Just SA: Expert Opinion: Edition: April / June 2019

Offer members what they can afford

Vital element in default strategies, urges Just SA chief executive Deane Moore.

From 1 March 2019, the board of trustees of every pension and retirement-annuity fund must be able to demonstrate to the Registrar of Pension Funds that it has in place an annuity strategy that is appropriate and suitable for its members, taking account of:

- their level of income;
- inflation and investment risks; and
- income protection for beneficiaries on death of the main member.

A member reaching retirement has two categories of needs:

- basic lifetime needs: a monthly income for life for the member and his/her spouse, which grows with inflation, to pay for essential expenses such as food, medical, accommodation, water, electricity, telephone, transport and insurance;
- lifetime aspirations: flexible income for other expenses, tax planning, or to leave as a legacy for beneficiaries.

In South Africa, most people reaching retirement have insufficient savings to consider aspirations. Their priority is to focus on maximising their incomes for life to cover their basic lifetime needs.

There are two retirement options for providing members with a sustainable income for life, where this is expected to grow with inflation: a living annuity or a guaranteed life annuity.

In a living annuity, members need to decide how to invest their retirement savings and how much income to draw from these savings each year. Income is not guaranteed, but the Financial Sector Conduct Authority has published a table to show what proportion of his/her assets a member can draw at each age to have a 90% probability of sustaining their income for life and increasing this with inflation each year. This table was developed by industry professionals and is currently under consultation.

A with-profit annuity is a type of guaranteed life annuity that provides members with a guaranteed income for life that is targeted to grow with inflation each year.

This table compares the income from a guaranteed life annuity and a living annuity on a consistent set of assumptions.

1. *The guaranteed life annuity rates are for the Just Lifetime Income with- profit annuity.*
2. *The maximum sustainable living annuity drawdown rates published forconsultation by the Financial Sector Conduct Authority on 7/11/2018 in their Draft Conduct Standard for Living Annuities in a Default Annuity Strategy. If individuals withdraw income at these rates, they have a 90% chance of being able to sustain their income for at least as long as their average life expectancy i.e. their income will keep up with inflation until their expected death.*

In a living annuity, when the main member passes away, his/her beneficiaries will receive any capital that is left in the living annuity.

In a guaranteed life annuity, members can opt for income to continue for the remainder of their spouse’s lifetime and until beneficiaries are no longer dependent. This is a death benefit that is specifically focused on the ongoing needs of beneficiaries to meet essential expenses.

In surveys carried out by Just in 2015 and 2018, over 85% of retired people said they would prefer a secure, guaranteed income for life against investing a pool of assets and deciding how much to draw each year.

www.justsa.co.za

ASHBURTON INVESTMENTS: Expert Opinions: Edition: April / June 2019
SANLAM INVESTMENTS: Expert Opinions: Edition: April / June 2019

Ashburton Investments: Expert Opinion: Edition: April / June 2019

Search for yield in private markets

Isabella Mnisi, the Ashburton Investments chief investment officer for private markets, discusses how SA lags when it shouldn't. Take a close look at where potential

advantage lies for the investor and for the country.

Increasing concerns around the global economy – the United States/China trade conflict, uncertainty around Brexit and emerging-market risks – are pushing investors to look for other sources of return. Global growth also seems to have peaked, creating downside risk.

On the domestic front, constrained economic growth projections (albeit in the right direction) – as well as disappointing stock market performance, lack of business confidence and political uncertainty – are leading investors to look for other sources of return. The market is also not expected to improve substantially in the short term.

Therefore, international factors coupled with local factors have led investors to start looking beyond traditional assets for other sources of returns. Alternative markets still provide attractive valuations and offer the potential for alpha while also offering diversification benefits to traditional assets.

However, SA institutional investors allocate only about 2% of their assets to alternatives. This is extremely low when compared to the developed world (US and Europe) where allocations are generally over 20%.

Below we look at the different alternative-investment options available. Please note that the industry data on alternative assets is not as readily available because this market is not as developed and standardised as for traditional assets.

Unlisted credit

In SA, more than 80% of companies fund themselves through the banking system (private markets). This means that fewer than 20% of companies use the public-debt capital markets for their funding requirements.

More developed countries have many more companies accessing the debt-capital markets for their debt funding; for example, the US represents the opposite of the SA scenario. The SA phenomenon has resulted in banks having very well-diversified balance sheet portfolios, whereas capital-market investors only have access to limited investment opportunities through the debt-capital markets.

Unlisted credit offerings give investors the opportunity to access diversified pools of assets that are currently not readily available to investors in funds regulated as collective investment schemes.

Yet, in the past few years, we have seen increased interest and demand for unlisted credit from SA institutional investors. Regulation 28 allows for 15% of a pension fund's assets to be invested in unlisted debt instruments. Most pension funds are below this limit.

Private equity

Southern Africa's private equity industry had R158,6bn funds under management as at December 2017. Of funds raised during 2017, 49,9% were from SA sources according to the Southern Africa Venture Capital & Private Equity Association (SAVCA) 2018 Private Equity Industry Survey.

SA institutional investors have been increasing their participation in the private equity market for many years, as can be seen from the above chart. Investors may include mezzanine debt under the private-equity category depending on the way in which the instrument is structured.

Real assets

Mnisi . . . strengthen alternatives

Investor participation in real assets will either be through a debt or equity structure. Institutional investor participation in real assets is key, especially for a country like SA with huge infrastructure funding needs.

Real assets offer a great source of inflation hedge for long-term liabilities, particularly for pension funds. These real assets' long duration, predictable cash flow and inherent inflation hedge characteristics are also highly attractive.

Investors have previously participated in toll road and renewable energy infrastructure funding. Some have preferred to participate in the post-construction phase of the transaction due to it being more de-risked. This is mainly because of a lack of understanding of the construction risk phase.

Policy and pricing uncertainty, due to political meddling, have seen investors scaling back from these assets in the SA market. But energy minister Jeff Radebe has moved swiftly to provide some certainty on the funding of renewable energy projects.

We hope that this will lead to increased confidence and funding from institutional investors. Our country's fiscal constraints will require institutional investors to plug the infrastructure-funding gap.

Be meaningful

We believe that any portfolio asset allocation needs to have a meaningful allocation to alternative assets. Alternative investments, when used as part of a multi-asset portfolio to complement traditional investments, can lead to improved long-term risk-adjusted returns.

First-time investors in the alternative markets should focus on the overall benefits that alternative investments could bring to a portfolio.

Sanlam Corporate: Expert Opinion: Edition: April / June 2019

Ride smoothly into defaults and Reg 37

Vital checklist for trustees offered by Danie van Zyl, head of Sanlam Smoothed-Bonus Centre of Excellence.

In August 2017, the Minister of Finance signed an amendment to s36 of the Pension Funds Act. This amendment contained the addition of regulations governing conditions for defaults.

Regulation 37, which covers default investment portfolios, applies to pension and provident funds. It excludes retirement annuity funds, beneficiary funds, preservation funds and funds in voluntary liquidation.

The amendments, effective from 1 March 2019, require retirement funds to ensure that they have a suitable default investment portfolio in place for pre-retirement savings. These portfolios must be appropriate, not excessively complex or unreasonably expensive.

Importantly, the board of trustees must be able to demonstrate to the Registrar that its chosen default investment portfolio is appropriate.

Most retirement funds already have a default investment portfolio in place. For the Sanlam 2018 benchmark survey, 62% of funds indicated that they have a default portfolio where members have the option to choose an alternative portfolio should they wish.

The survey also found that a lifestage solution, followed by balanced funds and smoothed-bonus portfolios, are the most popular. Many funds also use a smoothed-bonus portfolio towards the end stage of their lifestage solutions.

As there are many retirement funds that use smoothed-bonus portfolios in their default investment strategy, let's unpack what these funds need to consider and do to demonstrate that they meet the requirements set out in Reg 37.

Demonstrating compliance

Van Zyl . . . comply with defaults

The board of trustees should consider adding some or all of the following points as agenda items for their trustee meetings and then include the main points in their minutes. They can then be provided at a later stage if requested by the FSCA.

Default investment portfolio(s) are appropriate for the members who will be automatically enrolled into them.

- Many retirement funds appreciate that smoothed-bonus portfolios provide smooth returns to members, preventing them from experiencing the roller-coaster that members may experience from market-linked portfolios. The guarantees are also valuable to members in a default portfolio as they protect members from potentially losing some of their capital in a portfolio they did not choose. This is particularly relevant to blue-collar members who are risk-averse as well as members close to retirement.

What is a default investment portfolio?
As defined in Regulation 37, a "default investment portfolio means an investment portfolio in which the retirement funding contributions of a member must be invested unless the fund has been instructed by the member in writing to invest them in another investment portfolio provided in terms of the investment policy statement of the fund or options available to members of the fund".

The composition of assets and performance of the default investment portfolio are adequately communicated to members.

- Can members access the latest fund factsheets and quarterly reports? Sanlam provides various forms of communication which contain the asset composition and performance of funds e.g. monthly fund factsheets and quarterly reports for our smoothed-bonus portfolios.

Default investment portfolios are reasonably priced and competitive.

- How do the fees compare to other similar portfolios? Sanlam's smoothed-bonus portfolios have competitive investment management fees that reduce as the size of invested assets increases. The guarantee premiums charged are favourable compared to competitor products that provide similar levels of guarantees.

All fees and charges are disclosed.

- Sanlam discloses the fees and charges on all portfolios and provides the portfolio's Total Expense Ratio and

Total Investment Costs to clients on request.

No loyalty bonuses or other complex fee structures.

- Do trustees and members understand the underlying fees? The fees charged on the Sanlam smoothed-bonus portfolios are easy to understand and calculate. The portfolios have no loyalty bonuses.

Members are not locked into the default investment portfolio.

- Are there any unreasonable barriers to exiting the portfolio? Members can switch out of the Sanlam smoothed-bonus portfolios at any time. However, should this occur when the portfolios are underfunded, members will receive the lower of book value and market value. Members who leave the portfolio for benefit-payment events (death, disability, retrenchment, retirement, resignation) will always receive book value.

Funds are further required to record their default investment portfolio in their Investment Policy Statements. They are also required to record that the above conditions were considered when the portfolio was chosen. Additionally, trustees are encouraged to include the following:

- Set out in writing how and when the board will review (on a regular basis) the default investment portfolio to ensure it is still compliant with Reg 37;
- The merits of both passive and active investment and reasons for the decision to use either (or a combination of both).

The FSCA released a further standard with conditions that smoothed-bonus portfolios need to meet in order for them to be used as a default investment portfolio. This standard is currently in draft form.

Sanlam, as a leading provider of smoothed-bonus solutions, is engaging with the regulator and is fully supportive of the regulations' aims. Sanlam will keep clients updated with any new developments.

www.sanlam.co.za/institutional

PAIA APPLICATION: Editorials: Edition: April / June 2019

Futuregrowth: Expert Opinion: Edition: April / June 2019

RI tipping points

Whilst he finds encouraging signs, Futuregrowth's Andrew Canter also notices continued impediments.

There are meaningful changes in the world of responsible investment (RI).

Investors have now realised that global warming is real. It may be approaching the point of no return with visibly rising temperatures, melting ice and altered climates. The ability for humanity to make adjustments has dropped from decades to mere years. Investors seem less willing to trade 'ecology' for 'economy'.

Capital is shifting away from carbon emitters to sustainable practices. 'Stranded assets' – the idea that coal or oil in the ground may never be used – is a phrase first coined only a few years ago. But it has quickly become a real factor in company analyses.

More investors are behaving proactively. This may be defensive as global inequality, slow growth and corruption have created political risk. They create unwanted uncertainty. However, RI is also driven by the trend for investors to seek a sense of purpose in their lives and with their money.

As investors move toward 'making money and also being a positive force in the world', they take on a wider role and duty. This leads to more varied analyses and better decision processes.

Investors are finding new tools to be responsible and engaged. These include proxy-voting policies and transparency, direct dialogue with companies and improved reporting on sustainability issues. There is an organised global movement toward requiring more comprehensive and standardised reporting on a range of environmental, social and governance (ESG) factors. Improved information flow on ESG issues is a vital first step for analysts to do their work.

In SA, recent corporate and public sector shenanigans – plus the rising tide of stewardship codes such as the PRI, CRISA and Reg 28 – have led investors to contemplate how they can improve governance standards. Tickbox governance assessments are clearly inadequate. The King IV code, for all its merits, is evidently not a panacea.

Governance does not begin and end with the board of directors. A more sophisticated view is that governance is the duty of the board, insiders, capital providers (investors and funders), regulators, auditors, ratings agents, journalists and customers alike.

Canter . . . more must be done

While there are positive movements in RI, various challenges remain. Some asset managers put a veneer of ESG onto their investment processes, but investors are becoming increasingly savvy in differentiating between 'ESG on the label' versus 'ESG in the product'.

Equity fund managers may also fetishise their benchmarks, in many cases leading them to be 'closet indexers' – reticent to stray too far from benchmark exposures. Thus, a manager with a strong view (either financial or ESG-based) has a difficult time going to zero exposure of a large-cap share. Until their investor clients expect and encourage bolder positions (relative to benchmarks), asset managers will be reticent to act strongly on corporate misbehaviour.

Another challenge is that investment analysts can suffer a range of inappropriate pressures that impair their independence or stifle their public voice. For example, there are corporate bullies ready to punish analysts who make critical comments by excluding them from future conference calls or report-backs.

Likewise, some financial-sector employers are more interested in protecting their corporate relationships than to allow unfettered analysis. SA has seen strong evidence of the benefits of a free press. Investment analysts' independence is equally vital in maintaining accountability and transparency on issuers in public capital markets.

The world of RI has seen clear forward movement; at the least, an understanding that the choices about capital deployment have real-world consequences. To overcome the structural barriers to change, investors should start by recognising that ESG factors actually do impact risk:return considerations.

Value-adding investment processes can be built around this idea.

www.futuregrowth.co.za

MOMENTUM: Expert Opinions: Edition: April / June 2019
PERSONAL LIABILITY: Editorials: Edition: October / December

2016

Momentum: Expert Opinion: Edition: April / June 2019

ABC of prescribed assets

Momentum Investments head of strategy Rowan Burger believes it's important to distinguish between ANC policy proposals, actual government policy and the regulators tasked with implementation.

When there are tax benefits for investing in retirement vehicles (pension, provident, preservation and retirement-annuity funds), government feels that it is entitled to apply certain restrictions to the underlying investment exposures to ensure their policy intentions are delivered. These are primarily to ensure a long-term investment horizon (no gearing) and diversification (restrictions on the maximum exposure to assets to avoid concentration) to deliver a prudent investment outcome.

Many people will be familiar with these restrictions, often referred to as Regulation 28. A consequence of these restrictions is that government effectively directs investment. It is therefore possible for government to change these investment restrictions to channel pension-fund investment into certain asset classes. This would allow it to direct investment into certain government projects or to help fund ailing state-owned enterprises.

Why does this affect me?

Other than government employees, most South Africans are invested in defined-contribution funds. The retirement benefit is the accumulated value of the fixed contributions to a personal pension account plus investment returns on these contributions. If the restriction was such that a meaningful part of your account had to be invested in prescribed assets, you would retire with a lower benefit. It is reasonable to assume that prescribed assets would only yield a return equal to inflation rather than equities which generally yield 5% to 7% above inflation.

A redirection of 20% of the investment strategy would reduce real returns by (20% x 5%) 1% a year. While this may not sound like much, compounding it over a working lifetime of 40 years leads to an end pension 30% less than what it could have been (or half the value in the case of a lump sum for this period).

Has this been done before?

When SA was a pariah state under the National Party in the mid-1980s and could not enter international capital markets, a large allocation was required of pension funds to invest in government bonds. In those days funds were defined benefit. It meant that the retirement benefit was fixed and corporates had to pay higher contributions to funds to compensate for lower returns.

This situation has now changed. Individuals will bear the consequence of a restricted investment opportunity.

Why is there this proposal?

A number of asset managers have refused to fund certain parastatals, where there have been governance concerns, as well as other infrastructure projects where there are social and environmental concerns. The lack of support and feeling that the private sector would be dictating terms to government is probably a key driver behind the prescribed-assets proposal in the election manifesto.

Is there a lack of support for government initiatives?

No. Existing pension funds have many investments in programmes generating employment and developing the economy. The grievance from managers is a lack of 'bankable projects' that will be delivered on time and within budget.

In fact, ASISA (the industry body representing asset managers and life insurance companies) has committed to actively creating public/private partnerships with government and supporting these with capital to meet the broader employment and development policy objectives. There are many good examples – such as renewable energy producers, toll roads and student housing –where pension monies have been used to enhance the country and still deliver great returns.

As another example, we are currently working as an industry to find ways to improve water provision using pension monies. Momentum is an active participant in the conversations and investments.

Are prescribed assets likely to be implemented?

The proposal has been ANC policy for some time. In previous manifestos, policy was more strongly worded in terms of directing retirement outcomes with proposals for a compulsory national pension fund. On many occasions, the private-sector industry has engaged with regulators on this matter. General agreement has been that prescribed assets would not be a desirable outcome. As the latest proposal suggests a discussion rather than firm policy, turned down in the past, it is less likely to become a reality.

What would be a better proposal?

It is critical for a country to have large investment pools which can be deployed to fund investment in jobs and the betterment of living standards. Our pension industry could be significantly enhanced if government adopts the proposals – already put to it by the regulators – that will keep money invested in pension funds.

This large pot would create an attractive opportunity set for government to partner with the private sector to build these infrastructure projects. Equally, the levels of oversight of certain investments have led to better outcomes for SA because of the activism that the asset managers apply.

www.momentum.co.za

LIBERTY CORPORATE: Expert Opinions: Edition: April / June 2019
FUTUREGROWTH: Expert Opinions: Edition: April / June 2019

Liberty Corporate: Expert Opinion: Edition: April / June 2019

Behaviour, conversations and relationships

Default regulations highlight their

importance. Louis Theron, head of investments and annuity products at Liberty Corporate, explains why.

The default regulations under the Pension Funds Act, now effective, aim to lower charges and improve outcomes for members of retirement funds. All funds must ensure a minimum level of compliance even though the design, detail, extent and execution of the default strategies will differ between funds.

Still to become certain are whether discussions are taking place at the appropriate levels and whether behaviours, conversations and relationships are being considered. These are crucial for a retirement fund to achieve success and advance members' financial freedom. Investment strategies, product selection and financial-services providers are important, but must be considered against the right context related to each retirement fund.

Doubt and scepticism around the regulations will persist due to recent negative investment and market sentiment. Within the SA retirement industry, shorter-term changes and successes will arise with fundamental (appropriate) shifts requiring more time to settle.

Behaviour

Theron . . . clear objectives

Trustees generally have a good idea of the member behaviour in their funds. At Liberty we believe that the default regulations afford the opportunity to clearly articulate the ideal member behaviours that trustees would like to encourage. Identifying initiatives to change members' current behaviours accordingly can then be implemented to facilitate this.

As we are dealing with members, we need to remind ourselves that a one-size-fits-all approach is not possible and not something that the default regulations are trying to drive. Rather, they're about putting into place strategies that are suitable for the average member of the fund. In turn, these represent the main characteristics and preferences of the fund's membership.

They encapsulate the DNA of the fund – what it stands for and to which all intended behaviours should revert. The strategies should be regularly reviewed, monitored and adjusted to accommodate fundamental environmental shifts such as changes in regulations and the fund's membership profile.

Conversations

Stakeholder conversations across the value chain will promote the successful delivery of any strategy promoted and enabled by the default regulations. One example relates to discussions between trustees and their consultants. Another example is member communication around the default strategies.

Regardless of specific conversations, they should be seen as the delivery and support of mechanisms built around the default strategies. These are as important as the actual solutions themselves.

Liberty research has found that pensioners' needs and wants can broadly be grouped mainly into functional and emotional categories. The research also revealed an overarching need for communication and information. The specific communication-related needs of pensioners and those close to retirement are:

- Early career education and engagement opportunities;
- Regular access to knowledgeable advisors;
- Conclusive information that is simple and concise;
- Detailed breakdown of processes and procedures;
- Information in addition to product information, e.g. alternatives ways to save for retirement;

- Stories and testimonials from others.

Communication around a default strategy alone will not achieve the desired outcomes, whereas a conversational approach can be expected more successfully to deliver this.

Partnerships
The definition of a partnership, within a business context, is appropriate for the default-regulations context. As with conversations, different partnerships exist in the delivery of a fund’s default strategies. Most obvious would be the partnership between trustees, the product provider and consultants.

If appropriately addressed, the default regulations can introduce a new partnership in the delivery of the default strategies i.e. the partnership between benefits counselling and advice. According to the default regulations, benefits counselling is “the disclosure and explanation, in a clear and understandable language, including risks, costs and charges, of available investment portfolio and annuity options”. Most importantly, it is limited to the provision of factual information around the default strategies.

The default regulations have created opportunities for product providers, consultants and advisers to deliver better outcomes for fund members. These enhanced toolkits will not succeed by themselves. They’re intentionally associated with setting targeted member behaviours, the strategic enablement offered by member conversations and shared ownership focus from partnerships.

www.liberty.co.za

RISCURA: Expert Opinions: Edition: April / June 2019
MOMENTUM: Expert Opinions: Edition: April / June 2019

Riscura: Expert Opinion: Edition: April / June 2019

A GENERATION OF UNWILLING PENSIONERS

Fran Troskie, Investment Research Analyst, RisCura

As a generation of baby boomers reaches retirement, and as people live longer due to medical advances, an important question is getting more attention globally: What is the right age to retire? Should SA's aging workforce be working – and contributing – for longer?

Particularly in more developed markets, retirement reform has seen the retirement age increase, at times sparking the ire of would-be pensioners. But, there is also a flipside, particularly in countries where pension provisions are inadequate.

Picture a 64-year-old engineer, a year away from being pensioned off. He's grateful to have his health and looks forward to a touch of leisure. Yet, mostly, he's concerned because he knows he only has one year of working left to contribute to a comfortable retirement. Several factors makes this seem like a pipe-dream:

- Past mistakes: Cashing out his retirement savings when he changed jobs 20 years ago, and choosing the lowest contribution rate;

- Present circumstances: Was not offered an in-fund annuity by his employer and did not receive financial education on retirement saving;
- Future prospects: With advances in medicine, he believes his retirement years will last longer than he'd foreseen 20 years ago.

Unfortunately, there isn't much he can do to change the above. But, one thing he could do to improve his financial situation is to keep working – and contributing to his retirement savings. Company policy, however, doesn't necessarily allow him to. It may impose mandatory retirement, with normal retirement age at 65.

In many respects, he believes he's a more valuable employee now than ever before. He has a lifetime of knowledge, learning, and experience. He's the first one in the office in the morning, and the last to leave, since an empty nest means there are fewer responsibilities for him at home.

He is one of thousands of highly-skilled employees facing a financially uncertain future after unwillingly retiring. There is a whole generation of people who believe they are still fully capable of making a meaningful contribution to society – but the current employment system seems to underestimate their value. And, in a country like South Africa with soaring youth unemployment rates, they know that finding gainful employment elsewhere is highly unlikely.

Statistics SA's Q2 Quarterly Labour Force survey released in July 2018 has few positives to report. Compared to last year, the national expanded unemployment rate increased by 0.5 percentage points. The proportion of youth aged 15 to 24 who were not in employment, education or training (NEET) increased by 0.7% over the same period. At 39%, this means that an average of four per ten youths are unemployed, but are not in education or training to become employed. Within this context, the prospects for people of pensionable age are dim.

There are no simple solutions, but the retirement industry and government policymakers should take into account that policies and regulation should encourage trustees and investment consultants to help ensure that:

a) members receive sufficient financial education throughout their working careers;
b) funding models are appropriate (life stage models and asset-liability matching);
c) members are provided with appropriate savings-options at retirement (annuities/in-fund annuities).

Government may need to reconsider how it uses the longer-lived grey workforce. An added emphasis on skills transfer programmes would be laudable – not only in terms of making efficient use of valuable human capital, but also in addressing some of the concerns about youth NEET. Educated and experienced elderly instructors could work in training colleges, even if only on a temporary and substitute basis. Mentorship programmes can also add to the socio-economic impact of such initiatives. And, if such work were to be compensated (potentially partly by revisions to the old age grant system), all the better.

Deciding which interventions are feasible, needs more attention. But, at the very least, it is clear that a generation of unwilling pensioners and a growing grey workforce should not be left in the cold.

Don't miss out on the next RisCura Education Series for Institutional Investors:
Does investing for a better South Africa require prescription?
24 April 2019, 09h00 – 14h00 Radisson Blu Gautrain Hotel, Sandton, Johannesburg To register, email events@riscura.com

OLD MUTUAL CORPORATE: Expert Opinions: Edition April / June 2019
LIBERTY CORPORATE: Expert Opinions: Edition: April / June 2019

Old Mutual Corporate: Expert Opinion: Edition April / June 2019

Default regulations' learning curve

Andrew Davison, Head of Advice at Old Mutual Corporate Consultants, summarises what trustees need to know.

On 1 March 2019, the industry saw full implementation of the retirement-fund default regulations. They aim to deliver better retirement outcomes for members by addressing three key areas of retirement savings.

A fund default investment strategy is nothing new. It is unusual for a fund to not have one. Given that many people are invested in their fund's default strategy, the regulations seek to tighten up the requirements that such a default investment strategy should meet.

One of the biggest reasons why people fail to accumulate sufficient savings by the time they reach retirement is that they cash in their savings when changing jobs. The regulations aim to improve preservation of savings by providing cost-effective and easy-to-access methods of preservation. Then, at retirement, the regulations require funds to offer members an annuity or annuities to assist them to convert their accumulated savings into a pension for life.

There are three default regulations to the Pension Funds Act:

- **Reg 37** requires retirement funds to offer a sound default investment strategy;
- **Reg 38** requires that pension and provident funds offer a default preservation strategy;
- **Reg 39** requires funds to have an annuity strategy for members upon their retirement.

All three offerings should be appropriate, simple, cost-effective and transparent to improve members' overall benefits. Members should be provided with suitable communication in relation to the default investment strategy, including fees and performance, on an ongoing basis. They should also be given adequate information and guidance about their options when they leave a fund, either before retirement or at retirement.

The industry has been aware of these changes since they were promulgated on 25 August 2017. They align with the principle of Treating Customers Fairly which governs the way all financial-services providers treat clients.

What are trustees to do?

Even if trustees have already developed and implemented their fund's default solutions, there is still a lot of work to be done. It is essential that they carefully document the process followed and the decisions taken as compliance by boards will need to be evidenced.

The fund's Investment Policy Statement (IPS) must be updated to reflect any changes and specifically to reference Reg 37. The IPS should also refer to the annuity strategy that the fund has put in place and ensure alignment between pre- and post-retirement investment strategies. Trustees should consider drafting an Annuity Policy Statement to document the fund's annuity strategy.

There is also the important issue of communicating the default solutions to members and ensuring that they understand the options and solutions available to them, including any access to retirement benefit counselling. A further note offering interpretation and other guidance in respect of the default regulations was issued by the Financial Sector Conduct Authority (FSCA) on 12 December 2018.

There are two further draft conduct standards that are still to be released. They cover living annuities and smoothed-bonus portfolios.

Funds that utilise smoothed-bonus portfolios for their default investment strategy and those funds that have selected a living annuity as part of their annuity strategy will need to review their solutions to ensure that they comply once the final documents are released. The FSCA has indicated that these will be issued shortly, but with a delayed implementation date.

Challenges for trustees

There will be additional work for trustees. This relates to development of the solutions, selection of service providers, communication to members and then ongoing, regular review of solutions and providers to ensure they remain appropriate. Depending on the type of annuity strategy developed, the levels of administration and oversight will vary.

The default regulations are not a silver bullet. There will still be challenges. An important element is that trustees deal with a group arrangement. It is therefore impossible to build solutions that suit each and every individual member, but trustees need to communicate with members and advise them on how decisions were made in the members’ interests and to suit their personal circumstances.

Choosing annuity strategies

Regs 37(2) and 39(2) place an onerous responsibility on trustees when it comes to default investment portfolios and annuity strategies. Education and upskilling of trustees are paramount if they are to implement high-quality solutions that truly address their members' needs.

There are various training providers that are adapting their training to incorporate post-retirement solutions and default regulations. Employee-benefit consultants are also investing in training and building the knowledge of their consultants to advise trustee boards.

Asset consultants are also available to assist trustee boards to navigate this new territory. It is fair to say that this is a learning curve for the entire retirement industry. In the past it has not had to deal with post-retirement issues, especially in the defined-contribution space.

Trustees' key requirement is to justify that they are adhering to the regulations. They should be able to document and demonstrate that they have applied their minds and considered all the available options before selecting the solutions or service providers they have used. Clear objective comparisons will also have to be documented as part of the process.

There are many different types of annuities available in the market. It has proven a challenging exercise for most trustee boards to go about choosing annuities that meet the requirements of Reg 39.

Davison . . . improvements over time

This is exacerbated by the fact that it's a new area of expertise for most trustees. Annuities, particularly with-profit annuities, are not easy to compare because the levels of initial pension for a set amount of capital vary between providers.

Also, over time the bonus histories aren't always comparable and they need to be evaluated in conjunction with the starting pension. This means that it is difficult to assess the likely future performance.

This has undoubtedly been, and will still be, a steep learning curve for trustees and consultants.

Our view is that the institutional default annuity space will evolve over the next few years, both in terms of the products available as well as in terms of the ability to assess and compare the various annuities and providers.

For more information, please contact Andrew on adavison@oldmutual.com, or visit

www.oldmutual.co.za/omcc

SANLAM INVESTMENTS: Expert Opinions: Edition: April / June 2019
RISCURA: Expert Opinions: Edition: April / June 2019

Sanlam Investments: Expert Opinion: Edition: April / June 2019

Offshore equities not the panacea as SA investors believe

So argue Adam Bulkin, Mark Phillips and Peter Urbani of Sanlam Investments.

Those retirement-fund investors in the accumulation stage need to invest for both real (after-inflation) growth and also to preserve and grow their wealth in hard-currency terms. Over 2018, these objectives were extremely difficult to achieve.

The rand lost close on 14% as measured against the US dollar. As a result, along with the dismal performance of most domestic asset classes for the year, many SA investors suffered significant wealth destruction particularly when measured in dollar terms. Once again, offshore investing is front of mind for South Africans wishing to preserve and grow their real spending power.

Conventional wisdom is to utilise shares in SA-listed companies whose operations and revenues are based offshore (so called “rand-hedge” stocks), or shares directly in offshore jurisdictions, to benefit from and protect against rand weakness.

It makes intuitive sense to follow this strategy, since this should achieve diversification and negative or low correlation with a weakening rand and thus with a major driver of the returns of one’s dominant growth asset (domestic, non rand-hedge equities). But are investors following the correct strategy? Does research in fact support it?

The Legae Peresec firm conducted research based on the behaviour and correlations of rand-hedge stocks to the relative strengthening or weakening of the rand during the period 2013 to 2018. It wanted to investigate the hedging power of these rand hedges and the diversification benefits of offshore asset classes.

It found that the relative hedging strength of the rand-hedge stocks seems to vary greatly depending on the magnitude of the currency move and the particular stock, and that the relationship between currency and return is not a direct or linear.

Therefore, the evidence certainly does not support an investment strategy based on a simple, blanket assumption that rand weakness will automatically or necessarily equate to high relative or absolute returns for rand-hedge stocks.

What of other asset classes, such as offshore listed shares? Legae points out that diversification seems to disappear exactly when one needs it most – in extreme events, such as stock market crashes, particularly those brought about by global events. Specifically, it found that local property and global equities provided poor forms of diversification for the local equities market.

However, there were some good diversifiers. US dollar cash and US government bonds, as well as local fixed-income assets, provided protection in global risk-off events when domestic equities sold off.

This research was echoed by Avior Capital Markets. It had analysed the optimal strategic asset allocation needed to achieve the highest probability of outperforming various real return objectives.

Avior concluded that, to achieve the optimal asset allocation for a CPI+5% return objective within Regulation 28 confines, a high allocation to domestic bonds (slightly above 40%), about 25% to domestic equity and property and small allocations to gold and African equities (about 5% or less) was optimal.

Interestingly, the balance, allocated to offshore assets was exclusively to fixed-income assets i.e. US government bonds and US high-yield corporate bonds, with no allocation to global equities. Avior’s research therefore supports that of Legae with respect to the optimal offshore asset allocation being to fixed income assets.

We conducted our own conditional correlation analysis from January 2013 to December 2018 to examine Legae's and Avior's conclusions. We broke down this period into three regimes:

- January 2013 to January 2016, when the rand depreciated by 47% against the dollar and the JSE gained 37%;
- February 2016 to December 2017 when the rand gained 28,2% and the JSE gained 27,9% cumulatively;
- January 2018 to December 2018, when the rand fell 13,8% and the JSE returned -8.5%.

We found that the behaviour of asset classes is dynamic and affected by myriad factors. Correlations are different in different regimes. Using historical data simplistically, without forward-looking views and insight into the drivers of historical returns, is therefore not an optimal manner in which to make asset-allocation decisions.

That said, from the perspective of correlations, our conditional correlation analysis is broadly in line with the findings of Avior and Legae. US fixed-income assets were a good negative correlator to domestic equities and therefore protected wealth in hard currency.

Our analysis is therefore generally in agreement with Avior and Legae in that the expectation that US fixed-income assets will act as a good diversifier to domestic equities and protectors of wealth in the case of rand weakness.

Moreover, our analysis confirmed that the behaviour of rand-hedge stocks does not display a stable or directionally clear relationship to periods of rand weakness. It would seem that other drivers of returns for these stocks are more significant.

But our research also highlights that, from a longer-term perspective and taking into account the imperative of driving total returns, there is empirical evidence for utilising global equities (US and Japanese in particular).

We also observe that the drivers of returns of any particular asset are extremely complex and diverse. Thoughtful asset allocation needs to apply forward-looking views and judgment to investment decisions, as well as insights into the causes of observed past behaviour. Correlations are not static. There is evidence to suggest that the negative correlation between equities and bonds may be changing.

In short, a simple extrapolation into the future of asset classes' past behaviour – without considering fundamental drivers of such behaviour and the ways in which they may change – clearly would be imprudent.

Yet the empirical, historical research (discussed above) supports the contention that a SA investor should be circumspect in the use of both SA-listed rand-hedge stocks and offshore equities to manage the risks of rand weakness and its effect on the returns of domestic equities. Research indicates that assets such as local and global fixed-income assets may be far more effective for risk control.

However, in balancing the requirements of risk and return, global equities have definite merit and should be considered as an element of a well-diversified portfolio.

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