Submission template: Review of KiwiSaver default provider arrangements

Russell Investment Group Limited

Section 1: Your details

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Are you requesting that any of this submission be kept confidential? No

If yes, please let us know why the information should be kept confidential in accordance with the Official Information Act. Please also send us a redacted version of your submission for publication.

Reasons for withholding:

Section 2: Feedback on discussion paper

1. **What is your feedback on the proposed objective for the review?**

2. **What is your feedback on the proposed criteria for the review? How should the criteria be weighted?**

Russell Investments believes the proposed criteria are appropriate except for Criterion 4 (Support development of New Zealand's capital markets that contribute to individual's well-being) and Criterion 5 (Promote innovation, competition, and value-for-money across KiwiSaver). The most important criterion, and thus the one that should receive the highest weighting, is on improving the financial position for KiwiSaver default members; particularly at retirement. That might mean increasing efficiency and lowering costs within the Default schemes and developing investment strategies that are more suitable for long-term investors, such as a Life-Stages approach. Criterions 2 and 3 are important in that they contribute to the primary goal of improving the financial position of KiwiSaver members, however in our view they should receive less weighting. Criterion 5 is relevant to the entire KiwiSaver scheme but should not, in our opinion, be a driver of change in the Default offerings. We believe the Default offerings should be highly-regulated, consistent, transparent and/or offered by a single provider. As discussed earlier, while Criterion 4 is a worthy aim, it should not be a factor in the review of the Default schemes.

3. **What is your feedback on the problem definition for the investment mandate? Is a move away from a "parking space" purpose justified?**

4. **Should the investment mandate options (and other options, for example in relation to fees) apply only to default members who have not made an active choice, or should they also apply to members who have made an active choice to stay in the default fund? Why or why not?**

The construction of life-stages investment options is complicated and requires more commentary than can be incorporated into this submission. However, current global best practice is to plan for personalisation in Life-Stages investment criteria. Russell Investments offers Personalised Retirement Account offerings in the United States and Australia. However, there is increased complexity in managing and implementing this structure relative to a traditional Life-Stages strategy. Significant additional data is required on an individual's personal financial circumstances, which, given the current unengaged default investor population, may result in too high an implementation hurdle to consider this as a viable default structure.

Current Life-Stages offerings in New Zealand are age-adjusted, taking no account of an individual's personal financial circumstances. There is merit in considering the implementation of 'glide-paths' that move through retirement rather than to retirement. This involves maintaining a higher allocation to growth assets at retirement. The trade-off for this is that it increases the sequencing risk for members.

We note that implementing a life-stages default option would not suit people who are planning to withdraw assets to purchase a first home. Our recommendation is to set up a separate First Home Buyers investment option and, following withdrawal of these assets, default future payments into the Life-Stages option.

We further note that one of the key benefits of Life-Stages investment structures is that they rely on an investor's inertia. Using 'stage shifts' to increase member engagement and encourage changes to the investment options is counterintuitive to the design of a life-stages option and may reduce the investor outcomes over time.

5. **If a life-stages option is adopted, what "stages" should apply and to which age groups? Should there be a "nursery" period?**

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6. **If a balanced investment mandate is adopted, what range for growth assets should be applied?**

7. **If a growth investment mandate is adopted, what range for growth assets should be applied?**

8. **If a conservative investment mandate is adopted, what range for growth assets should be applied?**

9. **If a life-stages, growth, or balanced option was adopted, how should we mitigate the potential issue in relation to first-home buyers and other people making early withdrawals?**

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Buyers investment option and, following withdrawal of these assets, default future payments into the Life-Stages option.

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10. **What would be the administrative costs to providers of choosing a life-stages option?**

11. **What is your feedback on the different options? Do you agree with our assessment of the costs and benefits of the option? Which option do you think is best and why? Is there another option that we have not considered that would be better than the options discussed?**

12. **What is your feedback on the level of value that KiwiSaver default members get for their fees? What are the costs that are within and outside a provider's control? To what extent are fees too high?**

13. **Is it a problem that fees disproportionately affect those on low income and under 18s? Why/why not?**

14. **If the government sets a fee, what should the fee be set at for the different investment mandate options? What considerations, methods or models could be used to determine the fee? What should be the balance between fixed and percentage fees?**

15. **What fee arrangements would best promote the objectives of the review? What is your feedback on the fee options? Do you agree with the costs and benefits identified? Which option (or the status quo) do you prefer and why? What other approaches or models could be used to reduce fees?**

16. **How has the number of providers in the default market affected innovation, competition and value-for-money in the default market and in KiwiSaver more generally?**

17. **Do you agree with our assessment of the costs and benefits of the different approaches for the number of providers? Can you provide us with evidence that might help us quantify the size of the costs and benefits? What option do you prefer and why?**

18. **If a "minimum requirements" approach is taken should this be on a period-based or rolling system, and why?**

19. **Are there higher investment costs for responsible investing? If so, how likely are these costs to contribute to lower net returns?**

There are some additional costs associated with Responsible Investment. These costs relate to the additional research burden placed on Responsible Investing. These costs are either attributed to fund managers internal research capabilities or through the use of outsourced providers which charge a fee for their services. These costs form part of the investment management fee for products. The level of costs is proportionate to the responsible investing activity undertaken in a product, e.g. Active engagement, custom ESG exclusions/screens and bespoke research requirements will result in higher costs than simple sector-based exclusions.

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

Responsible Investments believes that responsible investing and performance can be complementary. We believe that ESG factors can impact security prices. These factors vary by company, industry and region and their importance can vary through time. A deep understanding of how these ESG factors impact security prices is value adding to a skilful investment process. We believe that embedding ESG considerations into a firm's culture and processes improves the likelihood of prolonged and successful investing. We also believe that active ownership is an effective tool for improving investment outcomes. Russell Investments has produced several publications that investigate how responsible investment impacts returns, these are available on our website www.russellinvestments.com/nz or on request.

Because 'Responsible Investment' is a broad definition it is difficult to categorically say that it increases or decreases returns. Some factors of ESG investing can increase returns and others may decrease returns. The important issue for KiwiSaver members is that their providers report on the impact that Responsible Investment has had on their portfolios.

21. **Should the default provider arrangements be used to achieve objectives in relation to responsible investment?**

We believe the primary focus of reviewing the default provider arrangements should be on trying to improve member outcomes over time. We do not believe that the Default schemes should be used to 'promote' responsible investing. There is the obvious definition challenge – what is responsible in the eyes of one person may not be for others – and there are clear contradictions and limitations in how various responsible investment programs are implemented in New Zealand. Additionally, the discussion to date has largely focused on equity investing, ignoring key components of most KiwiSaver funds such as corporate and government bonds, property and infrastructure.

We do believe that disclosure around how Default schemes are run should be improved to include a full detailing of the ESG credentials of all portfolio holdings. However, defining and establishing these credentials is challenging due to the subjective nature of the topic. Where any ESG criteria is applied, we also believe investors should be given information to its exact nature, including any additional costs and return differentials. We also believe that providers should be required to report on the impact Responsible Investment exclusions have had on an investor's portfolio. Additionally, standard benchmarks should be retained rather than amended following an exclusion, e.g. once a tobacco exclusion is implemented the benchmark should still include tobacco. After all, the decision to exclude a security is an active decision and investors should be aware of the consequences of this decision on investment performance.

Note: the above recommendation does not alter Russell Investments' commitment to incorporating ESG factors into our global investment policy. As highlighted earlier, we focus on 'value' rather than 'values' and believe in the positive role that engagement can play over time. It is our view that, over time, most asset managers will incorporate ESG factors into their investment philosophies and that engagement will lead to significant strides being made in the areas of climate change, human rights and governance.

Default members that wish to have their investments managed 'responsibly' should of course be free to choose strategies that more closely fit their needs.

22. **Would default members want their funds to be invested more responsibly? If yes, is the same true if responsible investment means potentially limiting future returns?**

Default members already have the option of actively choosing to invest in a variety of KiwiSaver vehicles that focus on Responsible Investment.

23. **To what extent is it a problem that default members do not have information about whether their investments are made responsibly? Would having more information make a difference to the behaviour of default members? What alternatives might there be to more/standardised information to address responsible investment concerns?**

As noted earlier, Russell Investments believes that improvements could be made to disclosures of KiwiSaver schemes across a range of factors, including responsible investment. Members should have information as to how their funds are managed and any responsible criteria that has been applied. This should include fund holdings, details of any securities that have been excluded on responsible grounds, the rationale for such exclusions and how that has impacted performance over time. Our concern is that, to date, the decisions made by some providers have been driven by the desire to appear 'responsible' in the eyes of the media with little regard as to how member outcomes will be impacted over the long term.

Default members have been difficult to engage, and Russell Investments does not believe improving or increasing disclosure around responsible investing would result in any material change in engagement statistics; at least in the near term. Despite this, Russell Investments believes in transparency and holds the view that all investors should have information as to how their money is being managed. We would hope that, over time, better transparency and improved information delivery leads to greater levels of engagement among the Default member universe.

24. **Do providers' current responsible investment exclusions meet what default members would expect?**

25. **If this option is adopted, what industries or sectors should be excluded? Should the government instead adopt an international exclusion standard or certification regime? What would be the costs associated with an exclusion or certification regime?**

Careful consideration of the consequences of exclusions on long term portfolio performance must be undertaken prior to any exclusions being implemented in portfolios. Russell Investments 2019 research paper "*Negative screening and performance consequences: How much is too much*": Ross, L and Ouyang, M. provides evidence of the consequences of exclusions on portfolios. Increasing levels of exclusion can impact the potential distribution of portfolio returns and should be analysed in advance of implementing exclusions.

26. **If this option is adopted, what form should standard disclosure take? For example, should all providers be required to provide a statement listing all excluded companies by sector?**

27. **What is your feedback on our assessment of the costs and benefits of the responsible investment options identified? Which option (or the status quo) do you prefer and why?**

28. **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?**

29. **How could the default settings be used to develop New Zealand's capital markets? What parts of New Zealand's capital markets are most in need of development?**

30. **Should default funds take an active role in helping develop the New Zealand capital markets? Would this support the purpose of the KiwiSaver Act and the accumulation of retirement savings by default members?**

New Zealand currently comprises approximately 0.07% of the MSCI World Index. On a market capitalisation weight, allocations to New Zealand shares should comprise a very small part of a New Zealand investor's portfolio; even after allowing for the tax benefits to New Zealand-domiciled investors. Moreover, it is clear to any involved in the capital markets that more investment opportunities exist offshore than in the local market. New Zealand shares have benefited from a benign risk environment and generally rising share markets over the preceding 10 years. Global investors have sought allocations to New Zealand shares as a result of the higher-than-average yield that they offer. This demand has boosted New Zealand share prices further and resulted in record amounts of foreign ownership in the local market. These strong returns mask the inherent illiquidity and concentration risks involved when investing in New Zealand shares. A prudent view given the characteristics of the New Zealand capital markets (both equity and debt), would be to limit asset allocation exposures in order to appropriately diversify portfolio risk.

Criterion 1 is aimed at improving financial outcomes for New Zealanders in their retirement. Mandating investment in New Zealand will reduce the investment opportunity set for KiwiSaver members, skewing asset allocations away from global best practice and potentially reducing retirement outcomes for members.

31. **To what extent is the management of default funds currently located in New Zealand or carried out by New Zealand entities?**

32. **What is your feedback on a New Zealand-based management option? If this option is adopted, which part of the investment process do you think should be based in New Zealand to help develop New Zealand's capital markets? What type of mechanism would best give effect to this requirement?**

33. **What is your feedback on a targeted investment requirement? If the option is adopted, what market should be targeted by an investment requirement (eg early stage companies)?**

34. **What is your feedback on our assessment of the costs and benefits of the options to develop New Zealand's capital markets? Which option (or the status quo) is best and why? Is there another option that would be better than the options discussed?**

35. **What is your feedback on the problem definition for the transfer of members? What other problems are there in relation to the transfer of members?**

36. **If default members are transferred from providers with more members to providers with fewer members, how should we decide which members are transferred?**

37. **If transfer option 1 or 2 were adopted, how should default members be given a choice to remain with their current provider for this option?**

38. **What is your feedback on the transfer options and the costs and benefits of the options? Which option (or not transferring at all) do you prefer and why? Is there another better option we have not considered?**

39. **What factors should the review consider in deciding transition timeframes?**

40. **Should active defaults be considered default members for the purposes of transfers? How should active defaults be treated and notified of any changes to default provider settings?**

41. **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?**

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

43. **Any other feedback?**

KiwiSaver is an important element of the financial well-being of millions of New Zealanders and most consider that it has been a success since its launch in 2007. With nearly 3 million customers and assets approaching $60 billion, KiwiSaver accounts are an increasingly important part of New Zealanders' financial assets. However, as mentioned in the MBIE Default Provider discussion paper, about a third of all automatically enrolled KiwiSaver members are currently in Default KiwiSaver schemes. This means that the 'do nothing' approach needs to make financial sense if the long-term objectives of the scheme and its members are to be met. With more than a decade of experience, it has become clear that some modifications should be considered for the Default schemes in order to ensure a higher chance of delivering good member outcomes.

Russell Investments has reviewed the discussion paper and believes it raises many important plan design and implementation issues which merit careful consideration. In this submission, we have addressed only those questions which we believe to be most meaningful from a member outcome perspective; particularly with regards to default plan design, responsible investment and capital markets and infrastructure development. In previous submissions, we have noted that we are strong proponents of developing 'outcome-oriented' investment products that maximise the probability of meeting the objectives of particular investor groups. In the context of the KiwiSaver Default schemes, that may entail developing appropriate 'Life-Stages' Default offerings, initially based simply on age and contribution levels, but with the potential to further develop over time to incorporate elements of customisation based on a range of factors, e.g. an assessment of an investor's ability to handle and tolerate investment risk.

The design and implementation of any Life-Stages-type approach introduces a level of complexity beyond that of the current conservatively-managed Default funds. This would require conducting additional due diligence around the capabilities of managers wishing to participate. Given our understanding of the capabilities of investment providers in New Zealand, we question whether all the existing default providers have the experience and global multi-asset capabilities to develop robust Life-Stages approaches. In addition, increasing the complexity of the default offerings would place additional administrative burdens on providers and government agencies.

Using Default KiwiSaver Assets as 'Development Funding'

We note that there are several questions in the discussion paper which address the issue of development in New Zealand, both in terms of its capital markets and its infrastructure assets. While development of both is no doubt a worthy aim, and it might be that growing the KiwiSaver asset base will naturally contribute to this over the long term, Russell Investments strongly believes that these factors should not be of consideration in the potential redesign of Default member offerings. Any changes ultimately made to the Default schemes should have member interests and member outcomes front and centre and it is hard to see how improving New Zealand's capital markets or developing its infrastructure are relevant to members investment outcomes.

It is our belief that New Zealanders require globally diversified investment portfolios in order to protect them from the potential vagaries of the New Zealand market as well as to provide them exposure to the broader growth and income potential found in global capital markets. It may be that an allocation to local infrastructure makes sense from an investment perspective, but such a decision could only be made after thorough analysis and review of the costs and benefits of adding this asset class. Mandating an investment in local infrastructure without consideration of the investment aspects of this could compromise the primary fiduciary obligations of providers and potentially reduce investment outcomes for members.

Responsible Investment

Likewise, responsible investing principles should not, in our opinion, be shoe-horned into the investment mandates of the Default schemes. Russell Investments believes in the importance of Environmental, Social and Governance (ESG) factors in investing today, but from a fiduciary perspective we view it through the prism of asset valuation and stewardship rather than that of imposing our corporate or personal values on our clients. We have observed that decisions to exclude sectors and securities have been made without a careful analysis of the consequences of these exclusions on portfolio outcomes and, whether these are desired by most scheme members. We believe that these decisions should be made on valuation or long-term performance grounds with evidence produced to support these arguments This appears to be limited or non-existent in some cases. Finally, where exclusions have been added to the investment mandates of Default funds, they have at times been naively and narrowly applied, i.e. mainly to equities rather than all asset classes, with little regard to the positive role that engagement can play over time.

The question of requiring KiwiSaver providers to invest 'ethically' should be considered in the same manner. It is our understanding that ethics vary from individual to individual and organisation to organisation. As such, ethics become a personal belief set that is best pursued either individually or with organisations that pursue a defined set of ethical standards. The proposition to mandate an ethical requirement would potentially alienate large portions of the investor base who do not share the same ethics as those that would need to be defined by MBIE in order to implement this consistently. Currently, there are many available products where KiwiSaver investors can make active choices with regards to how their funds are invested.

Ultimately, Russell Investments believes any KiwiSaver Default Scheme redesign should be focused solely on improving the outcomes for investors that are in these funds. We do believe that providers should be free to continue to offer KiwiSaver products that incorporate ESG, but when it comes to mandating what can or cannot be invested in, we believe a significant amount of caution is required.

Russell Investments does believe in improving transparency and it is our view that Default schemes should be mandated to improve the transparency around the funds they offer, including detailed descriptions of the ESG characteristics of a portfolio and explicit details of any investments that have been excluded on ESG-related grounds. An ESG rating should be provided by an independent rating agency that rates all products in the market.

Key recommendation – Improving fairness

The current process of allocating members to one of nine Conservative Default funds managed by different firms through a random process introduces the potential for significant variability in KiwiSaver member outcomes over the long term. To promote equitability and fairness, as well as develop confidence in KiwiSaver, Russell Investments believes all members of a similar profile who have not made an active decision otherwise, i.e. Default members, should ultimately have their investments managed in the same way and at the same cost. The current system of randomly allocating to one of a panel of KiwiSaver funds means that Default members are subject to different asset allocations, management styles, costs and ultimately results. Given the long-term time horizon of many KiwiSaver members, these variations could mean significant differences in members' ending balances and may even expose providers or the government to legal and/or financial risk.

Russell Investments believe there are two means of addressing this:

1. **Develop a single, low-cost government-run default scheme** (perhaps offered by the IRD). Plan design, investment implementation, ongoing monitoring and administration could still be outsourced to the private sector and the principles of equitability and fairness would be met as all default members of the same profile, e.g. age, income, would have their money invested in the same way, achieve the same investment results and be subject to the same costs.
2. **Mandate how default schemes are managed (e.g. asset allocation and means of implementation) and set the fees that can be charged.** Private organisations that meet the minimum criteria set forth to be KiwiSaver Default scheme providers would be free to offer the highly-regulated default schemes. As above, all default members of the same profile would essentially get the same results over time.