Submission

By

The New Zealand Private Equity and Venture Capital Association

To the

Ministry of Business, Innovation & Employment

On the

Review of KiwiSaver Default Provider Arrangements Discussion Document

24 December 2012

NZVCA
NEW ZEALAND PRIVATE EQUITY &
VENTURE CAPITAL ASSOCIATION INC

REVIEW OF KIWISAVER DEFAULT PROVIDER ARRANGEMENTS DISCUSSION DOCUMENT
SUBMISSION BY NZVCA

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1. ABOUT THE NZVCA

1.1. The New Zealand Private Equity and Venture Capital Association Incorporated (NZVCA) is a not-for-profit industry body committed to developing a world-best venture capital and private equity environment for the benefit of investors and entrepreneurs in New Zealand. Its core objectives include the promotion of the industry, and the asset class on both a domestic and international basis. NZVCA members cover the whole spectrum of investment in New Zealand private enterprise, including angel investment, seed and early-stage venture capital through to development capital and private equity (including management buyouts and buy-ins).

1.2. Contact details:

1.2.1. The NZVCA would be happy to discuss the issues raised in this paper. To engage further, please contact Colin McKinnon, Executive Director, on 09 302 5218 or email colin.mckinnon@nzvca.co.nz

1.2.2. The NZVCA has received technical advice in preparing this paper from Dr Edward Schuck. Dr Schuck is available for further comment by contact on 021 667 113 or email eschuck@fidatoadvisory.com

2. INTRODUCTION

2.1. NZVCA welcomes the opportunity to comment on the *Review of KiwiSaver Default Provider Arrangements Discussion Document* (referred to as ‘the Document”).

2.2. The KiwiSaver scheme is a good start for a voluntary work-based savings scheme but it has not contributed to the pool of capital that is available to private businesses.

2.3. Some of the design elements of the scheme (including the default funds) restrain intentions for allocation to unlisted assets and consequently limit the retirement benefits that could be produced by the scheme.

2.4. Private equity is regarded internationally as an asset class that is capable of returns which exceed those of comparable listed assets and enhance fund performance for investors.[1]

3. BACKGROUND TO NZVCA'S SUBMISSION

3.1. It has been widely accepted for some time that New Zealand needs vibrant capital markets for economic growth and well being.[2] Investor confidence and financial literacy are cornerstone attributes of healthy financial markets that encourage a propensity for individual savings. Together these lead to growing pools of capital for funding enterprises that employ people and contribute to economic growth.

3.2. One of the reasons for establishing KiwiSaver was the positive effects it would have on New Zealand's capital markets. Other reasons were: (1) to encourage a long-term savings habit amongst individuals; and (2) to provide individuals a mechanism for accumulating savings which they will be able to use in retirement to secure a lifestyle that is superior to that obtainable on NZ Superannuation alone.

3.3. KiwiSaver has been a success in the sense that there are now more people (two million KiwiSaver members) in New Zealand saving for the future and the number of savers continues to rise. Moreover, there is now a substantial and growing pool of retirement savings (over $12.7 billion) on which individuals can draw in their retirement.

3.4. However, KiwiSaver has not had anywhere near as beneficial an effect on New Zealand's broadly-defined capital markets as was expected when it was created, for three main reasons:

3.4.1. The allocation to growth assets (i.e. equities and equity-type investments) across all KiwiSaver schemes (around 40 per cent in aggregate) is lower than befits the demographics of the membership;[3]

3.4.2. Allocations by KiwiSaver funds to 'domestic' equity (14 per cent in aggregate) are invested almost entirely in securities listed on the NZX and ASX.

3.4.3. For savers that prefer low risk investments, KiwiSaver funds are at a disadvantage versus bank deposits influenced by Reserve Bank settings that encourage the retail bank short-term deposit yields to exceed fixed interest securities of comparable term.

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[1] Reference to 'private assets' means investment in private (distinguished from 'listed' or publicly traded) assets; 'private capital' refers to investment in privately-held businesses including early stage (venture capital) and mature companies (private equity).

[2] Capital Market Development Taskforce, 31 July 2009

[3] Morningstar KiwiSaver Performance Survey September Quarter 2012

As a consequence, private equity (including venture capital) in New Zealand has seen negligible inflow of fresh capital as a result of the creation of KiwiSaver.

3.5. Private capital is a source of economic growth and innovation that helps to create jobs and employ Kiwis across the country. Private capital is also a source of income for its investors.

3.6. The private equity industry:

3.6.1. Includes more than 50 Australasian based private equity firms and 3,400 worldwide; and

3.6.2. Invested over $4.3 billion in seven hundred New Zealand companies over the last 10 years.[4]

3.7. Australasian private equity has consistently outperformed comparable public markets by 4-9% over 5-10 year periods.[5] In New Zealand, for the period 1994 to 2012, $1.36 billion invested in New Zealand based firms returned $2.85 billion for investors, a 2.1 times cash multiple return that is comparable to the Australian mid-market experience.[6]

3.8. In NZVCA's view, several factors have contributed to the very low level of investment in private assets by KiwiSaver schemes, namely:

3.8.1. Retail investors in recent years have exhibited a relatively high sensitivity to risk as a result of the GFC, the finance company collapse and the European sovereign debt crisis. This has led investors to favour low-risk investments.

3.8.2. The RBNZ's BS13 Policy has led to a distortion in the traditional relationships between bank deposits and fixed interest securities in terms of their risk and return characteristics. For shorter maturities, bank deposits now offer yields-to-maturity that are well in excess of those of corporate bonds of comparable term and greater credit risk.

3.8.3. The KiwiSaver regulations require providers to effect member switches, on which there are no limits, within 35 days. This causes the managers of KiwiSaver schemes to avoid less liquid assets.

3.8.4. Private equity and venture capital are asset classes that are not widely understood by the general public, hence there is no explicit demand from KiwiSaver members for their funds to allocate to these asset classes.

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[4] New Zealand Private Equity and Venture Capital Monitor 2011
[5] The Cambridge Associates LLC Australian Private Equity and Venture Capital Index
[6] New Zealand Private Equity Returns 1994 – 2012, New Zealand Venture Investment Fund, November 2012

3.8.5. Because KiwiSaver funds have necessarily lacked performance histories, existing and prospective members have tended to focus on the fees and expenses of schemes as the basis for their purchase decisions.

3.8.6. Asset classes such as private equity, real estate and infrastructure are disadvantaged by the draft KiwiSaver Periodic Disclosure Regulations which require that all "fees of underlying managers" be included in the calculation of total expense ratios (TER). This is inappropriate for two reasons:

a) The fees charged by managers of private asset funds are compensation for both investment management and strategic/tactical services. The intention of the draft Regulations is that *only* investment fees (and not both) should be included in TER calculations; and

b) The fees charged by managers of *listed* funds that invest in private equity, real estate or infrastructure would not be captured in TER calculations under the proposed regulations. As such, the treatment of fees charged by managers of unlisted funds is inconsistent, thereby placing unlisted funds at a disadvantage.

3.8.7. The 'reasonable fee' test contained in clause 2, Schedule 1 of the KiwiSaver Act 2006 inappropriately applies to all KiwiSaver funds, not the default funds alone. Because this test imposes an unnecessary layer of compliance and Government scrutiny on the fees charged by non-default funds, it biases the managers of such funds away from asset classes that are relatively expensive to manage but may offer better net returns.

3.8.8. The mechanism in place for dealing with accounts opened by members who do not express a preference for a scheme, i.e. 'default members', has led to a large number of members being randomly assigned over the years to default funds with quite conservative investment strategies.

3.8.9. The lack of a formal mechanism for assisting default members to make an informed choice appears to have caused many default members to loiter in conservative funds to which they were randomly assigned and which are seemingly inappropriate to their circumstances.

3.8.10. The First Home Withdrawal provisions add further complications for fund allocation strategies. The unpredictability of withdrawals creates an additional bias against allocation to illiquid assets. The option to withdraw funds after being in the scheme for a minimum of three years frustrates a long term investment approach, and therefore complicates moves towards the introduction of a life cycle strategy.

3.9. The KiwiSaver scheme is a well–intended balancing of choices for the Government. The fund allocation bias to liquid assets is an unintended consequence of some aspects of the KiwiSaver scheme design, namely mobility and fees reporting. NZVCA’s concern is to improve the current scheme for the future benefit of KiwiSaver members.

3.10. We acknowledge the work of Inland Revenue in compiling information for public use (which includes the KiwiSaver evaluation annual reports), as well as MBIE for including much of this information in the Document (especially statistics involving default members) so that recommendations are, where possible, based on current evidence.

4. SUMMARY OF NZVCA'S RECOMMENDATIONS

Critical to Expansion of Private Capital Markets

4.1. The 35 day maximum permitted transfer period imposed by clause 56 (4) of the KiwiSaver Act 2006 should be amended so that it applies to default funds only. Managers of non-default schemes should have freedom to set the notice or redemption periods of their funds on a case-by-case basis.

This will facilitate investment in private assets by enabling fund managers to set notice or redemption periods that are consistent with the investment horizons of the assets in which the funds invest.

4.2. The draft KiwiSaver Periodic Disclosure Regulations should be amended to provide for the fees charged by managers of unlisted private asset funds (in which KiwiSaver funds may invest) to be excluded from the calculation of TERs. Alternatively, KiwiSaver scheme providers should be permitted to apportion these fees into their investment management and strategic/tactical services components, with only the former being included in TERs.

This will put unlisted private asset funds on an equal footing with listed funds and acknowledge the significant proportion of total fees that are associated with strategic/tactical services (and therefore should be excluded from TER calculations).

4.3. Clause 53 of the KiwiSaver Act 2006 should be amended so that a person may be a member of multiple schemes, rather than being restricted to one scheme.

Permitting membership of multiple schemes is the next step in the evolution of member choice. This change will also enable persons to be members of multiple funds with differing liquidity characteristics, e.g. Provider X's Balanced Fund, Provider Y's Property Fund and Provider Z's NZ Private Equity Fund. This is the choice that members of many superannuation master trusts have enjoyed for years.

Supportive of the Expansion of Private Capital Markets

4.4. When setting policy around the investment strategies to be pursued by default funds, Government should be indifferent to the potential for the members of such funds to avail themselves of the First Home Withdrawal facility.

Experience suggests that the number of persons who will actually take advantage of this facility will be small as a proportion of the total KiwiSaver member base.

4.5. NZVCA believes that default funds should not be short-term 'parking places', but retirement savings vehicles to which default members are assigned based on the information available, i.e. the number of years until they reach the age of entitlement for NZ Superannuation.

It is better for default members who have not made an active choice to be assigned to a fund based on their years to retirement, rather than being randomly assigned on the basis of no investor-specific information at all.

4.6. However, the default arrangements should be enhanced by the addition of a mechanism that leads toward default members making active choices within a short period of enrolling in KiwiSaver.

4.7. The mechanism should be extended to engage the 447,000 members of current default funds with the objectives of (1) ascertaining which members have not made an active choice, and (2) providing those members with the tools and/or advice they need to make an active choice. Those that choose not to avail themselves of the support to make an active choice should be migrated by their provider to an appropriate life-cycle fund.

4.8. Default funds should pursue life-cycle approaches to varying the asset allocations of KiwiSaver members over time. Capital markets research clearly demonstrates that members with suitably long investment horizons should invest their savings to take advantage of the return premiums associated with equity and illiquid assets.

5. NZVCA'S COMMENTS ON SPECIFIC QUESTIONS

5.1. Question 7

When considering the choice between life-cycle and target date solutions, it is important to bear in mind that the glide-paths in life-cycle strategies are implemented using administration systems to move investors from higher to lower risk funds, whereas in target date strategies they are implemented within a fund by progressively reducing its allocation to growth assets.

As such, moving the default funds to life-cycle solutions will incur cost in member administration by providers, whereas moving to target date solutions will require the creation of many more funds, with the ultimate number depending on the frequency of target dates that any given provider wishes to offer.

Taking a longer term view, investment in member administration is a superior pathway, as it could feasibly permit members to choose any target date they wish, and enhanced administration will facilitate the eventual adoption of self-managed KiwiSaver funds.

5.2. Question 13

Life-cycle based investment strategies are the most suitable for default funds, for the following reasons:

5.2.1. Life-cycle strategies follow professionally designed glide-paths that reflect the risk and return characteristics of the assets in the underlying funds. These are superior to the glide-paths followed by individual investors who make decisions on the basis of inferior information and, in some cases, emotion.

5.2.2. History has clearly shown that capital markets can be counted on to reward investors for taking equity risk, and the level of confidence investors can have in the equity risk premium is directly related to the length of the investment horizon. This empirical fact argues in favour of time-varying asset allocation strategies if the objective is to maximise wealth at a given future date.

5.3. Question 18

The analysis of passive versus active management contained in the Document is generally correct as applied to portfolios of listed assets. However, the concepts of active and passive management do not apply to portfolios of private assets.

5.3.1. The term 'active management' is commonly used in public markets to denote an approach to portfolio management that involves allocations to individual securities that differ from their market weights with the aim of outperforming the market on a risk-adjusted basis. In essence, active management is about market timing.

5.3.2. To be successful, an active investor must possess an advantage over other investors in the market. This might take the form of superior information, better forecasting skills (i.e. better use of information) or just plain (consistent) luck.

5.3.3. Passive management involves constructing portfolios so that they track market indices. This is a low cost approach that minimises trading and simply aims to achieve performance consistent with the market.

5.3.4. The concepts of active and passive management do not apply in private capital markets because it is not feasible for investors to invest in such a way as to track the performance of such markets. As private assets are unique, it is not possible for investors to build portfolios that reproduce the composition of market indices. Hence all portfolios differ in composition from their relevant market indices.

5.3.5. We note that investors commonly describe the management of private asset portfolios as ‘active’ because private investments such as companies, properties, infrastructure projects and the like require a high degree of managerial activity. This is an incorrect use of the term. The burden of managing portfolios of private assets is indeed more intensive than in the case of securitised assets because a high proportion of the decisions and activities involved in managing private assets are operational in nature. In other words, private assets require considerable asset management (i.e. strategic involvement) in addition to investment management (i.e. the timing and weighting of investments). In a financial economic sense, the terms ‘active’ and ‘passive’ apply only to investment management.

5.4. Question 20

In the view of NZVCA, MBIE’s rationale with regard to KiwiSaver schemes’ lack of investment in alternative assets is not entirely correct. Specifically:

5.4.1. High fees may be cited as a reason for not investing, but they should not be a hindrance because they are fair compensation to managers for the value they add. Moreover, it is not the level of alternative asset management fees that are the hindrance, but the manner in which they must be reported. Please see our earlier comments (refer 3.8.6 and 3.8.7) on total expense ratios and the complexity of the services provided by managers of alternative asset portfolios.

5.4.2. The term “high risk” applies to very few alternative investments. Well-diversified portfolios of assets such as property, private equity and infrastructure have arguably lower risk than listed equities.

5.4.3. Alternative assets do not lack performance track records. On the contrary, the body of knowledge relating to the performance of assets such as property, private equity and infrastructure is substantial. The performance of private equity in New Zealand has been excellent, as evidenced by recent data prepared by the New Zealand Venture Investment Fund.[7] While some individual managers may lack continuous track records because they have been in business for a relatively short time, this should not necessarily be a barrier to fund managers utilising their services.

5.4.4. The issue of the "relative illiquidity" of alternative investments has already been discussed at length. In the view of NZVCA, it is not the relative illiquidity of alternatives which is the problem; it is the design of KiwiSaver which constrains providers' ability to allocate to such investments and gain the return premiums that they generate.

5.4.5. In the view of NZVCA, several KiwiSaver funds have already reached more than sufficient scale to contemplate material investment in alternatives.

5.4.6. The allocation to alternatives should, of course, vary with investors' objectives, investment horizon and sensitivity to risks; hence there is no 'usual' allocation to alternatives. Large university endowment funds are regarded as leaders in the management of long-term portfolios and the 2011 NACUBO-Commonfund Study of Endowments[8] shows that institutions with assets in excess of US$1 billion have an average allocation to private equity of 22%. This level of allocation is theoretically optimal for retirement savers in the early stages of their life-cycle glide-path.

5.4.7. The optimal allocation for long-term portfolios in New Zealand is clearly more than the current extremely low level. NZVCA views some of the design elements of KiwiSaver as contributing barriers (see recommendations above).

5.4.8. Outside of KiwiSaver, the main barrier to investing in alternatives faced by retail managed funds is the relative illiquidity of investments. However, this is simply due to the fact that the public expects retail managed funds (which are not retirement schemes) to have redemption periods measured in days. This expectation has led fund managers to promise liquidity even when it cannot be delivered, creating issues such as frozen funds that have tarnished the retail funds industry.

[7] New Zealand Private Equity Returns 1994 – 2012, New Zealand Venture Investment Fund, November 2012

[8] 2011 NACUBO-Commonfund Study of Endowments, January 2012

5.5. Question 21

NZVCA's suggestions for making alternative assets more attractive for KiwiSaver investment are provided above. (Please see Section 4: Summary of NZVCA Recommendations.) To reiterate our key recommendations:

5.5.1. Remove the 35 day limit on scheme transfers;

5.5.2. Exclude from the calculation of TERs some or all of the management fees for unlisted private assets; and

5.5.3. Permit members to invest in multiple KiwiSaver schemes.

5.6. Question 32

NZVCA's comments on the process of transitioning existing members of default funds to life-cycle strategies are:

5.6.1. A mechanism should be designed that leads toward default members making active choices within a short period of enrolling in KiwiSaver.

5.6.2. The mechanism should be extended to engage the 447,000 members of current default funds with the objectives of (1) ascertaining which members have not made an active choice, and (2) providing those members with the tools and/or advice they need to make an active choice. Those that choose not to avail themselves of the support to make an active choice should migrate with their provider to an appropriate life-cycle fund.

5.6.3. The transition process should allow current members a period of two months to obtain advice and respond. The first port of call for advice would be the member's provider or an Authorised Financial Adviser that appears on a list of approved providers maintained by the Government.

5.6.4. Members who do not respond within the permitted period would be transferred to an appropriate life-cycle strategy, as above.

5.6.5. All new members of KiwiSaver that enrol in future should be assigned to the new default life-cycle strategies, as above.