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Responsible investment: the new standard in KiwiSaver?

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Two years ago, RPRC Associate Dr Matheson Russell wrote in *PensionCommentary* 2015-3: "The 'default' investment options offered by KiwiSaver schemes do not include 'socially responsible investments'." This *PensionCommentary* revisits Russell's arguments for socially responsible options, and reports on the remarkable transformation of KiwiSaver schemes since then.

1. Background

As of March 2015, KiwiSaver funds represented around $27 billion of assets under management, but the requirements for the 'default' investment options offered by KiwiSaver schemes did not include 'socially responsible investments'. In *PensionCommentary 2015-3*, *Making responsible investment the new standard in KiwiSaver*, Matheson Russell suggested that, having sustainable and responsible investment as the norm in KiwiSaver schemes would make sense given "the KiwiSaver system is intended to ensure a prosperous future for New Zealand workers for many decades to come".[3] He concluded that requiring the default funds of the nine default schemes to incorporate principles of socially responsible investment (SRI) "would be a lighthanded and constructive means for promoting this worthy goal".[4]

Based on the 2014 Assessment Report from The Intergovernmental Panel on Climate Change (IPCC),[5] and other research, Russell questioned the wisdom of investing in further exploration for coal, oil and gas.[6] In addition to contributors to climate change, responsible investment has traditionally excluded from investment portfolios, unethical businesses such as tobacco, armaments, gambling, and pornography. In recent years, a more holistic approach aims to incorporate an assessment of environmental, social and governance (ESG) factors into the responsible investor's decision-making process. The underlying belief is that more sustainable companies are more likely to be a better long-term bet for investors. By 2015, signatories to the Principles for Responsible Investment (PRI) initiative, launched in 2006 and supported by the United Nations, had combined assets of more than US $45 trillion under management.[7]

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[2] An RPRC *PensionCommentary* is an opinion piece designed to provoke discussion on an issue of public significance. The views expressed in this commentary are the author's, not necessarily those of the RPR.
[3] Russell, M., 2015, RPRC PC 2015-3, p. 10.
[4] Ibid.
[5] IPCC, 2014: *Climate Change 2014: Synthesis Report*. Summary For Policymakers, p. 20.
[6] See, for example, C McGlade & P Ekins, "The geographical distribution of fossil fuels unused when limiting global warming to 2 °C" *Nature* 517,187–190 (08 January 2015) doi:10.1038/nature14016.
[7] See the UN's PRI website.

In New Zealand in 2015, the New Zealand Superannuation Fund (NZSF), a global leader in responsible investment among sovereign wealth funds, is a founding signatory to the PRI. NZSF Chief Investment Officer states:

We believe that environmental, social and governance (ESG) factors are material to long term returns. Our governing legislation also requires us to avoid prejudice to New Zealand's reputation in the world community. ESG considerations are therefore integrated into all aspects of the Fund's investment activities, from investment selection and due diligence to ownership activities such as monitoring our external investment managers, exercising our voting rights and engaging with companies to improve their ESG policies and practices.[8]

In 2015 Responsible Investment Association Australasia (RIAA) reported that the responsible investment market in Australia and New Zealand accounted for around 17.7% of total assets under management, with investment under the PRI framework representing 15.7% of the total, and traditional 'ethical' investment making up the remaining 2.2%.[9]

The KiwiSaver market was clearly lagging far behind the NZSF with regard to offering responsible investment options to their clients; none of the KiwiSaver providers were a signatory to the PRI,[10] and only a few investment options, representing a mere 0.25% of the total assets under management in KiwiSaver, were described as 'ethical,' 'sustainable', 'responsible,' or 'socially responsible'.[11]

2. Challenges and benefits of socially responsible investing (SRI)

Difficulties and challenges with SRI listed by Russell include the requirement for costly and time-consuming 'active' investment strategy rather than a 'passive' (market-tracking) investment strategy. Second, any up-scaling of SRI in New Zealand would require up-skilling of the fund managers. Third, research tools for assessing ESG performance available through MSCI and other high-profile analytics companies are still relatively underdeveloped, so fund managers frequently have to undertake their own research and make assessments based on incomplete information.

Russell provides a number of arguments in favour of responsible investment as a more prominent feature of the KiwiSaver landscape:

- First is that responsible investment helps to promote better performance on environmental, social and governance criteria by publicly listed companies.[12] Since the finance sector is a key driver of economic activity, financial reforms could play a positive role in this transformation.

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[8] See https://www.nzsuperfund.co.nz/how-we-invest/responsible-investment.

[9] Figures based on the 2014 report published by the Responsible Investment Association Australasia: *Responsible Investment Benchmark Report*, here.

[10] AMP Capital is a PRI signatory, and launched the AMP KiwiSaver scheme in 2016. Some AMP Capital products were resold by Mercer Super Trust and under the AXA banner.

[11] The Funds included in this calculation: (i) Superlife Ethica, (ii) Grosvenor SRI Balanced Fund, (iii) Grosvenor SRI Growth Fund, (iv) Mercer Super Trust's AMP Capital Responsible Investment Leaders Balanced Fund, (v) Craigs Investment Partners Balanced SRI Fund, (vi) OneAnswer Sustainable Growth Fund, (vii) Amanah Growth Fund, (viii) Koinonia's Income, Balanced, and Growth Funds. It is possible that other funds not labelled as 'ethical' or 'responsible' also employ negative screens on so-called 'sin stocks' or employ responsible investment strategies such as ESG selection weighting. The Kiwi Wealth KiwiSaver Scheme, for instance, includes some selective negative screening, according to its Responsible Investment Policy. These are not included in the calculation Russell provides.

[12] For an overview of the major threats to the biosphere posed by modern economic activity, see the research undertaken by the Stockholm Resilience Centre: http://www.stockholmresilience.org/.

- Second, from a public policy perspective, any legislatively mandated retirement savings programme should not facilitate large new flows of capital into socially and environmentally harmful activities.
- Third, in 2015 there were no reliable data on consumer preferences for responsible investment in New Zealand,[13] but in a then recent survey of over 1,000 Australians, 54% stated a preference for investing in a responsible super fund rather than one which only considers maximizing financial returns.[14] Russell assumes "Kiwi attitudes are *broadly* comparable to Australian attitudes" and infers a similar Kiwi preference for investing in a responsible KiwiSaver fund.[15]
- Fourth: "Greater uptake of responsible investment frameworks by KiwiSaver providers would enable these institutions to better discharge their social responsibilities, to mitigate their complicity in the most destructive aspects of the capitalist economy, and to re-establish social trust."[16]
- And the fifth argument is the available evidence of the success of a responsible, sustainable, ethical approach to investing: available data indicate that managed funds using ESG criteria can perform as well as comparable mainstream funds, and in some cases the regularly outperform them.[17]

3. Low uptake of the SRI options in KiwiSaver

Some SRI options were currently available as KiwiSaver fund options, but they are not popular. One explanation for the low uptake of SRI among KiwiSavers is that investors give precedence to financial returns. SRI advocates argue that the public is largely unaware that SRI options are available in the KiwiSaver market, and athat that there are few high quality and attractive SRI options.

Russell argues that another factor that plays a decisive role in perpetuating the weak position of SRI in the market is known by behavioural economists as 'the default effect'.[18] Johnson and Goldstein, 2003,[19] explained that the way a default option is set has a dramatic impact on consent rates. In one example, European citizens have the choice of whether or not to be registered as an organ donor. In the opt-in countries, citizens have to register as organ donors, and the organ donor rates are low, for example, 27.5% in the Netherlands. In 'opt-out' countries where the default is to be an organ donor, the vast majority of people stay in, for example, in Austria, France, Hungary, Poland and Portugal, 99.5% or more people are registered as organ donors.

The KiwiSaver system, Russell argues, "creates a strong default effect that stacks the deck against SRI".[20] KiwiSaver members, automatically enrolled when they start a job, may know they are free to opt out, but they also know this involves taking active steps within a specified timeframe. Once automatically enrolled, members are placed "*either* in the

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[13] The Sustainable Business Network survey in 2014 showed very strong consumer preference for responsible KiwiSaver products among survey respondents, but the survey had a skewed sample group (namely, the mailing list of the SBN) and so has limited validity. Source here.

[14] "Responsible super fund" here refers to a super fund that "considers the environmental, social and governance issues of the companies it invests in AND maximises financial returns." The national poll was conducted online by Lonergan Research among 1,026 Australians aged 18 years or older, between the 5th and 7th November 2013 on behalf of the Responsible Investment Association Australasia. Source here.

[15] Russell, M., 2015, RPRC PC 2015-3, p. 4.

[16] Ibid.

[17] Thus far no detailed analysis has been carried out in the New Zealand context.

[18] Russell, M., 2015, RPRC PC 2015-3, p. 4.

[19] E. J. Johnson, D. Goldstein, 2003, "Do Defaults Save Lives?", *Science;* 302(5649): 1338-39.

[20] Russell, M., 2015, RPRC PC 2015-3, p. 6.

default fund of one of the government-selected default schemes *or* in the default investment option of a KiwiSaver scheme chosen by their employer".[21]

Russell suggests that automatic enrolment combined with inaction by KiwiSaver members means that about 24% of the KiwiSaver capital pool starts out in the conservative default funds of the government-selected default schemes. Because none of these default schemes is a signatory to the UN's PRI, or even claims to be an SRI fund, inertia creates a 'default effect' in the KiwiSaver system favouring non-SRI funds. Russell argues further that another effect of the non-SRI government-selected default schemes could create the impression that SRI funds are an unwise and idiosyncratic investment choice.[22] He writes: "The default effect in KiwiSaver thus positively disadvantages SRI at a time when, for the reasons discussed earlier, SRI arguably ought to be promoted in the KiwiSaver market."[23]

To rectify this low penetration of SRI in the KiwiSaver market, Russell suggests encouraging KiwiSaver providers to offer more and better SRI options; promoting its virtues among KiwiSaver providers in the hope that they will adopt SRI frameworks across the board; launching a public education campaign in an effort to mobilize latent consumer demand and convert it into uptake of existing SRI options; and legislating that some or all of the default KiwiSaver funds of the default schemes be SRI funds as defined by a set of specified criteria. Applying such rules to the default providers and/or default funds would not constrain or reduce consumer choice as other non-SRI options would remain available to KiwiSavers.

In addition to nudging consumer preference toward SRI investment options, Russell's modest proposal requiring introduction of SRI to the default provider options could encourage more 'responsible' behaviour by listed companies; reduce investments into "socially and environmentally harmful activities"; better align KiwiSaver investments with "consumer preferences"; and possibly improve investment returns.

4. An alternative view

In *PensionCommentary 2015-4*, responding to Russell's arguments in favour of requiring SRI for the default funds of default schemes, Michael Littlewood suggests that 'socially responsible investing' is constrained by the current restriction that no more than 25% of the default investment option of the default schemes can be invested in shares and property; SRI is not a robust concept; and that all KiwiSaver schemes, including the default schemes, should be allowed to set their own default investment strategy.

Littlewood calculates that the maximum possible amount of money that might be affected by an SRI requirement would be 4.5% of KiwiSaver's total assets: $963 million at 31 March 2014, and only a small proportion of those assets might be invested in assets outside the SRI principles. Thus, he suggests, SRI is a comparatively insignificant KiwiSaver regulatory issue."[24]

Then Littlewood argues that, with SRI, definitional issues arise at many levels. For example, although a tobacco company's product can only do harm, avoiding the purchase of shares in that company does not address issues such as investing in shares in a company that owns some shares in a tobacco company; or in a collective investment vehicle that has a tobacco company as one of its holdings; or in a listed supermarket company that sells tobacco to retail customers. "Legislating SRI into the default investment options of the default schemes is more complicated and a lot harder than it looks". There are similar boundary

[21] Ibid.
[22] Russell, M., 2015, RPRC PC 2015-3, pp. 6-7.
[23] Ibid.
[24] Littlewood, M. 2015, RPRC PC 2015-4, p. 3.

issues with fossil fuel exploration and development, and other 'unethical' businesses such as armaments, gambling and pornography.[25]

While Littlewood agrees that the default arrangements need reform, he opposes any regulation that would require the default investment options of the default schemes to comply with SRI.[26] He questions the usefulness of the UN's involvement in SRI as the PRI conditions are self-selected and non-binding; and challenges any claims of superior investment returns as evidence is lacking.

5. And then there was change

On 3 August 2014, the Sunday Star Times article: "NZ Super Fund has deadly portfolio",[27] reported that among the NZ Super Fund's $26 billion portfolio is a shareholding in Israel Chemicals, whose subsidiary ICL Performance Products produces a chemical that has been used as a weapon. The NZ Super Fund spokesperson acknowledged that a small number of companies are excluded from the Fund on the basis of their involvement in the manufacture of nuclear explosive devices and/or cluster munitions, but companies involved in the manufacture or supply of other types of armaments are not categorically excluded.

On 11 August 2014, in an Op Ed, Adrian Orr, chief executive of the Guardians of the NZ Super Fund, defined responsible investment for the Guardians as: relying on New Zealand and international law, conventions to which the New Zealand Government is a signatory, significant New Zealand Government policy positions, globally accepted corporate standards, and "taking account of" environmental, social, and governance (ESG) factors.[28]

On 23 August 2015, the Sunday Star Times article, "KiwiSaver, cluster bombs, mines and nukes",[29] reported that three of the nine companies on the NZ Super Fund's exclusion list tagged as being involved in the manufacture and supply of "cluster munitions" and, or "anti-personnel mines", appeared in popular KiwiSaver growth funds as revealed by their latest annual disclosure statements. The firms are US companies General Dynamics, excluded under the "cluster munitions" category, and Northrop Grumman, excluded under the "anti-personnel mines" category, as well as Singapore Technologies Engineering, excluded under both. While Westpac bank stated it was reviewing its KiwiSaver scheme's investments, ANZ and BNZ KiwiSaver growth funds, each with a small holding in one of the excluded companies, defended those investments. "It has however been very profitable to invest in defence stocks" writes reporter Rob Stock.[30]

On 18 August 2016, in "Dirty secrets of your KiwiSaver" the Herald investigation revealed that, of the $32.5 billion invested by KiwiSaver funds, $152 million of those assets were invested in companies involved with cluster bombs, landmines, tobacco and other assets blacklisted by the NZ Super Fund, such as nuclear explosives and human rights infringements. ANZ, the largest KiwiSaver provider managing $8.3b on behalf of 830,000

[25] Ibid, pp. 3-5.
[26] Ibid, p. 7.
[27] Sunday Star Times, 2014, see http://www.stuff.co.nz/business/money/10341818/NZ-Super-Fund-has-deadly-portfolio.
[28] Stuff.co.nz, August 2014, see http://www.stuff.co.nz/business/opinion-analysis/10371276/Investing-as-a-responsible-member-of-the-world-community.
[29] Stuff.co.nz, 23 August 2015, see http://www.stuff.co.nz/business/71324537/kiwisaver-cluster-bombs-mines-and-nukes.
[30] Ibid.

New Zealanders, which was found to have more than $50 million invested in tobacco companies, announced it was reviewing its investment policies.[31]

On 3 September 2016, the Herald published the intention of Westpac, ANZ and ASB to exit weapons investments.[32] That same month, Simplicity, a new, online, not-for-profit KiwiSaver provider was publically launched.[33] Acknowledging that while investors demand investment funds aligned with their personal values, Managing Director Sam Stubbs says it's too early to say they won't be investing in fossil fuel or oil companies, because as well as emissions from tailpipes, plastics and allied businesses are involved.

Simplicity's international investments are managed by Vanguard, a firm managing $5.3 trillion in investments worldwide and one of the most common suppliers of funds to KiwiSaver providers. As well as running an FTSE (London Stock Exchange) Social Index Fund since 2000, Vanguard had been managing investments in companies associated with making cluster bombs and nuclear weapons.[34] On 31 October 2016, "in response to consumer demand", Vanguard launched a new fund for KiwiSaver schemes in a move to offer an ethical or responsible investment option.[35] Although still included in Vanguard's International Shares Fund, the 23 companies excluded by the new ethical investment fund include Philip Morris International, British American Tobacco, Lockhead Martin Corporation, BAE systems and Boeing. The new fund will have increased investments in energy while recognizing that energy and fossil fuels are going to be an ongoing discussion point, specifically around climate change issues.

The RIAA's second stand alone Benchmark Report for New Zealand, published in 2016, found that as at 31 December 2015, responsible investment constituted $78.7 billion in assets under management in New Zealand, having grown by 28% year on year:

The most significant component of responsible investment involves large asset owners and asset managers undertaking an environmental, social and governance integration approach across their entire funds (as opposed to offering stand alone ethical or socially responsible investment (SRI) options). This category – the broad responsible investment – constituted 98% of total responsible investment assets with $77.1 billion.[36]

The report also noted some very strong stories of growth and inflows into the offerings of the eight retail asset managers of KiwiSaver funds with responsible investment products, describing this growth as "reflecting the early stages of a consumer awakening to the option to invest in line with their values"[37]

On 27 December 2016, the headline on the front page of the Herald's Business section read: "KiwiSaver schemes flee weapons funds". The Herald speculates that at least part of the motivation for the estimated transfer of $61 million from unethical to ethical funds under management came from individual KiwiSaver investors voting with their feet. Churn data provided by Inland Revenue revealed that, in the two months following the launch of the Herald series investigating 'dirty' KiwiSaver fund investments, an extra 5,300 people switched schemes.[38] However, the Financial Markets Authority reports that around

[31] NZ Herald, August 2016, see http://insights.nzherald.co.nz/article/kiwisaver-investments.
[32] NZ Herald, September 2016, see http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11703053.
[33] See http://www.canstar.co.nz/kiwisaver/new-player-simplicity-shakes-up-kiwisaver-market/.
[34] See http://www.maryholm.com/heraldholm.php?article=897.
[35] See http://www.canstar.co.nz/kiwisaver/new-kiwisaver-fund-drops-investment-tobacco-weapons/.
[36] Responsible Investment Association Australasia (2016) Responsible Investment Benchmark Report 2016 New Zealand. DOI: http://responsibleinvestment.org/wp-content/uploads/2016/07/RIA413_Benchmark_Report_A4_NZ_v5.pdf, p. 4
[37] Ibid, p. 5.
[38] NZ Herald, December 2016, see http://m.nzherald.co.nz/kiwisaver-which-fund/news/article.cfm?c_id=1503721&objectid=11771569.

170,000 members switch schemes or funds annually,[39] so 'ethical' motivation is a difficult claim to verify.

With the combined total of KiwiSaver funds worth more than $36 billion at the end of January 2017,[40] and the NZ Super Fund totalling $32.7 billion in December 2016,[41] the decisions of KiwiSaver members, KiwiSaver fund managers and the Guardians, will become increasingly important. The *Sorted* web page, 'Ethical KiwiSaver funds',[42] provides some helpful guidelines for investors, and reports that the latest *Sorted* survey of providers found 35 of the 205 publicly available funds screen out a variety of "undesirable" investments, and 38% of KiwiSaver schemes now include an ethical option.

But the issues of ethical investment remain complex, extending beyond the products produced to possible violations of human rights. For example, a report published on the Daily Blog on 25 August 2016 was critical of the NZSF's investment in Israeli banks funding the construction of illegal settlement colonies on Palestinian land. The persistence of the Guardians in this investment is surprising as the settlement have been condemned by both the New Zealand Government and the United Nations.[43] More recently, the Green Party challenged the NZSF and the Government Superannuation Fund over their $7 million investment in Wilmar International, a palm oil company embroiled in allegations of labour abuse on some of its Indonesian plantations.[44] Socially responsible investment extends beyond national borders.

6. Concluding comments

Since its introduction, KiwiSaver has undergone multiple changes, often with little warning, as with the removal of the 'Kickstart' in May 2015 on the same day as the change was announced in the Budget.[45] In addition to the two *PensionCommentaries* referenced here, the RPRC has published a number of working papers,[46] tracking KiwiSaver's transformation, its international relevance as a model for retirement saving, and its increasing importance as an investment vehicle as the various KiwiSaver funds accumulate.

While KiwiSaver is increasingly important to New Zealanders preparing for their retirement; opting for socially responsible investment raises complex questions. In addition, as the Guardians of the NZSF continue to find, complying with the existing legislation and regulation is inadequate to ensure an investment fund is not supporting the production of weapons of mass destruction or their component parts, or other unethical, irresponsible or unsustainable products or projects.

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39 Financial Markets Authority, 2016, KiwiSaver Annual Report 1 July 2015 – 30 June 2016, at https://fma.govt.nz/assets/Reports/161004-FMA-KiwiSaver-Report-2016.pdf.
40 NZ Herald, February 2017, see http://www.nzherald.co.nz/kiwisaver/news/article.cfm?c_id=1501206&objectid=11793443.
41 NZ SuperFund Media Statement 31 January 2017, see https://www.nzsuperfund.co.nz/news-media/nz-super-fund-generates-strong-returns-over-2016-now-totals-327-billion.
42 See https://www.sorted.org.nz/guides/kiwisaver-which-fund-suits?gclid=Cj0KEQiAw_DEBRChnYiQ_562gsEBEiQA4Lcssl5tlU9QpeiqrvaWcgak4k3uMRhb5gLdRDf4nOLUyX4aAtTb8P8HAQ.
43 See http://thedailyblog.co.nz/2016/08/25/nz-superfund-deepens-investment-in-israeli-banks/.
44 NZ Herald, 12 March 2017, see http://www.nzherald.co.nz/nz/news/article.cfm?c_id=1&objectid=11816835.
45 Stuff.co.nz, 21 May 2015, see http://www.stuff.co.nz/business/money/68745692/1000-kiwisaver-kickstart-canned.
46 See http://www.business.auckland.ac.nz/en/about/our-research/bs-research-institutes-and-centres/retirement-policy-and-research-centre-rprc/our-research-12.html#94592d61822c921cd4a2356fa3b23321.

Recent history shows it is possible to have responsible and ethical KiwiSaver funds, and there appears to be an increasing demand for such choices. Given the advantages enjoyed by the default providers of KiwiSaver funds, it seems appropriate that they should ensure their default fund is ethical and socially responsible. If government intervention is unlikely, especially in the short term perhaps it is time the KiwiSaver providers produced their own working definition of SRI, and offered default funds meeting that standard.

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