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Review of the KiwiSaver Default Provider Arrangements
Submission by LWCM Limited

Introduction

1. Thank you for the opportunity to submit our comments on the Review of the KiwiSaver Default Provider Arrangements discussion paper (the "Paper"). At LWCM, we are fully committed to developing the New Zealand venture capital ecosystem, which presently has a significant shortage of investment capital available to it. We believe well crafted changes to the portfolio allocations of KiwiSaver Default Providers would result in a meaningful changes to the amount of capital invested in the venture capital sector. This new investment will have several flow-on effects including increased returns and investment diversity benefits to KiwiSaver members, along with helping to establish a thriving venture capital ecosystem with a greater number of growth companies creating value, providing jobs and paying taxes for the benefit of New Zealand.
2. This submission is generally focused on how changes to KiwiSaver Default Provider Arrangements could potentially impact New Zealand's venture capital ecosystem.

Background of the Submitter

3. This submission is made by LWCM Limited ("LWCM"), the Manager of Punakaiki Fund Limited ("Punakaiki Fund"), which is one of a handful of active New Zealand venture capital funds. Punakaiki Fund invests exclusively into New Zealand companies and has a particular focus on Software as a Service and technology intensive businesses. Punakaiki Fund currently holds venture capital investments valued at $50 million across 19 different high growth businesses. These companies have combined revenues over the last 12 months of over $120 million and employ over 700 people.
4. Punakaiki Fund is structured as a company and has over 830 shareholders, who are almost entirely based in New Zealand. Punakaiki Fund raises capital from both wholesale and retail investors, two to three times per annum. If demand warranted it, Punakaiki Fund is suitably structured to move to a continuous offering in order to accept funds from KiwiSaver Default Providers on a continuous basis.

Submission on Question 28

5. LWCM agrees with the sentiments of paragraph 162 of the Paper that "Deep and liquid capital markets help promote long-run economic growth" and supports the development goals for New Zealand's capital markets as set out in paragraph 168 of the Paper.

6. As a major participant in New Zealand's venture capital markets, LWCM bears first hand witness to the lack of capital available to fund attractive growth businesses. Since first raising capital in 2014, Punakaiki Fund has been presented with high-quality investment opportunities in the venture capital space that significantly outweigh its ability to invest in those opportunities. The Government has noted this situation and is looking to address this capital shortfall with the $300 million Venture Capital Fund announced in this year's Wellness Budget.

7. While the Venture Capital Fund is a progressive initiative, it (as currently proposed) will only match private funding into venture capital funds and as such, does not solve the problem of increasing private investment into the sector. Having KiwiSaver default schemes invest into venture capital funds (or invest directly) would be a very important part of filling this venture capital funding gap. It cannot be understated how much we believe that current venture funding gap is impacting the ability of early-stage, high-growth businesses in New Zealand to grow and, over time, make a significant contribution to the economy.

8. While not as chronically underfunded as the venture capital ecosystem, there are also opportunities to invest in other alternative asset classes such as New Zealand-based private equity and infrastructure, where significant amounts of funding are required. The success of the NZ Super Fund in these areas illustrates the quality of local investment opportunities that are available.

9. We are supportive of a fixed minimum allocation of KiwiSaver default schemes' investments being applied to alternative asset investing. This support is based on the following factors:

    a. Increasing returns to KiwiSaver members (alternative assets such as venture capital and private equity seek higher returns compared to those delivered by listed equities and bonds. Examples of this in New Zealand include high-growth, high-value private companies started in New Zealand such as Rocketlab, Allbirds and Lanzatech; and others that ultimately become listed such as Xero, PushPay and Anaplan);

    b. Increasing diversity of KiwiSaver scheme investments (alternative assets such as venture capital and private equity have low correlations with listed equities and bonds); and

    c. The value creation and flow-on effects from these types of investments (employment, taxation etc.) will be beneficial to New Zealand.

    We note that in modern institutional portfolios a significant allocation to private alternative assets is considered best practice, and the absence of private alternative assets in KiwiSaver default schemes is unusual, especially given that their size does not restrict their access to these markets. Well diversified portfolios provide downside protection to KiwiSaver members, which is important during market corrections.

10. Paragraph 170 of the Paper refer to issues raised by KiwiSaver providers around illiquidity and lack of daily pricing as giving rise to barriers to investment. Private alternative assets are by their nature illiquid; however illiquidity should not be a concern in a portfolio context when the proportion invested in illiquid assets is small. For example, a fund with a 1% allocation to illiquid assets would need to experience a net fund outflow of 50% before this allocation would increase to 2%. Given (on average) New Zealand KiwiSaver schemes experience net fund inflows, we believe that an allocation to illiquid assets is very manageable in a KiwiSaver context.

11. As well as (and partially as a result of) being illiquid, private alternative assets tend to have low day-to-day price volatility. We believe that monthly pricing for private alternative assets is sufficient given this lack of price volatility, especially given the small proportion of a KiwiSaver schemes' investments that would be invested in such assets. Because of it structure and valuation techniques, Punakaiki Fund is able to provide monthly pricing to its investors and has done so in the past.

12. **Recommendation**: Require a set allocation of capital to be invested into New Zealand alternative assets by KiwiSaver Default Providers.

Submission on Question 29

13. Given the shortages of funding within certain capital markets in New Zealand, we are supportive of putting in place limits of the amount of foreign investment undertaken by KiwiSaver schemes. We believe channelling a greater level of funds into New Zealand capital markets will be beneficial for the development of those markets.

14. We do note, however, that some KiwiSaver schemes with an active mandate may become capacity constrained (i.e. have a diminished ability to generate excess returns due to the amount of funds that they need to deploy an any given market) in the New Zealand listed markets due to the limited size of those markets. New Zealand has a relatively small listed market compared to the size of its economy by international standards and this would indicate that private New Zealand investing will need to become a significant part of KiwiSaver portfolios. Overtime, KiwiSaver funds should be working in such a way as to promote the expansion of listed markets to alleviate these capacity constraints if possible.

15. As previously mentioned, the venture capital sector requires significant funding to develop and there are investment opportunities in many other types of New Zealand-based alternative investments including infrastructure and private equity. There are currently a minimal number of IPOs occurring on the NZX and additional IPOs are likely to be encouraged by direct investments into both pre-IPO funding rounds (capital raising rounds undertaking by the subject companies 6 - 12 months prior to their IPO) and into small-cap listed stocks (which receive limited investor interest on the New Zealand listed market). This would require a degree of active management by KiwiSaver Default Providers, or the establishment of specialist funds to undertake the management of these portfolios on their behalf.

16. **Recommendation**: Place reasonable limits on foreign investment in order to allow greater investment in New Zealand capital markets (especially private capital markets).

Submission on Question 30

17. We believe that all good actors operating within the New Zealand capital markets have a responsibility to help develop those markets. We also believe that both being in the privileged position of having KiwiSaver Default Provider status and being the manager of large pools of capital makes it imperative that KiwiSaver Default Providers are active in capital market development.

18. Strong capital markets will promote increased returns and diversification. This will benefit not just the members of KiwiSaver default schemes, but all market participants.

19. **Recommendation**: KiwiSaver Default Providers should take an active role in market development.

Submission on Question 32

20. We believe any increase in experience, expertise and capacity in the New Zealand capital markets that can be (not unreasonably) achieved will be beneficial to the development of those markets.

21. **Recommendation**: Any reasonable requirements that see increased experience, expertise and capacity in the New Zealand capital markets should be pursued.

Submission on Question 33

22. We are strongly in favour of an allocation by KiwiSaver default schemes to alternative New Zealand assets. As discussed earlier, not only do we see this as good portfolio construction practice (i.e. from a return and diversification perspective), but also as being invaluable from a New Zealand private capital markets development perspective.

23. We believe that the venture capital sector is the obvious sector for KiwiSaver default schemes to provide funding to. The high potential returns, coupled with the diversification benefits and the very large current funding shortfall experienced by the sector (as evidenced by the Government's planned $300 million Venture Capital Fund) provide an attractive sector to begin deploying KiwiSaver default scheme funds. We note that the New Zealand venture capital sector can become much better funded with a relatively small allocation from KiwiSaver schemes. This compares to New Zealand's infrastructure requirements, which require many billions of annual investment to satisfy.

24. However, the proposed 0.5% allocation to New Zealand alternative assets is not large enough and will only make a minor impact on capital market development in New Zealand. We would suggest a significantly higher percentage of at least 5%, if not more. We note that highly respected institutional investor Yale Endowment invests up to 50% of its investment portfolio into illiquid assets such as venture capital, leveraged buyouts, real estate and natural resources.

25. There are a number of privates markets that could be supported by additional funding and this may require further research and consultation to establish which private investment sectors are most beneficial to develop.

26. We recommend that if KiwiSaver Default Providers are mandated to invest in more than one New Zealand alternative asset sector, or are mandated to invest broadly in New Zealand alternative assets as an investment class, that specific investment allocations are developed for each individual alternative asset sectors (i.e. venture capital, private equity etc.) to avoid the situation where a KiwiSaver Default Provider may channel all funds required to be invested by such a mandate into the alternative investments that have the lowest fees, are most liquid or are seen to be the easiest to manage, without consideration to the sectors that have been targeted for development.

27. **Recommendation**: KiwiSaver Default Providers should have an allocation to New Zealand alternative assets, and it should be much higher than the 0.5% suggested by the Paper. The venture capital sector should be the initial recipient of funding given the benefits of doing so. Allocations should be made to specific alternative asset sectors (as opposed to the alternative asset class as a whole) in order to achieve specific capital market objectives.

A Note on Fees

28. We have heard concerns from KiwiSaver providers that under the current fee reporting regime, management fees associated with private equity and venture capital fund investments (typically 2% per annum) would be incorporated into their own fee reporting. Based on a 0.5% allocation to private equity and venture capital, this would increase reported KiwiSaver scheme management fees by 0.01%, however, a 5% allocation to private equity and venture capital would increase reported KiwiSaver scheme management fees by 0.10% - a material increase.

29. While prima facie this may appear problematic, the relatively high management fees charged for intensively managed private equity and venture capital funds needs to be considered in the context of the high returns that those funds are seeking. The addition of private equity and venture capital to a KiwiSaver scheme portfolio should be expected to increase returns to its members, despite the higher fees. We note that the NZ Super Fund readily uses external managers to deliver its private equity mandate, despite the higher fees incurred.

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LWCM Limited is the manager of Punakaiki Fund Limited