MAKING EVERYONE LOOK ~~GOOD~~ BAD? (PART II)

A BETTER APPROACH FOR BENCHMARKING KIWISAVERS (AND A PROPOSAL FOR A FAIRER DEFAULT SCHEME)

Matthew J. Arnold, CFA, CAIA, Director, Russell Investments

In the second of a two-part series on performance benchmarking in New Zealand we review the practices of KiwiSaver managers. Unlike in the local institutional market, where we argue total portfolio benchmarks are often easy beats[1], few KiwiSaver managers deliver returns in excess of their composite performance benchmarks net of fees. We find current practices are not serving anyone and propose a better solution – clear, transparent and easy to understand *KiwiSaver Benchmarks*.

We also review the progress to-date for the new default KiwiSaver managers. A little more than one year into the current structure, we see concerning variations in the results generated by the new managers, both relative to each other, and 'non-default' KiwiSaver balanced managers (as well as the legacy default conservative settings). In a 'no active choice' scheme, such as default KiwiSaver, we believe member equity must be *the* key objective. We detail an alternative default structure, based on the proposed KiwiSaver benchmarks, which we argue is better and fairer than the current approach.

[1] https://russellinvestments.com/-/media/files/nz/insights/benchmarking/nz-benchmarking-making-everyone-look-good-part-01.pdf

SUMMARY

- KiwiSaver is a member-led retirement programme in that *employees*, rather than *employers*[2], take on much of the responsibility for their retirement outcomes, i.e. provider selection, strategy etc. Recognising the low level of financial literacy in the KiwiSaver membership, every effort should be made to simplify while also increasing transparency and accessibility.
- A total portfolio benchmark should be useful as a gauge of both security selection <u>and</u> asset allocation – a simple, easy to understand yardstick to assess how an investment programme or diversified portfolio, such as KiwiSaver, is tracking over time.
- The impact of Responsible Investment decisions (and other *active* decisions) should be clearly attributed and accounted for. In most cases that means tracking total portfolio or KiwiSaver fund results versus broad market benchmarks (rather than heavily modified ESG indices).
- KiwiSaver benchmarks have evolved to the extent that most are a hodgepodge of often unrecognisable underlying fund benchmarks – inaccessible, meaningless, uninvestable constructs providing little in the way of relevant information for the millions of KiwiSaver members.
- Taking a leaf out of NZ Super Fund's book[3], KiwiSaver would be improved by the creation of five industry-wide, regulator-endorsed *KiwiSaver Benchmarks*, i.e. Reference Portfolios, to serve as high-level fund and sector benchmarks[4] used by all (e.g. KiwiSaver Conservative, Moderate, Balanced, Growth and Aggressive Growth Benchmarks)[5].
- Recognising that the current approach is not serving anyone, KiwiSaver managers should be freed from the obligation to develop composite benchmarks reflective of their strategy and of their responsibility to report on them in official documents like Fund Updates and SIPOs, i.e. they should use KiwiSaver Benchmarks instead.
- KiwiSaver Benchmarks could be used by other comparable defined contribution plans, such as corporate, public and industry retirement schemes, to monitor the progress of their investment programmes. Such benchmark standardisation across the local retirement sector would offer significant benefits to all members in NZ retirement schemes, e.g. improved transparency, provides for easier comparisons of value add, etc.
- An equitable, low-cost strategy for future KiwiSaver Default Fund assignments would be for all selected providers to manage assets passively based on the relevant KiwiSaver Benchmark (and at the same fee).[6] This would be fairer than the current process where chance plays too great a role in deciding relative outcomes for members, i.e. one member getting a very different result than another simply due to the random allocation process.

2 This structural feature of KiwiSaver, in comparison to employer-led programmes such as 401K in the US, has significant implications for KiwiSaver, from distribution considerations, i.e. how KiwiSaver managers sell their funds, through to reporting, oversight and governance. In cases where employees do not make a choice (and they do not opt out of the scheme altogether or are not already in a KiwiSaver fund) they are assigned to one of six default funds. The settings, i.e. risk profile, and managers are selected by the Government.

3 New Zealand Superannuation Fund utilises a Reference Portfolio approach, as do other local investors including fellow Crown Financial Institution, the Government Superannuation Fund Authority.

4 We note that Morningstar has created Morningstar Target Allocation indices to track the performance of New Zealand multi sector funds. While there is much to like about the indices, we believe a more straightforward approach to be optimal, including equities and bonds only, and at static, easy to understand weights. Our proposal also utilises what we consider to be the belwether indices for the asset classes concerned, meaning that a large number of investors utilise the component indices as fund benchmarks.

5 An interesting extension on this would be the reporting of wealth management portfolio results relative to simple Reference Portfolios such as the proposed KiwiSaver Benchmarks.

6 Other equitable, if potentially less palatable options, include selecting a single default manager or developing a government managed default KiwiSaver fund.

WHAT PURPOSE DO CURRENT KIWISAVER BENCHMARKS SERVE?

KiwiSaver funds are required by law to assign an appropriate performance benchmark. The primary objective of this requirement is to provide KiwiSaver members a means of comparing the performance of their fund relative to that of 'the market'.

Regulations note that indices used in the benchmark must be widely recognised and should reflect both the nature and level of risk of the underlying assets. In theory, the KiwiSaver performance benchmark should help members assess whether the returns they are receiving are appropriate given the fees paid and the risk taken, where risk is most often expressed as the volatility of portfolio returns.

This is a worthy aim. Investors should always be able to compare their investment outcomes to those of a viable alternative, i.e. the market, and a portfolio benchmark should be a useful indicator in helping to determine what is broadly achievable.

Added value or 'alpha', to the extent that it exists in a particular fund over a particular period, should be clear in all performance reporting, i.e. on websites and fund fact sheets, as well as in advertising and other member communications.

Likewise, where a particular fund has underperformed, that should be clear too.[7]

Are KiwiSaver benchmarks delivering on this overarching objective? No, not in our opinion. However, not for the reasons highlighted in, 'Making everyone look good? (Part I),' considering local institutional benchmarking practices. Far from being easy beats, few KiwiSaver managers outperform their performance benchmarks on a net-of-fee (gross of tax) basis.[8] This may simply reflect the realities of modern retail fund management – it is tough to beat performance benchmarks consistently net of fees and costs – rather than being a sign that something is wildly awry with the process. Benchmarks *should* be tough to beat.

The benchmarks are not delivering as they are not now, if they ever were at all, a straightforward means for members to assess the overall progress of a fund across all aspects of its investment process – security selection, asset allocation (strategic and tactical, if applicable) and market timing (if applicable).

Most benchmarks used by KiwiSaver funds are opaque, with fund managers typically offering little in the way of accessible detail about the composition of the benchmarks they use nor the governance around their construction.[9] To be fair to the KiwiSaver managers who do not display benchmark details on fact sheets and websites, many are now such *Frankenstein* constructs, that it is not clear anyone would be better off if there was more readily available data and information.

Additionally, with each KiwiSaver fund free to develop its own benchmark and change it whenever it sees fit, there is limited comparability of one fund's relative performance versus another's.

Finally, in most cases, the benchmarks are not reflective of any investable alternative either. With the exception of a few KiwiSaver providers, benchmarks are made up of so many component indices so as to render them, for all intents and purposes, uninvestable.

The requirement to compare KiwiSaver results relative to a benchmark is appropriate and necessary in our opinion. However, as we will see, the way in which the benchmarking process has evolved, means that the benchmarks themselves now offer little in the way of useful information to the typical layperson KiwiSaver member.

It is time for a more user friendly approach.

[7] As we have noted previously, that a fund or strategy underperforms the market should not in itself be cause for concern, we would expect most funds and strategies to underperform properly constructed benchmarks at times. The answer is not to shy away from presenting performance relative to fair benchmarks, but rather be clear as what a benchmark is and how and why a fund might be delivering different returns than it, i.e. fees, different asset allocation, active management etc.

[8] Among other work and research, please see Value for Money Industry Report, Financial Markets Authority (2021) and Douglas, Chris & Peacock, Greg, MyFiduciary Analysis of Active versus Passive Management in KiwiSaver (2020).

[9] Descriptions of benchmarks, if not the underlying indices and/or governance rules, are typically displayed in KiwiSaver Fund Updates. The full benchmark construction details are available in a KiwiSaver fund's Statement of Investment Principles and Objectives (SIPO) and may be available in other documents, i.e. the Product Disclosure Statement. In our opinion, they are far from accessible to all investors.

ARE CURRENT KIWISAVER BENCHMARKS 'EASY BEATS'?

In our previous paper, we showed how the frequent use of unrepresentative composite components (typically including cash, government-bond only, absolute return and/or peer universes), particularly for alternative asset classes, has contributed to many local institutional benchmarks becoming easy beats. This is not the case for KiwiSaver, where the majority of funds have generally struggled to beat their composite total portfolio performance benchmarks on a net of fee, gross of tax basis.

This is clear in the table that follows (Exhibit 1) where we present information on the top ten KiwiSaver growth funds by assets and compare their one and five-year net of fee (gross of tax) returns relative to their benchmarks. It has also been highlighted by other reviews of KiwiSaver performance.

Why such a *weak* relative performance record? Our experience, at least anecdotally, is that local institutional investors perform better (relative to their customised benchmarks) than is typical in the KiwiSaver sector, even though their absolute returns are similar (or worse).

Put differently, institutional investors might *outperform* their customised self-selected benchmarks, even though they *underperform* comparable KiwiSaver risk profiles, i.e. aggressive growth, growth, balanced, moderate or conservative.

We find two factors contribute to this.

Firstly, due to liquidity constraints and requirements, as well as an increasing focus on fees, KiwiSavers make limited use of the relatively more illiquid, complicated, and high fee asset classes and investment strategies. Most also tend to avoid holding funds or investing in strategies that have performance fees (typically calculated versus cash-plus benchmarks) embedded in them. They are invested predominantly in liquid 'plain vanilla' assets, such as short-term cash-like securities, local and international fixed interest and shares, all asset classes that have a large number of representative indices.

KiwiSavers are not (yet) big investors in asset classes like private markets, which are very long-term in nature and have variable cashflows (potentially introducing member equity concerns and reporting challenges), nor other alternatives strategies such as hedge funds and/or absolute return funds. These asset classes and investment strategies offer the prospect of high long-term returns, however, may introduce other challenges that offset the potential benefits.

Secondly, as noted earlier there are very specific regulations concerning benchmarking of KiwiSavers, so the opportunity to include easy beat components as part of a broader composite is limited – the benchmarks (and component parts) must match, as closely as possible, the assets held and the level of risk of those assets. As an example, comparing an asset class with the risk characteristics of equities, to an index with attributes similar to cash, is not permitted. This is not the case for institutional investors, where there is evidently much more leeway in determining what goes into a composite benchmark.

The result of this lighter regulatory environment, and market practice, means that KiwiSaver benchmarks are arguably more challenging performance benchmarks than many of those found within the institutional space.

This is not to say that most KiwiSaver benchmarks are 'good', far from it. But we do not believe they are easy beats in the way that many institutional total portfolio benchmarks are. In other words, they are sub-optimal, but not for the same reasons as many institutional total portfolio benchmarks.

Interestingly, there is apparently widespread KiwiSaver manager dissatisfaction with the requirement to use market indices as performance benchmarks at all.[10] This might reflect them being hard to beat, but also that in their current form, they are of limited use to KiwiSaver members and the broader industry, i.e. financial advisers and researchers, in evaluating success or otherwise of KiwiSaver funds. That is certainly out view too.

Case study: Top 10 Kiwisaver growth funds

To help us shed further light on whether KiwiSaver benchmarks are easy beats, we review the historical performance records of the top 10 (by assets under management) KiwiSaver Growth funds. *This task was a lot harder to complete than it should have been.*

We use one- and five-year trailing performance as these time periods were the only ones we could source across all funds. One- and five-year returns are *required* to be displayed in the Fund Updates, both benchmark and net of fee, gross of tax fund performance.

We could not find any other sources, e.g. fund fact sheets, data providers or provider websites, where both net of fee (gross of tax) fund performance <u>and</u> benchmark are displayed consistently across the funds across multiple time periods.

From our standpoint, this is another example of the currently benchmarking process not working – in many cases, KiwiSaver managers ignore their benchmarks from a performance reporting perspective altogether, outside of the required Fund Update documents.

[10] 'Feedback from participating MIS Managers suggests reasonably widespread scepticism about the value of using a market index as a reference for the risk-adjusted performance of a fund at all.' Value for Money Industry Report, Financial Markets Authority (2023)

At a minimum, every KiwiSaver fund should display its record over one-, three-, five-, and 10-years and since inception periods, net of fees, gross of tax, relative to its performance benchmark. Historical calendar or financial year periods should also be accessible easily. The often used cumulative growth charts are less relevant as they can distort performance records (for instance, a single strong period early in the life of a fund can make its record appear much stronger than it is from a relative performance perspective over all time periods). While good for marketing, they offer little in the way of useful information for evaluating historical fund performance.

We note there is some information available on the Disclose Register, the FMA's website and the Sorted website. While providing useful information, we were unable to produce long-term net of fee, gross of tax returns relative to benchmarks over multiple periods.

The table below shows assets, fees, growth-income splits and traling performance of the largest growth funds. We note that some information, i.e. fees or growth-income split, may have changed over time.

Exhibit 1

Top 10 KiwiSaver Growth funds by assets under management – 1- and 5-year performance versus benchmark

FUND	AUM (B)	FEE	GROWTH / INCOME	FUND (1 YR)	BENCHMARK (1YR)	FUND (5 YR)	BENCHMARK (5YR)
ASB KiwiSaver Scheme's Growth	$4.6	0.70	80/20	-12.26	-10.56	4.37	5.56
ANZ KiwiSaver-Growth	$4.0	1.05	80/20	-14.61	-12.98	4.92	5.38
Milford KiwiSaver Active Growth Fund	$3.3	1.05*	78/22	-7.91	-10.83	8.10	6.37
Fisher Funds Growth KiwiSaver Fund	$2.9	1.45*	81/19	-15.87	-11.12	5.41	5.76
Westpac KiwiSaver-Growth Fund	$2.4	0.64	80/20	-14.16	-12.67	4.09	4.79
Kiwi Wealth KiwiSaver Scheme Growth	$2.1	1.12	80/20	-15.50	-14.03	4.89	5.23
Simplicity KiwiSaver Growth Fund	$1.8	0.30	80/20	-14.71	-15.13	5.21	5.40
BNZ KiwiSaver Growth Fund	$1.3	0.51	80/20	-13.88	-12.61	4.68	5.39
Generate KiwiSaver Growth Fund	$1.1	1.34**	80/20	-12.31	-12.10	5.26	6.02
Fisher TWO KiwiSaver Scheme-Growth	$1.0	1.04	81/19	-11.12	-11.12	5.46	5.34

Red denotes undeperformance relative to the benchmark. *These funds are subject to additional performance-based fees. **Member fee of $36 per year. This equates to an additional 0.12% on a $30,000 investment. Source: Provider Fund Updates as of December 2022. Annualised performance in NZD, net of fees, gross of taxes. Past performance is not guarantee of future results.

A single firm, Milford Funds, has managed to add value relative to its benchmark on a net-of-fee basis over both one and five years. As well as proving adept at outperforming their benchmark, the benchmark return itself was strong too (suggesting strong asset allocation decisions). The majority of firms have failed to add value relative to their self-selected benchmarks over both time periods. This is a both a reminder of the realities of active management and illustration that the current benchmarking strategies adopted by KiwiSavers are not fulfilling their primary objectives.

According to the FMA's description, one of the purposes of benchmarking is to provide a means for KiwiSaver members to assess whether they are getting appropriate returns for the fees they pay and the risks that they have taken on. Given that the majority of the funds above, the largest growth funds in the market, failed to outperform their benchmarks on a net of fee (gross of tax) basis, does it mean they are not providing value for money? If that is not the case – the funds do represent good value for money and are delivering from a performance perspective – then what purpose do these KiwiSaver benchmarks serve?

They are certainly not straightforward, easy to understand, clear portfolio constructs that allow for easy comparison. Diversified fund benchmarks in New Zealand often have ten or more component indices rolling up to the total portfolio benchmark. We found one Balanced Fund benchmark comprising of a bewildering 17 separate indices including six for one asset class asset class, Australasian equities.

In most cases one needs to visit the depths of a government-related website or obscure official fund document to find any information on the underlying make-up of the KiwiSaver benchmark.[11] As noted earlier, even if the make-up of these benchmarks were easier to determine, we do not believe they provide much information to assist with an assessment of value-add or peer-relative performance, particularly from the perspective of the typical layperson KiwiSaver investor.

[11] Fund benchmark details for all funds can be found here: https://www.disclose-register.companiesoffice.govt.nz/

Of the Growth funds above, there is a wide range in benchmark returns (4.79% on the low-end for Westpac KiwiSaver Growth over 5 years versus 6.37% for Milford KiwiSaver Active Growth Fund) and in excess returns (+1.73% on the high-end for Milford KiwiSaver Growth Fund to -1.19% for the ASB KiwiSaver Scheme's Growth Fund on the low end). Is 'success' determined by how close a fund gets to outperforming its benchmark? Or is success determined by its absolute return, whether it is meeting overall objectives, how it performs relative to a simple alternative and, perhaps, by how it compares relative to comparable peer funds?

Generate KiwiSaver Growth Fund for instance, has underperformed its benchmark over five years, but has also delivered strong absolute returns comparing favourably with its peers. Additionally, its benchmark, a representation of its asset allocation decisions, has outperformed all others with the exception of Milford Funds over five years. So while its aggregate security selection may not have added value relative to the benchmark after fees, the asset allocation decisions have proved successful, certainly in comparison to peer growth funds listed above.

In such circumstances, we do not see that the benchmark used is providing much in the way of useful information for its members or prospective members. As noted earlier, it is hard to tell what is in the benchmark and how it has evolved over time. It certainly does not represent an investable alternative.

Similarly for the other KiwiSaver funds and benchmarks. What can we determine by looking at one benchmark return relative to another? And if they are not providing much in the way of useful information for the typical layperson KiwiSaver member then what is the point of having them at all?

An additionally complexity, and one that we will address further later, is the propensity of some fund managers to offer members additional features, such as providing exposure to impact and 'ethical' investing or making donations to charity. Most would agree that where possible, the financial impact of such decisions, if there are any, should be made clear to members.[12]

ARE KIWISAVER BENCHMARKS TOO COMPLICATED?

A good portfolio benchmark should be broadly reflective of the opportunity set, transparent and measurable, unambiguous in its construction and, hopefully, represent the basis of an investable alternative. Some also view a portfolio benchmark as the neutral position or starting point. At the total portfolio level, they provide a means by which to assess the overall progress of an investment programme, portfolio or diversified fund, like KiwiSaver.

The table below lists some of the indices used by the ten growth funds above to represent the core asset classes found within their portfolios. To construct a benchmark for their respective KiwiSaver funds, the managers create an aggregate or composite which is made up of the individual indices (or sometimes spliced indices) representing the various asset classes that the KiwiSaver holds. The indices that make up the composites are typically weighted according to the target or Strategic Asset Allocation (SAA), i.e. the component benchmarks are effectively rolled up to form a total portfolio benchmark. Some KiwiSaver funds invest in other diversified multi-asset funds, which themselves have composite total portfolio benchmarks, just adding to the opaqueness of the total portfolio benchmark.

It is this total portfolio benchmark that passive managers generally attempt to track, and active managers attempt to outperform.

[12] In many cases, charitable donations are funded at the fund manager level, rather than at the fund level. However, a recent fund has been launched in the market where management fees and investment returns are donated to charitable causes.

Exhibit 2

Underlying benchmarks used by top 10 KiwiSaver Growth Funds

ASSET CLASS	BENCHMARK
Cash	S&P/NZX Call Rate Deposit (TR)
	S&P/NZX 90-Day Bank Bills (TR)
	Bloomberg NZBond Bank Bill (TR)
New Zealand Fixed Income	S&P NZX NZ Government Bond Index (TR)
	S&P/NZX A-Grade Corporate Bond Index (TR)
	S&P/NZX NZ Inflation-Indexed Government Bond Index (TR)
	Bloomberg NZBond Composite 0+ Year Index (TR)
	Bloomberg NZBond Credit 0+ Year Index (TR)
	Bloomberg NZBond Govt 0+ Yr Index (TR)
Global Fixed Income	Bloomberg AusBond Credit 0+ YR Index (TR)
	S&P/ASX Corporate Bond Index (TR)
	FTSE World Government Bond (3-5 years) Index (TR)
	FTSE US Inflation Linked Securities (TR)
	FTSE World Broad Investment Grade Bond Index (TR)
	FTSE World Government Bond Index (TR)
	Bloomberg Global Aggregate Bond Index (TR)
	Bloomberg Global Corporate 3-5 Year (TR)
	Bloomberg Global Corporate 1-10 Yr Index (TR)
	Bloomberg Global Treasury 1-20 Yr Index (TR)
	Bloomberg Barclays MSCI Global Aggregate SRI ex ESG Exclusions Index (TR)
Australasian Equities	S&P/NZX 50 (TR)
	S&P/NZX 50 (TR) with imputation credits
	S&P/ASX Small Ordinaries Index (TR)
	Solactive Australian 200 Index (TR)
	Morningstar New Zealand Index (TR)
	FTSE Australia Choice Index (TR)
Global Equities	MSCI ACWI (NR)
	MSCI ACWI ex Australia (NR)
	MSCI World ex Australia (NR)
	MSCI Emerging Markets (NR)
	5% S&P/NZX Call Rate Deposit + 95% MSCI World (NR)
	S&P Global Large MidCap Index (NR)
	FTSE Developed Choice ex Australia (TR)
	FTSE All World Index (NR)
	Solactive Kiwi Global Markets Screened NZD Index
Property	S&P/NZX All Real Estate Index
	S&P/ASX 200 A-REIT Index (TR)
	FTSE EPRA NAREIT Rental (NR)
Infrastructure	FTSE Global Core Infrastructure 50/50 (NR)
	S&P Global Infrastructure Index (NR)

Source: We have sourced the indices above from the latest available respective fund manager Statement of Investment Policy and Objectives (SIPO) document on the Government Disclose website. As of end of Dec 2022.

The table above lists some of the indices used for the top ten KiwiSaver Growth funds, sourced from the KiwiSaver Statement of Investment Policy and Objectives (SIPO) documents (found on an obscure government-related website!). With a mind boggling 40 different indices being used to represent just seven core asset classes the scale of the problem is clear. As professional investors ourselves, we find the variety of indices used as core asset class benchmarks, to be baffling – far removed from anything we would recommend if building a composite total portfolio benchmark for a client.

What does the Bloomberg Global Corporate Bond 3-5 Year Index or the FTSE Developed Choice ex Australia Index mean for the typical KiwiSaver member? Even if they could find information on these component indices – and we suspect most members would have no idea where to look – few will have any concept as to what they mean individually or as part of a rolled-up composite benchmark.

Market practice has also evolved further to the extent that rather than KiwiSaver managers choosing an index to represent an asset class, for instance MSCI All Country World Index (ACWI) for global equities, they invariably use an underlying fund or strategy benchmark to represent the asset class. So if a KiwiSaver manager moves from one fund to another (in its KiwiSaver portfolio) its aggregate benchmark may change too even if the asset allocation and/or strategy otherwise remains the same.

This perhaps explains the presence of ex-Australia global equity indices. Rather than being reflective of the true global equity opportunity set they are benchmarks for Australian domiciled global equity funds (or strategies) that are frequently found in KiwiSaver funds.

Likewise the presence of KiwiSaver managers that do not include emerging markets in their benchmarks. While avoiding emerging markets in recent times has proved beneficial, it would seem a significant oversight – or exercise of convenience – to exclude the capital markets of such a large portion of the world in a total portfolio benchmark. With more than $10 trillion in market capitalisation, close to 50% of global gross domestic product and home to more than four billion people, emerging markets are quite simply too big to ignore.[13] We see no good reason why they are not represented in *all* KiwiSaver benchmarks.

There are more than 140 diversified KiwSaver funds in the market today. Within those funds there are dozens of different indices representing a handful of core asset classes. What function do all these different indices and asset class benchmarks serve? Rolled up to form benchmarks for KiwiSaver funds, do they help *anyone* in the assessment of how a particular fund is performing?

The current benchmarking practices, rather than bringing clarity and transparency, simply add to the overall confusion. Instead of benchmarks providing a reliable means to assess comparative performance, financial adviers and members are left to rely on often cherry-picked performance data released by the KiwiSaver managers themselves (e.g. 'top fund over three years and three months') as they survey the records of the various funds available to them in the market.

Current KiwiSaver benchmarks are *far* too complicated.

[13] MSCI, World Economics.

LOST IN THE SHUFFLE – EVALUATING THE IMPACT OF RESPONSIBLE INVESTMENT DECISIONS

Further complicating the issue is the increasing penetration of Environmental, Social and Governance (ESG) based investing within KiwiSaver funds. Some KiwiSaver managers proport to invest 'ethically' – whatever that might mean – excluding certain stocks, sectors, asset classes or countries from their opportunity set. They may also invest in funds, strategies or assets which in their assessment are making a positive contribution across whatever metric they are considering. How best to judge the impact and performance of these decisions within the total portfolio context?

As noted earlier, KiwiSaver benchmarks typically resemble a rolling up of underlying fund or strategy benchmarks. So if a KiwiSaver manager invests in a fund or strategy that is, say, ex-tobacco, controversial weapons and fossil fuels, then often the total KiwiSaver fund benchmark also excludes stocks in these sectors. If this is the case, how are members ever going to know what the impact of these exclusions were on their investment results? After all, these are effectively active decisions and yet often the securities, sectors or countries are simply removed from the performance benchmark never to be seen again.

With a few exceptions, the companies excluded from investment in some of the local ethical funds offer legal (in New Zealand) goods and services and trade on exchanges around the world. They are investable from the perspective of most KiwiSaver managers and so any decision to avoid must surely be considered an *active* one.

To illustrate how this might work in practice, imagine the case of a global equity manager managing a sleeve or portfolio of a KiwiSaver fund. Reflecting their Responsible Investment beliefs and policies they manage their strategy relative to the MSCI ACWI Socially Responsible Investing[14] index, rather than the broad market MSCI ACWI. Because of this, the impact of their Responsible Investment decisions, relative to the broad market and 'opportunity set', as measured by the MSCI ACWI, is harder to ascertain.

The universe has already been reduced significantly, in this case by more than two thirds. This is an extreme example, but it highlights the challenge of removing or otherwise significantly modifying a portfolio benchmark. It begins to be more reflective of an end state – and the result of *active* decisions – rather than a broad representation of the available opportunities.

Does this matter? In some years it certainly does. The exhibit below shows the performance of the broad market index and several ESG-oriented variants in 2022. Over the year, there is a range of about 450 bps from top to bottom, in what are ostensibly the same asset class benchmarks. A fund manager may track the MSCI ACWI Socially Responsible Investing index closely, or even outperform it, but for the typical KiwiSaver investors would that really be the most appropriate yardstick for a global equity portfolio?

We highlighted this point in Part I of the benchmarking paper, where we argued in most cases it was appropriate that high level, total portfolio results are tracked relative to broad market benchmarks, reflecting that often times there is a choice being made.

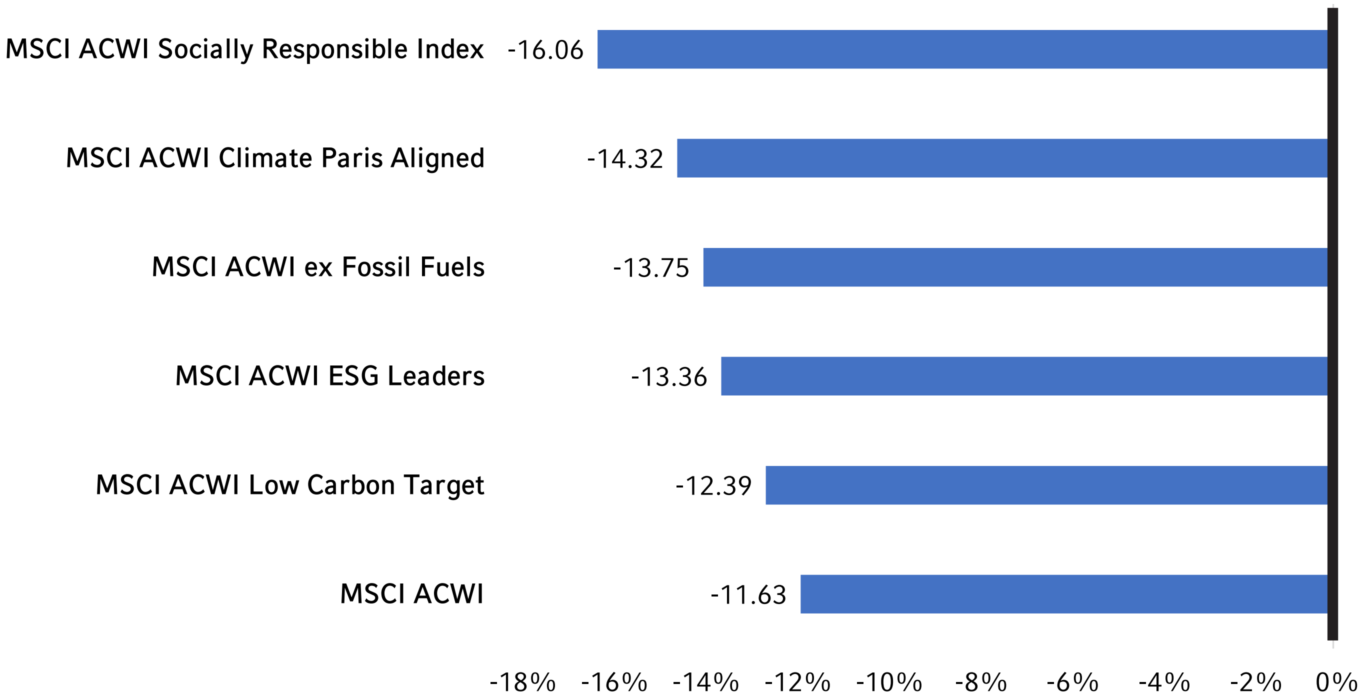
In the case of the hypothetical global equity manager described above, as well as being compared relative to a fund benchmark, it would be appropriate that results are compared to a broad market index such as the MSCI ACWI. Then, members would be better able to assess whether their Responsible Investment decisions have added or detracted value enabling a greater understanding of whether the KiwiSaver fund was meeting their needs.

To be clear, we are not making an assessment of the Responsible Investment practices of local fund managers, or suggesting that investors avoid considering ESG factors (and would note that we have a detailed set of beliefs, policies and procedures ourselves). We are simply stating, that investors should consider any moves away from the broad, investable universe as active decisions. This is even the case where a fund may be managed passively, for instance, a global equity index fund tracking an ex-fossil fuels index. Sure, track that against its benchmark, but at the KiwiSaver fund level, broad-based indices are best.

[14] The index is designed for investors seeking a diversified Social Responsible Investment benchmark comprised of companies with strong sustainability profiles while avoiding companies incompatible with values screens. Constituent selection is based on MSCI ESG Research.

Exhibit 3

2022 performance for global equity benchmarks (in NZD, unhedged)



Source: MSCI, Morningstar Direct. Net total return indices in NZD. As of 31 December 2022. Past performance is no guarantee of future results.

What about in the case of the Default KiwiSavers, where they were mandated to exclude securities from certain sectors? While some may argue there is cause to exclude the securities from the manager benchmarks given the portfolio restrictions and constraints were imposed on them by the government, we believe the full impact of these decisions should be made clear through benchmarking, i.e. core broad benchmarks should be used. We expand on this later.

BRINGING CLARITY TO KIWISAVER – FIVE NEW SIMPLE KIWISAVER BENCHMARKS

In Part I of our benchmarking paper we suggested local asset owners adopt simple Reference Portfolios to help assess their investment programmes over the medium to long-term. We think KiwiSaver would also benefit from the introduction of Reference Portfolios – *KiwiSaver Benchmarks* – that are consistently applied to all funds of the same risk category, i.e. Conservative, Moderate, Balanced, Growth, Aggressive Growth. As well as providing simple benchmarks for all KiwiSaver funds on a like-for-like basis, they could also be used for illustrations and member education produced by fund managers as well as other organisations such as the FMA or the Retirement Commission. We think the practice of publishing composite benchmarks, essentially meaningless and unverifiable constructs, should be stopped altogether.

Were it up to us to design the industry-wide KiwiSaver Benchmarks, the following are the key features that would define them:

1. **Straightforward and transparent:** The KiwiSaver Benchmarks would have two asset classes – fixed interest and shares, across two geographies, local and global.
2. **Representative of the opportunity set:** Local assets would represent 20% of the KiwiSaver Benchmarks. Obviously, there will be different views as to an appropriate allocation, but from our vantage point 20% is a good baseline. It reflects the desire of many investors to 'overweight' local assets (relative to a market portfolio approach), but as a neutral starting point this strikes a pragmatic balance, being large enough to reflect market practices and preferences while not being so large that managers could not overweight the local assets should they wish to. The global indices, representing 80% of the KiwiSaver Benchmarks, would capture around 2,500 shares and almost 20,000 individual bonds across thousands of issuers.[15]
   We note that 20% is a little below the estimated amount of 'New Zealand domiciled assets' for KiwiSaver funds in the aggregate according to Morningstar. For instance, based on their methodology, the average amount for a KiwiSaver Growth Fund is 31%.[16]
3. **Consistent 'neutral' hedging strategy:** The hedging strategy would be 100% for global fixed interest and 50% for global shares. In our previous paper we discussed the rationale for each. Suffice to say, as a starting point and neutral stance, this balance is the most appropriate, removing currency risk from the defensive global bond allocation and accepting the risks and benefits of partial hedging of the global shares portfolio. It also broadly aligns with current practice and provides the opportunity for fund managers to increase or reduce the hedge ratio with the equity portfolio (versus having the neutral position as 0% or 100% where there is only one possible move).
4. **Widely accepted indices as component benchmarks:** The indices used to represent the KiwiSaver Benchmarks would be the: MSCI All Country World Index (ACWI) Net Total Return for global shares; Bloomberg Global Aggregate Bond Index NZD-Hedged, Total Return for global bonds; S&P/NZX 50 Total Return with imputation credits for local shares; and, the Bloomberg NZBond Composite 0+ Yr Index Total Return for local bonds. All are broad, representative indices published by reputable index providers, widely adopted by fund managers and clearly accepted as measures of 'the market'.
5. **Simple rebalancing:** They would be rebalanced annually at the end of the last trading day of the financial year, i.e. the last trading day in March.
6. **Ease of administration:** The growth-income splits, determined at launch, would be consistent for at least a period of at least five years. Growth assets would be as follows: Conservative (20%), Moderate (30%), Balanced (60%), Growth (80%) and Aggressive Growth (90%). We arrived at these levels having reviewed market practice, FMA guidelines as to risk profiles and a desire to keep things simple.
7. **Straightforward management and calculation:** the KiwiSaver Benchmarks would be easy to manage and calculate performance. While fund managers and supervisors could calculate performance easily, the FMA, MBIE or another party could be responsible for producing 'official' KiwiSaver Benchmark performance. Given the simplicity in construction and availability of index data, most market participants could calculate the performance of the benchmarks. KiwiSaver Benchmarks could also be added to market data services like Morningstar or Bloomberg and reported on investment websites such as Sorted.[17]
8. **Investable:** the KiwiSaver Benchmark is investable. There are a range of products, active and index-oriented, on the market today that could be used to build a portfolio based on the allocations presented. Over time, we suspect further KiwiSaver managers would look to offer low-cost funds that mirror the

[15] MSCI and Bloomberg

[16] Morningstar. KiwiSaver Survey September Quarter 2022. New Zealand Domiciled Assets.

[17] https://sorted.org.nz

KiwiSaver Benchmarks. These funds would represent a true investable alternative. Given low fees and the likely strong peer relative performance, we suspect such funds would attract significant assets over time.

9. **Gross of member taxes:** the KiwiSaver Benchmarks would be presented without accommodation for member taxes, i.e. at the 0% prescribed investor rate. While there may be an argument to also calculate KiwiSaver Benchmarks at the various member tax rates, this would increase complexity and potentially add to industry costs. Initially, we believe gross of member tax returns compared to net of fee, gross of tax KiwiSaver returns, would be most appropriate. All firms should be required to report results in this form, i.e. net of fee, gross of tax versus their KiwiSaver Benchmark, whenever presenting or advertising performance. Currently, many KiwiSavers do not report performance relative to benchmarks on websites and advertisements. Cherry-picked performance data, often over short time periods, is a marketing staple. Raising performance presentation standards, through requiring standardised performance reporting, would be an additional benefit of KiwiSaver Benchmarks.

The proposed KiwiSaver Benchmarks are displayed below.

Exhibit 4

Five new KiwiSaver Benchmarks

ASSET CLASS	INDEX	WEIGHT (%)				
		CONSERVATIVE	MODERATE	BALANCED	GROWTH	AGGRESSIVE
Income		80	70	40	20	10
New Zealand Fixed Income	Bloomberg NZBond Composite 0+ Yr Index (TR)	16	14	8	4	2
Global Fixed Income	Bloomberg Global Aggregate Bond NZD-H (TR)	64	56	32	16	8
Growth		20	30	60	80	90
New Zealand equity	S&P/NZX 50 (TR) with imputation	4	6	12	16	18
Global Equity (unhedged)	MSCI ACWI (NR)	8	12	24	32	36
Global Equity (hedged)	MSCI ACWI (NR) 100% NZD-H	8	12	24	32	36
Total		100	100	100	100	100

The KiwiSaver Benchmarks above reflect the key principles and, in our opinion, are clear and easier to understand than the benchmarks used by many KiwiSaver managers. They represent a significant improvement on current practice and would better fulfill the primary objective of the benchmarking process for KiwiSaver funds.

KiwiSaver managers, through their actual portfolios, may well believe they can improve on such simple globally diversified, liquid portfolios.

Were we to offer a KiwiSaver scheme, we may too.

Nevertheless, the KiwiSaver Benchmark portfolios above are accurate representations of the five diversified fund risk profiles that exist in the market today.

There may be a desire to attempt to optimise these benchmarks further. We can understand that sentiment, however, believe that the collective effort of fund managers, consultants and advisers, would probably be better spent trying to build KiwiSaver portfolios that might do better than these simple benchmarks over time.

In our view, rather than being detrimental, the simplicity of the KiwiSaver Benchmarks proposed here, is a real strength.

Below we show the historical performance of the KiwiSaver Benchmarks.

Exhibit 5

Historical performance of proposed KiwiSaver Benchmarks (% annualised return)

RISK PROFILE	1 YEAR	3 YEARS	5 YEARS	10 YEARS
KiwiSaver Conservative Benchmark	-11.48	-1.11	1.61	4.37
KiwiSaver Moderate Benchmark	-11.79	-0.33	2.33	5.21
KiwiSaver Balanced Benchmark	-12.71	1.82	4.35	7.68
KiwiSaver Growth Benchmark	-13.30	3.10	5.61	9.27
KiwiSaver Aggressive Benchmark	-13.59	3.70	6.21	10.05

Historical volatility (standard deviation of returns) of proposed KiwiSaver Benchmarks (%)

RISK PROFILE	1 YEAR	3 YEARS	5 YEARS	10 YEARS
KiwiSaver Conservative Benchmark	7.13	5.81	4.88	3.96
KiwiSaver Moderate Benchmark	7.79	6.71	5.66	4.54
KiwiSaver Balanced Benchmark	10.07	9.87	8.55	6.86
KiwiSaver Growth Benchmark	11.77	12.10	10.64	8.58
KiwiSaver Aggressive Benchmark	12.64	13.23	11.70	9.46

Source: MSCI, S&P Down Jones Indices, Bloomberg and Morningstar Direct. KiwiSaver benchmarks, weights as per Exhibit 4, rebalancing annually at the close of 31 March. Costless rebalances and no fees assumed. As at 31 December 2022. Past performance is no guarantee of future results.

While dependent on the fees charged, fund manager implementation capabilities and product efficiency, we would expect an indexed-based approach, tracking the component indices, to be able to deliver a net-of-fee return within about 20 to 30 basis points of the returns displayed above.

We note that financial markets data provider, Morningstar, currently calculates a selection of diversified multi sector fund benchmarks for the New Zealand market. They share many of the positive characteristics of the KiwiSaver Benchmarks process described above, but we find the level of complexity and lack of investability to be undesirable. The Morningstar NZD Target Allocation indices include component indices tracking government-only fixed interest and cash as well non-core asset classes like real estate. We believe the simplicity and transparency of the proposed KiwiSaver Benchmarks, with core assets only, to be preferable to the Morningstar indices. We also note that the component indices are more widely used by the industry to as fund benchmarks suggesting there is broader investor acceptance.

LIKELY CRITICISMS OF SIMPLE KIWISAVER BENCHMARKS

Some industry participants and commentators may be against the roll-out of straightforward KiwiSaver Benchmarks such as those proposed here. As well as concerns about regulator overreach and 'meddling', we suspect some would argue that such benchmarks would contribute to the homogenising of KiwiSaver offerings with a myopic focus on fees leading to further increases in low-cost passive management.

There would also likely be concerns that such simple benchmarks would discourage KiwiSaver managers from investing in more esoteric 'value-adding' asset classes and strategies, such as alternatives (e.g. hedge funds), impact investments or private markets activities (e.g. direct lending, private equity, unlisted real estate and unlisted infrastructure). Some might also say that tracking performance relative to core, broad market indices may slow the growth of Responsible Investment practices. Finally, we suspect some fund managers would view the KiwiSaver Benchmarks as unfair hurdles, given they do not include any allowance for fees and costs.

Our response to likely criticisms

We do not find these arguments to be credible. As *the* private sector retirement vehicle for millions of Kiwis, the government, through the Treasury, the Ministry of Business, Innovation & Employment (MBIE), the FMA and the Inland Revenue Department (IRD), continue to develop and improve the KiwiSaver programme. They have made various changes over time and evolve practices, rules and regulations with the aim of improving long-term investor outcomes.

The adoption of KiwiSaver Benchmarks as proposed here, would be another step forward, in recognition that the current benchmarking process is not working for anyone – fund managers, financial advisers, researchers, members and prospective members.

Benchmarking for local managed funds is certainly topical. The FMA is currently addressing the topic within its Value for Money process and has highlighted several deficiencies about current practices.[18]

The approach we are proposing here is not radical having been implemented to good effect by sophisticated institutional investors in New Zealand and around the world.

Would the adoption of KiwiSaver Benchmarks lead to the further homogenisation of KiwiSaver with an undesirable 'race to the bottom' on fees at the expense of innovation and long-term investor returns? Not in our view. Focus on fees is mostly positive and while the benchmarks would be prescriptive, i.e. the same for everyone, there would be no additional restrictions imposed on fund managers. They could invest in most global asset classes as is the case currently. KiwiSaver members might start to question whether the fees they are paying are justifiable but that is not a bad outcome.

The adoption of standardised core asset class benchmarks may 'raise the bar' for investments that fall outside of this universe, but again, we do not believe this is a negative. Non-core asset classes and approaches inevitably involve some trade-offs, be those liquidity, transparency, cost and/or complexity, in the pursuit of higher returns. In asset classes like private equity, there are very real challenges in maintaining member equity, due to the long-term nature of most investments and the uneven cashflows, i.e. the private equity 'j-curve' effect and the challenge in treating investors equitably. There *should* be a high bar for such investments for KiwiSaver funds.

As well as experiencing periods of outperformance, the adoption of these simple benchmarks may lead to some uncomfortable periods for fund managers that veer markedly from the KiwiSaver Benchmark asset allocations. This would likely be the result of highly active strategies, significant asset allocation shifts (e.g. higher allocation in local assets, different hedging strategy) or due to investment in non-core, asset classes or market segments, alternatives, and/or esoteric investment strategies. Managers leaning heavily towards ESG-oriented approaches may also experience periods of significant under- and outperformance relative to the KiwiSaver Benchmarks.

We do not see any problems with this. KiwiSaver managers should always be prepared to justify their investments and attribute performance. KiwiSaver members also need to accept performance variability relative to benchmarks and peers if they invest in funds that adopt differentiated investment processes and/or invest outside the core asset classes and strategies.

Unlike the current free-for-all, the KiwiSaver Benchmark process would bring some consistency and transparency to the benchmarking process enabling easier like-for-like comparisons and assessments of the real value add. Members might actually *know* what is in their benchmark.

Finally, that the KiwiSaver Benchmarks do not provide for any allowance for fees or costs, should not be an issue. Properly constructed investment benchmarks are not easy to beat. The robustness of the KiwiSaver Benchmarks process would be lessened in our view if some theoretical fee was deducted from the return. As is the case now, it would be clear that benchmark returns to not account for any fees or investor costs.

[18] Financial Markets Authority, Value for Money Industry Report (2022)

Determining the initial portfolio settings

One likely criticism or at least challenge of the KiwiSaver Benchmark process would be in the initial setting of the asset class weights as well as the indices used to represent those asset classes. We have arrived at what we consider to be appropriate weights (and broadly in line with market practice) and have selected the most widely used indices. However, there may be a case to be made to use slightly different weights and indices.

We suspect were the KiwiSaver Benchmark approach adopted (either mandated or voluntarily) there would be a period of consultation with industry participants, and it may be that independent advisory firms contribute to the development of the composite indices, i.e. local versus global weights, growth vs. income and hedging strategy.

We note that this process is not too far removed from the current practice in that growth-income splits for the various diversified fund buckets have been determined, while for Default members a significant portion of the total portfolio approach has been decided and mandated by the government, e.g. balanced strategy, largely low-cost passive, ex-fossil fuels etc.

Sticking to the principles that the KiwiSaver Benchmarks be simple, easy to understand and an appropriate starting point or neutral position, we believe that they could be adopted without over engineering. Round number weights, simple principles (e.g. 20% local, 80% global, 50/50 hedging for global equity) and ease of administration and calculation are all desirable features of the KiwiSaver Benchmarks promoting a high level of transparency for all.

As noted earlier, efforts are better spent building portfolios, that might outperform these simple KiwiSaver Benchmarks, rather than spending time agonising over the makeup of the most efficient composite benchmarks.

Our experience suggests that the KiwiSaver Benchmarks detailed above, *will* prove tough to outperform over time, even if it might be *possible* to construct a series of benchmarks that have higher expected risk-adjusted returns based on capital markets forecasts. In our view, near enough, would be good enough in the development of KiwiSaver Benchmarks.

EXTENDING KIWISAVER BENCHMARKS TO DEFAULT KIWISAVER

The default KiwiSaver programme is for eligible workers who do not choose a KiwiSaver fund when they start start work at a new employer and are not already in a KiwiSaver fund.

Unless the worker actively 'opts out', they will be assigned to one of the nominated KiwiSaver default funds, currently offered by six private firms.

Fund managers, transfer arrangements, portfolio settings and other policies are developed primarily by the Treasury and MBIE, but also with input and analysis from the FMA and the IRD.

The government departments effectively become fiduciaries for default members, even if not in the strictly legal sense, implying actions should always be taken with the best interests of members at heart.

The initial Conservative setting for default KiwiSaver was adopted as it was thought default funds would be something of a 'parking space' for members – short-term holdings before being transferring out to a provider and risk setting of choice.

As it happened, members were much stickier, meaning more were remaining in default KiwiSaver funds for extended periods of time. As part of the most recent review, it was decided to change the setting from 'Conservative' to 'Balanced' to reflect that for many the Default KiwiSaver option is a long-term option.

With the experience of a little over a year to call on, we believe the default KiwiSaver programme could be significantly improved, with the proposed KiwiSaver Benchmarks playing an important role.

In our opinion, the recent default KiwiSaver selection process was flawed, with an imbalanced evaluation process favouring low fees above all else (apparently a 60% weighting), relegating traditionally important 'manager research' factors such as investment management capabilities, compliance, risk management processes and resources, operational capacity, customer service and investment strategy to the background. In addition, while there were elements of portfolio design that were mandated, for instance the requirement to be investing in a Balanced fund without exposure to fossil fuel producers, much variation was permitted and indeed exists today.

With multiple default KiwiSaver managers being appointed, all free to adopt strategies broadly Balanced in risk stance but potentially quite different, there is the likelihood of significant inequity among the 300,000 members[19], a highly undesirable feature of a default programme where provider selection decisions are taken on behalf of others.

Other elements, such as the restriction on default KiwiSaver investing in companies involved in fossil fuel production, while permitting those same very funds to

[19] KiwiSaver Annual Report 2022 (Financial Markets Authority)

lend money to petrostate sovereigns like Saudi Arabia, Qatar, Kazakhstan and others add to a general sense of imprecision and randomness in the default KiwiSaver process[20].

Financial markets have an uncanny ability to make even apparently well-informed decisions look silly, particularly in the short-term.

So even while the decision to transition members from Conservative funds to Balanced funds may turn out to be beneficial for most default members, as might the ESG restrictions, it is a reminder to those acting on behalf of others of their responsibilities. Decisions in this context must be taken with the clearest intent and mandate – to always seek to act in the best interests of the *majority* of members. Anything else is surely asking for trouble.

Already, a little more than one year into the latest reassignments, we see a wide variation in the returns generated by the Default KiwiSaver managers. The leading firm by returns, Smartshares/Superlife (-7.8%), outperformed the weakest, Simplicity (-12.6%), by about 480 basis points (annualised, net of fee, gross of tax return) since inception in December 2021. Assuming a beginning investment of $9,000 (roughly the average balance at the time of the transition), the Default member in the worst-performing fund is already around $450 *worse* off than the member in the top performing fund.[21] That difference, the result of random allocation, is hard to defend.

A cursory glance at portfolio holdings shows that Smartshares did not invest in global bonds while Simplicity has invested in heavily screened ethical index funds that remove a large portfolio of the investable market (i.e. non-renewable energy, 'vice' sectors, controversial weapons etc). Beyond that, it is difficult to fathom why one Default KiwiSaver Balanced Fund has so drastically underperformed another given the aim should surely be that they offer broadly similar portfolios and outcomes over time.

To be clear, we are not making a comment or passing judgment on one strategy relative to the next. As well as a little over one year being *way* too short a period to be meaningful, that is not really the point. It is the *difference* between the two strategies – the best and the worst – that we take issue with.

Likewise, there is wide variation in fees, with the highest cost provider, Westpac (0.40%), being double the price of the lowest cost provider, Smartshares (0.20%).

Over decades, such variations may result in some default members being thousands of dollars worse off than other members simply because they were randomly stuck in the 'wrong' fund.

The outright restriction on fossil fuel production, has also been costly in 2022[22]. Notwithstanding its future plans, the irony of a government banning investment in fossil fuel producers for default KiwiSavers (but not other KiwiSavers), while the vast majority of the nation's 3.5 million passenger car fleet[23] rely on fossil fuels to function will not be lost on anyone.

As we have noted in the past[24], exclusions can be difficult to implement effectively and often introduce contradictions within the portfolios opening investors up criticisms of 'window dressing'. We believe portfolios can be adapted to reduce aggregate carbon emissions from portfolio companies as well as reducing exposure to fossil fuel reserves, without requiring significant exclusions or introducing tracking risk relative to core benchmarks like the MSCI ACWI.

The experience of default members (since Dec 2021)

Many default members suffered weaker returns than non-Default members in 2022 as sectors such as energy and utilities outperformed in 2022.[25] Most would have been better off remaining in the Conservative funds in which they were exited from in late 2021. For reasons detailed earlier it is hard to determine from the benchmark figures below, but we believe the various additional restrictions (relative to non-default KiwiSavers) likely 'cost' default members upwards of 60 basis point in 2022.[26]

The table below shows the performance of the new default KiwiSaver funds relative to their benchmarks, where available. We also show the performance of the average KiwiSaver conservative and balanced funds over 2022 and since the inception of the new structures in December 2021.

[20] The decision not to use transition managers to minimise default member costs moving from the previous default Conservative funds to the new default Balanced funds is another example.

[21] Source: Morningstar Direct. Assumes $9,000 invested at inception with no additional contributions. For illustrative purposes only.

[22] While not necessarily a direct like-for-like, we can assume the Default KiwiSaver restrictions detracted value in 2022. As an example, the MSCI ACWI Select Energy Producers IMI gained 53% in 2022, outperforming its parent index, the MSCI ACWI IMI, but more than 60%. Performance in NZD, past performance is no guarantee of future results.

[23] National Vehicle Fleet status, November 2022. Waka Kotahi (NZ Transport Agency)

[24] Ross & Ouyang, 2018, Negative screening and performance consequences: How much is too much?

[25] Source: MSCI, global sector performance in 2022. Past performance is no guarantee of future results.

[26] We compared the average performance of Default Balanced Funds to the average performance of other Balanced Funds. For illustrative purposes only.

Exhibit 6

Default KiwiSaver returns ranked best to worst since inception (% annualised return)

FUND	AUM ($M)	FEE	GROWTH / INCOME	FUND (1 YR)	BENCHMARK (1 YR)	FUND (S.I.)	BENCHMARK (S.I.)
SuperLife KiwiSaver Default	$389.4	0.20	54/46	-10.59	-11.04	-7.75	-
Westpac KiwiSaver Default Balanced	$554.2	0.40	50/50	-10.82	-10.40	-8.21	-
Booster KiwiSaver Default Saver	$395.9	0.35	55/45	-12.09	-11.25	-9.42	-
BNZ KiwiSaver Default	$464.3	0.35	60/40	-12.73	-11.55	-10.34	-
Kiwi Wealth KiwiSaver Scheme Default	$495.9	0.37	60/40	-14.04	-13.59	-11.21	-
Simplicity KiwiSaver Default	$371.1	0.30	59/61	-13.74	-13.94	-12.57	-

MEDIANS / AVERAGES	FUND (1 YR)	BENCHMARK (1 YR)	FUND (S.I.)	
Default (Median)	-12.41	-11.40	-9.88	-
Default (Average)	-12.34	-11.96	-9.92	-
KiwiSaver Balanced (Median)	-11.93		-9.47	-
KiwiSaver Balance (Average)	-11.67		-9.25	-
KiwiSaver Conservative (Median)	-8.32		-6.85	-
KiwiSaver Conservative (Average)	-7.62		-6.33	-

The source for KiwiSaver risk profile medians and averages is Morningstar Direct. The medians and averages above include all Balanced or Conservative KiwiSavers in the NZ Insurance Multi Sector Balanced and Conservative universes. There were 31 and 21 peer funds respectively. The 'Since Inception (S.I.)' period is from 1 December 2021 to 31 December 2022. Returns presented net of fees, gross of tax. Past performance is no guarantee of future results. For illustrative purposes only.

The table above, if not opening the government up to lawsuits from disgruntled members having been allocated to the *wrong* default KiwiSaver, surely highlights some of some of the shortcomings of the current approach.

The wide variation between the best and worst performing default managers, combined with the difference between the average conservative and balanced KiwiSavers, suggests that default member interests have not (yet) been well-served by the decisions made on their behalf.

A better approach for the Default KiwiSaver, would be for an asset mix to be defined (i.e. based on the KiwiSaver Balanced Benchmark), with an appropriate strategy also defined, (i.e. low-cost passive management, 50% hedging of global equities etc.). Should the government desire minor portfolio restrictions or carbon-emission targeting (as examples), these could be incorporated too, but the funds could still benchmarked to the standard KiwiSaver Balanced Benchmark. All firms with the appropriate minimum credentials (i.e. financial resources, investment capabilities, risk management, compliance, client service, tax efficient products etc.) and willing to manage the assets at the lowest fee of all those applicants (identified during the bidding process) that applied could be awarded Default KiwiSaver assets.

This would be fair to both default KiwiSaver members and to the local fund management community. And, most importantly, it would ensure default KiwiSaver member equity as individual returns would not be determined by the randomness that we see today – the outcomes for one default member would be virtually the same as the outcomes for all of the other default members.

FIVE SIMPLE STEPS TO A BETTER, FAIRER DEFAULT KIWISAVER:

1. **Base default KiwiSavers mandates on broad market, straightforward portfolios with as few 'active' decisions as practically possible.** Recognising that government departments are making investment decisions for hundreds of thousands of Kiwis, ensure that portfolios are broad-based and largely passive (to reflect 'the market' and keep costs low). Resist the temptation to use default KiwiSaver assets to signal priorities, further political aims or other agendas, i.e. local capital markets development, infrastructure investment and action on climate change, recognising that default members are free to transfer to funds that offer differentiated strategies should they choose. Keep the asset allocation and strategy as simple and low-cost as possible. The KiwiSaver Balanced Benchmark proposed here would be a good place to start.

2. **Ensure fees are the same across all default managers and are set during the tender process (at the lowest price proposed by the successful firms).** All default members should pay the same fees. The current situation where one member may pay double the fees of another is untenable for a programme that *should* promote fairness above all else. It could be determined by the level of the lowest fee proposed during the tender process. There would need to be the proviso that fees are high enough so as to be sustainable, i.e. to permit the delivery of the portfolio management services as mandated as well as conducting member engagement and other client servicing requirements.

3. **Award all fund managers with the capabilities (and desire) to deliver the mandate default KiwiSaver status.** If fees are the same and all assets are managed by well-resourced, professional firms (passively tracking the benchmarks and adopting the same asset allocations), results between default KiwiSaver schemes should be near enough the same over the long-term, ensuring member equity and fairness. Allowing all qualifying fund managers to participate would be fair to the industry too.

4. **Ensure default KiwiSaver funds are as tax efficient as possible for the majority of members.** The current practice of investing in exchange traded funds or offshore unit trust vehicles means that net of tax member returns may be negatively impacted. Require that default KiwiSaver mandates are managed efficiently from a member tax perspective.

5. **Utilise transition managers to facilitate large scale fund transfers**, i.e. q4 2021. Large scale transitions, such as moving from one default KiwiSaver fund to another, cost money. Selling out of one fund *en masse* and buying into another is likely to be the *least efficient* means of conducting transactions of this nature. All efforts should be made to minimise costs for default members. These include transactions costs, taxes, market impact and time out of the market.

CONCLUSION

KiwiSaver is the sole private sector retirement savings vehicle for millions of Kiwis. For many it is their only exposure to the fund management industry and global investment markets. The programme itself is getting a lot right, with globally diversified portfolios the norm and fees broadly competitive. Member engagement is improving too. With assets approaching $90 billion across dozens of fund managers it is surely a success and a source of real pride for both the government and the fund management industry.

But there remain shortcomings. This paper looked at two – benchmarking practices and elements of the default KiwiSaver programme. Some simple and workable suggestions, based on our experience working with defined contribution retirement plans around the world, offer the prospect of a better KiwiSaver programme for all.

APPENDIX

QUALITIES OF A GOOD BENCHMARK – CFA SOCIETY UNITED KINGDOM

Unambiguous. The identities and weights of securities or factor exposures constituting the benchmark are clearly defined.

Investable. It is possible to forgo active management and simply hold the benchmark. That is, investors can effectively purchase all securities in the benchmark.

Measurable. The benchmarks return is readily calculable on a reasonably frequent basis. A good benchmark will have transparent set of public rules and, therefore, predictability for investment managers.

Appropriate. The benchmark is consistent with the manager's investment style or area of expertise.

Reflective of current investment opinions. The manager has current investment knowledge (be it positive, negative, or neutral) of the securities or factor exposures within the benchmark.

Specified in advance. The benchmark is specified prior to the start of an evaluation period and its calculation methodology is known to all interested parties.

Owned. The investment manager should be aware of the strengths and weaknesses of any benchmark they are asked to replicate or be judged against. It must also accept accountability for a client's portfolio performance against that benchmark, and be ready to explain to the client any variance from the benchmark. Consideration of the benchmark should be embedded in and integral to the investment process and portfolio construction conducted by the investment manager

In essence, a high-quality benchmark or index should be:

1. Free of conflicts of interest

2. Provide independent review/pricing; and

3. Have transparent methodology

…Essentially, a good benchmark that possesses the qualities cited above will be best placed to enable the asset owner/beneficiary to:

- Assess how their portfolio is progressing towards their objectives.

- Provide insight into how performance aligns with risk appetite and tolerance for losses.

- Evaluate the value for money delivered by their asset managers/investment team.

While benchmarks are not always perfect, the closer they are to reflecting the risk appetite, loss tolerance and beliefs of the asset owner, the more meaningful the benchmark will be.

Benchmarks and Indices
Ansumana Bai-Morrow & Sheetal Radia, CFA
Supported by CFA UK's Market Integrity and Professionalism Committee

FOR MORE INFORMATION

Call Russell Investments at +09 357 6633
or visit russellinvestments.co.nz

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