# **Submission on discussion document:** Enabling KiwiSaver investment in private assets

## Your name and organisation



| | |
|---|---|
| **Name** | Dr Huong Dang (HD), Jan Heldmann (JH) |
| **Date** | 14 February 2025 |
| **Organisation (if applicable)** | HD: University of Canterbury; JH: University of Bayreuth (Germany) |
| **Contact details** | HD: ***huong.dang@canterbury.ac.nz***; JH: ***Jan.Heldmann@uni-bayreuth.de*** |



## Privacy and publication of responses

[To tick a box below, double click on check boxes, then select 'checked'.]

☐ The Privacy Act 2020 applies to submissions. Please check this box if you do not wish your name or other personal information to be included in any information about submissions that MBIE may publish.

☐ MBIE intends to upload submissions received to MBIE's website at ***www.mbie.govt.nz***. If you do not want your submission to be placed on our website, please check the box and provide an explanation in the box below.

| |
|---|
| I do not want my submission placed on MBIE's website because… [*Insert text*] |

## Please check if your submission contains confidential information

☐ I would like my submission (or identified parts of my submission) to be kept confidential, and **have stated below** my reasons and grounds under the Official Information Act that I believe apply, for consideration by MBIE.

| |
|---|
| I would like my submission (or identified parts of my submission) to be kept confidential because… [*Insert text*] |

## Responses to discussion document questions

Please enter your responses in the space provided below each question.

| | Liquidity management tools – questions for KiwiSaver providers or other industry |
|---|---|
| 1 | For KiwiSaver managers: Please describe your current practice around investing in private assets, including levels of exposure you have to these types of assets, how you invest in these assets, and your management of liquidity risk. |
| | |
| 2 | Do you think that the current legislative framework for KiwiSaver effectively allows for the use of liquidity risk management tools that may impact transfer or withdrawal times (e.g. suspending redemptions or side-pocketing)? |
| | |
| 3 | For KiwiSaver managers: If you cannot use these tools, can you please explain the reasons for this and the impacts in terms of:<br>a. your ability to increase investment in private assets<br>b. risks associated with your current allocation of private assets. |
| | |
| 4 | Please provide any other comments on the availability of liquidity management tools. |
| | |
| 5 | Do you support the proposed approach? Why/why not? |
| | |
| 6 | If redemption gates were allowed, would you consider developing new products more focussed on private assets? |
| | |
| 7 | Will you face implementation costs if this change is made? If yes how much will they be and will they be one-off or ongoing? |
| | |
| 8 | Do you have any comments on the detailed design considerations noted above? |
| | |
| 9 | Please provide any further comments on this issue of liquidity management tools. |
| | |

| Liquidity management tools—questions for the public | |
|---|---|
| **10** | Do you support more investment by KiwiSaver funds into private assets? Why / why not? |
| | Investing in private assets results in more diversified portfolios for investors and probably enhanced returns over the medium to long term. Due to their long-term nature, private assets are not affected by the irrational changes in investor sentiment that often cause high volatility in publicly traded assets. This characteristic *may* help stabilize returns and reduce short-term market risk.<br>However,  the valuation of private assets is challenging since these assets are not traded on liquid markets and are priced less frequently. Instead, fund managers may rely on internal models, resulting in smoothed volatility and lagged price updates compared to publicly listed securities. These issues are more pronounced during market downturns. During periods of high volatility, it can take substantial time to liquidate private assets, and  these positions are likely to be closed at depressed prices which are much lower than the prices most recently updated by fund managers.<br>Considering the illiquid and opaque nature of private assets, we support more investment in these assets by KiwiSaver Growth or Active Growth funds. We do not support greater investment in private assets by KiwiSaver Conservative or Balanced funds. |
| **11** | Do you support the use of liquidity management tools like ‘side pockets’, if they may have an impact on the availability of your KiwiSaver funds? Please explain. |
| | We do support the side pocket tool for Growth or Active growth funds as these funds take on more risk in exchange for potentially higher returns. Member of these funds can handle having some money tied up in assets that are hard to sell, because they focus on long-term growth. However, the side pocket should only apply for private assets and should only be activated when the asset’s market price deviates significantly from the most recently updated valuation provided by fund managers. The threshold (to activate side pocket) for unlisted securities can be based on a multiple of the volatility of listed securities. For example, the side pocket will be used if the market price of an unlisted security deviates (in percentage) from the price updated at the end of the past quarter by more than  2 times the standard deviations of NZX50 returns over the past year. The multiple (2 in this example) reflects the degree of risk and opaqueness of the concerned unlisted asset. This mechanism isolates illiquid private assets and acts as a dynamic buffer against sudden market fluctuations, thereby safeguarding long-term investments.<br>Conservative and Balanced funds are meant to be safer relative to Growth funds.  Both categories tend to offer more stable returns and lower risk (as they invest more in fixed come securities and cash equivalent).  Locking money in assets that are difficult to sell is not in the best interests of members who are more risk averse (compared with Growth funds’ members). That's why side pockets, which are used to manage the risks of highly illiquid investments, should only be used by Growth or Active Growth funds and not by Conservative and Balanced funds. This is consistent with our view that do not support more investments in private assets by Conservative or Balanced funds. |
| **12** | Please provide any further comments on the proposed approach. |
| | |

| Private asset categories – questions for KiwiSaver providers or other industry |
|---|

| | | |
|---|---|---|
| 13 | Do you consider that the current asset classes in the Financial Markets Conduct Regulations 2014 are problematic as they relate to private assets? If yes, please explain. | |
| | | |
| 14 | How do think the categories should be described? | |
| | | |
| 15 | Please provide any other comments on the lack of private asset categories. | |
| | | |
| 16 | Which option do you think is best and why? | |
| | | |
| 17 | Will you face implementation costs if this change is made, if yes how much will they be and will they be one-off or ongoing? | |
| | | |
| 18 | Please provide any further comments on this issue of including private assets in asset categories. | |
| | | |

**Private asset categories—question for the public**

| | |
|---|---|
| 19 | Do you think it would be useful to have better visibility over how much KiwiSaver funds are investing into private assets? |
| | Investment in private assets must be disclosed clearly to all members of a fund and disclosed in a manner that is understandable by financially non-savvy members.<br>We support option 3 (Modify existing categories and apply categories to the underlying assets, i.e. the category reflects the underlying assets held). This enhanced clarity helps investors by providing a transparent view of their investments but also facilitates better risk management and informed decision-making. |

**Valuation requirements – questions for KiwiSaver providers or other industry**

| | |
|---|---|
| 20 | For KiwiSaver managers: Do your governing document(s) include a valuation methodology which is challenging to apply to valuing private asset? If you do, can you please explain the impact in terms of:<br>a. the extent to which your governing documents require amendments to allow for the inclusion and pricings of private assets within your funds.<br>b. whether you have tried to amend the valuation provisions in the past or not, and why. Include examples of where the supervisor has or has not approved a valuation methodology. |
| | |

| | |
|---|---|
| **21** | Please provide any other comments on the valuation methodologies in governing documents. |
| | |
| **22** | Do you agree that this is an issue that needs addressing? |
| | |
| **23** | Do you have views on how it should be addressed? |
| | |
| **24** | Will you face implementation costs if this change is made, if yes how much will they be and will they be one-off or ongoing? |
| | |
| **25** | Please provide any further comments on this issue of valuation requirements. |
| | |
| **Total Expense Ratio—questions for KiwiSaver providers or other industry** | |
| **26** | Do you currently outsource fund management for private assets? |
| | |
| **27** | Do you see any issues with the current TER calculation and if so, what are they? |
| | |
| **28** | Does the current TER calculation impact your decision to invest in private assets, or to utilise third-party fund management? |
| | |
| **29** | Are there any other issues you would like to draw attention to on the TER? |
| | |
| **Total Expense Ratio—questions for the public** | |
| **30** | Do you look at KiwiSaver scheme fees when deciding which KiwiSaver scheme to put your money with? |
| | While what matters most is the net return, we do examine fees and compare fees across schemes that share similar risk/return characteristics. What we want to know is whether the fees are reasonable (compared to peers), and if not, we will explore the reasons. |
| | What do you think should be included in any figure that is called "KiwiSaver scheme fees"? |

| | |
|---|---|
| **31** | In the discussion document, question 31 is: *"Do you think it is fair to include outsourced management fees charged to KiwiSaver managers in the overall "KiwiSaver scheme fee" that is eventually charged to members?"*<br><br>Answer:<br>Yes, outsourced management fees charged to KiwiSaver managers should be included in the scheme fee as they are passed over to members (though not directly).<br>We do not support exempting third-party private investment costs from the calculation of TER. This is likely to encourage fund managers to choose risky investments (i.e. outsource fund management for private assets). Undisclosed high fees/ costs could mislead potential members in making investment decisions. It is also important that existing members are fully informed of all the fees incurred.<br>Fee transparency helps protect long-term net returns and reinforces trust in the management of our investments. |
| **32** | Please share any thoughts you have around the TER (total expense ratio) and its function to inform the public of the expenses involved in KiwiSaver management. |
| | Private assets-related fees and expenses are a central concern because they tend to be less transparent than those in public markets. For example, the California Public Employees' Retirement System admitted that it had not maintained precise records of the carried interest paid to private equity firms over years. After consulting several of its fund managers, the pension plan estimated that from 1990 to June 30, 2015, about US$3.4 billion in carried interest had been paid out (Clayton, 2020, pp. 323-324).<br>Dang (2019) finds that fees are the primary drivers of KiwiSaver funds' underperformance (relative to their benchmarks). Rising fee levels can undermine investors' returns. For KiwiSaver funds considering investing in private assets, it is important to articulate clearly that higher and sometimes hidden costs can significantly influence the net performance of the investments. A careful review of fee structures and expense allocations is needed to ensure that the higher fees charged are justified by the value delivered and reasonable considering the risk profiles of the investments.<br><br>References:<br>Clayton, W. W. 2020. Public Investors, Private Funds, and State Law. *Baylor Law Review* 72 (2), pp. 294–354. https://law.baylor.edu/sites/g/files/ecbvkj1546/files/2023-11/9%20Clayton.pdf<br>Dang, H. D. 2019. KiwiSaver fund performance and asset allocation policy. *Pacific Accounting Review* 31(2), pp. 232-257. https://doi.org/10.1108/PAR-06-2018-0044 |

**Final comments—question for KiwiSaver providers or other industry**

| | |
|---|---|
| **33** | Please provide any further comment on barriers to KiwiSaver investment in private assets that you see (including any comments in relation to issues identified in paragraph 18b-f). |
| | |

**Final comments—question for all respondents**

| | |
|---|---|
| **34** | Please use this question to provide any further information you would like that has not been covered in the other questions. |
| | We would like to comment on valuation methodology issues, and for illustration purpose, we use examples of private equities. |

The valuation methodology that can be applied to derive the intrinsic values of private assets should be clearly articulated in the governing document. This is important to prevent inconsistent application of valuation methodologies or decisions to switch methodologies over time without a valid reason. Fund managers may be tempted to change valuation approaches, i.e. from backward-looking historical models to forward-looking estimates, to create favourable numbers under certain market conditions.

There are technical challenges, and an important consideration is how detailed the methodology in the governing document should be and how flexibility fund managers have in employing an approved methodology under different economic conditions. Although the public may not directly question a valuation methodology, it is important to consider technical challenges and address these challenges in the governing document.

When benchmarking private assets against peers, selecting the right comparators is difficult, particularly in a small and thin market like New Zealand.[1] Fund managers may cherry pick peers or transactions to derive intrinsic values from multiples. Another issue is the valuation metrics (multiples) that can be used to value private assets, for example, unlisted shares. While Price to Earnings (P/E) multiple is popular, P/E is artificially high in times of high inflations, and earnings fluctuate during a business cycle. The P/E ratio of a cyclical company usually reaches its highest point during a recession and drops to its lowest level when the economy is at its strongest. Furthermore, earnings can be manipulated or can be distorted by transient (one-off) earnings. Thus, the multiple P/E is not a universal option across different stages of a business cycle.

Valuation quality is also a critical factor. Poor valuation practices can cause rebalancing errors during market downturns. For instance, if listed securities experience a significant decline while private equities remain relatively stable with “stale” values (due to its opaque and illiquidity nature), this may misleadingly suggest that private equities are over-weighted compared to listed ones. This misrepresentation can cause a fund’s actual asset allocation to drift from its intended target allocation, prompting the fund manager to rebalance the portfolio in an attempt to restore alignment. Such rebalancing errors can increase return variability and elevate the portfolio's overall risk. This example highlights the importance of high-quality valuation and technical challenges that need to be addressed in the governing documents.

In conclusion, a clearly defined and rigorously applied valuation framework is essential to protect investor interests, maintain portfolio stability, and support informed decision-making even in volatile market conditions.

Reference:
Dang, H. D., and Jolly, M. 2017. Red flags for IPO downfalls in New Zealand. *Managerial Finance* 43(9), pp. 1034-1051. https://doi.org/10.1108/MF-05-2017-0197

[1] In a study of the performance of Initial Public Offerings (IPOs) in New Zealand, Dang and Jolly (2017, p. 1037) noted that New Zealand’s small market size creates challenges in finding peers with very similar valuation metrics.