their investment processes involving discussions with other clients and, as far as possible, visits to the manager's office. Once appointments are made, there is extensive ongoing monitoring to ensure that conviction in the ability of the manager is maintained.

Considerable effort is put into identifying and selecting top-quality managers within each asset class.

It is also recognised that no manager selection process can guarantee that every manager will deliver the performance objectives set for them. For that reason, manager risk is diversified by appointing more than one manager within each asset class. As the Fund grows in size, the stable of managers is expected to increase, further diversifying the risk of any one manager underperforming.

A schedule of the investment managers used by the Guardians during the financial year, and the classes of investments for which each was responsible, is set out below.

SECTOR	MANAGER	AMOUNT HELD AS AT 30 JUNE 2004 (NZD MILLIONS)
New Zealand Equities	AMP Capital Investors	$172.6
	Brook Asset Management	$172.3
	Fisher Funds Management	$51.2
New Zealand Fixed Income	ING (NZ) Ltd	$472.6
International Large Cap Equities	Alliance Capital Management	$252.8
	Barclays Global Investors	$1,350.8
	Bernstein	$202.8
	LSV Asset Management	$214.7
International Small Cap Equities	AXA Rosenberg	$121.6
	Goldman Sachs Asset Management	$40.3
	Grantham, Mayo & Van Otterloo	$121.0
	Numeric Investors	$81.1
	Thompson, Siegel & Walmsley	$82.2
Emerging Markets	WestAM	$79.4
International Fixed Income	Vanguard Investments Australia	$560.5
Cash	Held by BNP Paribas Securities Services as custodian	$9.5
TOTAL		**$3,985.4 million**

Note: An international large cap equities mandate was withdrawn from Allianz Dresdner (RCM) Asset Management during the year. This followed an organisational restructure within the firm. Alliance Capital Management was appointed to replace Allianz Dresdner.

Total fees paid for investment management and custody of the Fund's assets during the year were $5.515 million. This is equivalent to 0.17% of average assets under management during the nine months from 30 September 2003 to 30 June 2004. This ratio is lower than the expected costs of these services in future years as during 2003/4 the Fund held a large portfolio of Treasury bills which did not attract investment management fees. In future years, all assets will be placed with investment managers.

REPORT AGAINST STATEMENT OF INTENT

The Guardians submitted a Statement of Intent, setting out the most important expected outcomes for the year, to the Minister of Finance in June 2003 as required by the Public Finance Act 1989.

This was revised in December 2003 once the Fund's investment strategy had been finalised and implementation was underway. The revision enabled the Guardians to comment more effectively on the expected investment performance of the Fund for the year, the risks to that performance, and to prepare financial statements estimating the investment income for the Fund.

The key objective for the year to 30 June 2004 was the establishment and implementation of the investment strategy for the New Zealand Superannuation Fund.

Supporting objectives related to the development of the Guardians' governance infrastructure, managing the responsibility to invest within an ethical framework, meeting stakeholders' expectations in relation to information on the operation of the Fund, and building a competent internal staff complemented by insights from a network of respected international organisations.

The key objectives are outlined below with a report on progress against them.

A) ESTABLISHMENT OF INVESTMENT STRATEGY

- Appoint a Master Custodian by 31 August 2003 with record keeping testing completed by 30 September (achieved);
- Commence investment of the Fund's assets by 30 September 2003 with initial manager appointments (achieved);
- Prepare initial Statement of Investment Policies, Standards and Procedures by 30 September 2003 (approved early October);
- Complete appointments of an additional five to ten managers by 31 December 2003 and all inaugural managers to be appointed by 30 June 2004 (achieved);
- Complete initial research into the risk and return characteristics of alternative asset classes and how they might best be used in the Fund by 31 March 2004, with more specialised research undertaken by 30 June 2004 (substantially deferred to 2004/5);
- Generate investment earnings of $182 million for nine months to 30 June 2004 (achieved).

Contributions to the Fund had been accruing within Treasury since 2002/3 and the Statement of Intent indicated that the Guardians intended to begin investing these assets by 30 September 2003. The Board announced the inaugural asset allocation in mid-August 2003, and confirmed that it was on track to meet this target.

The appointment of a custodian to hold the Fund's assets was a critical first step in achieving this. The appointment of BNP Paribas Securities Services in July 2003, and the settlement of terms for the administration of the assets over the next two months, allowed the Board to meet its commitment of taking over responsibility for the management of the accrued assets from Treasury by 30 September 2003. This was achieved with the transfer of $2.402 billion in Treasury bills on that date.

The 2003/4 year was important in establishing the infrastructure for the ongoing management of the Fund.

The Board decided that over the nine months from 30 September 2003 to 30 June 2004 the portfolio would be transitioned from being wholly in Treasury bills and cash to being fully invested in market-linked assets. Consistent with the Statement of Intent, the initial Statement of Investment Policies, Standards and Procedures was adopted in October 2003, providing a framework for the investment strategy to be implemented. This was revised in June 2004 and the current version can be viewed on the Fund's website.

Manager Appointments

The Statement of Intent indicated that the Board intended to appoint a number of investment managers in the New Zealand equities and fixed interest sectors, as well as international equities and currency management, by 30 September 2003. It was also targeted to appoint an additional five to ten investment managers by the end of December 2003. It quickly became clear that detailed research and due diligence on investment managers was well rewarded, and the Board decided that the quality of the process should not be compromised by deadlines. The first manager appointments were made on schedule in September 2003 and by 31 December 2003, six investment management firms had been appointed and funded for seven investment mandates. By this time 44% of the Fund's assets were invested with these managers. These covered New Zealand and international equities as well as fixed interest.

The manager selection and appointment programme continued over the next six months to 30 June 2004. By that date the Fund's assets were fully invested with 15 managers appointed for 16 mandates and the residual holding in Treasury bills and cash was around 0.26% of assets.

The Statement of Intent identified steps to be taken in progressing the investment to alternative asset classes, as well as property, with the end of the third and fourth quarters nominated as key dates. Early work in these sectors revealed the challenges of effectively managing their introduction to the portfolio. As a result of this, the Board determined that further work would be substantially deferred until the allocation to listed assets was completed. Research commenced during 2003/4 will be built on during 2004/5.

Earnings Estimates

In December 2003, when the modified Statement of Intent was forwarded to the Minister of Finance, the Guardians estimated the investment income on the Fund for the year to June 2004 at $182 million in pre-tax earnings, based on earnings to the end of November and expected earnings over the next seven months. In fact, as a result of stronger than anticipated returns from equity markets, the earnings to 30 June, on a pre-tax but after fees basis, amounted to $239 million.

It was also noted in the Statement of Intent that, as a result of the substantial holdings of Treasury bills in the portfolio during the transitional phase, the Guardians did not expect to achieve the long-term target of Treasury bills plus 2.5% p.a. during 2003/4. By 30 June, however, on a time weighted and annualised basis, the return was equivalent to Treasury bills plus 5.10% for the year.

B) INVESTING WITHIN AN ETHICAL FRAMEWORK

- Establish and implement a policy to ensure the Fund's investment activities do not prejudice New Zealand's reputation as a responsible member of the world community by 30 September 2003 (achieved);
- Establish interim policy for ethical investing more broadly by 30 September 2003, with further analysis in this area continuing through to 30 June 2004 (achieved).

A second objective outlined in the Statement of Intent was to progress the development of a policy on ethical investing, including the requirement to ensure that the reputation of New Zealand as a responsible member of the world community was not compromised. This was developed prior to the commencement of the investment programme in October 2003 and subsequently reviewed during the year. It can be viewed as part of the Statement of Investment Policies, Standards and Procedures.

The Board has appointed Innovest Strategic Value Advisors, based in London, and Sustainable Investment Research Institute Pty Ltd, based in Melbourne, to review all securities in the portfolio to ensure compliance with the standards set down in the policy. The first such screening was completed by 31 December 2003. While further research into this aspect of institutional management is continuing, the commitment to develop and implement policies in this area was met on schedule.

C) DEVELOPMENT OF GOVERNANCE AND MANAGEMENT STRUCTURES

- Operate at all times within the budget appropriated by Parliament (achieved);
- Complete, by 31 March 2004, interim benchmarking analysis with other funds to measure efficiency (approach identified but not implemented);
- By 31 March 2004, develop a full business plan with key performance indicators for use across the Guardians' business (commenced).

The 2003/4 year was important in establishing structures for the management of the Fund. Fiscal responsibility requires the Guardians to operate within an annual budget agreed by Parliament and this was complied with.

The Statement of Intent also committed the Guardians to the establishment of benchmarks against similar funds in order to compare the efficiency of the operating structures. A number of informal discussions comparing the structure of the Guardians with other funds were undertaken during the year, and a decision was made to participate in a benchmarking service which compares the cost effectiveness, and decision-making efficiency, of many of the largest pension funds around the world. For this to be effective it is necessary for there to be a sufficient operational history for the Guardians to compare with others. Now that the first nine months of investment operations have been completed, and having established the most appropriate peer group of institutions (based on size and asset allocation), the first comparison will be undertaken in October 2004 and be followed up with results for calendar 2004.

It was also recognised at the beginning of the year that it would be valuable to establish working contacts with a number of internationally highly regarded institutions in order to learn from their management practices. During the year a number of important steps were taken in developing these relationships, and the observed experience is being incorporated into the Fund's operating structure.

The Guardians also committed to the development of a full business plan by March 2004. The Board agreed to a number of key operational objectives for 2004/5 early in the year and has been measuring progress against these. The Statement of Intent for 2004/5 builds on these. A final version of the business plan is expected to be approved by the Board in October 2004.

D) COMMUNICATING WITH STAKEHOLDERS

- By 31 December 2003, launch Fund website (achieved);
- Report quarterly, or as otherwise required, to the Minister of Finance, and actively engage with interested organisations (achieved).

Recognising that the assets of the Fund are public, and that its performance will increasingly impact the Crown's balance sheet, the Guardians has committed to providing as high a degree of transparency into the operation of the Fund as commercial sensitivities will allow.

The establishment of a website, which provides interested parties with an insight into the current status of the Fund, as well as an understanding of its future directions, was recognised in the Statement of Intent as a critical step in meeting this obligation. This was launched ahead of schedule in August 2003. It contains all public accountability documents as well as current information on the construction and performance of the Fund.

Quarterly updates to the Minister of Finance on developments within the Fund continue to be provided. More generally, especially around the time of the launch of the Guardians' investment programme, a number of presentations outlining the purpose and approach of the Fund were made – both within the financial services sector as well as the broader community. This will continue to be a priority for the organisation to ensure its objectives are well understood.

E) INVESTING IN PEOPLE AND EXPERIENCE

- Attract quality staff to assist the Guardians to meet its objectives (achieved);
- Foster working contacts with at least ten comparable funds, and complete an analysis of their management practices and experiences by 30 June 2004 (commenced).

The Statement of Intent recognised the value in attracting, and retaining, high quality staff in order to maximise the opportunity for the success of the Fund. As noted elsewhere in the Report, while still a modestly sized organisation, the addition of talented and committed staff during the year has enabled the first year of operations to be successful. A small number of additional resources are sought in 2004/5, but the focus will shift to complementing the internal management team with quality external advisors across a range of sectors and issues.

Recognising the benefit of the experience of other institutional investors, the Guardians has established contact with a number of respected institutions around the world. Analysis of the features that have led to their success has commenced and, now that the internal team is fully operational, it is planned to build on this during 2004/5.

The Statement of Intent recognised the value in attracting, and retaining, high quality staff in order to maximise the opportunity for the success of the Fund.

GOVERNANCE STATEMENT

FUNCTION OF THE GUARDIANS

The function of the Guardians is to manage and administer the New Zealand Superannuation Fund in accordance with the New Zealand Superannuation Act 2001.

The Guardians must invest the Fund on a prudent, commercial basis and in doing so, must manage and administer the Fund in a manner consistent with best-practice portfolio management, maximising return without undue risk to the Fund as a whole, and avoiding prejudice to New Zealand's reputation as a responsible member of the world community.

A governance framework and policy has been developed by the Board with the following aims:

a) To lay solid foundations for management and oversight;

b) To promote ethical and responsible decision making;

c) To safeguard integrity in financial reporting;

d) To recognise and manage risk; and

e) To recognise the interest of stakeholders.

OBJECTIVES OF THE GUARDIANS

The general objectives of the Guardians are:

a. To implement and maintain a diversified and well managed investment portfolio for the Fund that:

- ensures the Fund meets its investment objectives;
- applies best-practice portfolio management principles;
- maximises the return without undue risk to the Fund as a whole; and
- avoids prejudice to New Zealand's reputation as a responsible member of the world community.

b. To ensure excellence in the governance and management processes of the Guardians;

c. To ensure all the stakeholders in the Fund are well informed about its activities; and

d. To create a "centre of excellence" in the management of an investment portfolio with a long-term horizon.

THE BOARD OF THE GUARDIANS OF NEW ZEALAND SUPERANNUATION

The Act provides for between five and seven members of the Board. A nominating committee has been established by the Minister of Finance to nominate candidates to the Minister for appointment as members of the Board. Board members, who are appointed by the Governor General upon the recommendation of the Minister, are selected for their experience and their mix of complementary skills. Board members, and the dates when their appointments expire, are:

DAVID MAY

Chairman

David May was appointed Chairman of the Board of the Guardians of New Zealand Superannuation in August 2002. His term of office expires on 31 May 2007.

David is Deputy Chairman of the Government Superannuation Fund Authority, established in 2001 to administer eight superannuation schemes for public sector employees. He is also a Director of Southern Cross Medical Care Society, New Zealand's largest private health insurer and hospital operator, a position he has held since 2002.

David has 35 years' experience in the financial services, superannuation and insurance industries, including 27 years with Colonial Group, most recently as managing director of Colonial Life NZ Ltd (1995-2000). A former chief executive of Jacques Martin NZ Ltd (1985-1990), David was also a board member, and latterly deputy chairman, of the Investment Savings and Insurance Association of New Zealand Inc.

David holds a Bachelor of Science (Hons) in Mathematics from Manchester University, England, and is a Fellow of the Institute of Actuaries in both England and Australia.

RT HON SIR DOUGLAS GRAHAM

Deputy Chairman

Sir Douglas was appointed Deputy Chairman of the Board of the Guardians of New Zealand Superannuation in August 2002. His term expires on 31 May 2007.

A Member of Parliament from 1984 until his retirement from politics in 1999, Sir Douglas was Minister of Justice (1990–1998) responsible for major company and securities law reform. Other portfolios included Attorney General (1997–1999), Minister for Courts (1995–1997) and Minister in Charge of Treaty of Waitangi Negotiations (1991–1999). He was appointed to Her Majesty's Privy Council in 1998 and knighted in 1999.

Prior to his distinguished political career, Sir Douglas practiced law from 1965–1984. He is Chairman of the Lombard Group, a private banking firm with assets under management of approximately $150 million, and is a director of Watercare Services Limited, New Zealand's largest company in the water and wastewater industry. He is also the Commonwealth Special Envoy to the Kingdom of Tonga.

Sir Douglas holds a Bachelor of Laws Degree from the University of Auckland and was awarded the Degree of Honorary Doctor of the University of Waikato in 1999. He is a member of the Institute of Directors in New Zealand

DR MICHAELA ANDERSON

Dr Michaela Anderson was appointed to the Board of the Guardians of New Zealand Superannuation in August 2002. Her term of office expires on 31 May 2006.

Michaela is Director, Policy and Research at the Association of Superannuation Funds of Australia (ASFA), the industry body for superannuation funds. She leads a team that consults with government on policy and implementation issues, provides expert technical advice to government, and assists ASFA to remain a key contributor to public debate on retirement income policy issues.

Michaela has worked in the superannuation industry for 17 years. 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.

Michaela participates in a range of government and industry committees and currently represents ASFA on the ASX Corporate Governance Council. She holds a Bachelor of Arts (Hons) and a PhD from Macquarie University, Sydney.

IRA BING

Ira Bing was appointed to the Board of the Guardians of New Zealand Superannuation in August 2002. His term of office expires on 31 May 2005.

Ira is an investor with more than a decade of investment banking experience within global financial institutions, and is a Principal of the Whiterock Group. Before returning to New Zealand in 2002, Ira was most recently a managing director of the investment banking division of WestLB, the European Banking Group.

Prior to joining WestLB in the late 1990s, Ira held senior positions in the capital markets divisions of the London office of Merrill Lynch, one of the world's largest financial management and advisory companies. In the early 1990s he worked as a capital markets banker for an investment arm of the Edmond de Rothschild Group, having moved to Europe after a number of years with New Zealand investment bank, Fay Richwhite.

Ira holds a Bachelor of Laws Degree from the University of Auckland, a Master of Laws (Hons) from Victoria University, Wellington, and a Master of Economics and Laws from Oxford University, England. He is a past recipient of numerous awards and academic fellowships, including a European Economic Commission (EEC) Fellowship in the early 1990s, on which he spent time working at EEC headquarters in Brussels. Ira is also a past Fellow of the not-for-profit Asia 2000 Foundation of New Zealand.

BRIDGET LIDDELL

Bridget Liddell was appointed to the Board of the Guardians of New Zealand Superannuation in August 2002. Her term of office expires on 31 May 2005.

Bridget has been a director of several New Zealand companies, including Sky City Entertainment Group, Fisher & Paykel Appliances Holdings Ltd and UniServices Ltd. She has held senior executive positions at Carter Holt Harvey where she was also chairperson of the Carter Holt Harvey Superannuation Fund from 1992-1998. She was also a director of CS First Boston NZ Ltd.

Until recently, Bridget was chief executive officer of University of Auckland Development Ltd. She is a former member of the Council of the University of Auckland and a former director and trustee of Competitive Auckland Ltd.

Bridget received Bachelor of Commerce and Master of Arts (Hons) degrees from the University of Auckland and gained a Harkness Fellowship to study in the United States in 1998. She is also a Chartered Financial Analyst (USA). Bridget is Chief Operating Officer of Fahrenheit 212, an innovation consultancy based in New York.

THE ROLE OF THE BOARD

The Board is responsible for all decisions relating to the business of the Guardians and may delegate functions or powers to a committee of the Board, or any other person, with the exception of the power of delegation, granting a power of attorney, appointing an investment manager or a custodian.

Broad governance responsibilities of the Board include:

- Establishing investment policy for the Fund and business objectives for the Guardians;
- Communicating the organisation's objectives to the Minister of Finance and accounting for progress against these;
- Delegating responsibility for achievement of specific objectives to the Chief Executive and management;
- Monitoring organisational performance towards achieving objectives; and
- Overseeing effective systems of internal control.

BOARD COMMITTEES

The Board has established three committees which have been delegated responsibility to develop and recommend policy and monitor compliance against policies in the respective areas. The current Board committees are:

(i) **Audit and Governance Committee** (Dr Michaela Anderson [Chair], Sir Douglas Graham). 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.

(ii) **Responsible Investing Committee** (Ira Bing [Chair], Dr Michaela Anderson, Sir Douglas Graham, Bridget Liddell). The objectives of the committee are to assist the Board in the development of policies and procedures for ethical investment and for responsible use of the voting rights as an institutional investor.

(iii) **Employee Policy and Remuneration Committee** (David May [Chair], Sir Douglas Graham). The objectives of the committee are to assist the Board with human resources policies and practices.

At the beginning of the year there were two other Board committees, the Manager Selection Committee and the Communications Committee. Resources for the selection of investment managers and communication of the Guardian's activities were developed internally and the Board decided to no longer operate these committees.

DIVISION OF RESPONSIBILITY BETWEEN THE BOARD AND MANAGEMENT

The Board is responsible for setting the policy and strategy for the Fund as well as the appointment of investment managers and key advisors. Management is responsible for developing recommendations on policy and strategy for the Board, for researching and recommending suitable investment managers and monitoring them once appointed, and for implementing approved policies. The Board has a schedule of matters specifically reserved to it for decision. This schedule includes:

- Setting investment strategy;
- Appointment of fund managers and custodians;
- Approval of accounts;
- Approval of budget;
- Approval of the business plan;
- Approval of financial policies;
- Approval and review of risk management strategy;
- Approval and review of Statement of Investment Policy; and
- Approval and review of Statement of Intent.

THE BOARD HAS ESTABLISHED THREE COMMITTEES WHICH HAVE BEEN DELEGATED RESPONSIBILITY TO DEVELOP AND RECOMMEND POLICY AND MONITOR COMPLIANCE AGAINST POLICIES IN THE RESPECTIVE AREAS.

The Board delegates a number of areas of responsibility to the Chief Executive and then monitors performance of management in carrying these out. Key areas of responsibility for management include: analysing the most efficient use of investment markets to meet the risk-adjusted return expectations for the Fund; selecting, contracting with and monitoring investment managers; managing the Fund's transactions in the most cost-effective way; developing and implementing controls for the management of operational risk; financial reporting and communication with external stakeholders.

The Guardians' management team is as follows:

	NAME	BACKGROUND	KEY RESPONSIBILITIES
	Paul Costello, CEO	Previously CEO of Superannuation Trust of Australia	Overall operating responsibility
Investment Policy	Paul Dyer, CIO, Investment Strategy	Previously CIO of AMP Capital (NZ) Limited	Strategic asset allocation and risk budgeting including ensuring adequate portfolio diversification
	Tim Mitchell, CIO, Portfolio Construction	Previously CIO of Colonial First State Investments Managers (NZ)	Manager selection and monitoring with aim of generating excess returns from active management
Investment Operations	Andy Greening, Manager, Investment Operations	Previously Operations Director for UBS Global Asset Management, Zurich	Operational risk management including oversight of transactions, settlements and portfolio valuation and reporting
	Ryan McCulloch, Portfolio Analyst	Previously Portfolio Analyst for Bank of New York, London	Day-to-day relationship management with investment managers and custodian
Financial Control	Stewart Brooks, Chief Financial Officer	Previously Group Company Secretary for Sterling Grace Portfolio Management Group (NZ)	Financial and compliance reporting, risk management and audit relationships
	Laren Adams, Financial Accountant	Previously Financial Controller, Centaur Holdings, London	Financial management of activities of the Guardians
External Relations	Sarah Loutit, Communications Manager	Previously Head of Corporate Communications, Eversheds (UK)	External relations and communications
Office Administration	Sheryl Coker, Office Manager	Previously Office Manager for a variety of organisations	Day-to-day operations of the Guardians' office and suppliers

RISK MANAGEMENT

A substantial part of the business is concerned with the management of credit, liquidity, operational, currency, market and other financial risk. The Board has determined that the quality of all its risk management procedures must be best practice standard.

The Board has, through its policies and contractual arrangements with investment managers and the custodian, put in place procedures to manage these risks.

LEGISLATIVE COMPLIANCE

The role of the Audit and Governance Committee includes reviewing compliance systems to ensure compliance with legislation. A legislative compliance system has been developed to identify and comply with legislative requirements.

CODES OF CONDUCT

The Board has adopted a governance statement for the Guardians and Codes of Conduct for members of the Board and for employees. The Codes set out standards for appropriate ethical and professional conduct and include procedures for dealing with conflicts of interest. The Board maintains a register of interests and ensures Board members are aware of their obligations to declare these.

The Codes have been prepared having regard to information guidelines and other published codes of practice. The codes outline practices necessary to maintain confidence in the Guardians' integrity and the responsibility and accountability of individuals for reporting and investigating reports of unethical practices. The full codes are available on the Fund's website .

STATEMENT OF INVESTMENT POLICIES

The Fund's governing legislation states the annual report must include a Statement of Investment Policies, Standards and Procedures for the Fund.

A full copy of the Statement can be found on our website. The key provisions are summarised below:

1. The classes of investments in which the Fund is to be invested and the selection criteria for investments within those classes

The asset classes, which may make up the portfolio, are as follows:

- **Global Equities**
  - > Large/mid/small capitalisation
  - > Emerging markets
- **Global Fixed Interest**
  - > Sovereign debt
  - > Non-sovereign debt
- **Property**
  - > New Zealand
  - > International
- **New Zealand Equities**
  (including constrained allocations to Australia)
- **New Zealand Fixed Interest**
  - > Sovereign debt
  - > Non-sovereign debt
- **Other Growth Assets**
  - > Private Equity
  - > Commodities
  - > Infrastructure
  - > Forestry

The strategic asset allocation identifies the mix of asset classes determined to best meet the long-term performance target for the Fund. This is formally reviewed at least annually.

The selection criteria for investments are agreed with each investment manager in the form of an investment mandate which forms part of the contractual arrangement with investment managers. Typically, constraints include minimum and maximum numbers of shares that can be held, maximum exposure to a company, sector, country, or credit rating, ranges for ex-ante tracking error relative to a manager's benchmark, and maximum deviation from a manager's benchmark exposure to a particular company, sector, currency or country.

2. The determination of benchmarks or standards against which the performance of the Fund as a whole, and 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 selected 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 Board recognises that investment performance objectives are expected to be met over the long term and, from year to year, investment returns may not meet those long-term objectives.

The performance measures will be reported at least annually. The Board will measure performance against these objectives on rolling five-year periods as milestones towards achieving the stated 20-year objective.

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

3. Standards for reporting the investment performance of the Fund

A comprehensive reporting framework has been established. The 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;
- Analyse manager, asset class and whole-of-Fund performance.

Management reporting to the Board enables 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.

4. Ethical investment, including policies, standards or procedures for avoiding prejudice to New Zealand's reputation as a responsible member of the world community

The aim is to ensure that the Fund conducts its investment activities with integrity and professionalism.

Investment in any activity that is consistent with the laws of New Zealand will be permitted – unless, and until, that investment breaches the standards set out in the Statement of Investment Policies, Standards and Procedures. Where sovereign or corporate behaviour approaches, but does not breach, those standards, the Guardians may elect either to engage with that entity to encourage a change to that behaviour, or to divest.

The Guardians will regularly review all its sovereign and corporate securities 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.

5. The balance between risk and return in the overall Fund portfolio

Analysis of the risk/return tradeoff, 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 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.

6. The Fund management structure

The Board has overall responsibility for the management of the Fund.

The Board has appointed an internal management team supported by a range of external advisors and a global custodian to provide the appropriate separation between the investing function and the settlement of transactions, as well as the recording and reporting of investment activities.

The Board has also appointed a range of external investment managers to carry out the investment function.

7. 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.

8. The management of credit, liquidity, operational, currency, market and other financial risks

The Board has 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 2004 the policy for managing foreign currency exposure was that all of the foreign currencies in the international fixed interest portfolio, and 60% of the foreign currencies in the international equity portfolios, would be hedged back to New Zealand dollars. This policy is subject to review and it is anticipated that the level of hedging in the international equities portfolio will be increased.

9. 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.

Proxy voting is a key to maintaining shareholder oversight of directors and company policies. 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; and
- 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 Board.

In general, investment managers will be delegated with 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.

10. The method of, and basis for, valuation of investments that are not regularly traded on a public exchange

Investments not regularly traded on recognised exchanges will generally be held in pooled vehicles subject to external valuation by the investment manager on behalf of all investors, and will be valued according to accepted market practices.

As at 30 June 2004 no investment in these assets has been made.

11. 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. Legislation prohibits the Fund having a controlling interest in any other entity.

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

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 2003/04 financial year.

David May

Chairman

Chief Executive