focus

KiwiSaver and the magic of compounding returns

When KiwiSaver started in 2007, there was a stampede to sign up. There was the $1,000 kickstart dropped into your account and that, along with the contributions from government and employers, had people asking "why wouldn't you?" There was no sensible answer to that question and so people joined in droves. (There are now over 3,000,000 members).

Early on there were many experts who tried to be helpful and suggested things like being in the right fund and avoiding savings suspension. This advice was right but not everybody took notice – after all, the amount in people's accounts was tiny.

With balances so small there was little engagement early on but with the average KiwiSaver account now at about $20,000, people are much more interested. Nevertheless, we still have a way to go to be confident that we are all making the most of our KiwiSaver opportunity.

Financial crises always expose poor behaviour. Sometimes this is malfeasance (people are marched off to jail) and sometimes it is people managing their money poorly. COVID-19 has

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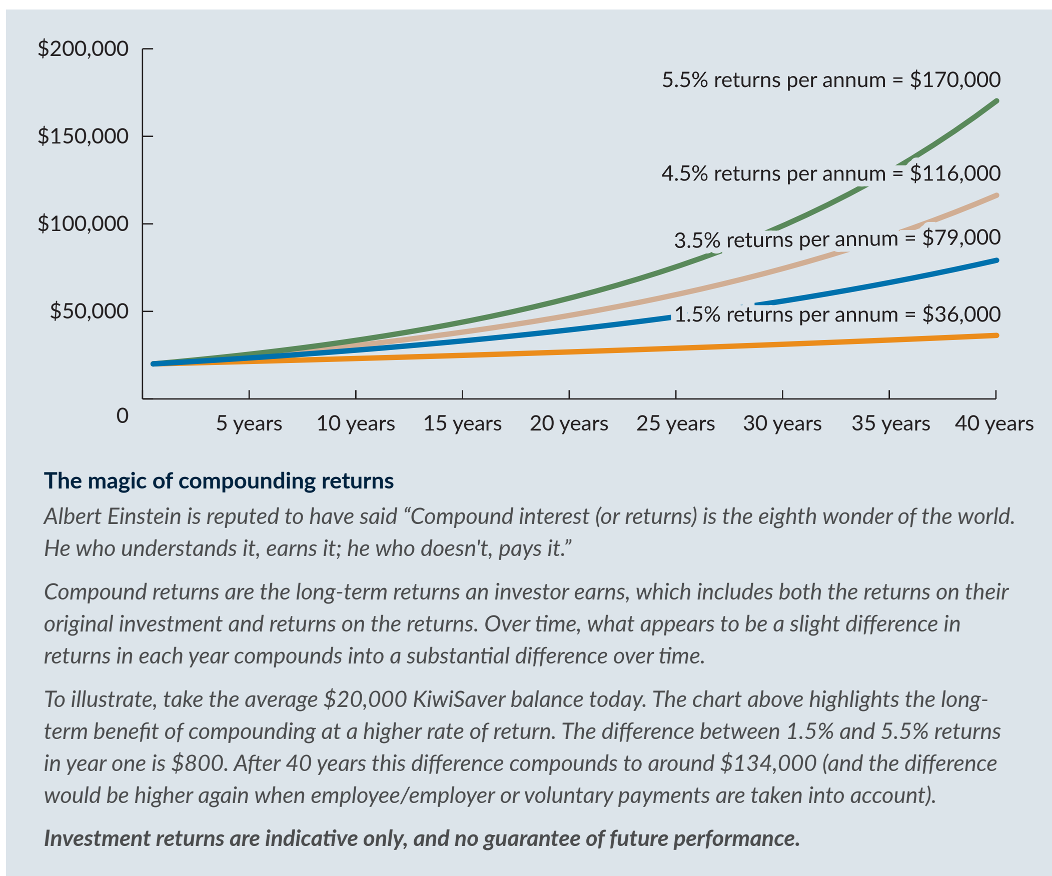

The magic of compounding returns

Albert Einstein is reputed to have said "Compound interest (or returns) is the eighth wonder of the world. He who understands it, earns it; he who doesn't, pays it."

Compound returns are the long-term returns an investor earns, which includes both the returns on their original investment and returns on the returns. Over time, what appears to be a slight difference in returns in each year compounds into a substantial difference over time.

To illustrate, take the average $20,000 KiwiSaver balance today. The chart above highlights the long-term benefit of compounding at a higher rate of return. The difference between 1.5% and 5.5% returns in year one is $800. After 40 years this difference compounds to around $134,000 (and the difference would be higher again when employee/employer or voluntary payments are taken into account).

Investment returns are indicative only, and no guarantee of future performance.

proved no exception and the thing that has been exposed this time is some poor KiwiSaver behaviour. While I know that many people (maybe most) are managing their KiwiSaver accounts well, there are still quite a lot of people who have yet to sit up and take notice – COVID has caught them asleep at the wheel.

KiwiSaver is a long-term retirement scheme and to make it work, savers need to contribute and stick with the plan through thick and thin. KiwiSaver works on the great engine of wealth that we call compound returns. This requires that money is invested and stays invested so that returns are earned on returns and funds grow.

This takes consistency as you get into the right fund and make contributions without a break. It may be slow at the start, but as funds accumulate your account will grow at an ever-increasing rate.

The biggest fault exposed by COVID was that some KiwiSaver members were in the wrong fund: people new to investment found that they were more risk sensitive than they thought. The rush to lower risk when share markets collapsed in March is evidence of this as people panicked and changed their KiwiSaver account from growth funds to conservative.

In doing this they effectively sold shares – their timing could hardly have been worse as they sold into the bottom of the market.

This was a flight to safety, but many were too late – markets move quickly and for most KiwiSaver members fleeing the collapse, share prices had already fallen. Since then, of course, markets have bounced back and those who sat tight find that their KiwiSaver balances are about back to where they were when the COVID crisis struck.

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However, those who flinched and sold down are stranded in conservative funds which have a relatively small amount in growth assets – their KiwiSaver balances will not have recovered with the market bounce. In doing this, they have broken the virtuous cycle of compound returns.

There is a basic rule of investment that you should take as much risk as you can to get better returns, but never so much that volatility will frighten you to become a forced seller. KiwiSaver members should be prepared for wild swings in markets but the fund they are in should never be so wild that they cannot tolerate the ride.

The first big lesson from COVID so far is that you should find a level of risk that is comfortable for you, one that will not see you rattled out of the market by volatility.

The second key to KiwiSaver is that you should keep contributing throughout. A crisis like COVID means that there are some people who are simply unable to continue to contribute: they have lost their businesses or jobs and they are in such straightened circumstances that they need to prioritise survival in the present rather than saving for the future.

That is a great shame because people who are able to keep on contributing when markets are down are effectively buying cheap shares. Those who have to withhold contributions miss out and, long-term, are poorer.

The level of contribution into KiwiSaver is a critical part of the scheme's success. It's not just your own money for compound returns to work its magic but employer and government contributions as well. Stop your contributions and the virtuous circle stalls and, maybe, stops.

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Government and the regulator are aware of what makes compound returns work and have, accordingly, made it difficult to withdraw funds for hardship purposes. People would be well advised to hold emergency money in separate funds or bank accounts; these should be liquid funds which can, unlike KiwiSaver, be accessed when things turn for the worse.

The strength of KiwiSaver lies in its simplicity. There are only two things you really have to do: be in a good fund with the right level of risk and keep on contributing. If you can manage this, your funds will grow and you will prosper.

Martin Hawes
Chair, Summer
Investment Committee

To check that you are in the right risk category, do an online questionnaire (you can use the Summer KiwiSaver scheme Investment Profile tool or Sorted tool below).

https://www.summer.co.nz/investment-profile/

https://sorted.org.nz/get-sorted/get-your-kiwisaver-settings-right/#fundFinder

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