6 September 2019

Financial Markets Policy
Building, Resources and Markets
Ministry of Business, Innovation & Employment
PO Box 1473
Wellington 6140

Re: H.R.L. Morrison & Co Limited Submission to the Ministry of Business, Innovation & Employment in respect of KiwiSaver Default Provider Arrangements

H.R.L. Morrison & Co is a fund manager which specialises in undertaking and managing investment in the infrastructure sector. It has offices in Wellington, Auckland, Sydney, Melbourne, Hong Kong and London and manages gross assets of approximately NZ$20 billion. In New Zealand its most well-known management contract is with NZX-ASX listed infrastructure investor Infratil. Most of Morison & Co's other mandates are with institutions such as the NZ Superannuation Fund and Commonwealth Super.

Morrison & Co has no direct involvement with KiwiSaver, although many KiwiSaver funds do own shares and bonds issued by Infratil. None of Morrison & Co's funds management contracts are with KiwiSaver funds.

This submission principally relates to section 7 of the MBIE Discussion Paper with particular reference to Question 28.

1. Are there types of investments not now favoured by KiwiSaver fund managers which are depriving investors of valuable opportunities?
    - The ability of investors to withdraw funds at call encourages funds to invest almost solely in liquid investments. I.e. to match the liquidity of their assets and liabilities.
    - A significant yield premium exists in some situations between liquid and illiquid assets. Hence KiwiSaver investors are being deprived of returns by favouring liquid assets.
    - Many asset classes do not fit comfortably as traded securities. Pastural land, infrastructure, development projects.
2. Specific examples include:
    - Development projects require funds to be committed so that a building, windfarm, etc. can be planned-consented-contracted-built. There is naturally a significant yield premium sought by and offered to capital providers who fund pre-commissioning stage.

      Infratil's windfarm development initiatives are good examples. Refer to our annual report for elaboration.

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While KiwiSaver funds can get exposure to such developments via listed developers (such as Infratil and Tilt Renewables), that obviously reduces the addressable market considerably.

- The gap between the rate of return a developer can achieve on a project and the return sought by an investor buying an operational asset can be large. At present Infratil associates and subsidiaries are building five substantial renewable generation projects (four in the USA and one in Australia).

  One of these projects has already been on-sold to a long-term investor. This was the Phoebe 315MW solar generation facility in Texas. Its construction cost was US$307 million and its sale price US$397 million. Had the developer retained ownership its return on investment would have been mid-teens whereas the long-term investor settled for roughly half that.

- Another specific example relates to "bond-like" investments. Infratil's USA associate, Longroad Energy, has completed the development-sale of two generation projects (one is summarised above) and it and Tilt Renewables are looking at further project sales. Earlier this year Infratil sold its interest in a student accommodation concession to AMP Capital. Right now, Morrison & Co is seeking bids for a social infrastructure fund it established and manages.

  Each of these assets is "bond like", providing a long-term annuity income stream for 15 to 25 years. In each instance the investors will receive a very substantial premium to what is available from corporate bonds, especially on a risk-adjusted bases.

  The short-listed bidders for the above noted social infrastructure fund are all non-residents, yet this would seem to be an excellent fit for long-term KiwiSaver type investors.

- A major driver of outperformance of Australian industry super funds relative to Australian retail super funds is the formers ability to invest in illiquid assets. This is similar to the track record of New Zealand's two largest financial investors, the NZ Superannuation Fund and the Accident Compensation Corporation investment fund.

- Attached is a recent report by the CFA Institute Research Foundation on USA university endowment funds. It seeks to identify the common features of endowment funds which outperform and while they found several, what stands out is their proportion of unlisted assets.

  There is an ineluctable link between outperformance and investing in unlisted assets.

  Please note however that there are clearly several other, also critical, features of the investments funds which outperform over the long-run. But if KiwiSaver returns are to have any prospect of achieving best-in-class, they are going to have to be structured to allow more investment in unlisted assets.

3. Are there other costs from KiwiSaver funds prioritising liquid investments?

   - Excluding certain classes of investment from the KiwiSaver ambit both limits capital in some fields and means that investors that place a lower priority on liquidity gain preference, no doubt this is a reason for high levels of foreign ownership of NZ forests, agricultural land, and certain types of infrastructure. It also means that most development projects are the preserve of entities with an ability to both develop and to hold.

- Just because KiwiSaver funds do not undertake certain types of investment does not mean that investment doesn't happen. As noted, it means that development projects are mainly the preserve of entities able to hold the resulting asset.

  It also means that where individual investors do participate, they are likely to do so in less regulated ways. For instance, contributory property syndicates are increasingly popular in the current interest rate environment and, if history is a guide, their being unregulated will cause problems at some point. Gresham's law, "bad money drives out good", pertains. If KiwiSaver was better suited to funding such projects, it would impose greater regulatory discipline on the sector.

4. The changes to KiwiSaver we recommend.

   - That investors can accept to be locked into a fund for a specified period. So that the fund could invest in assets which require a longer hold-time.
   - That investors can allocate their KiwiSaver funds to several funds. For instance, so they could commit 25% of their funds to a locked in period, while allocating the remaining 75% to other funds.
   - Some form of external monitoring to ensure that the assets of locked-in funds are being appropriately managed and are subject to appropriate reporting.

In summary:

- This submission is not directed to the structure of Default Funds. It is rather focused on the gap between best-in-class risk-adjusted returns and what seems prevalent amongst KiwiSaver funds and funds which prioritise liquid investments in general.
- It is our view, backed by considerable direct experience and third-party research, that illiquid investment and unlisted investments in general can deliver higher risk-adjusted returns than what can be achieved from buying listed securities.

  Consequently, we recommend that any review of KiwiSaver look at ways to enable fund managers to de-emphasise listed and other highly liquid assets.
- As the CFA Institute Research Foundation paper on USA university endowment funds illustrates, and this is consistent with our experience, achieving "outperformance" involves a lot more than owning illiquid assets (it may be a necessary condition, it is not sufficient by any stretch). Rules around transparency and valuation independence will be important. It is easy to envisage bad behaviour at investors' expense.

We would be happy to meet to discuss any of the above.

Yours sincerely

Tim Brown