MILFORD

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Financial Markets Policy
Building, Resources and Markets
Ministry of Business, Innovation & Employment
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Submission: KiwiSaver default provider arrangements

Milford Asset Management welcomes the opportunity to provide a submission on the above-mentioned review.

Milford Funds Limited is a 100% owned subsidiary of Milford Asset Management Limited and is the issuer of the Milford KiwiSaver Plan. The Milford KiwiSaver Plan has over 32,000 members and funds under management of over $1.8 billion.[1] Milford also offers a range of Investment Funds (PIE's) to retail, wholesale and private wealth clients. Milford's total funds under management is approximately $8 billion.[1]

Milford is not a default KiwiSaver provider, however we have chosen to provide a submission because there are some important issues being raised and we are keen to see the evolution and improvement of KiwiSaver for the benefit of all members.

KiwiSaver (both default and non-default funds and providers) has provided an excellent platform for New Zealander's to provision for their own retirement needs over the past 12 years. This review provides the ideal opportunity to ensure the industry continues to meet, and indeed exceed, the needs and expectations of members as we move into the next phase of KiwiSaver.

Should you have any questions or wish to discuss any aspect of our submission I can be contacted on email at mharris@milfordasset.com or phone 021 372 736.

Yours sincerely

Murray Harris
Head of KiwiSaver

[1] As at 31 August 2019

Submission template: Review of KiwiSaver default provider arrangements

Milford Asset Management Limited

Section 1: Your details

Name of contact person: Murray Harris, Head of KiwiSaver

Organisation (if applicable):

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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?**

We agree with the objectives of the review. It is important the features, benefits and services provided to default members continue to evolve and meet their needs. We would also note that KiwiSaver overall has been a fantastic success in growing the retirement savings of New Zealanders – via both default funds and non-default funds and providers. It is important that we do not lose sight of this and that KiwiSaver members continue to have choice of funds and providers (default and non-default) to meet their needs.

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

We would comment that the criteria are broadly relevant. We do not have any particular view on the weighting of the criteria, but the order of them in the discussion paper makes sense.

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

We think a default fund should be a 'parking space' option, but we would suggest a renaming from 'default fund' to something more appropriate and which reflects the fact a default fund is a 'temporary' or 'parking space' for a member's contributions until they make an active choice. This naming convention should also be included in all member communications and statements, including their payslip, as a constant reminder that they are in a temporary fund and need to make a more active choice.

Whilst Milford is not a default provider, we understand the difficulty default providers have experienced in engaging default members to discuss the most appropriate fund for their risk appetite and retirement savings goals. This has resulted in high numbers of default members remaining in very low risk /low return funds when they could be more suited to a fund with more growth assets, helping to better grow their savings over time.

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?**

If changes are made to the investment mandate for default funds, then they should only apply to members who have not actively chosen to remain in the default fund. Members who have chosen to remain in a default fund likely did so for a reason. Those members should be re-engaged to discuss their options, however it is likely they would want to remain in the old default asset allocation. Members who have not made an active choice to be in a default fund should then be moved to the newly mandated option (balanced if adopted), as that would likely be a more suitable option for them.

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

We do not think default funds should adopt a life stages asset allocation. We believe a default fund should be a reasonably vanilla, basic, no frills, all-rounder solution which will meet the needs of most people, and without complexity and unnecessary cost. A life stages option would add to complexity and costs in both investment management and member communication.

To address the current issue of default funds being very low risk / low return solutions we think the asset allocation should be changed to a standard balanced fund asset allocation. This provides a good 'middle-of-the-road' solution between a low risk and higher risk asset allocation and is more suited to meeting members retirement savings needs over time if they do not make an active choice to move to another type of fund.

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

We suggest the asset class ranges for a balanced mandate are best determined by an actuary, asset consultant or fund research house. There are several in the NZ marketplace who have a depth of research and expertise to recommend the most appropriate asset class mix and ranges. We would also note that most (if not all) KiwiSaver providers would already have balanced funds which could be suitable options.

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

We do not think a growth mandate should be adopted.

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

We do not think a conservative mandate should be adopted.

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?**

Inherently a default approach cannot cater for everyone. In an ideal world, default providers should continue to contact default members to discuss the appropriate fund for their circumstances. This very issue further highlights why a default fund should only be a 'parking space' solution and members with specific requirements are moved to more suitable funds.

An alternative suggestion is either at the initial KiwiSaver sign-up stage, or when beginning or changing employment, the KS2 deduction form is amended to include a question "Do you intend to use your KiwiSaver funds to purchase your first home within the next 5 years?" Members who answer Yes to this question are 'defaulted' into a conservative fund with the default provider.

We would expect members who are thinking of using their KiwiSaver for a first home purchase should be more engaged with their savings and therefore motivated to make a suitable active choice of fund.

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

We have no visibility of this; however, we would expect that a life-stages option might involve more administration than a non-life-stages fund, particularly in tracking the age of members and moving them through the stages. The costs of investment management and member engagement and communication could be higher than an all-rounder balanced 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?**

For default members who chose not to engage with their retirement savings and appropriate asset allocation and risk /reward over their savings journey then an all-rounder, middle-of-the-road balanced fund is the best option we believe. Members could then be encouraged to move up or down the risk scale to more appropriate funds from the default balanced fund. A balanced fund is more likely to meet a member's savings needs over time than the current very conservative default fund asset allocation.

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?**

We have no visibility of costs for the default providers. Morningstar report the average investment management fee for default funds is 0.52% p.a. This would seem to be reasonable given the range of options and management styles available from passive to active. When compared to similar types of funds in the non KiwiSaver / unit trust market the current default fund fees appear competitive and good value, particularly when also considering the regular reporting, servicing and education which accompanies default funds.

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

The monthly admin /member fee is disproportionately higher for lower balance members and under 18's. Several providers are now waiving the member fees for under 18's. Milford has recently waived the annual member fee for under 21's and members older than age 65. This is to support younger people to develop good savings habits and build their savings early; and to align KiwiSaver with unit trust funds for over 65's now they can invest in either vehicle.

We do not think no fees for low balances or under 18's is the right approach. Providers face a number of overheads to engage and service these members and should be able to cover these costs + a fair and reasonable margin. Part of that cost goes towards education and advice to members to help them make good financial decisions which will support their retirement savings outcomes. By charging no fees may have the unintended consequence of a worse outcome for members if providers reduce servicing and engagement.

By charging no fees in default funds may also mean members in these funds will be resistant to moving to more appropriate funds that may better meet their risk appetite and savings goals because those funds would charge fees. There is a common notion that something which is not paid for is not valued as much as something which is.

We do not think capping fees is the right approach. The experience of capped fees in other markets such as Australia is providers then set their fees very close to the cap, rather than allowing market forces to determine appropriate fees.

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?**

We do not think the government should set the default fund fees. We would question what experience the government has in managing and administering managed funds and hence in determining appropriate fees. If fees are set on a pre-determined basis it risks providers reducing services to meet pre-set fees. It may also lead to less choice for members if providers decide they cannot provide a suitable offer for the fees charged and therefore choose not to be a default provider. This may lead to poorer member outcomes. We would reiterate the point made above at Question 13 regarding the experience in Australia of set 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?**

We think fees should be set by market forces and the economic forces of those providers who choose to be default providers and their ability to cover costs plus make a margin which is fair and reasonable. If fees are prescribed or are set too low it may lead to poorer outcomes for members as providers potentially scale back services, innovation and important education. It should also be noted that if the default fund asset allocation moves to a balanced fund option it is likely fees could be higher due to the broader selection of assets including a higher growth asset allocation. The quid pro quo is, it would be a more suitable fund for members, with related benefits of more in savings at retirement.

If a balanced fund default approach is adopted it should be done so in the most efficient and cost-effective manner possible. One approach could be to get prospective providers to put their best foot forward with their existing balanced fund, at a competitive fee, rather than the expense of building new default fund solutions. We note from the June 30, 2019 Morningstar KiwiSaver Survey the average fee for the balanced category is 1.10% p.a. A competitive tender process may get this fee down somewhat, but in order to offset any additional fee, consideration could be given to a portion of the default fund fees being used to support broad market investor education and engagement via an agency such as The Commission for Financial Capability. Default fund providers would then be required to pay a pre-determined portion of default fund fees (e.g. 25 basis points) to the CFFC's activity, in return for the benefit of getting a steady flow of new members via the default system with little to no acquisition cost for the provider.

Option 3 of requiring percentage-based fees to reduce over time as funds under management grows cannot be treated in isolation. This must be considered in terms of value for money and the net benefits which members are receiving for the fees they are paying. As funds under management grows and fee income increases, providers may pass through benefits in more ways than simply reducing fees. This could include improvements in existing services or additional services such as financial advice, online tools and other technology enhancements, education, member servicing, reporting, communications and refinement of the investment process. Providers should be able to point to these enhancements as part of member value for money.

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?**

We would observe the current default providers and funds are all very similar. Other than some variation in investment approach between active and passive there is little else to distinguish providers and investment options. Most innovation in KiwiSaver has occurred outside the default options as new providers and fund options have become available. The challenge for this review will be to attract new and innovative solutions. However as pointed out in the submission document, a focus on lowering costs and fees may result in less choice and innovation.

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?**

We think the discussion paper captures the pros and cons of the number of default providers well. The challenge for the review will be to ensure appointed default providers continue to meet the needs of members with suitable, all-round solutions to retirement savings that offer appropriate choice at a fair and reasonable cost.

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

We do not think an unlimited / minimum requirements approach should be taken. We think default providers should be appointed to fixed terms which are reviewed on a periodic basis, as at present.

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

An integrated ESG investment approach (Environmental, Social, Governance) requires a team of fundamental analysts with in-depth knowledge of the businesses they analyse. Milford now has a dedicated Responsible Investing Analyst, which is an explicit additional cost. Proxy voting services, sustainable indices and externally sourced ESG research and ratings also incur additional expense. Milford have not adjusted our management fees to reflect these additional costs.

A fully fledged and integrated RI approach for default funds would come at a higher cost than today. In order to manage costs and due to the fact default funds should only be a ‘parking space’ solution, they should have only a basic RI approach.

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

Philosophically, people who subscribe to the concept of responsible investing believe it delivers superior investment returns over the very long term. As well as peace of mind and potentially long-term return benefits, there are costs and complexities associated with responsible investing that need to be clearly explained & well understood by investors.

There is limited data at this stage (but we note there is more recent data than the 2014 & 2015 studies referred to in the discussion paper) and initial analysis shows responsible investing can increase returns over time. Responsible Investing is predominantly about risk, so understanding it (or, more specifically, environmental, social and governance factors) is about understanding risks within a company or an investment case. This understanding should therefore improve risk-adjusted returns by better avoiding risk.

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

Default funds should meet the broad needs of members via a simple, low cost solution and therefore should include only a basic level of RI management. This is dependent on the ability of the default providers to provide this.

KiwiSaver investors should be offered choice about how their money is invested. There are costs, benefits and complexities associated with responsible investing that need to be clearly explained and well understood by investors. Evaluating these costs & benefits depend on the belief-system and investment time horizon of the individual. Some examples of the benefits include:

- Peace of mind that capital is being denied to businesses who cause environmental or social harm, in favour of businesses that aim to create a positive impact on their customers, staff, community and environment. Over time, this method of capital allocation is believed to increase the cost of capital for companies with poor practices and create a financial incentive for change.

- The belief that, over the very long term, companies with stronger management of ESG risks will demonstrate better operational performance and ultimately, deliver superior financial outcomes.

- ESG controversies have material, negative financial consequences for companies, including onerous environmental rehabilitation expenses, stranded assets, legal damages and adverse regulatory outcomes.

- Intangible assets including goodwill, licences and brands represent a significant component of corporate balance sheets. Stronger ESG policies better preserve their value and aim to reduce the risk of impairment.

Offsetting these benefits are the following potential complexities:

- Those who feel strongly that companies causing environmental or social harm should be denied capital are willingly and knowingly narrowing their investable universe to achieve this objective. This creates relative performance risk versus a benchmark that includes excluded sectors and industries. For example, sustained strength in the price of thermal coal will drive underperformance versus benchmark for a portfolio that excludes fossil fuels.

- Divesting their shareholding in companies with the potential to do the greatest harm, means institutional investors forfeit the capacity to drive change, and potentially shift the register to investors with no engagement agenda or sustainability criteria.

- Reducing the number of investable stocks can necessitate substituting highest conviction investment ideas and imposes constraints on portfolio construction.

- Given additional resources, higher fees may be necessary. This does not align with the low cost, basic objectives we think a default fund should be trying to achieve.

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?**

We have no actual evidence of what default members want; however, supported by interactions with our own members, given the choice, we believe many default members would elect for their funds to be invested more responsibly. However, it is imperative this decision is based on a comprehensive understanding of the costs, benefits & complexities associated with various forms of responsible investing, over different time horizons. This requires significant member engagement, which is not always possible with default members. We would maintain that default funds should have a basic level of responsible investment and members who desire a higher level of RI management would be either more motivated to move, or should be encouraged to move, to a more appropriate fund.

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?**

In Milford's experience, our KiwiSaver members increasingly want more information about our responsible investing approach. More information will allow KiwiSaver members to make more educated choices in regard with whom their money is invested. Again, we would say basic, low cost default fund should provide some basic information but members who desire more information should be encouraged to move to a more appropriate fund for their needs.

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

We have no evidence of what default members expect. However, would comment that expectations should be based on a comprehensive understanding of what responsible investing means, the various forms it can take and the costs, benefits & complexities of each, over various time horizons. (See Question 21.) We note that exclusion criteria form only one part of responsible investing.

Positive screens, an integrated ESG investment process and shareholder engagement are also relevant and important.

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?**

Currently, NZ Super provide something of a benchmark for an exclusions list, and Milford sees no advantage to this benchmark being prescribed by the government, particularly given NZ Super's expertise and resource in this important area. Again, we stress that exclusion criteria are only one aspect to a responsible investing approach. While Milford believes an exclusions list is an important tool in our own responsible investing approach, there are other providers who do not follow a set exclusion list but are still being responsible investors. Furthermore, as outlined in the submission guide, determining which investments are irresponsible is very subjective, and could lead to inconsistencies with other investment funds. Being too prescriptive with the industries or sectors to be excluded could also affect a provider's ability to have a positive impact in that industry or sector.

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?**

If responsible investing is indeed important to the KiwiSaver population, then providers will have to become more transparent with their responsible investing approach, or risk losing clients to others whom are more transparent. We do not believe an approach needs to be prescribed by the government and would reiterate that default funds should maintain a basic level of RI management and disclosure, without complexity.

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?**

Please see response to question 26.

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?**

We think the key issue for NZ capital markets is the relatively small and illiquid nature of the NXZ and the lack of IPOs. More KiwiSaver money (default or not) should be invested in NZ listed companies. We note this is an issue for the NZX to address and the Capital Markets 2029 report has made some suggestions to address this issue.

According to the Morningstar KiwiSaver Survey as at 30 June 2019, the estimated KiwiSaver market asset allocation shows just 10.8% invested in NZ shares. Other retirement savings jurisdictions (such as Australia) have a much higher investment in domestic companies (around 20-30%).

We do not think default funds should have a targeted requirement to invest in NZ or early stage / venture capital or private equity and make the point not all providers have expertise or skill in private market investing. Providers could outsource this part of the investment management, but this would add to complexity and costs of the default funds.

To invest well in private markets and companies, with good outcomes for investors, takes a considerable amount of dedicated skill and resource. In Milford's case we have three full-time dedicated investment professionals managing a very small allocation (2-3%) of our KiwiSaver funds to private companies. Not many providers have that capability, including the default providers.

Default funds should provide a basic allocation to standard, liquid asset classes across the risk spectrum. More specialist investment in private companies, start-ups and venture capital should be the domain of providers with a track record and expertise in this field. This may include some default providers but should not be mandated for all default funds. Part of the motivation for members to move out of default funds should be to access more specialist investments that will help to meet their risk appetite and long-term savings goals.

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?**

We do not think the default settings should mandate investment in NZ capital markets. The NZ allocation should be at the discretion of the providers / managers, based on their views of the NZ market, economy and companies relative to alternative investment options. Furthermore, refer to answer in Q28.

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?**

See answer to Q29.

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

We have no ability to comment on this.

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?**

See answer to Q29.

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)?**

See answer to Q28 and Q29.

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?**

Refer above responses.

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?**

As Milford is not a default provider, we have no experience of managing and servicing default members other than the anecdotal evidence we hear from the default providers. Our observation would be one logical approach could be for members who have actively chosen to be in a default fund are given the option to stay there if the fund / provider loses default status, as they actively chose that fund. All other default members could be transferred to the new default funds / providers based on some reasonable transfer system. We have no firm views on how that should occur.

We do not think providers should be tendering on the basis that they expect to receive a windfall of members allocated to them from other default providers who may lose their default status. They should be tendering on the future business opportunity.

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

We do not think this approach is sensible.

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?**

Default members with a provider who loses their default status should be contacted and given the option of staying where they are (noting they will no longer be in a default fund) or moving to a new default fund of their choice. If no choice is made, then they could be transferred to a new default provider. Member engagement is the ongoing challenge here for default providers.

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?**

We have no further comments to make here. We do not have a view of what the transfer costs could be.

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

We do not have a view on this.

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?**

As noted above, they should be contacted and notified the fund is no longer a default fund and given the option to stay where they are, given they actively chose to be in that fund, or to move to another fund or provider, or be transferred under whatever transfer system is adopted.

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?**

All KiwiSaver providers (not just defaults) have an obligation of regular engagement with members on financial literacy, education, maximising KiwiSaver and retirement savings benefits. This should be demonstrable via seminars, presentations, workshops, online tools, regular communications to members. Providers should be able to point to the impact and outcomes of this activity by members making well-informed choices and reporting on the activity undertaken. Other measures might be the percentage of members receiving the full government contribution, overall percentage of members contributing regularly, members in appropriate funds for age and risk profile and member satisfaction survey results.

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

We have no further comments to make.

43. **Any other feedback?**

Milford Asset Management is not a default KiwiSaver provider. We have submitted because we have an interest in seeing the evolution and improvement of KiwiSaver for the good of all members.