KiwiSaver & Concerns About a Market Correction

MJW Investments

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Introduction

Stock markets have boomed in recent years with an annual return in excess of 20% for both NZ stock markets, and global developed markets (hedged to the NZD). As one would expect there are concerns about the possibility of a major market correction in the near future and the effect it will have on KiwiSaver members. A risk identified is that members in a “growth” option or similar will suffer a significant negative return, causing them to switch to a more conversation option and then sit in this fund in the future suffering further reduced returns as a result. In this article we explore the effect of a hypothetical market correction in the near future.

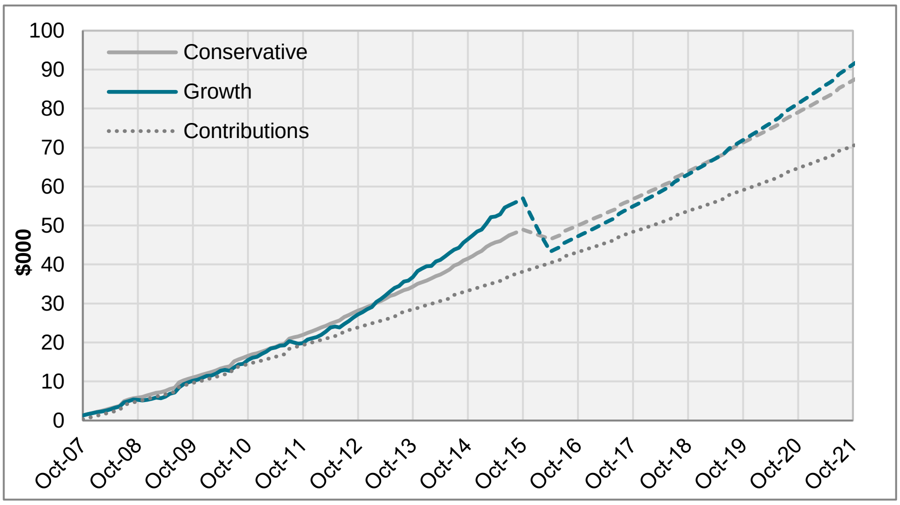
The Scenario

We look at the performance of two hypothetical KiwiSaver funds: a *Growth Fund*, with 80% invested in growth assets and a *Conservative Fund*, with 20% in growth assets. The two funds are invested in NZ shares, global shares, NZ bonds, global bonds and cash in proportions typical of funds in the KiwiSaver sector. We assume that the funds receive a benchmark return less tax and fees and each adds additional value of 1% per annum above this benchmark. The fee rates for the Growth and Conservative Funds are 1.25% and 0.95% respectively. The members in each fund begins with an annual salary of $70,000 which increases by 3% each year. The total combined contribution rate from employee and employer is 5% of this salary. Both members begin KiwiSaver on 1 October 2007 with a balance of $1,000 and in addition, both members receive the full government tax credits each year.

We assume that a market correction starts on 1 October 2015 and is equivalent to a loss of 27% for the Growth Fund and 9% for the Conservative Fund spread evenly over the following 6 months. This is consistent with the assumption that equity returns in NZ and abroad would drop more sharply than bond returns. From 1 April 2016, the Growth and Conservative Funds return a steady 5.1% and 3.0% per annum respectively.

Summary of results

The graph alongside tracks the value of the two member balances in dollars from 1 October 2007 to 1 October 2021. The results see the Growth option lag behind initially due to the GFC hitting within the first couple of years of KiwiSaver results.



The Growth Fund overtakes the Conservative in early 2013 and pulls steadily ahead up to the present day.

During the hypothetical correction, the growth member’s balance drops below the conservative balance once again. After this time, the Growth Fund steadily catches up, overtaking the Conservative Fund again in 2019.

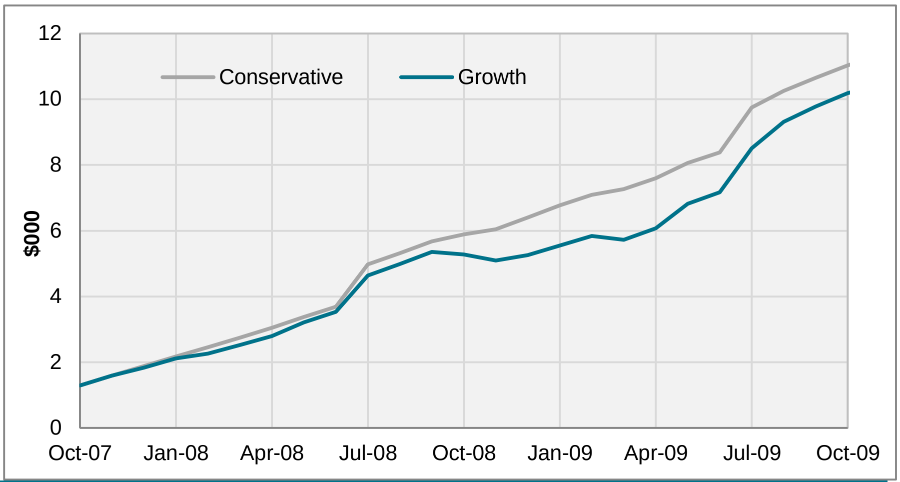
The GFC

The effect of the GFC on the member balances above is fairly minor. This is because both member balances are fairly low at this point, so the employer/employee contributions are still the factor that has the most influence on balance size at this time - this will be the case for all members invested in KiwiSaver over the GFC.

The chart over the page zooms in on the balance sizes over the 2 year period from 1 October 2007 to 1 October 2009. This period sees the two balance sizes initially close. While the Conservative Fund continues to see steady increase over this period, the Growth Fund struggles somewhat over this time, with the member balance actually shrinking in size over the second half of 2008. The Growth Fund recovers in late 2008 moving closer to the Conservative Fund again in the 2009 but still finishing below the Conservative Fund come October 2009.

As noted above, while the GFC was obviously a setback for those invested in more aggressive KiwiSaver Funds, in our example, the setback is only temporary and the Growth Fund catches up again by early 2013.

In fact the setback in performance can be looked at as the opportunity to buy into the market at a lower entry price and arguments relating to dollar cost averaging come into play here.



Market correction

Using our example, at 30 September 2015 we see the Growth Fund member balance at around $57,000 while the Conservative Balance is at $49,000. Applying the late 2015 market correction that we have modelled sees the growth balance down $14,000 to $43,000 and the conservative balance down just $2,000 to $47,000. The fall is less than one might have expected due to two factors: firstly the fall in markets is spread over a 6 month period and secondly over this 6 month period contributions continue to be paid into the funds.

So while the Growth KiwiSaver member emerges from this correction in a worse position, the momentum it had already built up in the years leading up to it means that its position is not markedly worse off than the Conservative KiwiSaver member who was shielded from the brunt of the loss due to high investment in fixed interest and cash assets. Of course, the best outcome would be achieved by switching from a growth to a conservative option in time for the correction, and then switching back into a growth option once the troubles had passed. In practice however, no one can really say for certain if and when a correction while occur, and if it does, it is similarly difficult to judge the point at which things will return to “normal”. Our scenario and its timings are purely hypothetical and we believe that it would be impractical for members to attempt to switch options at the right time in anticipation of it.

Looking forward

As we mentioned above, after our modelling correction, the Growth Fund member once again overtakes the Conservative Fund member in 2019 and the balance accelerates further head as time goes on. While not shown on our chart, by 1 October 2025, the growth member’s balance has increased to $137,000 versus $123,000 for the conservative. By 1 October 2035, the growth and conservative member balances are $313,000 and $244,000 respectively.

This is the point our analysis wishes to illustrate. While we see an initial unfavourable outcome in the event of a correction, investors with a long-term focus are still very likely to enjoy superior results over the long-term. There is of course still the possibility of a second adverse event over this time period. However a similar analysis could be undertaken to show that this setback would also be only temporary. While there is always a temptation to “cut your losses”, members who have selected a more aggressive investment style must be focussed on the long-term and need to wait out any correction that occurs in order to achieve the best result.

ABOUT MELVILLE JESSUP WEAVER

Melville Jessup Weaver is a New Zealand firm of consulting actuaries. The firm was established in 1992 and has offices in Auckland and Wellington. The firm is an alliance partner of Towers Watson, a leading global professional services company that helps organisations improve performance through effective people, risk and financial management. The company offers solutions in the areas of employee benefits, talent management, rewards, and risk and capital management. Towers Watson has 14,000 associates around the world and is located on the web at towerswatson.com.

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