

How to improve our KiwiSaver smarts

Three changes would help people make meaningful decisions on the scheme, writes **RICHARD JAMES**

KIWISAVERS have been thrust into the financial world of investment and are being bombarded with return data by fund managers, researchers and the media. But if KiwiSaver investors are to make good investing decisions, they need financial education and meaningful performance information.

Traditional financial theory assumes all investors are rational. It assumes individuals make decisions taking all information into account and dispassionately process that information in order to maximise their wealth.

In practice this theory fails miserably. Individuals and even professionals are subject to all kinds of emotional forces and biases when making investing decisions. As economist and investor Benjamin Graham once said, "The investor's chief problem — and even his worst enemy — is likely to be himself."

Through KiwiSaver, New Zealanders are developing their first meaningful pool of individually owned and directed retirement capital. KiwiSaver stands at more than \$7.5 billion in assets and is growing at a rate of \$3 billion or so a year. Over the next decade, KiwiSaver will become the largest financial asset for most households in New Zealand.

Our concern is not just that KiwiSaver investors will repeat the same behavioural tendencies that have contributed to the disappointing long-run investment outcomes achieved by most individual investors, but that the KiwiSaver industry, with the financial media, fund researchers, and even regulators, will tend to magnify rather than mitigate these tendencies.

At the heart of the problem lies a lack of appreciation of the difference between return and performance. Return measures the outcome achieved by an investment over a specific period of time. Performance takes into account not just return but also the risk taken to achieve that return.

To illustrate the forces at play let's look at some calendar year return figures for two semi-fictional KiwiSaver growth funds in the first table on the right.

Manager A is crowing that they are up over 30 per cent over the past two years.

By contrast, Manager B is struggling to justify why they have produced a comparatively insipid 10 per cent total return over the same period. The financial media and research houses add accelerant to the fire by promoting Manager A as the "top performing" KiwiSaver manager and publish interviews attempting to unveil the secrets behind his or her genius. Manager B is reported as "bottom of the pack".



HIGHS AND LOWS: Volatile returns can be stressful for KiwiSaver investors. Picture / AP

But if we think about performance rather than just reported returns we develop a very different picture of the merits of the two managers.

If we look back further on the second table, we can see Manager A has lost 13 per cent of their original investor's capital (assuming a January 1, 2008 inception date) as a result of being heavily exposed to sharemarkets during the financial crisis (the same driver of their recent outsize returns). In contrast, Manager B has eked out a small but positive return over the same period.

The journey taken by investors with Manager A and Manager B has been starkly different. Manager A's clients have been through the depths of despair, having seen their retirement capital initially decimated. Manager B's clients will have been mildly disappointed but comparatively calm throughout the last three years. In a relative sense at least, Manager B's performance has made it considerably easier for their investors to remain disciplined.

Unfortunately, many of Manager A's investors will have fled after the initial precipitous decline and will not have enjoyed the strong subsequent recovery. They may well have fled to Manager B (whose returns looked pretty good at the end of 2008). If they did, they will today be down around 26 per cent on their original capital invested.

It is critical to remember that if your investment falls 33 per cent, then you require a 50 per cent gain to arrive back where you started. If your investment falls by 7 per cent, you require only an 8 per cent recovery to get back to square one.

Moreover, behavioural finance tells us investors feel the despair of losses much more acutely than they feel the joy of gains.

TWO GROWTH FUNDS

	2010	2009
Manager A	10%	19%
Manager B	2%	8%

A WIDER LOOK

	2010	2009	2008	Total return
Manager A	10%	19%	-33%	-13%
Manager B	2%	8%	-7%	2%

HERALD GRAPHIC

Both financially and emotionally, downside risk, or the extent to which our investment declines while we are invested, matters and influences our buy and sell decisions.

KiwiSaver is a self-directed retirement scheme. While there are default options, it has been built on the assumption individuals will make reasoned investment decisions. To improve the probability of that assumption holding true, we advocate three critical initiatives for the industry:

1. A legally prescribed way to report performance. KiwiSaver providers, reporters and researchers should be legally obliged to report returns using the same calculation method and the same time periods — always including since inception of the fund — rather than using whichever period suits best. It should also be required that a commonsense measure of risk (for example, maximum decline since inception) is reported.

2. Make automatic rebalancing the default option for all schemes. The present default fund framework is dumb. It will deliver cash-like returns in the long run and will periodically encourage default investors to chase returns, particularly after

periods where the default returns look weak compared to the higher-risk higher growth options. For someone in their late 50s or early 60s, that could turn out to be financially debilitating.

Having all of your retirement savings in cash is a time-proven formula for turning \$1 saved today into 50c of future spending. Retirement savings should focus on the opposite — turning 50 cents of savings today into a \$1 of future spending.

For individuals whose primary financial decision was to join KiwiSaver — rather than what fund or mix of assets to hold — their default option should be a scheme which automatically makes long-run wealth maximising decisions on their behalf.

The most effective way to do this is to match the age of the investor to an appropriate mix of assets. For example, a 20-year-old with 80 per cent growth and 20 per cent income, a 50-year-old with 50 per cent growth and 50 per cent income.

3. Make financial advice a workplace responsibility. Given that KiwiSaver is a workplace savings scheme, it follows that assisting individuals to make these decisions intelligently should be a workplace responsibility.

We believe these three steps would progressively alter the investment behaviour of the nation.

We may have been slow in enabling individual retirement planning, but a benefit of being late to the party is that we have the opportunity to learn from the global experiences and do things smarter, sooner. With a little rationality and an intelligently applied regulatory hand, the impacts of a successful retirement savings programme can be far reaching.

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