



SMITHS ECONOMIC PAPERS

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The Price of Panic

Asset pricing, behavioural economics, and why markets reward emotional endurance.

Henry W. Smith

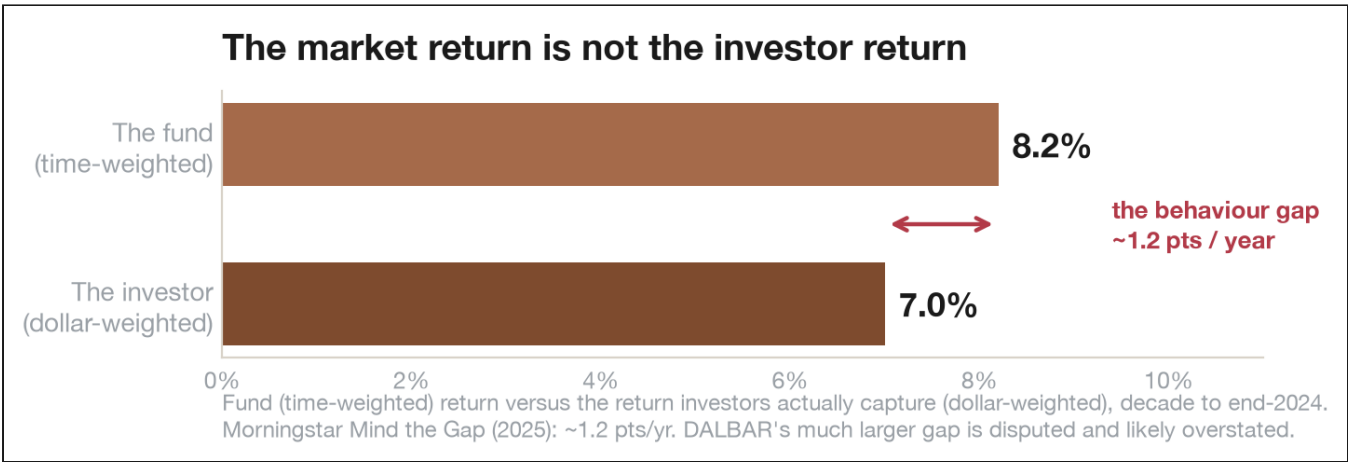
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Returns are made by markets, captured by behaviour

Over a working life the market hands every investor in the same fund the same return. Almost nobody keeps it. The gap between what a fund earns and what its investors take home is one of the most reliable findings in finance, and it is made of behaviour, not markets.

An investor return is not a market return. A fund publishes a **time-weighted** return, the performance of the assets. The investor lives a **dollar-weighted** return, the assets *and* the timing of every decision to add, hold or sell. Add money after good years, pull it after bad ones, and the dollar-weighted return falls below the time-weighted one. That shortfall has a name: the **behaviour gap**.

This paper draws on the equity premium puzzle (Mehra & Prescott, 1985), prospect theory (Kahneman & Tversky, 1979), myopic loss aversion (Benartzi & Thaler, 1995) and the measured value of behavioural coaching (Vanguard Advisor's Alpha) to argue that the decisive variable in long-term investing is the investor's conduct during fear, not the fund, the fee or the forecast. We introduce three frameworks, **the Discomfort Premium**, **the Panic Cycle** and **the Behaviour Circuit Breaker**, to make that conduct visible and plannable.



The fund earns one number; the investor keeps a smaller one. The difference is timing, and timing is behaviour.

~6% historical real equity risk premium over the risk-free rate, US 1889–1978 (Mehra & Prescott, 1985)	~1.2 pts defensible annual behaviour gap, fund versus investor return (Morningstar Mind the Gap, 2025; DALBAR's larger figure is disputed)	~1.5 pts annual value attributed to behavioural coaching alone (Vanguard Advisor's Alpha)
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"The market return is only the return available. The investor return is the return captured after behaviour."

THE ECONOMIC PROBLEM

Why the available return is so rarely the captured one

Markets pay a premium for owning risky assets. That premium is real, large and well documented. The problem is not whether the return exists; it is that capturing it requires sitting through exactly the experiences that make human beings want to sell.

1. The return is paid for discomfort, not for time alone

Shares have outperformed cash and bonds over the long run by a wide margin, the equity risk premium. But that premium is compensation for something specific: tolerating volatility, uncertainty, frightening headlines, temporary losses and years of delayed gratification. Remove the discomfort, by switching to cash, and you remove the return with it.

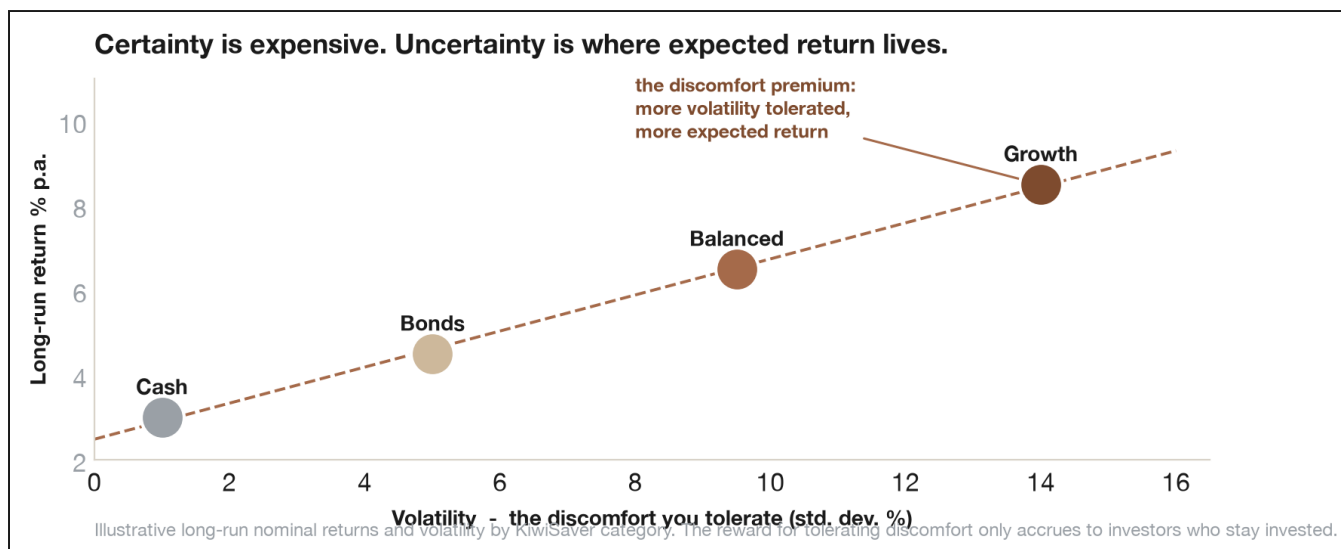
2. Losses are felt harder than gains, though how much is contested

Prospect theory holds that the pain of a loss exceeds the pleasure of an equal gain, with the often-quoted coefficient around **2.25**. We should be honest that this number is contested. Gal and Rucker (2018) argue loss aversion has been over-generalised into a universal law it does not earn, and that the evidence supports a more conditional claim. The high-class position is not to defend 2.25 as a constant of nature, but to note that a 25% fall plainly feels worse than a 25% rise feels good, enough to manufacture a real urge to sell. Our practical conclusion does not depend on the exact coefficient. It depends only on the behaviour gap being observed directly in the data, which it is.

3. We judge a long-term plan over far too short a horizon

Benartzi and Thaler called this *myopic loss aversion*: a loss-averse investor who checks a forty-year portfolio over a one-year window experiences a long-term plan as a series of short-term threats. Frequent evaluation turns a fund built for decades into a source of monthly anxiety, and anxiety is what drives the sell.

Certainty is expensive. Uncertainty is where expected return lives. The investor who insists on feeling safe at every moment pays a premium to give the premium away.



The reward for risk rises with the discomfort tolerated. Cash is comfortable and cheap to hold; it also pays the least. Growth is uncomfortable and pays the most, but only to those who stay.

THE THEORY BEHIND IT

Half a century of economics, in one idea

The equity premium puzzle

Using United States data for 1889 to 1978, Mehra and Prescott document a real equity return near 7% against a real risk-free return near 0.8%, an equity premium of roughly six percentage points. The reason it is a *puzzle*, not just a fact, is that fitting it inside a standard consumption-based model requires a coefficient of relative risk aversion above 30, when a plausible value sits near 1. No one is that frightened of a fair bet. The premium is a real, standing offer that theory struggles to rationalise. The candidate resolutions are illuminating in their own right: rare disasters, a small annual chance of a large consumption crash (Rietz, 1988; Barro, 2006); habit formation, where risk aversion rises in downturns (Campbell & Cochrane, 1999); and long-run risk, persistent shocks to expected growth (Bansal & Yaron, 2004). Each says, in its own language, that the premium pays for the fear of bad times, which is exactly when investors sell.

Mehra, R. & Prescott, E. C. (1985). The Equity Premium: A Puzzle. *Journal of Monetary Economics*, 15(2), 145–161. Rietz (1988); Barro (2006); Campbell & Cochrane (1999); Bansal & Yaron (2004).

Prospect theory and loss aversion, with the live debate

Kahneman and Tversky show that people value outcomes relative to a reference point, with a value function steeper for losses than for gains. The widely quoted coefficient, about 2.25, comes from later lab estimates. It is worth being candid that the field is mid-replication-crisis and this number is genuinely contested. Gal and Rucker (2018), in "The Loss of Loss Aversion", argue the principle has been inflated into a universal law the evidence does not support. We do not need it to be a universal law. The behaviour gap is measured directly in investor returns, so panic selling is a documented outcome whether or not the coefficient is 2.25, 1.5 or context-dependent.

Kahneman, D. & Tversky, A. (1979). Prospect Theory. *Econometrica*, 47(2), 263–291. Contested by Gal, D. & Rucker, D. D. (2018). The Loss of Loss Aversion. *Journal of Consumer Psychology*, 28(3), 497–516.

Myopic loss aversion

Benartzi and Thaler combine loss aversion with narrow, frequent evaluation. An investor who judges a long-term portfolio over short windows is far more likely to abandon the plan in a drawdown. The cure is to lengthen the horizon over which results are judged.

Benartzi, S. & Thaler, R. H. (1995). Myopic Loss Aversion and the Equity Premium Puzzle. *Quarterly Journal of Economics*, 110(1), 73–92.

The behaviour gap, observed not assumed

Mental accounting and recency bias

Thaler shows that we sort money into separate mental accounts and judge each in isolation, so a paper loss feels real and urgent. Greenwood and Shleifer show that expectations are *extrapolative*: people expect more of whatever just happened, most optimistic at the top and most fearful at the bottom.

Thaler, R. H. (1999). Mental Accounting Matters. *JBDM*, 12(3). Greenwood, R. & Shleifer, A. (2014). Expectations of Returns and Expected Returns. *Review of Financial Studies*, 27(3).

The behaviour gap and adviser alpha, sized honestly

The behaviour gap, dollar-weighted investor returns below the time-weighted returns of the same funds, is real, but its size is disputed and the dispute matters. DALBAR's QAIB reports gaps as large as roughly six points a year. Pfau, Blanchett and others have shown DALBAR's method overstates this. The defensible figure is Morningstar's Mind the Gap, about 1.1 points a year over the decade to 2023 and 1.2 over the decade to 2024, and even that is contested at the margin (Fulkerson and colleagues, 2024). One to two points, not six, is the honest number. Vanguard attributes roughly 1.5 points a year to behavioural coaching alone, almost all of it earned in a few frightening moments.

Morningstar. Mind the Gap (2024, 2025). DALBAR QAIB (contested; see Kitces/Pfau). Fulkerson, Jordan, Riley & Yan (2024). Vanguard (2014, rev.). Quantifying Advisor's Alpha.

Notice what this collection of theory does and does not require. The exact loss-aversion coefficient is contested, the equity premium puzzle is unresolved, and the largest behaviour-gap estimates are disputed. None of that weakens the practical case, because the conclusion does not rest on any single coefficient being a law of nature. It rests on a directly measured outcome: investors capture less than the funds they hold, and they capture least when they trade most through fear. The theory explains the mechanism; the data confirms the result whatever the mechanism's precise size.

THE SMITHS FRAMEWORK, PART ONE

The Discomfort Premium

If the equity premium is the market's offer, the Discomfort Premium is the price of admission. Investors are paid to tolerate five specific discomforts, and paid nothing if they refuse them.

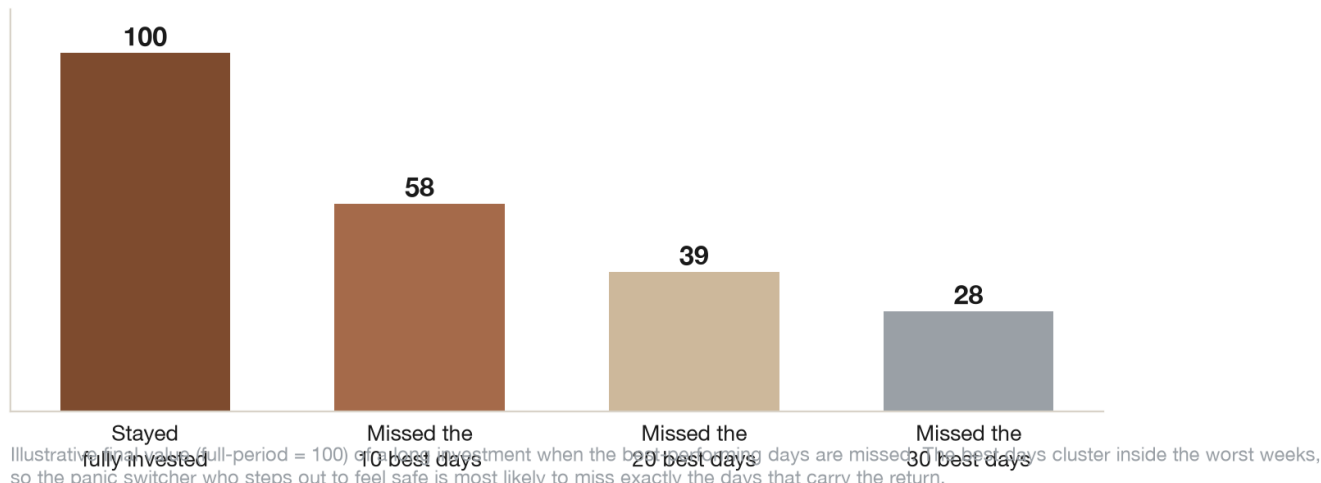
- **Volatility.** Prices that swing, sometimes violently, with no schedule and no warning.
- **Uncertainty.** No guarantee, at any moment, that the next move is up rather than down.
- **Bad headlines.** A constant stream of credible reasons to be afraid, loudest at the bottom.
- **Temporary losses.** Real, visible falls in a balance you can see online every single day.
- **Delayed gratification.** A reward that arrives in years and decades, not weeks.

The crucial word is *tolerate*. The premium is not paid for buying a growth fund. It is paid for **holding** one through every one of these discomforts. The investor who buys the right fund and then sells it in the first storm has bought a ticket and walked out before the show. They paid the discomfort and collected none of the premium.

The Discomfort Premium is not a reward for being clever. It is a reward for being able to sit still while it is unpleasant to do so.

This reframes risk tolerance entirely. The question at the start of a plan is not "how much return do you want?" Everyone wants more. The real question is "how much discomfort can you actually live through without selling?" because the answer to the second question sets the return you will truly capture. A growth fund you abandon at the bottom is, in practice, a worse investment than a balanced fund you can hold forever.

The recovery hides in a handful of days

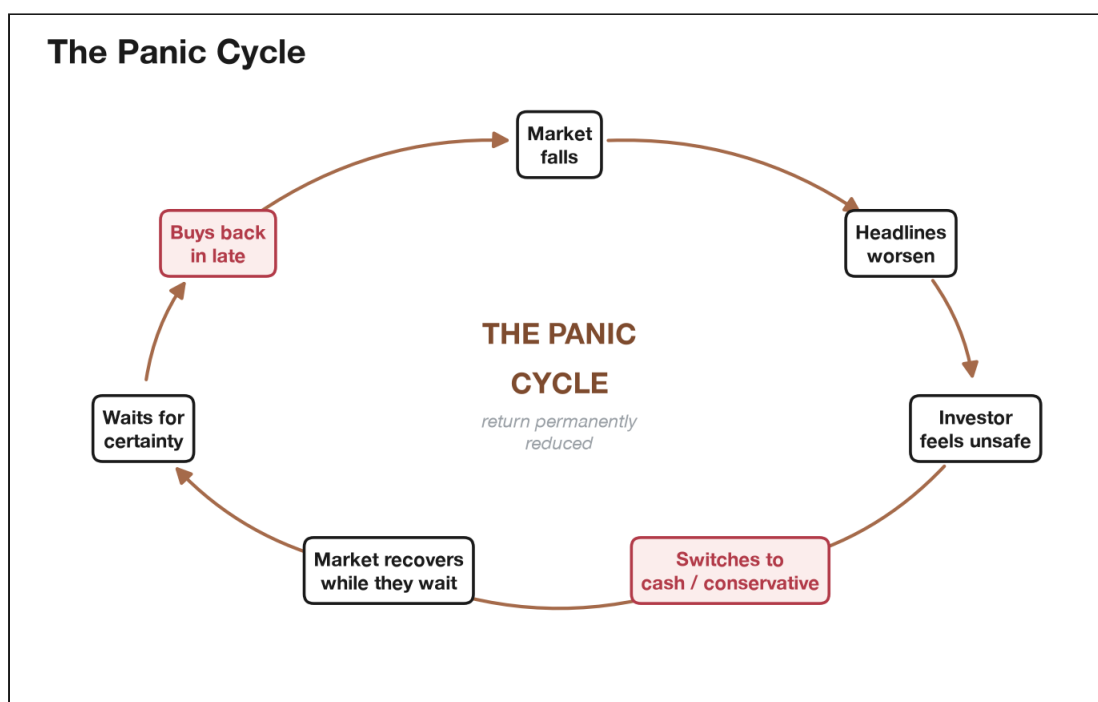


Why staying matters mechanically. The market's best days cluster inside its worst weeks, so the investor who steps out to feel safe is the one most likely to miss exactly the days that carry the return.

THE SMITHS FRAMEWORK, PART TWO

The Panic Cycle

Panic is not random. It runs through a household on a predictable loop, and every turn of the loop converts a temporary, recoverable loss into a permanent one.



The Panic Cycle. Each stage feels rational from inside it. The damage is done at the two red nodes, where a paper loss is made real and the recovery is bought back late.

The cycle is seductive because *every individual step feels sensible*. The market falls, so caution feels wise. The headlines worsen, so fear feels justified. Switching to cash feels like taking control. Waiting for "certainty" before re-entering feels prudent. Buying back once the news is finally good feels safe. Each step is reasonable; the sequence is ruinous.

The trap is built from the biases in the previous section. Loss aversion makes the fall feel like an emergency. Recency bias, the extrapolation Greenwood and Shleifer measured, makes the investor expect more falling at the bottom and more rising at the top. Mental accounting turns a paper loss into a felt one. Myopic evaluation shrinks a forty-year horizon to the length of a news bulletin. Together they manufacture the urge to sell low and the patience to buy high.

The market recovers before confidence does. By the time it feels safe to invest again, the recovery you were waiting for has already happened, and you paid for it.

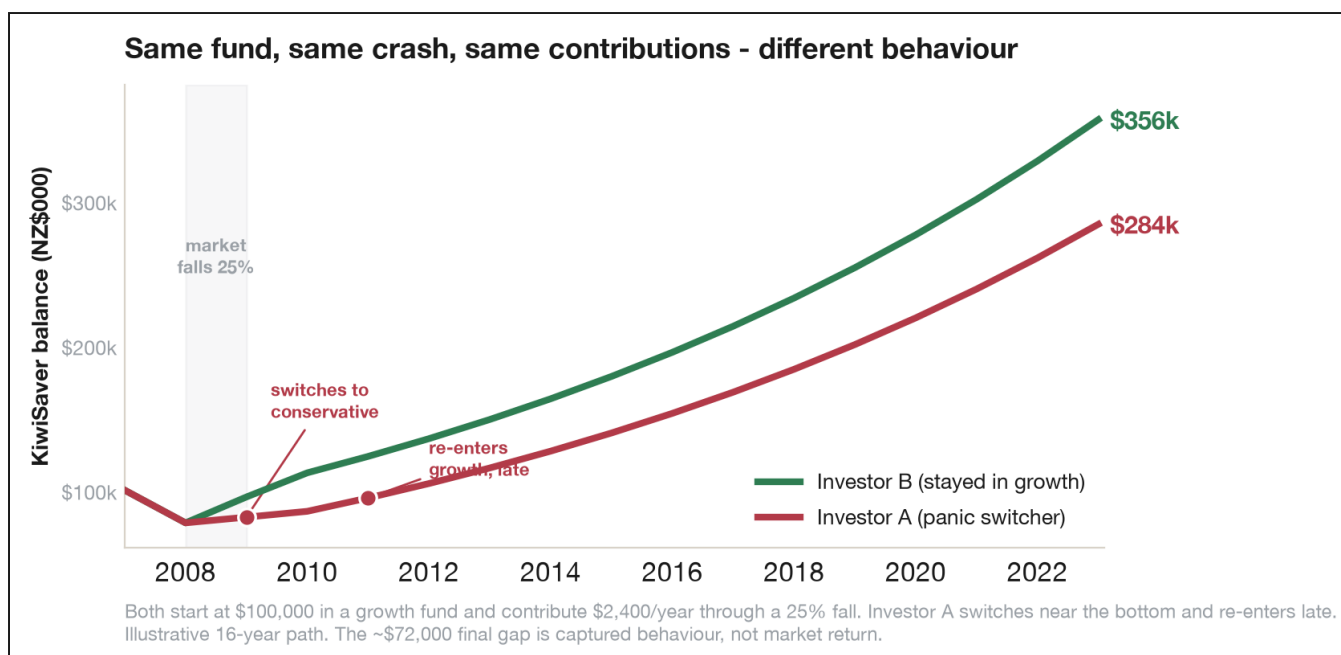
This is the single most expensive feature of the cycle. Recovery does not wait for permission. The market turns while the headlines are still terrible, so the investor who waits for good news to return is guaranteed to re-enter after the cheapest units are gone. They sell at the bottom and buy back higher, and the round trip is subtracted from their balance for the rest of their life.

THE NEW ZEALAND INVESTOR

Two KiwiSaver members, one crash

Consider two New Zealanders in the same growth KiwiSaver fund, the same age, the same balance, the same contributions, hit by the same 25% fall. The only difference is what they did next.

Investor A - the panic switcher		Investor B - the disciplined investor	
Starting balance	\$100,000	Starting balance	\$100,000
Contributions	\$2,400/yr	Contributions	\$2,400/yr
Action in the crash	switched	Action in the crash	stayed
Re-entered growth	late	Re-entered growth	never left
Balance after 16 yrs	\$284,000	Balance after 16 yrs	\$356,000
Watched the balance fall 25%, switched the lot to a conservative fund near the bottom, waited for good headlines, and only re-entered growth after the recovery was well underway. Locked in the loss, missed the cheapest units, bought back high.		Felt the same fear, but held the plan. Stayed in growth, kept contributing right through the fall, which bought units cheaply, and captured the full recovery. Same fund, same crash, different conduct.	



Same fund, same crash, same contributions. The ~\$72,000 gap at the end is pure behaviour, not market return.

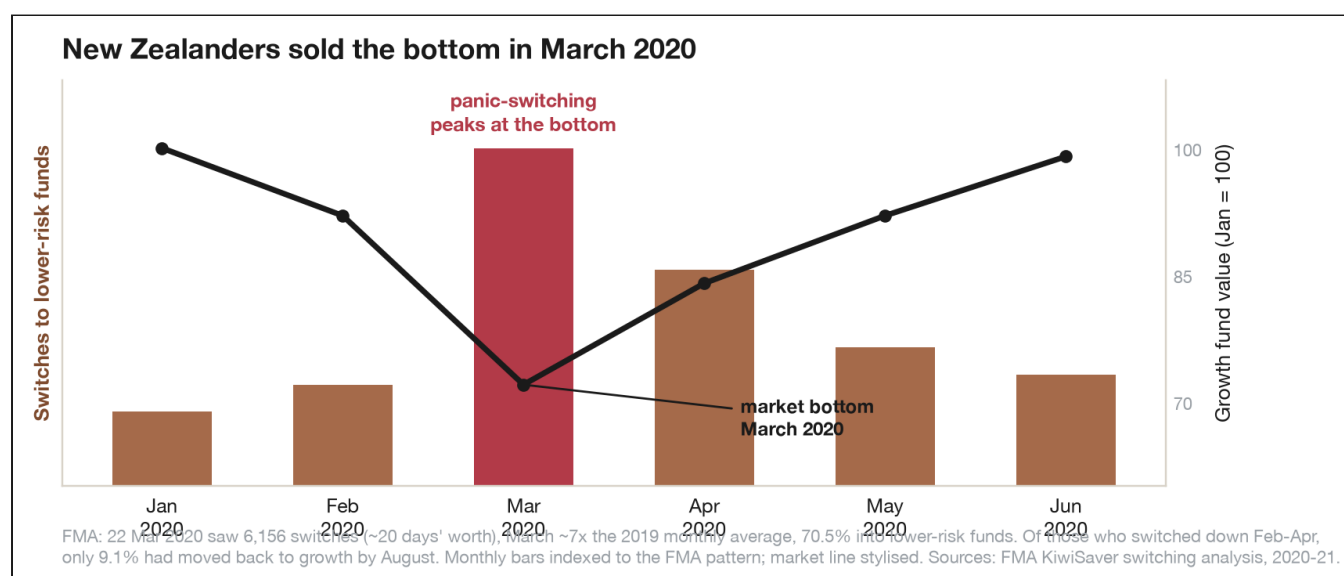
Investor A is not foolish. They did what fear and the headlines told them to do, and every step felt safe at the time. But the fund did not reward the decision; it rewarded the discipline. The market return was identical; the investor return was permanently, materially different.

Illustrative KiwiSaver paths over sixteen years on representative growth-fund returns. Modelling detail is in the Technical Appendix.

IT ALREADY HAPPENED HERE

March 2020: New Zealand sold the bottom

The Panic Cycle is not a thought experiment. New Zealanders ran the whole loop in real time during the COVID-19 crash, and the data captured it.



Switching into conservative and cash funds peaked almost exactly as the market bottomed in March 2020, then the market recovered within months. FMA: 6,156 switches on 22 March alone, 70.5% into lower-risk funds. Monthly bars indexed to the FMA pattern; market line stylised.

When the market fell hardest, a wave of KiwiSaver members switched out of growth and balanced funds. The FMA documented it precisely. On **22 March 2020**, near the very bottom, there were **6,156 switches in a single day**, about twenty days' worth of normal switching, with March at roughly seven times the 2019 monthly average. **70.5% were into lower-risk funds**, and the switchers skewed young, the members with the longest horizons and least reason to flinch.

Then comes the figure that turns a switch into a permanent loss. The market recovered within months, but of those who moved to a lower-risk fund between February and April 2020, only **9.1% had moved back to a high-growth fund by August**. Roughly nine in ten stayed put in the safer fund and so banked the fall while sitting out the rebound. It was textbook myopic loss aversion at national scale: the drop felt like an emergency, the headlines were uniformly grim, switching felt like prudence, and the recovery arrived long before the confidence to re-invest did.

SMITHS FINDING 04A

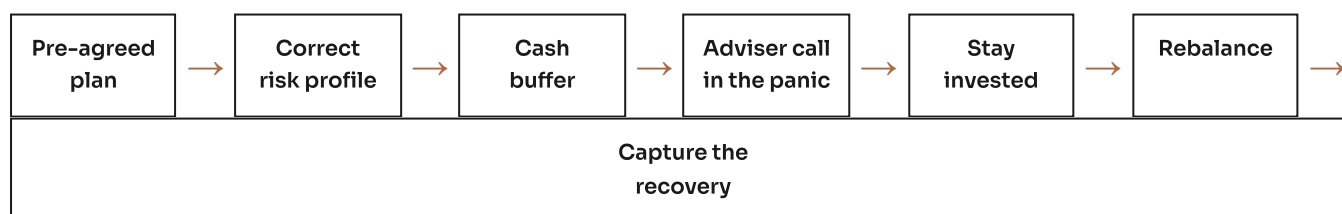
"A drawdown is a price. A panic-switch is a purchase. The first is temporary and refundable; the second is permanent and paid in full."

The lesson is not that conservative funds are bad. For an investor near retirement with a short horizon, a conservative fund can be exactly right. The damage is in the *timing*: switching at the bottom on fear rather than a plan, and re-entering late. Behaviour, not the fund, did the harm.

THE SMITHS FRAMEWORK, PART THREE

The Behaviour Circuit Breaker

If the Panic Cycle is a chain reaction, the cure is a circuit breaker: a small set of pre-committed steps that interrupt the cycle before it reaches the long-term plan.



The genius of a circuit breaker is that the decision is made *before* the fear arrives, when the investor is calm and rational, and is simply executed during the panic, when they are not. Each step disarms a specific link in the Panic Cycle.

WHERE THE CYCLE ATTACKS	THE CIRCUIT BREAKER THAT HOLDS
Fear of further falls	A pre-agreed plan that names volatility as expected, not as failure
The fund feels too risky	A correct risk profile chosen for the discomfort you can truly hold
Need to raise cash now	A cash buffer, so the long-term fund is never sold at the bottom
The urge to switch to cash	One adviser call before acting, the single highest-value moment
Waiting for "certainty"	Stay invested and rebalance on a rule, not on a feeling

Each row converts a moment of panic into a pre-decided action, so the recovery is captured rather than missed.

The adviser call is the load-bearing step, and it is where the measured value of advice concentrates. Vanguard attributes roughly 1.5 percentage points a year to behavioural coaching alone, almost all of it earned in a handful of frightening moments where an adviser stops a client from selling the bottom. The fee is paid across the years; the value is delivered in minutes.

The most valuable thing an adviser ever says is "do nothing", on the one day every instinct is screaming to act.

Return to Investor A and Investor B. Nothing separated their outcomes except whether a circuit breaker fired. B had a plan that named the fall as expected, a buffer that meant nothing had to be sold, and the discipline to stay invested and keep buying cheap units. A had none of it, and met the crash with instinct alone. The Behaviour Circuit Breaker is simply the difference between those two responses, written down in advance so it survives the one day it is needed.

WHAT IT MEANS FOR YOUR MONEY

Building a portfolio you can actually hold

Risk profile

Choose the fund for the discomfort you can *survive*, not the return you would *like*. A growth fund you sell at the bottom underperforms a balanced fund you hold forever. The right risk profile is the most aggressive one you can hold through a real crash without switching.

The cash buffer

A separate cash buffer, sized to your near-term needs, is what lets the long-term fund stay invested. It means a shock is met from cash, not by selling growth assets at the worst possible moment. (This connects directly to the resilience argument of Paper 01.)

Horizon and how often you look

Myopic loss aversion is cured by lengthening the horizon over which you judge results. Check a forty-year KiwiSaver against a forty-year horizon, not a daily app balance. Less frequent looking is, counter-intuitively, better investing.

The pre-committed plan

Write down, in advance and in calm, what you will do when, not if, the market falls 25%. A plan made before the fear is the only plan that survives the fear. The decision to hold is made once, at the start, and simply honoured later.

In every case the principle is the same: a portfolio is only as good as the investor's ability to hold it through the worst of the cycle. Design for the behaviour, not just the return, and the return takes care of itself.

WHAT IT MEANS FOR YOUR MONEY, CONTINUED

The honest objections, and where the rule bends

The honest counterargument

The central claim, that staying invested beats reacting, deserves its strongest objection: not all selling is irrational. Some de-risking is sound risk management. Rule-based rebalancing trims what has run and tops up what has lagged. Glide-path lifecycle investing dials down equity as retirement nears. A genuine regime shift, a new need for the money, or a horizon that has genuinely shortened can each justify a real change. None of that is panic. The distinction is the whole point. Disciplined rebalancing and planned glide-path de-risking are decided in advance and executed on a rule. Fear-driven liquidation is decided at the trough and executed on a feeling. This paper warns against the second, not the first. The test is simple: would you have made this move on a calm day, written into the plan, or only because the screen is red today?

Sequence risk and the limits of the 4% rule in New Zealand

The same behaviour that erodes accumulation does worse damage in retirement, where the *sequence* of returns matters as much as the average. A bad run early, met by selling to fund spending, can sink a portfolio that the same returns in a kinder order would have sustained. This is why the safe-withdrawal-rate literature exists. Bengen (1994) and the Trinity study (1998) gave US retirees the 4% rule. But that is a US finding from an unusually favourable century. Pfau's and Estrada's international work shows the 4% rule does not travel: across twenty developed markets, safe rates fell below 3% in over half, and the US sat near the top. New Zealand was one of the better cases, near 4%, yet the honest line is that a US-calibrated 4% should not be assumed for New Zealand, and an NZ-applicable safe withdrawal rate is arguably lower. A cash buffer is what lets a retiree avoid selling growth assets into a down market, the retirement version of the same circuit breaker.

This is also why the four papers in this series belong together. Resilience (Paper 01) builds the cash buffer that lets the long-term fund stay invested. Insurance (Paper 03) stops a health or income shock from forcing a sale at the bottom. And the discipline described here converts the market's available return into one actually captured. Each removes a different reason a household might be forced, or frightened, into selling at the wrong moment.

IN ONE SENTENCE

"The best portfolio is not the one with the highest expected return. It is the highest-returning one you can actually hold when you are afraid."

IMPORTANT: GENERAL INFORMATION, NOT ADVICE

This paper is general information and economic commentary only. It does not consider your particular objectives, financial situation or needs, and it is not a recommendation to buy or hold any product.

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TECHNICAL APPENDIX

Model, assumptions and data

A.1 The behaviour gap

The **time-weighted return** measures the assets, independent of cash-flow timing. The investor's **dollar-weighted return** is the internal rate of return that solves, over periods t with net flows F_t and ending value V :

$$0 = \sum_t F_t / (1+r)^t - V / (1+r)^T$$

The behaviour gap is the time-weighted return minus this dollar-weighted return, negative whenever money is added after strong periods and withdrawn after weak ones.

A.2 Case-study model (Investor A vs B)

Both start at \$100,000, contribute \$2,400 a year, and face the same path: -25% in the crash year, then +20% and +15% in recovery, then +8% per year, over sixteen years. Investor B holds growth throughout; Investor A switches to conservative (+2%) for the two recovery years, capturing the fall but missing the rebound.

OUTCOME	INVESTOR A	INVESTOR B
Behaviour in the crash	switched	stayed
Ending balance (16 yrs)	~\$284,000	~\$356,000
Behaviour gap	~\$72,000 (~20% of B)	

A.3 Reference magnitudes used

QUANTITY	VALUE	SOURCE
Historical real equity premium	~6% p.a.	Mehra & Prescott (1985)
Implied risk aversion to fit premium	>30 (vs ~1)	Mehra & Prescott (1985)
Loss-aversion coefficient (contested)	~2.25	Tversky & Kahneman (1992); Gal & Rucker
Behaviour gap (defensible)	~1.1–1.2 pts	Morningstar Mind the Gap; DALBAR disputed
NZ safe withdrawal rate (SAFEMAX)	~4.1%, lower	Pfau (2010) international SWR
Value of behavioural coaching	~1.5 pts p.a.	Vanguard Advisor's Alpha

A.4 Assumptions and limitations

Case-study investors are illustrative and return paths stylised; the 2020 switching chart is indexed to the FMA pattern, but the FMA figures cited (6,156 switches on 22 March, 70.5% to lower-risk funds, 9.1% returning to growth by August) are real and sourced. Behaviour-gap and coaching magnitudes are report-specific approximations, not guaranteed premia. The loss-aversion coefficient is contested (Gal & Rucker, 2018); the paper's conclusion does not depend on it.

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The Smiths Economic Papers

Earlier in the series

Paper 01 - The Death of Net Worth

Why high-net-worth New Zealand households can still be financially fragile, and why resilience, not net worth, is the true measure of strength.

Paper 03 - Insurance as Balance-Sheet Engineering

How life, income-protection, trauma and health cover protect the largest asset most households own, their future income.

About the author

Henry W. Smith (BBusMan) is a financial adviser and the author of the Smiths Economic Papers. The series applies established economic theory to the real financial lives of New Zealand households, and is published by Smiths Insurance & KiwiSaver.

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