KiwiSaver, Who Is Really Reaping The Benefits?

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New Zealand KiwiSaver fund industry enjoys a near monopoly situation, with no exposure to international competition. Annual fees that KiwiSaver funds charge New Zealanders (which are now close to $350 million p.a.) are far above international standards and not justifiable given their relatively poor performance since inception. We believe that allowing self-managed retirement portfolio investments by employees, expanding the menu of investment choices including low cost international ETFs, and opening the industry to international competition will be beneficial for individual investors and the country as whole.

Keywords: KiwiSaver; Fund Performance; Fund Fees

1. Introduction

The KiwiSaver scheme, predominantly a work-based voluntary pension system, has attracted the attention of private investors, finance professionals and the policy makers in New Zealand. Since the scheme's inception in July 2007, investors have gradually recognised the importance of investing in KiwiSaver and have joined the scheme on mass. At the time of writing this article, November 2014, assets under management of KiwiSaver fund providers exceeded NZ$ 23 billion, with more than 2.2 million investors (Morningstar, 2014).

The main aim of the government, when introducing the KiwiSaver scheme, was to increase the long-term savings of the public and encourage them to provide for better retirement. However, the options given to the investors have been far from optimal. KiwiSaver investors are not allowed to manage their own portfolio but are required to choose among New Zealand-based fund providers which in turn provide the investors with a very limited number of choices. Most fund providers offer four to five categories for KiwiSaver investments. For example, BNZ offers: Cash, Conservative, Moderate, Balanced, Growth Funds[1]. These investment funds, to varying degrees based on their risk exposure, then invest in cash, domestic bonds, international bonds, domestic equity, international equity, and property. We would argue that New Zealanders are essentially forced to invest through local fund providers which based on international standards have been charging far too much. For example, Warren (2014) compares the fees charged for KiwiSaver funds and those of MySuper in Australia and shows that New Zealand fund providers charge up to 30% more in fees on assets under management. As for KiwiSaver fund performance, Frijns and Tourani-Rad (2014) show that none of the equity funds have been able to outperform either the local or international market indices. The government, by limiting New Zealand employees in their choice of KiwiSaver investment opportunities, has created a captive market for these fund providers, and with no international competition, they are enjoying a tremendous windfall.

2. Risk versus Return

The main challenge that an investor faces in choosing among the fund providers and investment types is "***risk versus return***". In a recent study, Frijns and Tourani-Rad (2014) demonstrate that the risk level of funds offered by different KiwiSaver providers, despite being marketed in the same category like balanced or growth, are misleading. For example, a fund like Smart Growth had almost twice the level of risk (standard deviation of past returns) than that of the Westpac Growth fund. Similarly, some Balanced funds end up having higher levels of risk than some Growth funds. This different level of risk exposure by funds indicates that in the long-run investors in such funds could end up with significant differences in the values of their final portfolio endowment. To give the reader an idea of the impact of risk, please refer to Table 1.

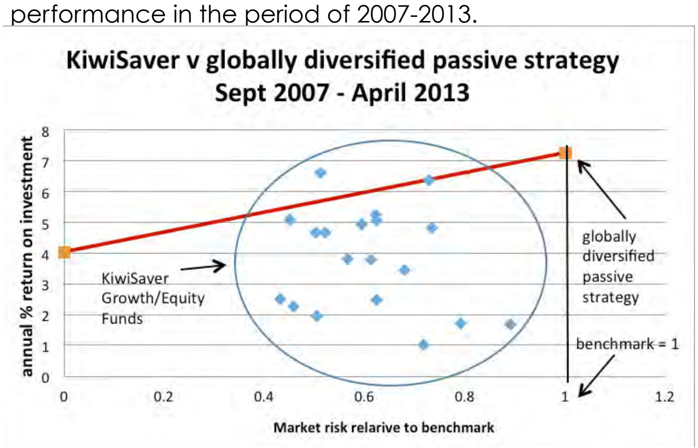
Table 1. The Impact of Risk Exposure on Final Endowment

Assumptions	
Inflation: 2%	Bond yield: 5%
Contribution: 6%	Market Return: 10.5%
Salary: $50,000	Market risk (stdev.): 20%
Age of 30	Simple linear glide path
Fund 1 (beta = 0.5)	Fund 2 (beta = 0.9)
• Expected: $487,978	• Expected: $587,090
• Lower Bound: $156,459	• Lower Bound: $107,165
• Upper Bound: $3,683,345	• Upper Bound: $31,415,281
• Total Contributions: $155,983	• Total Contributions: $155,983

Note: A simple linear glide path assumes a full allocation to equity funds at the start of the investment and then gradually reallocates money from equity into cash as a person approaches retirement. This is a generally recommended strategy for younger people joining a pension system like KiwiSaver.

As can be seen, the investor has two choices for taking risk (Beta is relative level of risk of a fund compared to the average market, in this case NZX). While in both scenarios the total contribution is the same, $155,983, the expected final endowment should be higher for the riskier alternative. However, the variation in the final endowment is far more extreme for this fund as well. Knowledge about the level of risk and transparency by fund providers regarding the amount of risk they take have important implications for KiwiSaver investors. The observation by Frijns and Tourani-Rad (2014) that KiwiSaver growth/equity funds differ substantially in their degree of risk taking implies that investors should be very cautious when choosing among these funds purely based on the performance of the funds which is usually boasted in the media and some professional magazines. In the long-run, investors in different growth funds could end up with significant differences in the values of their portfolios despite having invested in the same category of equity fund. What is needed from KiwiSaver fund managers is more transparency and disclosure around their risk taking so that investors are well-informed when investing in these funds.

Another aspect that Frijns and Tourani-Rad (2014) investigate among the growth/aggressive funds was their relative and absolute performance. They note, at least among their sample funds in the period 2007-2013, that there was no statistically significant outperformance by any of the funds, given the level of their risk taking, compared to passive strategies investing in the local market (NZX) or a global market (Morgan Stanley international index). We provide a graphical illustration of these findings in the following graph. The blue dots indicate the position of KiwiSaver growth/equity funds based on their risk and return performance in the period of 2007-2013.



The benchmark employed is a globally diversified passive investment strategy which can very easily and inexpensively be replicated by buying an international ETF (see Mazumder, 2014) in this issue for a detailed overview of pros and cons of investing in ETFs versus traditional mutual funds). Unfortunately, in the current KiwiSaver scheme, investor cannot invest in these international ETFs. The blue dots represent the actual KiwiSaver fund returns and market risk combinations. All, bar one, are under the red line. The red line, passive benchmark, represents the possible risk and return combinations that an investor can construct by investing in a risk–free security (NZ government fixed- interest bond) and a globally diversified portfolio (an international ETF). Depending on the risk attitude of investors, they can move up or down this line; for example, those with higher risk-taking attitude would invest more in the international fund and less in the government bond. Blue dots that plot below the red line represent the New Zealand KiwiSaver funds. These funds do worse relative to the globally diversified passive investment strategy, i.e., for the same level of risk taking an investor could obtain a higher return; dots that plot above the line represent funds that do better than the globally diversified passive investment strategy. All in all, with the exception of one single fund even though in this case not statistically significant, all KiwiSaver funds have underperformed compared with a passive international strategy.

3. Fees

The next issue is fees that KiwiSaver providers charge, which eat into net returns. The above findings that none of the funds are able to outperform the local and global benchmarks, implies that investors should be quite concerned about the fees that they are being charged, especially if funds charge these fees for self-proclaimed superior investment skills. For investors to better understand what they are investing in (the degree of risk taking) and what they are paying for (fees), it is vital that they are well-informed.

Let's consider the current amount of KiwiSaver assets under management of these providers, which is about $23.39bn as reported recently by Morningstar (2014). Fees, on average, are 1.17% as per the paper by Warren (2014) in this issue, or 1.12% as per Morningstar. There are about 2.2 million members and assuming a realistic average fixed fees at $34, we observe a total of $348,463,000 fees going to the pockets of the KiwiSaver fund industry this year.

Consider the following examples in Table 2, where we have chosen two typical investors who pay a relatively low and high level of fees over their active working lives to the KiwiSaver fund providers, for an average fund having a beta of 0.6:

Table 2. The Impact of Fees on Final Endowment

Inflation	2.50%			
Contribution	6%			
Risk-free rate	5.00%			
Market Risk Premium	5.50%			
Income	$45,000		$90,000	
beta	0.6		0.6	
Low Fee (0.75%)		Inflation adjusted		
Total Fees (30 years)	$ 29,723.35	$ 17,303.42	$ 58,696.57	$ 34,051.66
Total Fees (40 years)	$ 77,357.38	$ 36,850.19	$ 154,042.72	$ 73,175.02
High Fee (1.5%)				
Total Fees (30 years)	$ 53,127.16	$ 30,987.24	$ 105,723.49	$ 61,548.01
Total Fees (40 years)	$ 133,421.19	$ 63,971.10	$ 266,671.17	$ 127,661.53
Inflation	2.50%			
Contribution	6%			
Risk-free rate	5.00%			
Market Risk Premium	5.50%			
Income	$45,000		$90,000	
beta	0.6 Glidepath		0.6 Glidepath	
Low Fee (0.75%)		Inflation adjusted		
Total Fees (30 years)	$ 25,762.98	$ 15,180.51	$ 50,737.94	$ 29,785.50
Total Fees (40 years)	$ 58,721.34	$ 28,763.08	$ 116,597.76	$ 56,925.57
High Fee (1.5%)				
Total Fees (30 years)	$ 46,149.14	$ 27,236.46	$ 91,700.72	$ 54,010.54
Total Fees (40 years)	$ 102,165.90	$ 50,343.20	$ 203,871.79	$ 100,279.38

A person with an income of $45,000 per year pays in excess of $100,000 and a person with an income of $90,000 pays in excess of $200,000 over an investment period of 40 years. These figures, especially when we consider that their relation to the final endowment of investment being on average somewhere between $450,000 for investor 1 and $950,000 for investor 2, are enormous. Investors pay in excess of 20 percent of their savings to the fund providers in New Zealand. Mazumder (2014) provides an overview of fees charged by investing in ETFs. These are on average about half the lowest fees charged by KiwiSaver funds in New Zealand. The only option for New Zealanders to invest in an ETF is the NZX's Smartshares, having a fees of 0.80% which again is ludicrously high.

4. Conclusions

On the whole, we believe that New Zealanders will benefit from having more access to international passive investment opportunities like ETFs and being allowed to self-manage their future retirement. Currently, investors are being restricted to choose a local fund provider that on average charge them high fees and are providing them with rather sub-standard performance. Finally, while the issue of disclosure, specially fee structure, has recently been taken up and progressing, we argue that here needs to be better disclosure reflecting the true nature of risk and return including investment strategy; risk-adjusted returns; benchmark return and risk measures.

References

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Note

1. There are some options for having tailor-made KiwiSaver schemes but these are very expensive and limited to very wealthy individuals.

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