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Home or Away?: Investing the Cullen Fund

The New Zealand Superannuation Fund (sometimes referred to as the Cullen Fund) was established to partially pre-fund New Zealand Superannuation.

It was established on an arms'-length basis from politicians. Its Guardians are mandated to manage the Fund in a prudent commercial manner in order to maximise returns without taking on undue risk. The aim is to maximise its contribution to meeting future superannuation costs.

Many criticisms can be made of the scheme, and the Business Roundtable opposed it on the grounds that a preferable strategy was to continue to run down debt for a period rather than create an equivalent 'cookie jar'.

One reason among others for doing so was the risk of political interference. It was naïve of finance minister Michael Cullen to think this would not happen. Similar funds elsewhere have routinely been raided for political purposes. The Rudd government in Australia already plans to tamper with the Future Fund established by the Howard government to underwrite public servants' superannuation.

There is no end to proposals for directing the Cullen Fund's investments: into infrastructure, renewable energy, venture capital and so forth.

Recently, the New Zealand Exchange and the New Zealand Institute came out in favour of directing the Fund to allocate a greater proportion of its capital to domestic investment in the belief that this would boost our capital market.

One objection to this idea is that as soon as any binding restrictions are imposed on the Fund's portfolio allocation, the expected return is reduced for a given level of risk. It will make less of a contribution to the future superannuation burden.

Another is that it views the capital market in Fortress New Zealand terms. New Zealand is now part of the huge world capital market. The Cullen Fund is miniscule in world terms. Any investment it makes in New Zealand would otherwise have been made by someone else, assuming the project is sound. There is no shortage of capital for profitable investment projects in New Zealand, given good overall economic management.

But a more basic objection relates to how the Fund operates. Many people focus on the fact that only around 20% of the Fund is directly invested domestically, including in cash. But this is only a partial picture of where the Fund is invested. The reality is that most if not all of the money is effectively invested in New Zealand.

The explanation is straightforward. Most of the Fund's offshore investment is hedged back into New Zealand dollars. This is sensible because the ultimate New Zealand Superannuation liabilities are in New Zealand dollars.

According to the Fund's website, its long-term target for its net foreign currency exposure is only 10% (the current target is 13%). This means 90% is targeted for investment back into New Zealand.

How does hedging work? Fundamentally, currency hedging means borrowing short term offshore and investing short term in New Zealand, so that the net investment remains in New Zealand. The instruments commonly used to achieve this are forward contracts, but the counterparty still has to borrow offshore and invest the proceeds in a NZD investment.

To use a simple illustration, if the Fund hedges a \$100 overseas investment back into NZD, the counterparty to the hedge will borrow overseas and invest \$100 in New Zealand for as long as the hedge is in place. Typically this counterparty will be a local bank. As a result, the \$100 would remain invested in New Zealand. All that happens is that the ownership of the \$100 changes.

The upshot is that most of the Fund's capital is already invested in New Zealand. Of course, we don't know exactly where. That is up to the New

Zealand banks or other financial institutions that accept the contracts from the forward contract counterparties.

Directing the Fund to allocate a higher proportion of its capital into direct New Zealand investments would just mean that the Guardians, rather than New Zealand financial institutions, would decide where the investments would go.

In fact, even the 10% of the Fund that is unhedged can be regarded as investment in New Zealand, given our floating exchange rate regime. If the Fund chooses to buy, say, Microsoft stock it must sell NZD to acquire US currency. If it sells to a New Zealand party, the money stays in New Zealand, and if it sells to an external party the NZD can effectively only be used for investment in New Zealand.

Any debate about the Fund's investment policy should start from a recognition of this reality. It should not start from the false proposition that the Fund is diverting capital that could be made available for productive investment in New Zealand.

There are other complexities but they do not alter the basic story. Competent economic journalists should have pointed out the fallacy long ago.

Roger Kerr (rkerr@nzbr.org.nz) is the executive director of the New Zealand Business Roundtable.