Key messages

All providers who meet the criteria should be included

There is a randomness about the number of providers, and we think all should be included who ‘make the cut’ in terms of performance, fees and service benchmarks MBIE applies.

Underperforming managers should be excluded

Some managers who have been default providers from the start have delivered below benchmark performance over the 11 years they were gifted business, costing New Zealanders (and our most vulnerable) many millions of dollars. A clear message about underperformance should be delivered and the bottom 3 performers should be excluded from consideration this time. The industry needs to get a clear message that long performance really matters.

Fees should be standardised

A standard fee should be applied, we think it should be $25 a year and 40bp for every default fund, regardless of how it’s managed. Simplicity can offer all it’s funds at 30bps in a non profit format, so a 10bp profit margin is plenty to motivate managers, especially when they are committing almost no capital to fund management.

Effective communication and education should be mandatory

Default members should be phoned and emailed by their provider at least once, have a risk assessment performed and offered (if appropriate) a better fund for their needs.

The effort made my many managers in this area has been woeful because it involves them incurring costs. Default providers should be supplied with emails and phone numbers of default members they are looking for. They don’t currently get their email from the IRD. If the IRD cannot or will not provide the email and phone number of default members, then a standard risk assessment should be sent to the members by the IRD.

However, it cannot be stressed highly enough how dis-empowering it is to not have access to a default members current email and mobile phone numbers. Eg. With Simplicity, this is the only way we can communicate, and without emails, any communication via mobile phone is unnecessarily difficult and expensive.

Default providers should also have a demonstrably effective financial education program for default members. If managers were serious about it, they should already have that in place. There should be no credit for miraculously coming up with a new literacy program just as their default status is getting reviewed.

Any default fund should be a balanced one

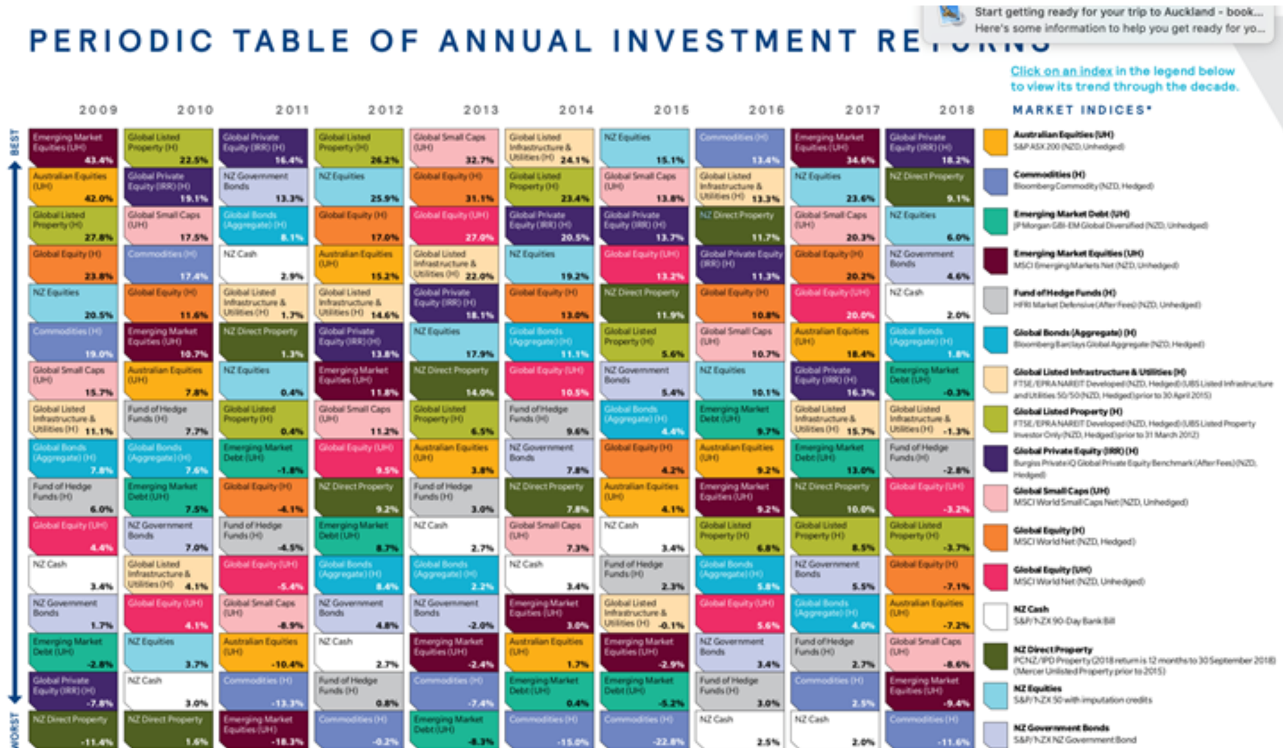
This will enhance returns over time, yet offer some measure of protection from market downturns. A 'life stages' product is intellectually elegant, but hard to understand, and is unlikely to increase either returns or trust in KiwiSaver over an investors lifetime. 'Balanced' is perhaps a good word to describe what most NZers aspire to in most areas of life, and it shouldn't it be any different for their investments.

The problem with life stages is young people will be overweight in asset classes that could lose value over the critical time they are saving for a first home. That could also set a bad early impression in terms of returns for people new to KiwiSaver, who are, by virtue of being default members, more likely to be dis-interested from the start. There is also the very real possibility of retired people being put into conservative assets too soon and seeing returns suffer. This is a critical and often under-appreciated vulnerability with life stages product, as the supplier is encouraged to allocate to conservative assets too early lest capital be lost in the short term.

By way of example, Simplicity is the default provider for many large NZ companies for the last 3 years, and has our balanced fund as the default fund. We have not received a single complaint regarding asset allocation or being in a balanced fund.

Asset allocation should be standardised, with only minor variations

Asset allocation for default funds (ideally a balanced fund) should be standardised by the Govt. actuary, with tight ranges for variation from the benchmark. Poor asset allocation is where most fund managers lose value for members. They think they know better, when in fact they have no competitive advantage in predicting what asset class will outperform. The following table from Mercer illustrates this;



https://www.mercer.co.nz/content/dam/mercer/attachments/asia-pacific/NewZealand/Investments/2019/NZ_Periodic_Table_July_2019_Interactive.pdf

Simplicity effectively does this by taking the average of the top 12 suppliers to achieve asset allocations, and then strictly managing costs. This is a winning formula, all of our 9 funds are ranked 1st or 2nd in the latest 12m Morningstar study due to tight asset allocations tracking the mean of our competitors, and low fees. One other factor contributes, see next point.

Exclusions for default funds could be mandatory, but this is fraught with subjectivity.

You can see the exclusions Simplicity has here;

https://simplicity.kiwi/about-us/ethical-investments/

These were carefully selected with Vanguard and MSCI to both align with our members values *and to enhance returns*. Over the last 5 years, excluding the sectors we have would have increased returns by @0.5%-1.5% per annum, depending on the type of fund. This last point is key, as the data now shows that ethics probably enhances returns. We use the word ‘probably’, as this is a complex subject. For example, outperformance may have been because tech companies in the last decade have outperformed more than ethically challenged companies have underperformed. But the fact remains that excluding them would have enhanced returns over the last 5 years.

The challenge for any mandated regime is which sectors to exclude and how to define whether companies are sufficiently involved in an undesirable area to warrant exclusion. It is very difficult to establish a benchmark, which is why we used Vanguard, who then used MSCI, to establish criteria and an index. This excluded companies like Boeing and Airbus because of their military contracts, even though the public might be surprised to know this. But it didn’t exclude Barrick Gold, who are widely criticised for human rights violations.

We are working with Vanguard and MSCi to extent our exclusions to downstream fossil fuel companies, human rights and child labour, but setting these standards will be as challenging as the others. How the Government will mandate them, and defend the decisions, is difficult. The only way we can see that happening in a defensible manner is to outsource this to an industry provider eg. MSCI, or the NZ Super Fund.

Another complicating factor is the credit any manager would receive for being pro-active, rather than just excluding investment in a sector or company. Eg. As well as excluding investment in industries, Simplicity has been pro-active in co-authoring research on diversity, and actively lobbying companies for change using its shareholder status. We have also targeted shareholder actions towards specific companies on specific issues eg. The ANZ house sale to the wife of David Hisco. How would this activity be recognised in any default review, and how could it be objectively assessed? We don’t now how it could be, but we feel it is a critical role for some KiwiSaver managers to play to ensure efficient and

fair capital markets which reflect the broad interests and values of many KiwiSaver members.

Investment in desired asset classes can be reflected via asset allocation changes to default funds

Mandated asset allocation for default funds solves the issue of investing in new asset classes eg. in infrastructure or NZ Private equity. If the Government wants to encourage an industry, and the actuaries agree on the asset class being appropriate in a balanced fund, a small allocation will move a meaningful amount of money into that asset class over time, and it will grow predictably. This would remove the need for the Government to allocate taxpayers money directly to grow an asset class, as they have just done with $300m into NZ Venture Capital in the latest budget.

In asset classes like infrastructure and private equity, it's important to build long term capability, because they are long term investments and in large scale. A one off Government grant to support this will help. But because asset allocation decisions by nature tend to be very long term and very balanced, an ‘industry’ can develop around the asset allocation, where suppliers invest in capability in the knowledge the money will arrive and be there for a long time. One off allocations by Governments are much less likely to develop an industry.

And in the process of managers gearing up for any new asset class like Venture Capital or Infrastructure, they will invariably offer it across their other (non default) funds too.

Note: It is critical that the actuary approves this asset allocation, which will remove criticism of undue politicisation of where KiwiSavers savings are concerned. The actuarial review must be by an independent actuary well respected for their professionalism in this area. That will remove public criticism, and ensure the industry develops a corpus of capability and ability to execute.