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KiwiSaver (and other superannuation) schemes Comparing the Uncomparable
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> ***"Uncomparable"*** *adjective* – "such that comparison is impossible; unsuitable for comparison or lacking features that can be compared;" (Source: Dictionary.com)

We'll soon be looking at investment performance data from the wildly popular KiwiSaver schemes. More than 700,000 Kiwis have signed up and schemes must soon report financial and other data as of 31 March 2008.

Members can shift from one KiwiSaver scheme to another so scheme promoters will want to score points and convince members to move. There is much at stake in all this. Promoters have spent large sums in building systems, printing material and marketing. They need a return on that investment.

There will be lots of spin - members will wonder what to make of the claims and counterclaims.

It should be simple to rank all 68 KiwiSaver schemes from top to bottom – Scheme A was the top and Scheme ZZO was the bottom. For "simple", read "simplistic":

> ***"Simplistic"*** *adjective* - "characterised by ... [t]he tendency to oversimplify an issue or a problem by ignoring complexities or complications." (Source: Dictionary.com)

If someone says that Scheme A outperformed all other KiwiSaver schemes, a cellar full of salt should accompany the story. It might be true but probably won't be.

Before or after tax?

Most KiwiSaver schemes are 'portfolio investment entities' (PIEs) that pay tax on behalf of members. There can be three different rates of tax and so four different types of PIE return – so-called 'before tax'; then after either 30% tax (after 1 April 2008) or 19.5% tax. PIEs will also have a 0% rate for other superannuation schemes and non-taxpayers like charities. The return on that 0% tax rate may be the same as the 'gross' return.

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[1] Declaration of interests: Michael Littlewood is also an independent director of SuperLife Trustee Limited, the trustee of the SuperLife KiwiSaver scheme and is a member of the SuperLife KiwiSaver scheme.

KiwiSaver schemes that aren't PIEs have a single tax rate of 30%.

Because of these options, some suggest using the before-tax numbers. But sometimes each provider's 'before-tax return' will be before tax and fees; sometimes, before tax and some fees and in other cases it will be before some tax and some fees. None will be directly comparable.

The only return that really matters to members is the actual after-tax, after-fees number.

What is 'before tax'?

Providers should know the before-tax investment return. It should be the headline pre-tax or 'gross' rate. Some KiwiSaver schemes directly manage all their investments (holding the shares, bonds, cash deposits directly). The trustee receives any investment income and pays tax on taxable income. That's not all income as some will be tax-free, such as trading gains earned by PIEs on New Zealand and Australian shares.

The net income in those simple cases will be taxable income less tax at 0%, 19.5% or 30% in the case of PIEs and 30% for non-PIEs. Added to this will be any non-taxable income.

However, most KiwiSaver schemes hire investment managers that pool money from different schemes to invest in particular parts of different markets, both here and overseas. Those investment 'products' have their own tax treatment – their income could be taxed in another country, in New Zealand or even in both countries. Sometimes, assets are invested in a particular way just for tax reasons. The KiwiSaver scheme's return might be paid without tax but will often be recorded as after the tax that the investment product pays. The scheme may not pay more tax over what the product paid but may even pay all the tax if the product is itself a PIE.

The new 'Fair Dividend Return' (FDR) tax basis for overseas shares adds more complexity. Taxable income is a deemed 5% of the 1 April market value of those shares with complicated rules about shares bought and sold after 1 April. Even if capital values fall, you still have to pay tax. Some providers will accrue tax from the start of the year; others will spread it over the year; yet others will cancel units at year-end so you won't see any tax in the unit prices. FDR also doesn't just apply to shares. A manager may set up a bond product to look like a share product because tax on a deemed 5% income will be less than tax on the full income.

How will a KiwiSaver scheme describe its 'before tax' income? It *should* simply quote the returns actually received before the appropriate tax on taxable income. In directly invested and product-based schemes, it should be based on the dollars actually credited to the scheme's account.

However, a scheme might take the net number after, say, 30% tax and divide that by 0.7 to synthesise ('make up') the before-tax number. If all income were taxable at 30%, that would produce an accurate result. However, not all 'income' is taxable to the KiwiSaver scheme, even where the scheme directly invests all its own money. Dividing the net number by 0.7 will produce a pre-tax number that is larger than the scheme actually received. But some providers will still describe it as "gross" as it will look better in the survey results[2].

A KiwiSaver scheme's true before-tax income will depend on its investment strategy, the way it implements that and its success. All these matter to the KiwiSaver member –comparing so-called "gross" returns will turn an already complicated subject into a misleading mess.

KiwiSaver members should pay no attention to comparisons based on either before-tax or so-called 'gross' returns. Some providers will make them up; others may refuse to provide them because they are either artificial or uncomparable. None of the numbers will be useful – but that's not the only problem.

The investment strategy effect

There are 65 KiwiSaver schemes (43 available to the public) but probably more than 250 investment options. A 'like with like' comparison of those is impossible. You can't compare two options if the investment strategy of each option is different, even if they are called something similar.

To illustrate:

Two schemes have a 'Diversified Option'. Scheme 55 has a 'benchmark' strategy that is 55% in unhedged overseas shares (not Australasian –to keep things simple) and 45% in cash. Scheme 65 on the other hand has 65% in overseas shares and 35% in cash. To keep the case simple, each provider earns exactly the index return on both the asset classes in each portfolio - they added no value by smart decisions.

Though KiwiSaver started on 1 July 2007, the Inland Revenue held all money for the first three months so comparisons including that initial period are pointless. Between 1 October 2007 and 31 March 2008, we know that the indices for our two asset categories had the following before-tax returns: cash +4.44% and overseas shares -14.71%. Each scheme's 'Diversified Option' earned:

- Scheme 55: -6.09% before-tax (-7.21% after-tax)[3];
- Scheme 65: -8.01% before-tax (-9.06% after-tax).

So what will the headline say? Scheme 55 beats Scheme 65 in the 'diversified' category of KiwiSaver investment options? Scheme 55 will use that headline to persuade Scheme 65 members to move but Scheme 65 members should stay right where they are, as long as they

[2] We already see this with providers advertising returns on 'cash' investments through a PIE as 'equivalent to 9.47% before tax". The actual before-tax return is 8.25%. The rest depends on a 39% taxpayer paying only 30% through a PIE. 9.47% is not the "before-tax return."

[3] In times past, if a portfolio lost money, the after-tax return was usually no larger than the before-tax result. Under FDR, the tax is payable whether the overseas shares made or lost money.

want 65% of their KiwiSaver money in unhedged overseas shares. Though six month numbers are pointless, moving to Scheme 55 means that their investment strategy is no longer what they want.

What should the headline say instead? The two providers haven't added value by smart decisions. Each Scheme returned the index return. The headline *should* read "Scheme with fewer shares does better in a falling market." That's accurate but not very catchy. More likely, we'll see "Scheme 55 outperforms Scheme 65": subtext – "time to think about moving". Schemes aren't called "55" or "65" to indicate the level of shares and so the headline will probably be "ABC outperforms XYZ; time to think about moving".

Direct comparisons can be valid only when the benchmark investment strategies are exactly the same and where the investment manager's skill can be directly measured and compared – both by positions taken around the benchmark, by asset selection and by the tax treatment and product structures used.

KiwiSaver members should pay no attention to comparisons that put different portfolio mixes into the same group for a comparison. That again compares the uncomparable.

What about the impact of fees?

Getting good before-tax returns and paying as little tax as possible should identify the more successful KiwiSaver scheme. But fees are the next complication. Higher than average fees can defeat better than average after-tax returns.

Fees are complex and usually opaque. They include the obvious membership fees (subsidised by the government's $40 a year) and direct money-based charges, normally a percentage of assets that could be as low as 0.2% or as high as 1.5% a year. Then there are less obvious fees like out-of-fund costs for printing, administration, promotion, trustee and support.

Sometimes these fees are stated as after-tax; sometimes before-tax but often, you won't be told. Fees may even be netted off returns in products used by the KiwiSaver scheme and not disclosed to members. These all reduce the headline 'Before-tax' or 'Gross' returns and muddy comparisons.

Asset-based charges are usually based on asset type. Share-based investments are usually more expensive than bonds which are normally more expensive than cash-based options. So, Scheme 65 members should expect higher fees than Scheme 55 because there are more shares in Scheme 65. The difference in fees will worsen Scheme 65's comparative position over Scheme 55 in the current market.

The only return that should matter to a KiwiSaver member is the after-tax, after-fees number actually added to the member's account. That is quite complicated to work out for cross-scheme, multi-option, multi-strategy comparisons so probably won't happen.

One answer might be that each KiwiSaver scheme should provide an auditor's certificate showing the net return added, after fees and tax, to a 'model' member's account (specified by law) in each of the scheme's investment options. Schemes could then advertise and compare only certified numbers with appropriate disclaimers to emphasise the impact of market returns on the results, as opposed to skill.

Certifying the 'value added' to (or subtracted from) the market's index return in each asset class might also help. Cross-scheme, option-specific comparisons of this 'value added' would actually be more helpful than uncomparable headline comparisons.

So what should a member do?

Members need to think about the basics when they make their decisions on:

- Which KiwiSaver scheme?
- What investment strategy to adopt?

Savers should pick a scheme based on whether the provider is really in the retirement savings business and is likely to survive the likely reduction in providers over the next few years; whether there is enough investment flexibility; whether mortgage diversion is available and on low fees – the lower the better.

The member's investment strategy will depend on things like other assets; willingness to take on volatility; how long to retirement and whether the member can sleep at night.

Investment managers often say that past returns are no promise for the future. In fact, the warning should probably read "Past investment returns are *no* guide to future returns."

Members shouldn't worry too much about six-month headlines that will try to compare the uncomparable even if the author is described as "independent". Life's too short.