

Default 'socially responsible investment' for KiwiSaver? An alternative view

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In *PensionCommentary* 2015-3, Matheson Russell argues that the default options of all KiwiSaver schemes should be required to use 'socially responsible investments' in their investment strategy. This *PensionCommentary* suggests that 'socially responsible investing' is not a robust concept. Further, all KiwiSaver schemes should be allowed to set their own default investment strategy.

1. What is 'socially responsible investment'?

The key indicators by which managers were measured and compared used to be returns (short and long term), volatility, fees, risk, liquidity and access.

Some now suggest an additional dimension that goes under a range of titles – 'socially responsible investing' (SRI) is the general description but other terms labelled 'ESG' (environmental, social and governance), 'sustainable', 'socially conscious', 'green' or 'ethical investing' cover similar territory.

Here is one definition of SRI:

“An investment that is considered socially responsible because of the nature of the business the company conducts. Common themes for socially responsible investments include avoiding investment in companies that produce or sell addictive substances (like alcohol, gambling and tobacco) and seeking out companies engaged in environmental sustainability and alternative energy/clean technology efforts. Socially responsible investments can be made in individual companies or through a socially conscious mutual fund or exchange-traded fund (ETF).” (From *Investopedia* [here](#))

The United Nations has sponsored a special group, the Principles for Responsible Investment Initiative (PRI) to establish “...an international network of investors working together to put the six Principles for Responsible Investment into practice. Its goal is to understand the implications of sustainability for investors and support signatories to incorporate these issues into their investment decision making and ownership practices.” (see [here](#)) – more on that below.

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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 the RPRC's.

2. KiwiSaver and SRI – the case for change

In making the case for introducing SRI to the KiwiSaver framework, Matheson Russell, in *PensionCommentary 2015-3*, ‘Making responsible investment the new standard in KiwiSaver’ (accessible [here](#)), concludes:

The KiwiSaver system is intended to ensure a prosperous future for New Zealand workers for many decades to come. It makes sense, therefore, that sustainable and responsible investment should be the norm in KiwiSaver. Requiring default providers to sign on to the PRI and/or requiring default funds to incorporate principles of responsible investment would be a lighthanded and constructive means for promoting this worthy goal. This would constitute a first step in the right direction, with much deeper reforms to KiwiSaver and other sectors of the finance industry likely to be required in the years ahead.

SRI would, the author suggests, see the default investment options of the nine default providers avoid investing in fossil fuel exploration and development (CO₂ impact on global climate change) and also investment in ‘unethical’ businesses such as tobacco, armaments, gambling and pornography. This would, the author suggests:

- Encourage more ‘responsible’ behaviour by listed companies;
- Reduce investments into “socially and environmentally harmful activities”;
- Better align KiwiSaver investments with “consumer preferences”;
- Improve investment returns.

PensionCommentary 2015-3 also argued that the cards were stacked against SRI because of the way the default schemes’ arrangements were structured (the ‘default effect’). The author recommended re-casting the default investment options so that SRI was either required by law or that the providers were obliged to sign up to the PRI policies. That would still let members choose an alternative non-SRI strategy but those who made no decisions about investment strategy would have an SRI strategy by default.

3. ‘Behavioural economics’

KiwiSaver was designed with the principles of ‘behavioural economics’ in mind. Auto-enrolment into KiwiSaver was justified on the grounds that New Zealanders needed to save more for retirement and all employees would join on starting a new job but could opt-out within eight weeks (or at any time after 12 months) if they preferred not to save in KiwiSaver.

The government chose six default KiwiSaver providers (now nine) to accept auto-enrolments and they had to provide a regulated default investment option with no more than 25% in shares and property. Given that the government has stepped into both the retirement saving decision and, in the absence of a member’s choice, the investment strategy decision, the argument for SRI suggests that it is a relatively small but significant step to ensure the default investment option complies with what society apparently thinks is ‘acceptable’ investment behaviour.

4. A *de minimis* observation

There is a *de minimis* case against the regulatory introduction of SRI to the KiwiSaver framework: no more than 25% of the default investment option of the default schemes can be invested in shares and property. According to the Financial Markets Authority

(FMA), only 18% of KiwiSaver's total assets at 31 March 2014 was invested in the default schemes³. Members of default schemes can still choose to have their money invested outside the default investment option so the maximum possible amount of money that might be affected by an SRI requirement would be 25% of 18% or 4.5% of KiwiSaver's total assets. At 31 March 2014, that would have been \$963 million.

Only a small proportion of those assets might (but might not) be invested in assets outside the SRI principles. So, the *de minimis* case might wonder why we need to enforce a requirement that, at the most, might apply to less than 4% of all KiwiSaver schemes' total assets. There must be more important KiwiSaver regulatory issues to discuss.

5. Looking more closely at SRI

The next difficulty is one of definition. The SRI definition quoted above suggests that "...companies that produce or sell addictive substances (like alcohol, gambling and tobacco)" should be avoided while investors should be "...seeking out companies engaged in environmental sustainability and alternative energy/clean technology efforts".

The definitional issues arise at many levels. We can accept that, for example, a tobacco company produces a product that can only do harm, but is it enough to just avoid buying shares in a tobacco-producing company? What about:

- (a) Shares in a company that has tobacco-production or trading as a minor part of its overall business?
- (b) Shares in a company that owns at least some shares in a tobacco company?
- (c) A collective investment vehicle (a CIV such as a managed fund or an exchange traded fund – an ETF) that has a tobacco company as one of its holdings?
- (d) The direct ownership of a building or property that has a tobacco company as a tenant?
- (e) A CIV that owns, as one of its investments, a building with a tobacco company as a tenant?
- (f) A listed supermarket company that sells tobacco to retail customers (or a CIV that includes such shares)? According to the *Investopedia* definition quoted, the supermarket owner would be a company that sells an addictive substance.

Taking a share-based CIV to illustrate this (example (c) above), one of the world's largest fund managers (State Street Global Advisers – SSgA) runs many low cost, passively managed, index-pegged investment funds. In these, shares are not chosen for their investment merit but rather because they form part of a regularly measured index.

Taking just one of those SSgA funds as an example - the 'SPDR MSCI ACWI IMI'⁴ that invests in 793 of the largest listed global shares: Philip Morris is one of those shares. At 11 May 2015, Philip Morris comprised 0.26% of the value of the ETF's total holdings. The ETF has Philip Morris shares because the company is one of the 793 largest listed global companies, not because the manager SSgA chose Philip Morris as a 'good'

³ *KiwiSaver Report 2014*, Financial Markets Authority accessible [here](#).

⁴ See [here](#) for more on this fund. "The MSCI ACWI IMI Index is a free float-adjusted market capitalization-weighted index that is designed to measure the combined equity market performance of developed and emerging markets. The Index covers approximately 99% of the global equity investment opportunity set."

investment. If the Philip Morris shares were not included then the ETF would produce returns that did not track the chosen global share index.

Of the \$US80.5 billion in that SSgA ETF, just \$US206.1 million was invested in Philip Morris shares. Does that mean this particular fund fails to qualify as an SRI holding?⁵

For a property-related issue (example (d) above), Philip Morris's Canadian office is at 1500 Don Mills Road, Toronto. This is a large, 10-storey office building that has many tenants including the City of Toronto, Florida Design College, China Crusher Machine, Acces Employment, Delimark Café and many others. The building happens to be owned by a private company but what if it were part of a property-based CIV? Would the SRI principles prevent an investment in that CIV because Philip Morris is one of the tenants?

Perhaps SRI principles should apply not just to shares, CIVs and properties that are associated with Philip Morris but also to other securities issued by Philip Morris such as listed bonds. It's possible that a KiwiSaver scheme buying an investment in an international corporate bond fund may be participating indirectly in a Philip Morris-issued security. Again, would SRI prevent an investment in that bond fund?

A KiwiSaver scheme could decide not to buy Philip Morris shares or bonds directly as part of its own SRI policy. To be fully true to those principles, it should also avoid all pooled and indirect investments that have some connection to Philip Morris.

Legislating SRI into the default investment options of the default schemes is more complicated and a lot harder than it looks.

6. Other 'boundary' difficulties in defining SRI

PensionCommentary 2015-3 suggests that an SRI policy would see no investments in fossil fuel exploration and development or in 'unethical' businesses such as tobacco, armaments, gambling and pornography. Paragraph 6 above has looked at the issue of tobacco. There are similar boundary issues with all of the other suggested categories. For example:

- (a) **Fossil fuel exploration and development:** All the major oil companies are heavily involved in exploration and development so does this mean the parent companies' shares would be infected by this activity? If not, this suggested SRI restriction will favour the current oil companies. And, if the objective of this restriction is to lower carbon emissions, shouldn't SRI be favouring the development of gas reserves to replace coal-burning electricity generation (for example)? This particular restriction seems to apply just to expansion of the fossil fuel industry but not to existing production levels and use of those fossil fuels. That seems to apply different moral standards to different pieces of this particular industry.
- (b) **Armaments:** Aspects of the armaments trade are undoubtedly unsavoury but a blanket ban seems not to be the answer. If there were no armament manufacturers, how would we arm our own defence forces and police? Perhaps

⁵ The same argument applies to a CIV that tracks the UK's FTSE 100 index. That index measures the performance of the largest 100 listed companies on the UK's share market. British American Tobacco is one of the 10 largest listed companies so investing in such a CIV is, indirectly, an investment in tobacco production and selling.

this exclusion is intended to avoid investing in manufacturers that sell arms to ‘incorrect’ buyers (non-democracies, kleptocracies, terrorists etc)? Or does this exclusion literally mean any business that produces anything that is related to weapons? If so, that would exclude Lockheed Martin, BAE, Boeing, Westinghouse, Rolls Royce and anyone else on this list [here](#) (and that’s only the largest 100 companies outside China). Some other names on the list include GE, Hewlett Packard, Goodrich, Samsung, Mitsubishi and Kawasaki. A Japanese motorcycle manufacturer and a US computer maker seemingly run the risk of being dubbed non-SRI.

(c) Gambling: Again, we might understand the social harm that gambling can cause when it becomes an obsession. However, gambling is quite deeply embedded in New Zealand society. We have a government-run Lottery; the ANZ Bank issues bonus bonds; the horse-breeding industry is founded on horse-racing and then we have the regular fund-raisers for charities like Auckland Coastguard and local school facilities. SRI seems to suggest that it’s only companies that have gambling as part of their business that must be avoided, not gambling itself. Again, there are the property-related issues described above in relation to tobacco.

(d) Pornography: We understand what ‘pornography’ means but is that just through ‘liberal’ Western eyes? Someone of the Muslim faith, for example, will have a very different view. Anyway, where does unacceptable ‘pornography’ become acceptable ‘adult’ material? Views on that have changed dramatically over recent years. Will the views on whether activities under this heading can be SRI or not also change? That possibility precludes regulatory intervention.

7. What about the UN's Principles for Responsible Investing (PRI)?

As mentioned above, the United Nations has developed an organisation to promote PRI. Investors, fund managers and other institutions agree to “...put the six Principles for Responsible Investment into practice.”

PRI is not just about ‘socially responsible investing’. Together, the principles are designed to “...contribute to the development of a more sustainable global financial system.” This allows “good governance, integrity and accountability” to be part of a signatory’s programme.

Each participating organisation commits to its own version of PRI. Here for example is the New Zealand ACC’s statement on PRI from its report (the Accident Compensation Corporation’s *RI Transparency Report 2013/14* accessible [here](#) at page 12):

“ACC has an ethical investment policy that requires our investment activities to be conducted in an ethical manner that avoids prejudice to New Zealand's reputation as a responsible member of the world community.

We apply ethical principles that, in our judgement, are widely held by the New Zealand public. The spirit of New Zealand laws is used as a guide to reflect the ethical views of the New Zealand public, together with the values and principles set out in the United Nations (UN) Global Compact and UN Principles for Responsible Investment (UN PRI).

The ethical investment policy sets out the following framework.

- ACC engages with companies that have serious environmental, social or governance issues in order to modify corporate behaviour and improve performance in relation to ethical issues. This is undertaken directly with the companies or in collaboration

with other Crown Financial Institutions, other investors or the UN PRI Engagement Clearinghouse.

- We don't invest in companies that undertake activities that are repugnant to the laws of New Zealand and exhibit corporate behaviour that seriously breaches ethical/responsible investment standards. This includes tobacco companies and those involved with the development and/or production of anti-personnel mines, cluster munitions and nuclear explosive devices.
- We encourage our fund managers to cast proxy votes in a manner that is consistent with the principles of good corporate governance and with the ethical investment policy.”

Testing the ACC's own stated principles against some of the SRI suggestions, the ACC could invest in:

- companies with small to moderate “environmental, social or governance issues”; even companies with serious problems as long as the fund manager was working to “modify corporate behaviour and improve performance in relation to ethical issues”.
- Arms and munitions companies as long as they don't make anti-personnel mines or cluster munitions.
- Nuclear energy production (only nuclear explosive devices are prohibited).
- Fossil fuel exploration and extraction (not mentioned).

Here is another example: AustralianSuper, a \$A78 billion fund that has signed up to the UN's PRI:

“AustralianSuper has joined the following collaborative programs:

1. Carbon Disclosure Project - a global initiative asking the largest companies to disclose investment-related information on their greenhouse gas emissions.
2. Investor Group on Climate Change - aims to ensure that risks and opportunities associated with climate change are incorporated into investment decisions for the benefit of the investor.
3. ESG Research Analytics - aims to encourage better investment decision making through better investment research.

The Fund encourages all listed managers to consider ESG investment issues by actively engaging with them and by requesting updates of their ESG considerations.

AustralianSuper also relies on its investment adviser to communicate its ESG investment concerns to fund managers and to keep the Fund informed of ESG investment issues and trends.

The Fund's Investment Department reports on its ESG activities to AustralianSuper's Investment Committee on a regular basis.” (accessible [here](#)).

So, what does this mean in practical investment terms? For example, requiring the “largest companies” (not all of them) to “disclose investment-related information on their greenhouse gas emissions” does not preclude an investment in any of those largest companies, never mind the smaller equivalents. Again, AustralianSuper's fund managers are invited to consider ESG considerations and to report those to AustralianSuper's investment committee. There is no requirement for either party to do anything about those considerations and reports.

For those interested in SRI, the UN's involvement may be a step in the 'right' direction but do not represent a basis for requiring compliance by KiwiSaver default providers for their default investment options.

8. Investment performance comparisons

PensionCommentary 2015-3 also suggests that SRI funds seem to be achieving better investment returns, internationally and in Australia. There is no New Zealand evidence for such outperformance and even in Australia, the periods measured are too short to be significant.

In any event, if future experience supports the outperformance suggestion then savers and their managers will want to shift to SRI for the most direct reason of all, regulation or not.

Whether or not the outperformance is measurable and sustainable, that of itself does not support regulation to require the default investment options of the default schemes to comply with SRI.

9. The default arrangements do need reform

In the RPRC's *Submission on the Review of KiwiSaver Default Provider Arrangements* (December 2012; accessible [here](#)), we recommended changes to the default provider arrangements. On the default investment option, we suggested that each KiwiSaver provider should set its own default option, with no official constraints:

“There seems no compelling reason for the government to set the default investment option, as it does now. In fact, it has no expertise on this topic yet, by becoming involved in this process, the state is representing itself as ‘knowing’ what is appropriate for a very large and disparate group of members. A government-determined minimum set of conditions for the provider-set default avoids the need to become involved in issues associated with: - life-cycle strategies, risk/volatility, target-date investment strategies, first home withdrawals, passive versus active, and - so-called ‘alternative assets’.”

We also recommended the abolition of the preferred default scheme selection process as, again, the state has no particular expertise in the choice of superannuation scheme managers. Instead, we suggested that all KiwiSaver schemes should be able to qualify as a default scheme on satisfying minimum governance, disclosure and administrative performance standards.

These recommendations suggested that the government should pull back from direct involvement in the internal management of KiwiSaver schemes. Despite the failure of the government to adopt our recommendations, we continue to support less government involvement, rather than more. That would limit the possibility of further regulation based on SRI.

10. Conclusion

There are several reasons not to support an SRI requirement for the default investment options of the default schemes:

- (a) What constitutes SRI and what precisely the boundaries might be between complying and non-complying investments is less than clear. Greater clarity is required if SRI is to become a legal requirement, even if only for the default investment options of the nine selected default schemes.
- (b) Nothing presently prevents a KiwiSaver scheme, including the default schemes, from adopting SRI.
- (c) Individual savers can move easily from their current KiwiSaver scheme to one that has adopted SRI, if that is their preference.

It could be argued that requiring all the KiwiSaver default providers to sign up to the UN's PRI needn't mean much for the reasons described above. The PRI don't actually have to change investment behaviour and perhaps that's why so many providers have been able to sign up⁶. It is difficult to see what making PRI compulsory would achieve.

When the government re-appoints default providers in 2021, it could insist that the default investment options conform to the principles of SRI, or that the providers sign up to the UN's PRI. Because the government makes the rules in this regard, providers would have to comply. However, the definitional difficulties described above will still make that a largely symbolic gesture.

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⁶ In 2015, 1,325 asset owners, investment managers and service providers had become 'signatories'. Together, they manage \$US45 trillion. There is more information in the organisation's 2014 annual report [here](#).