Submission on the Review of KiwiSaver Default Provider Arrangements

18 September 2019

About MyFiduciary

We specialise in investment governance education and consulting to a fiduciary standard of care. We work with Advisers, Charities, Foundations, Maori and Iwi organisations, Superannuation and KiwiSaver Providers, and Industry Bodies across New Zealand, Australia and the Pacific. Our mission is to shape the investment world to one that is good for our clients and to provide individuals and organisations with the training, tools, and resources necessary to ensure assets under their care are managed and grown to a fiduciary standard.

Our team has considerable expertise across investment governance, responsible investing, institutional asset management, advice, investment due diligence, and direct investing. Our team also serve investment committees and Boards across the public sector, foundations, and commercial organisations.

The Submission

Our submission focuses on the following areas for review:

- Investment mandate for default providers
- Fees
- Responsible investment
- Capital market development
- Member engagement
- Criteria and weighting for the procurement of providers

We consent for our written submission to be made public. If helpful to the review process, we are also available to present our submission via video conference or face to face.

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1. Investment Mandate

Default Providers are required to adopt conservative mandates. Is it appropriate to move away from this?

Options for consideration:

- **Option 1 - life-stages investment mandate**
- **Option 2 - Balanced investment mandates**
- **Option 3 - Growth investment mandate**
- **Option 4 - Conservative investment mandate**

We favour Option 1 because in our view the life-stages investment mandate is the most consistent strategy that aligns with the legislative goals of the KiwiSaver Act. We believe consideration of design and transition issues can adequately deal with the first home buyers grant.

The key legislative goals of the KiwiSaver Act are to:

1. To encourage a long-term savings habit and asset accumulation by individuals who are not in a position to enjoy standards of living in retirement similar to those in pre-retirement; and
2. To increase individuals' well-being and financial independence, particularly in retirement, and to provide retirement benefits.

KiwiSaver has been very successful regarding the first goal. Since its inception in 2007, it has become by far the most widely held voluntary private savings vehicle in New Zealand. There are now around 2.8 million individual members in the scheme, representing over three-quarters of the population aged 18 to 64. Our view is that it has positively contributed to the net-wealth of its members, particularly members on middle-level or lower lifetime incomes.[1]

However, our view is that the current conservative default mandate is not as well-aligned with the second goal outlined above given (i) the much lower long-term return potential and expected retirement wealth of a conservative scheme compared to the other options above; and (ii) the well-established shortfalls in the way the standard theoretical life-cycle model of savings behaviour captures actual savings behaviours. These points imply that members allocated to a default scheme may often have a materially lower than optimal allocation to risky assets, but they do not shift from this position given inertia and other behavioural biases.[2]

In the options above for a default scheme we favour a life-stages approach. This is because it likely offers the best asset allocation match to the time-horizon of members defaulting into a scheme, and staying with their default allocation. An important exception to this is members looking to use KiwiSaver for the first home-buyer scheme. Such members have a short time-horizon and much lower tolerance for a negative return, and hence should in principle be allocated to a conservative investment mandate where the volatility in returns is relatively low. We think that this issue can be well-addressed under a life-stages approach via simple on-boarding checks, such as:

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[1] See Drew and Wilson (2015)

[2] See Table 6, Drew and Wilson (2015).

1. Requiring new KiwiSavers to elect whether they are likely to use KiwiSaver for a first home grant when they elect to join KiwiSaver; and
2. Requiring Providers of a default scheme to check whether new members have considered the first home grant scheme.

If a life-stages mandate is selected as a default option, we also note that there are transition and design choices that will still need to be carefully considered. Members in present conservative default schemes would need to be informed of the change, and Providers would need a reasonable period of time to contact members and to change their mandates (presuming they remain a default provider under the shift).

In terms of design, the common themes from academic research into optimal lifecycle strategies and reviews of actual products in the market include:

1. Lifecycle products are too conservative overall.[3]
2. People would be better off if their portfolios did not become less aggressive until much later in their working life.[4]
3. Ideally, the asset allocation should depend on more than just the person's age. These include:
    a) The individual's risk preferences or ability to absorb risk.[5]
    b) How much the investor has invested – or more precisely, their investment balance relative to the amount they are *targeting* at retirement.[6]
    c) Market conditions, with the portfolio becoming more aggressive when equities are cheap.
4. Some products are not sufficiently diversified and/or would benefit from greater exposure to inflation-proof assets.[7]

While points 1 and 2 above may be correct for a cool-headed actuary, it ignores behavioural factors including whether investors would be able to stick with a more volatile strategy through the bad times, and the disappointment that may come from having to cut back spending plans after an equity market downturn (loss aversion; anchoring). For these reasons, portfolios of 80% or more in growth assets through retirement (as can be recommended from theoretical analysis) are likely unsustainable for the investor, even if they can be shown to be 'optimal' in a wealth accumulation sense.

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[3] For instance, Shiller (2005), Ang (2014), Arnott (2012), Estrada (2014) and Australian Productivity Commission (2019).

[4] For instance, Shiller (2005), Arnott (2012) and Estrada (2014).

[5] Many practitioners make this point. See Khemka et al (2019) for an attempt to estimate whether this makes a substantial difference in practice.

[6] In Australia, QSuper takes account of account balances as well as age the reasoning being that someone with a higher balance has less need to 'go for growth'. See also Giron et al. (2018) for a goals-based framework which uses a conservative portfolio to target a minimum or base level of wealth plus a growth-focussed portfolio to maximise returns once the base level has been achieved

[7] Analysis by PIMCO (2015) suggests that greater use of inflation-linked bonds would increase the probability of investors achieving their retirement goals (defined as a minimum 30% income replacement at retirement).

Points 3 and 4 may be valid in principle, but they are also true of products that keep the asset allocation fixed through the lifecycle (e.g. Options 2 to 4).

The issue is not whether a life-stages product is better than some theoretical alternative that may not exist in the marketplace, but whether it is better than the real-world alternative of a fixed weight allocation.

In its review of the Australian Superannuation Industry, the Australian Productivity Commission was supportive in principle of lifecycle funds, concluding in Finding 4.3 that '*well designed life-cycle products can produce benefits greater than or equivalent to single-strategy balanced products…*' But it also cautioned that some life-stages products in the marketplace were not well designed, a concern we share for some, but certainly not all, current New Zealand products.[8]

2. Fees

If there are problems and issues that exist with the fees of default providers? The options for consideration are:

- **Option 1 - Government sets a fee**
- **Option 2 - Two-stage assessment of fees in procurement**
- **Option 3 - Percentage-based fees reduce as provider's funds under management I increase**
- **Option 4 - No fees for under 18 year olds**
- **Option 5 - No fees for low balances**
- **Option 6 - No annual fees**

We favour Option 1 because in our view KiwiSaver fees, in general, are not good value for money given likely excessive Provider margins. The issue is more acute with non-default funds, indicating that a broader inquiry into KiwiSaver fee levels is warranted in our view.

KiwiSaver Schemes often do not provide good *value for money.* That is, in our view fee levels are generally too high **for the types of strategies that most schemes employ.** This is not to say that lower fees necessarily offer better value. Fee levels could arguably be higher, but still offer good value for members, if strategies employed included a higher allocation to private markets and "alternatives" in general (see Section 4). But at present most schemes, particularly default conservative funds, are quite generic. The inference we draw is the margin between external manager costs and Provider costs is excessive. In our view this is not acceptable given all KiwiSaver Providers have benefited from generous government incentives and Default Providers received a privileged investment flow.[9]

There is little evidence to see any price competition and a reduction in fees across the KiwiSaver Providers. The inference we draw is that end investors, on average, are not price sensitive and do

[8] MyFidcuiary conducted a recent review of life-stages products in New Zealand for NZ Funds Limited. Our commentary in this section of the submission draws from this review.

[9] For example, a provider who has managed a default investor's assets since inception would have benefited from 11 years of tax incentives and the $1,000 kickstart from the government in which its fees apply to.

not appear to fully-appreciate the impact of the costs on their returns.[10] Instead, in our view Providers have focused on building out their distribution network, whether it be through existing infrastructure (e.g. bank providers) or offering incentives to third-party distributers like financial advisers.

KiwiSaver Default Provider fees have a wide range despite offering quite homogenous products. Percentage-based fees range 0.38% – 0.78% and account fees from zero - $50 per annum.

	Average Cost (total expense ratio)*	Range (total expense ratio)*
Default Provider's default conservative scheme	52bps	38bps[1]-78bps[2]
Default Provider's non-default conservative scheme	98bps	70bs[3] – 115bps[4]
Non-default providers conservative scheme	85bps	31bps[5] – 119bps[6]

Source data: Morningstar and Disclose Website. * excludes dollar based account fees
1. Booster 2. KiwiWealth (Kiwibank) 3. Westpac 4. Booster 5. Simplicity 6. Lifestages (SBS Bank)

Given this, it should not be a surprise to see that over 5-years the cheaper products have tended to be the better performers[11]. Of further concern, as shown in the Table above, is that non-default conservative schemes, on average, are more expensive **including for non-default schemes run by Default Providers.** We wonder, hence, the extent to which providers engage members in a default scheme for the purpose of shifting them to a more expensive scheme in which they receive a larger margin.

In our view, the government should set a **default fund fee schedule** for all KiwiSaver default funds given the conduct which has been observed in the industry to date. (This view holds even if the risk profile of the default status changes). This schedule should recognise that some types of strategies incur higher costs, and hence some flexibility in the total fee level should be permitted. The key consideration in setting the fee is that:

- the government insists on full cost transparency, particularly for vertically integrated firms where costs can be bundled.
- the government periodically **benchmarks** all material costs in the Providers' supply chain so that it can be assured the total fee is good value for money. These costs include:
    - Custody and registry of members.
    - Source fund management fees (and sub-fund manager fees where applicable); whether through engagement of external managers or internally run mandates.
    - Any **overlay fees and charges** applied by the KiwiSaver Provider to the source fund manager fees. We observe that this is an area where there is large variation in costs for the same or similar underlying manager access and strategies. In principle, these overlay fee could be set on a fixed cost basis rather than percentage basis.
    - Administration and compliance costs.
    - Marketing and member engagement costs.

[10] See for example Heuser *et. al.* (2015), page 88.
[11] See Morningstar (2019)

- The government should be assured that the **Provider margin is reasonable**, and our view is that we should see this declining with scale.

Outside of Default Providers, we think all other KiwiSaver Schemes should be subject to a capped schedule in line with the mechanism set for Default Providers.

3. Responsible Investing

How does responsible investment affect returns? Does it increase or decrease returns, and to what extent?

- **Option 1 - Require mandatory exclusions of certain industries or companies**
- **Option 2 - Standard disclosure for responsible investment**

We favour Option 2, which we also expect would lead to certain industries or companies being excluded under Responsible Investment Grounds.

In our view, in-line with international best practice and the direction of international legal opinion and regulation, KiwiSaver Providers have a fiduciary duty to consider Responsible Investment and report on their RI activities. We assess that most Providers still have a lot of ground to make up to integrate Environmental and Social Governance (ESG) into their investment process.

Responsible Investment includes a number of activities, including:

1. Ethical and/or legally determined exclusions (in the pursuit of avoidance of harm and/or compliance with legal obligations).
2. Incorporation of Environmental and Social Governance (ESG) into investment decision making and due diligence processes.
3. Engagement with companies to try and change behaviours or activities.
4. Ethical and impact-based investing.

Early literature and activity on Responsible Investment was focussed on (4), and typically found that the activity led to poorer return outcomes. But today, much of the Responsible Investment activity is focussed on (2). Our assessment of the large literature on incorporating Environmental and Social Governance (ESG) into investment decision making is that it **can be expected to improve investor returns and reduce risks.**[12] The clearest evidence for this is with respect to the Governance factor, while the evidence on how consideration of Environmental and Social factors (in particular) is more mixed, partly due to more challenging measurement issues. Given the literature findings we regard it as necessary that all (not just Default) KiwiSaver Providers at the very least consider, document and disclose their approach to Responsible Investment.

KiwiSaver Providers are **fiduciaries** responsible for the management of assets of their members. We regard, in line with the increasing direction of international regulation and practice, that Responsible Investment to be a key part of discharging fiduciary duty (in particular the duty of care to members).

[12] See for example the meta-study by Friede et al. 2015.

Examples of the international direction include[13]:

- The *UN's Fiduciary Duties in the 21st Century*, which concludes there is a positive duty to incorporate ESG into a fiduciary's investment governance.
- In the UK, the Pensions Regulator published a new Defined Contribution Code and trustee guide in July 2016. This states that there is no legal obstacle to integrating ESG, and it encourages trustees to consider the long-term sustainability of investments.
- In South Africa, the 2011 Amendment to the Pension Funds Act states that "Prudent investing should give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund's assets, including factors of an environmental, social and governance character."
- In the EU, 2019 pension fund governance and investment regulation (IORP II) explicitly sets out the "prudent person" should consider ESG factors, in terms of both the potential impact on portfolio risks and returns and the institutional investor role as long-term investors.
- The *Fi360 Prudent Practice* investment governance standard, which prescribe ESG to be an activity that must be factored into advice and investment processes. Globally, firms that manage over USD 600b voluntarily adhere to this fiduciary standard.

In New Zealand, the NZ Superannuation Fund has been a leader in its Socially Responsible Investment activities. We observe that other "pinnacle" fiduciaries such as the Community Trusts are also moving in this direction.

In KiwiSaver, our assessment is that the incorporation of SRI is lagging considerably compared to global best practice, and behaviours are arguably often driven by as much by a desire to remove newspaper "headline risk", rather than conviction in SRI and adopting a higher fiduciary standard of care. Some Providers do very little, most exclude some sectors but not consistently across their portfolios, and only a handful of schemes comprehensively incorporate ESG. See Annex 1 for details.

In Summary, we support Option 1 but also think that MBIE should take into consideration that this remains a low bar compared to global best practice.

4. Capital Market Development

What limitations or problems exist in relation to New Zealand's capital markets? How could the settings for KiwiSaver default providers be amended to support the development of New Zealand's capital markets? How do the liquidity and pricing rules affect default provider investment in alternative New Zealand investments? The options are:

- **Option 1 - New Zealand-based management requirement**
- **Option 2 - Targeted investment requirement**

We do not favour either option as a mandated requirement as it may potentially compromise member returns, and is hence inconsistent with the Kiwisaver Act. We do believe however that liquidity, pricing and Scheme structures need to be looked at to reduce the barriers of Providers adding alternative investments, including NZ alternatives.

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[13] See OECD (2017) and United Nations (2016)

Currently, it is striking that across KiwiSaver very little of member's portfolios are invested in private markets (i.e. non-listed exposures) or "alternatives" (everything aside conventional listed asset classes) in general. This is out of step with international practice and where we observe that in government sponsored or run pension schemes alternatives and private markets comprise a significant fraction of the asset allocations (around 15%)[14], with percentages are higher still in long-term institutional investors such as Sovereign Wealth Funds (including the NZ Super Fund and ACC).

In general, alternatives and private markets to member portfolios have the potential to improve **net** risk-adjusted returns for members, despite the often materially higher costs associated with these exposures. Private markets generally offer a higher return to compensate for their higher level of risk (including illiquidity, complexity and concentration risks). Some private market exposures (e.g. timberlands) also offer a clear diversification benefit given their low correlation with listed markets. They also expand the opportunity set that providers can access, which may be particularly important in today's environment where MyFiduciary, in line with many other asset managers or consultants, expects materially lower returns going forward than what has been achieved over the past decade.

Our understanding from Providers is that there are two main reason why KiwiSaver schemes remain "plain vanilla":

1. Liquidity and pricing rules provide a constraint on how much illiquid exposures can be brought into portfolios to manage switching or redemption risks (up to around 5%).
2. Concern that these higher cost exposures will lead to higher fee levels, and hence may compromise default status and/or market competitiveness.

On the first issue we think that liquidity and pricing rules need refinement to permit providers greater leeway to offer private market exposures. Such exposures could, and likely would, include NZ private equity and venture capital, NZ infrastructure, NZ timber and agricultural sector investments and other NZ private market exposures given NZ-based KiwiSaver providers would have an advantage in sourcing and investing in NZ private markets c/f offshore markets. We see this in practice, for example, with the NZ Superfund and ACC where 'local advantage' has led their direct and private market investment activity to be concentrated in New Zealand. This would in principle have the potential to improve the well-recognised breadth and depth issues prevailing in NZ's capital markets covered in the last capital markets task force, and likely persisting today[15].

On the second point we regard value for money, as discussed in the fees section, to be a much better metric for assessing provider cost competitiveness than fees. But it may be hard for many members to accept the materially higher fees associated with private markets, and providers may find it in practice very difficult to manage member switches once a certain threshold of illiquid investments are surpassed. This problem would become acute if members reacted negatively to the normal J-Curve we expect in private market funds (e.g. VC and PE funds).

For these reasons, we think consideration should also be given to how structuring of KiwiSaver could be altered to alleviate these risks. For example, enabling providers to offer a separate or carved-off private markets scheme in which clients "sign off" that they understand the higher costs and risks, and agree that their funds cannot be switched to another scheme for a period of years.

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[14] See Hentov *et al.* (2018)

[15] See Capital Markets (2009).

5. Member Engagement

What is your feedback on the member education requirements that default providers should have in relation to default members, and how these should be enforced in the instruments of appointment?

Member engagement is critical to ensure members are placed in a strategy that best meets the time horizon, risk tolerances, tax status and preferences (e.g. over SRI and/or fee levels). We agree that the FMA's guidance on sales and advice published on page 46 of the MBIE consultation document is a useful basis for member engagement requirements.

We understand from Providers that it can be very difficult to engage members, so do not support an *outcome* based metric. Instead, we support that the requirement should be process driven, as it is for the Fi360 Prudent Practices Standard.[16] The specific criteria we suggest should be included in evaluation a Providers' process and capacity to implement the process includes:

- Summary reporting to the FMA on the Providers efforts.
- Assurance that there is a sufficient number of full-time staff available for member education.
- Assurance that IT (CRM) systems are in place to adequately record engagement efforts and outcomes.
- External assessment of the engagement process followed.

We do not regard making effort to engage as particularly onerous given modern communication technologies, and note "Robbo advice" tools should be considered as part of the engagement package. As such, failing to meet these requirements should carry a large penalty, including potentially losing Default Provider status.

6. Criteria and Weighting for Default Providers

What is your feedback on the other requirements that should apply to default members?

Given the importance of KiwiSaver for New Zealander's retirement needs, and the privileged advantage that Default Providers have, we favour a selection approach that verifies that the Provider meets a **global best practice standard** on both initial selection, and a period basis (e.g. annually). This would include:

- Verification that the Provider meets and continues to meet MIS licencing and any other regulatory requirements.
- Verification that the Provider meets commonly accepted global best practice standards for pension providers. Relevant examples of standards that could be considered as a baseline in this regard includes the *Santiago Principles* for Sovereign Wealth Fund and the Fi360 Prudent Practices for Investment Stewards.

Our concern with the current selection framework is that the weighting of criteria is very ad-hoc. For example, Corporate Structure and Governance has a weight of 1.5% (10% times 15%), yet this is often regarded as one of the most crucial determinants of an investors long-term returns and the

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[16] This is regularly applied to firms in the US seeking accreditation that their Plan Sponsor (401(k)) engagement efforts conforms to the Fi360 standard.

fiduciary care that the provider takes.[17] We have experience in applying assessment frameworks to various types of investment entities including Advisers, Pension Providers, Fund Managers and Charities and Foundations, and would be happy to engage with MBIE and provide details on how this could be done in the context of KiwiSaver.

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[17] See Drew and Walk (2019)

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Annex 1 KiwiSaver and the SRI Continuum[18]

Summary

In August 2016 the KiwiSaver landscape changed. Few KiwiSaver Schemes had in place responsible investment policies which directed their investment activities. But once it was unearthed that KiwiSaver providers had exposure to cluster bombs and land mines, and the resulting public outcry, this led to some fundamental changes to how KiwiSaver Providers invest.

Responsible, ethical or sustainable investing has been getting a significant amount of media coverage since this time. And for good reason, it brings the conversation of investing to the dinner table. Few people sit on the fence when it comes to this topic, and most have specific views about how they want to invest their hard-earned money.

To help inform this debate we have put together a clear guide showing where KiwiSaver Schemes sit on the Socially Responsible Investing (SRI) Continuum. Most KiwiSaver schemes have some consideration for SRI, but only a few go the extra mile of skewing all investments made to companies with superior environmental, social and governance practices.

Introduction

The investment industry loves jargons and acronyms as much as anyone, so it's easy to see why many are confused about investing. For those seeking out ethical or green investments, there are a myriad of terms. To keep this simple, we will refer to any form of ethical, responsible, or sustainable investing (commonly referred to as ESG[19]) as Socially Responsible Investing or SRI. This catch-all term covers the full spectrum of options.

What is SRI? The most common form of SRI is to exclude certain sectors or companies due to religious or moral beliefs. For example, an investor may exclude all tobacco companies because of the long-term health problems that smoking causes. This way they won't support these companies by investing into them. Exclusions are a relatively straight forward approach for KiwiSaver Providers investing in a responsible manner. But it's also a very one-dimensional approach.

A more comprehensive approach to investing responsibly is to seek out companies who have measurably superior environmental, social or governance (ESG) practices. Most KiwiSaver Schemes don't include ESG analysis in how they select fund managers or investments, although some individual schemes do (more on this later).

Companies that better manage water, waste and their carbon footprint (usage of fossil fuels) than comparable companies score well on environmental practices. Social factors take into account factors such as the impact companies have on the communities they operate in, the diversity of the workforce, how well workers are treated. The later can be an important factor for companies with factories in developing countries, where worker rights are often weaker than what we enjoy in New Zealand. Finally, governance factors analyse how a company is being managed and the diversity,

[18] This Annex is a published article by Chris Douglas, MyFiduciary. See https://www.myfiduciary.com/fiduciary-perspectives.html

[19] ESG stands for Environmental, Social and Governance. It provides a framework to analyse and compare companies by scoring companies on these three factors. Investors who consider ESG may also engage with companies directly or use their voting power to try and change company behaviours.

transparency and accountability of its Directors to shareholders, customers and communities. The social media giant Facebook has been downgraded in this dimension in recent times given rising concerns on user data privacy, and the responsiveness of its Board and senior executives to these concerns.

In general, the literature finds that incorporation of ESG, and in particular G, into due diligence processes can reduce risk and improve long run returns. Aside from expressing member preferences, we hence believe that KiwiSaver providers have a fiduciary duty to at least consider how ESG is integrated into the investment funds they select on behalf of members.

Responsible Investment KiwiSaver Schemes Analysis

We have scanned the responsible investment policies of the 16 major KiwiSaver Schemes and checked this against actual investments in the portfolios they manage. From this we developed a KiwiSaver SRI continuum that ranges from minimal or no exclusions of companies on SRI criteria through to comprehensive exclusions and increased investment into companies with relatively good ESG practices. This is shown in the figure below.

Cluster munitions are excluded from 14 out of 16 KiwiSaver Providers, with Aon KiwiSaver and SuperLife the only two who do not exclude them across all their investment options. Nuclear Weapons and Tobacco investments are excluded across the entire portfolio for the vast majority (13 out of 16) of KiwiSaver Providers. Three KiwiSaver schemes have more comprehensive exclusions, and also exclude one or more of the following: adult entertainment; alcohol; factory farming; firearms; gambling; and thermal coal.

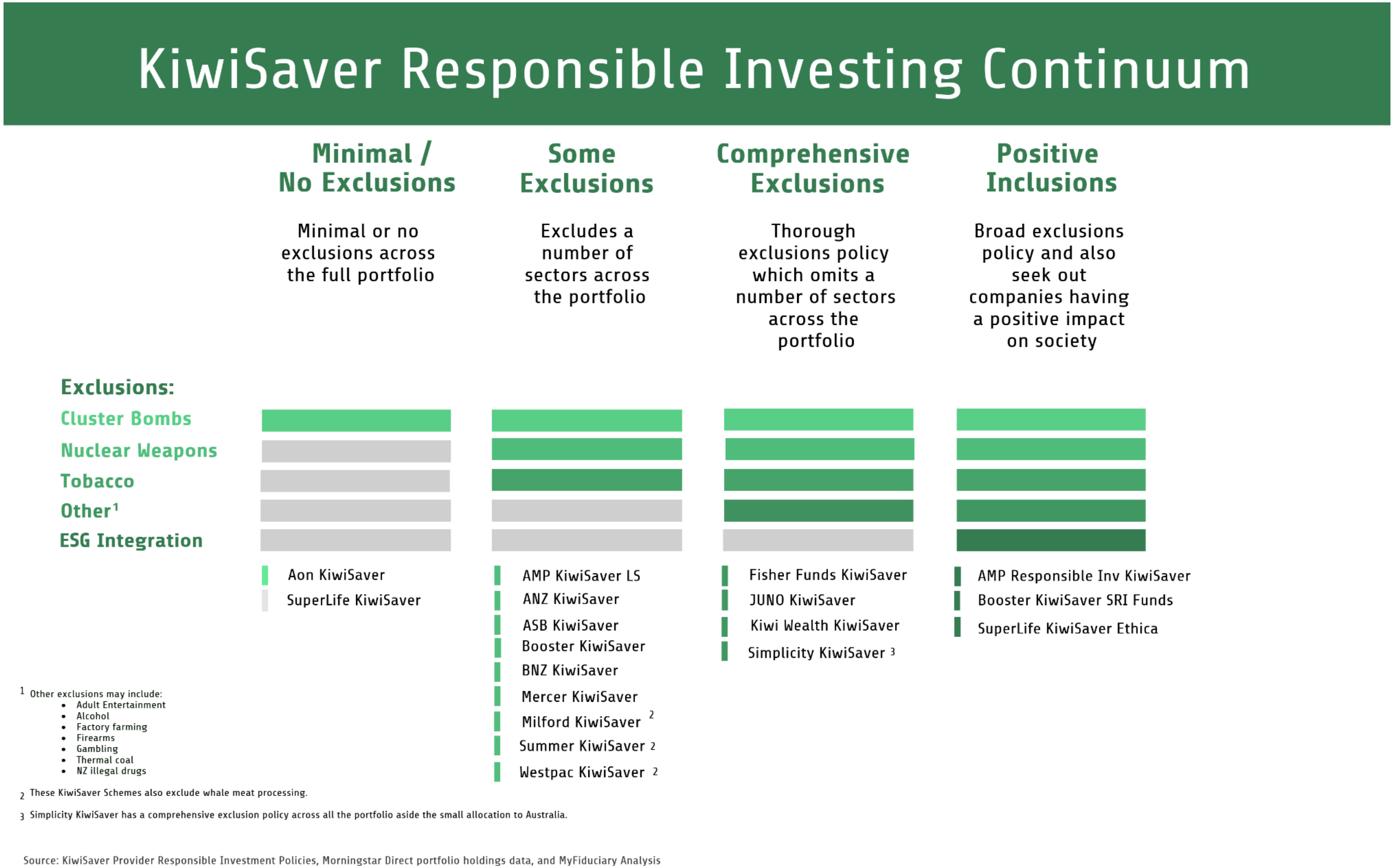
Finally, there are four KiwiSaver schemes which have an ethical or socially responsible investment charters and as a result have very broad-based exclusions and by nature of their process seek out companies with good ESG practices. These options are the AMP KiwiSaver Responsible Investment Balanced, Booster Socially Responsible Investment Balanced and Growth, and the SuperLife KiwiSaver Ethica scheme.

With regards their SRI policies all 16 KiwiSaver providers have some form of exclusions or responsible investment framework in place. But while many KiwiSaver providers say they incorporate ESG analysis across their full portfolio, we only found a handful which can explicitly outline how they do this.

Final Thoughts

Socially responsible investing has become part of mainstream over the last few years as evidence has mounted SRI at least does no harm and can improve returns, and as more investment choices have come to the market. The vast majority of KiwiSaver providers have listened to their investors and changed their investment approach accordingly. However, our analysis shows that there are still only a few options for investors that want a comprehensive approach across all their investments.

This is an evolving place and it's something that we will be updating on an annual basis to see how each KiwiSaver provider is developing their responsible investment process. If you're interested to learn more, the government mandated NZ Super Fund is a world leader in this area and have a very clear overview of how they invest responsibility. Another good resource is the Responsible Investment Association Australasia.



The KiwiSaver Responsible Investment Continuum has been updated using data as at September 2019.