



# Trustee Tutor: Issue 8

## Understanding Risk

As a trustee, member or service provider of a retirement fund, understanding and managing risk is a key part of the decisions that you make. It is therefore important to understand the various risks the fund is exposed to and have a clear framework in place to mitigate these. Especially if you consider that many times, these risks might be in conflict with one another.

The *Cambridge Advanced Learner's Dictionary* provides the best and most concise definition of risk as: "the possibility of something bad happening".

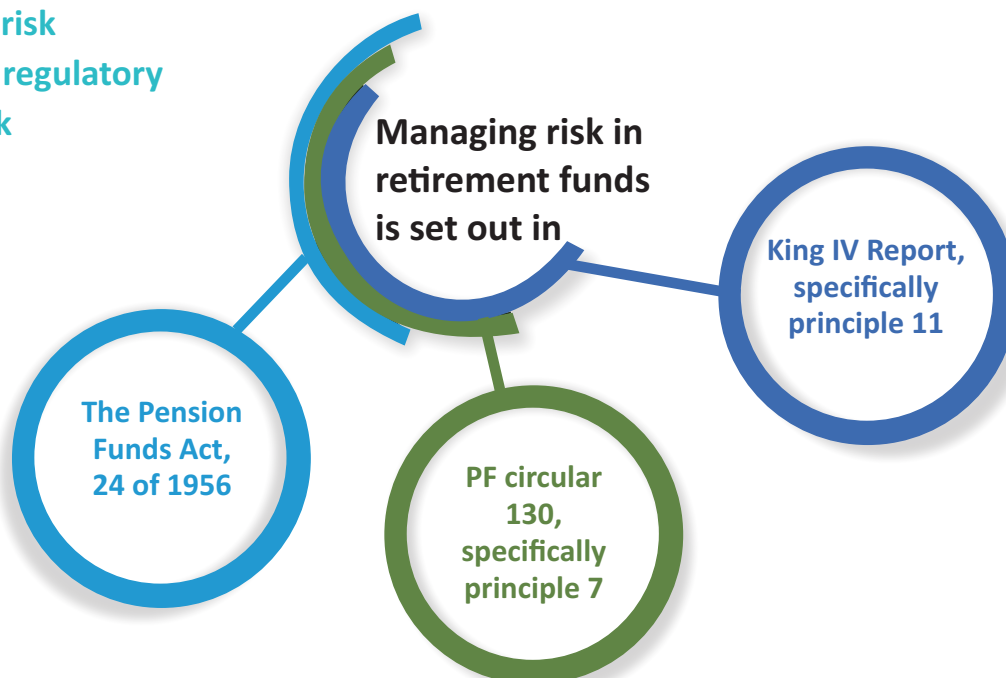
In the retirement industry, we're often bogged down in the technical jargon of the issues we deal with. Risk is an important concept to understand to be able to manage to make the best decisions possible given any set of facts or circumstances.

Practically, we deal with risk in our everyday lives. We use the roads, we consume products, we expose our minds to information. And every time we do one of those things, there is the possibility of something bad happening. But we choose to go ahead anyway, because we balance the benefits of our actions against the risks, and decide that the benefits outweigh the possible bad outcomes.

The same applies in retirement funds. Role players need to understand the risks, in order to weigh up the benefits and decide the best course of action to take.



### Managing risk within the regulatory framework



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### Pension Funds Act, 24 of 1956 ("the PFA")

Regulation 28 of the PFA sets the limits up to which a retirement fund can invest in various asset classes. These limits are there to protect members against all their retirement savings being invested in only one asset class or in only "riskier" asset classes. Regulation 28 also states that a retirement fund must "... give appropriate consideration to any factor which may materially affect the sustainable long-term performance of a fund's assets ...".

#### **PF Circular 130 – Principle 7: Risk Management**

Although not law, Pension Fund (PF) circulars are guidance circulars issued by the Financial Sector Conduct Authority (FSCA) which set out the Regulator's interpretation of governance and best practice.

Principle 7 of PF 130 specifically deals with the risk management framework within a retirement fund stating that "the management of risk in a fund is a vital component of the governance of a fund". The circular requires that every retirement fund must have a risk management policy which should be reviewed every year. We deal more with the requirements of PF 130 later in this Trustee Tutor under the heading "governance risks in retirement funds".

#### **King IV Report on Corporate Governance**

Principle 11 of the King IV Report on Corporate Governance for South Africa provides: The governing body should govern risk in a way that supports the organisation in setting and achieving its strategic objectives.

King IV recognises that risk may lead to opportunity. It is therefore important to note that retirement fund trustees are not supposed to eliminate risk totally, because to do so would remove the opportunity of reward. Rather, trustees must ensure that a robust risk governance framework underpins their strategy by balancing risk and reward.

Based on the above regulatory framework, there are generally two key documents that deal with and explain a retirement fund's risk framework, types of risks and how these are dealt with. These are the investment policy statement and the risk management policy.

### Risk in investments

According to Investopedia: "Risk is defined in financial terms as the chance that an outcome or investment's actual gains will differ from an expected outcome or return." In other words, it is the chance that an investment will perform differently than expected, that is you may lose some or all of your investment.

There are a number of investment risks that trustees need to consider when setting the fund's investment strategy. And, in retirement funds that give members investment choice, members also need to be aware of these risks in order to make informed decisions about their retirement savings.

**Capital risk** - is the risk that an investor could lose a part or all of their investment. This risk applies to almost all investments that a retirement fund can invest in – it is simply the extent of the risk that changes as you change asset classes. For example, capital risk is higher when investing in equities (shares), than when investing in fixed interest investments.

**Inflation risk** – is the risk that your investments will not provide returns that beat inflation over the period of your investment. Inflation is the general rise in prices in an economy, and is the reason why you are able to buy less and less with R100 each year that goes by. If your investments don't grow at the same rate that the prices in the economy grow, you are able to buy fewer goods and services – in other words, the value of your investments can't buy you what they used to and effectively, you're losing money. This is called negative real returns.



**A real return is the return earned by an investment after taking inflation into account.**

Retirement fund trustees must monitor that the fund's investment returns are greater than inflation over reasonable investment periods.

**Liquidity risk** – is the risk that an investment can't be sold quickly enough to meet financial obligations or liabilities. In a retirement fund context, generally some members leave at the end of every month. The fund must always make sure that it has access to enough cash in order to be able to pay members their exit benefits. For example, if a member is due a large retirement benefit, it will more than likely be necessary for the fund to sell investments in order to realise the cash to pay the member's benefit to them.

**Liquidity** refers to how quickly an investment can be exchanged for cash.

**Volatility risk** - is the risk of a change in the value of an investment portfolio due to unpredictable changes in the volatility of the underlying assets. Investors should consider the range between the high and low prices at which an investment has traded – the wider this range, the higher the volatility risk. This most commonly applies to portfolios of derivatives instruments.

**Volatility** is the movement of an investment's returns compared to its average over a period of time. An investment that is more volatile (that is, it has more and wider movements in its return) is described as more risky.

**Systematic risk** – is the risk of the whole market or of a market segment. It is within the market as a whole and shows the impact of economic, geopolitical and financial factors.

**Market timing risk** – is the risk that an investor sells an investment at exactly the wrong time, in others words, right before benefitting from the full positive return that the investment earns, or as the investment reaches its lowest value (thus missing out on the investment's recovery).

## Measuring investment risks in retirement funds

Trustees and investors must be able to measure the risks in their investment portfolios in order to make an informed decision on whether to accept the risk, in exchange for an anticipated return, to avoid it, or to mitigate it.

There are a number of ways investment managers analyse and measure the risk in their investment portfolios.

**Standard deviation** – is the most common measure of risk and measures how much the investment's current return differs from its returns in the past. An investment with a high standard deviation means that its returns differ a lot from their previous average – meaning the investment is volatile, therefore more “risky”. An investment with a low standard deviation means that its returns stay relatively close to their historical average and what is expected, in other words is less volatile and thus less “risky”.

**Sharpe ratio** – shows an investor how much extra return they have earned on an investment after taking into account the volatility of that investment. Simply put, it measures the extra return an investor earns for each additional unit of risk.



When comparing two investments to a common benchmark, the one with a higher Sharpe ratio provides a better return for the same risk (or the same return for lower risk).

# Beta

measures the amount of risk a share or a sector has relative to the whole market

**Beta** – measures the amount of risk a share or a sector has relative to the whole market. The whole market has a beta of 1. If a share has a beta of more than 1, it means the share is more volatile than the market and investments with a beta of less than 1 are less volatile than the market.

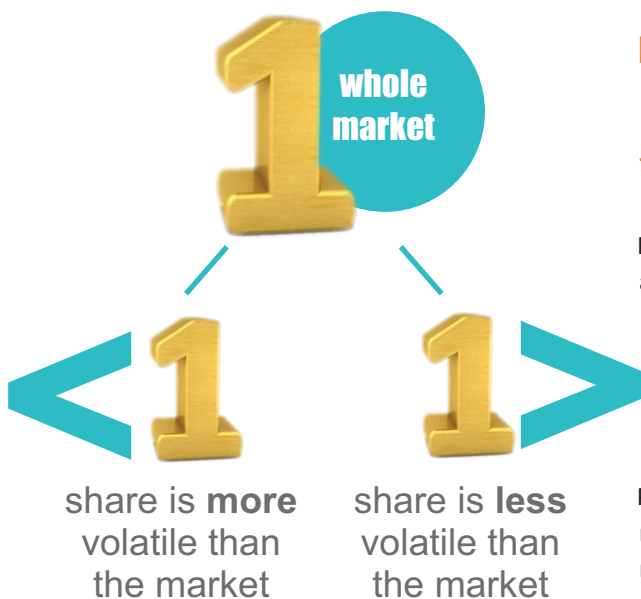
## Mitigating investment risk in retirement funds

**Risk mitigation** means to take steps to reduce the impact of a risk, ensuring that the risk becomes less harmful.

Now that you as a trustee or investor know what risks to look out for and how to measure them, you'll need to consider whether you:

- Accept the risk – in exchange for higher potential returns;
- Avoid the risk – and simply choose not to invest; or
- Mitigate the risk – and limit its impact on your portfolio.

Practically, trustees need to put an investment strategy in place for the members of the retirement fund, meaning that avoiding investment risk totally is not an option. Rather, trustees need to make considered decisions within an investment risk framework.



## Manage risk through diversification

The best way to mitigate, or lessen, the investment risk in a retirement fund is through diversification.

**Diversification** in investments is the strategy used by an investor to invest across a variety of different investment opportunities. This might be, for example, by investing in different sectors (financials, mining, retail); asset classes (shares, bonds, property), geographies (local and offshore) and investment managers.

It is putting into practice the age old saying of not having all your eggs in one basket

Meaningful diversification is a delicate balancing act. Trustees should aim for the right balance of uncorrelated investments.

**Investment correlation** is simply how various investments move or behave in relation to each other or the market. **Uncorrelated investments** are investments who move or behave differently to each other, in other words, as one investment does well in certain markets, another may perform poorly.



By investing in uncorrelated investments, trustees are able to lessen the impact of poor investment returns, by offsetting these losses with good returns in other parts of the portfolio where the investments respond differently to various market events or conditions.

Most investment professionals agree that, although it does not guarantee against loss, diversification is the most important factor in reaching long term investment goals while minimising risk. Diversification therefore is a key part of trustees' investment risk mitigation strategies.

Regulation 28 of the Pension Funds Act builds investment diversification into our regulatory framework by placing maximum limits that retirement funds can invest in certain asset classes and in certain assets. The main aim of this piece of law is to protect retirement fund members from poorly diversified investment portfolios.

Retirement fund trustees are able to diversify across:



Market sectors – examples include mining, agriculture, manufacturing, information and communication technology, tourism, finance and retail.



Asset classes (or types of investments) – the most common of these are shares (also known as equities), bonds (also known as fixed interest investments), cash or cash equivalents, property and others (like hedge funds or alternative investments).



Companies – for example in the retail sector different shares include Mr Price, Cashbuild, Woolworths and Shoprite, amongst many others.



Geographical locations – South Africa, Africa and offshore.



Investment managers – different investment managers have different styles, philosophies, systems and people, making each unique. By spreading the fund's investments across different investment managers, trustees and members benefit from the key skills and competitive advantages of different managers.

As mentioned earlier, meaningful diversification is a tricky business. If trustees get the balance wrong, it may result in diluted performance over the long term.

Trustees will set out their identified risks and their mitigation strategies in their Investment Policy Statement (IPS). In Annexure B to PF 130, the FSCA sets out the good governance guidelines to an IPS, where it recognises that there will always be an element of risk in the investments of a retirement fund. The trustees' responsibility is to manage and, where possible, mitigate the fund's risks. To be able to do this properly, trustees need to be aware of the types of risks the fund is exposed to, and could be exposed to into the future.

## Governance risks in retirement funds

### Types of governance risks

Broadly, the types of governance risks that may impact a retirement fund are:

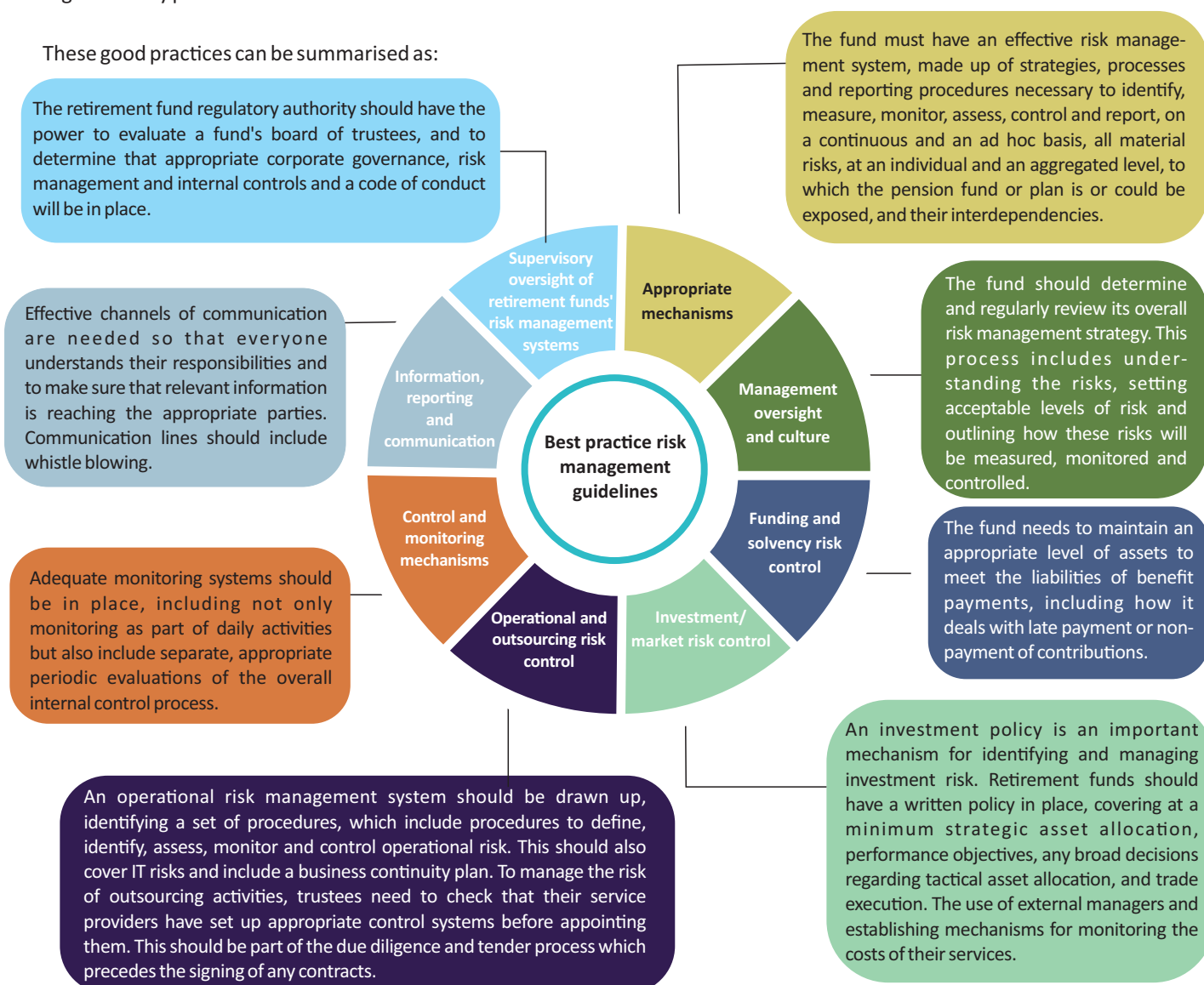
- **Management of the fund** – including aspects for example whether the board is properly constituted, conflicts of interest disclosure and management, the appointment process of trustees, decision making procedures in meetings or by round robin and continued trustee education.
- **Operational** – the risk that the operations of the fund may fail (administration, investments, insurances or advice), service providers may not comply with their contracts, contribution payments, loans, insurance arrangements, amongst many more.
- **Financial** – including solvency of the fund (sufficient assets to meet liabilities) and asset liability matching.
- **Legal, regulatory and compliance** – the likelihood of unfavourable consequences for the fund due to a failure to comply with all laws and regulation.

Importantly, the risks identified should not only be limited to those that have financial consequences, but also those that may affect the governance of the fund and its credibility.

### Best practice risk management guidelines

In South Africa, the FSCA is a member of the International Organisation of Pension Supervisors (IOPS). The IOPS provides general good practices for risk management in retirement funds, these to inform and supplement the framework that any local regulator may provide.

These good practices can be summarised as:



You can see that the 8 international best practice risk management principles are “baked into” the risk management regulatory framework in South Africa's retirement funds industry, specifically PF 130 and the King IV Code on Corporate Governance.

### **Your retirement fund's risk management policy**

In terms of the best practice guidelines set out above and in PF 130, each retirement fund needs to have a risk management policy, which must include:

- Identifying the risks facing the fund,
- Assessing the impact of these risks,
- The controls in place to mitigate these risks,
- The monitoring of the controls to ensure they remain adequate and appropriate, and
- Communication to fund members and stakeholders on what these risks are and how they are managed.

The fund's risk management framework is also set out in the fund's annual financial statements (which are reported to the FSCA).

When considering the content and extent of their risk management framework, the trustees must take the size and complexity of their fund into account. More complex funds will need a more complex risk management system and process in place.

### **The risk management process**

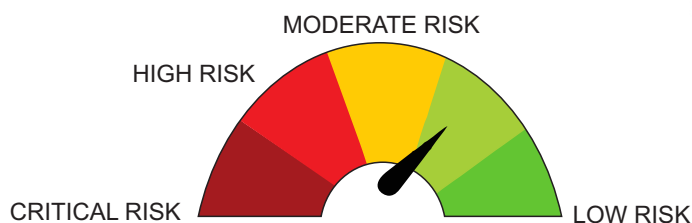
Trustees can follow the five steps below in their risk management process:

#### ***Step 1 – Identify the risk***

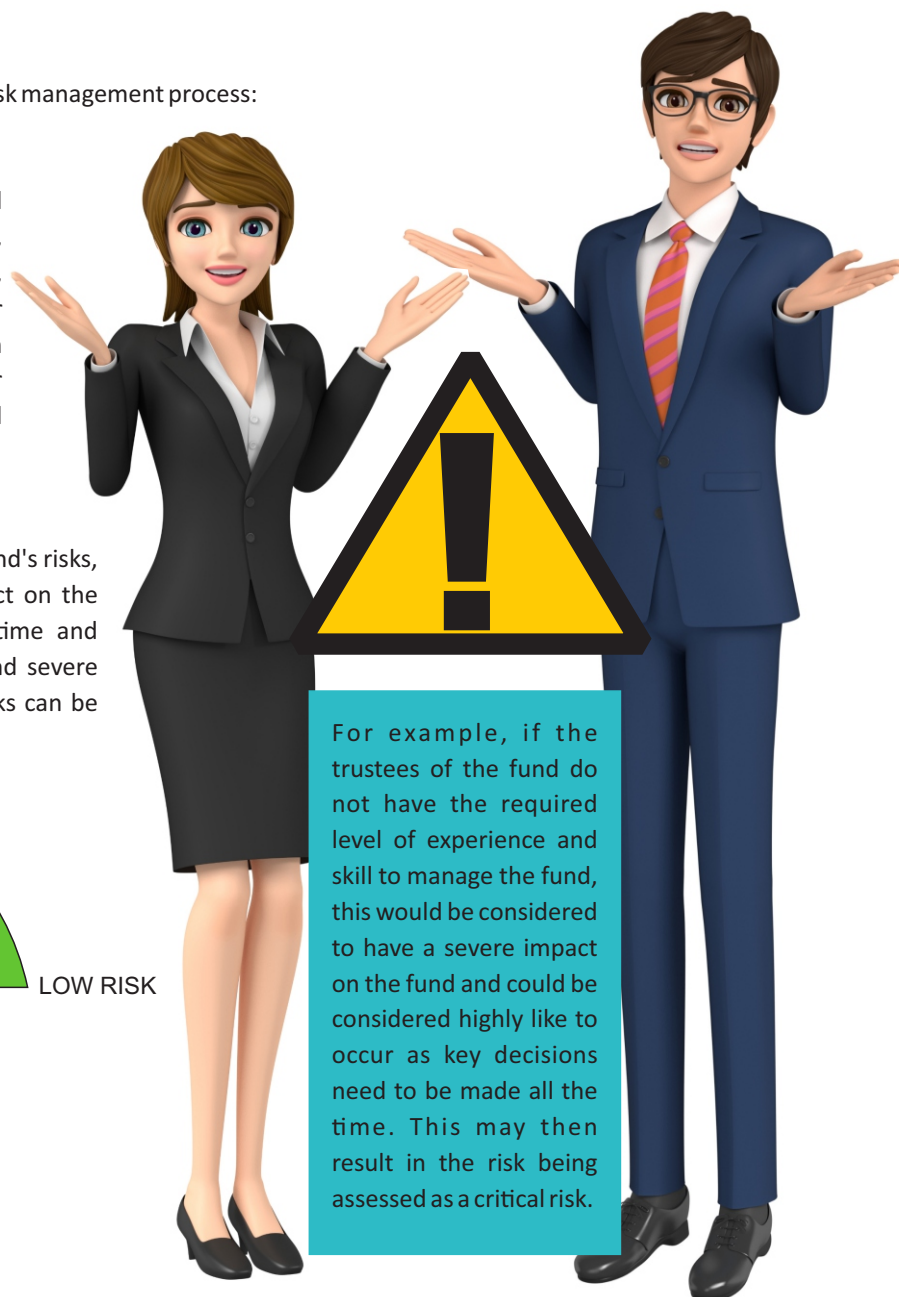
Consider all the risks the fund is exposed to and categorise these as operational, financial, management of the fund, investments or legal, regulatory and compliance. This will take a fair amount of time as you carefully reflect on each role player and process in your fund, together with the regulatory framework in which the fund operates.

#### ***Step 2 – Assess the risk***

Once you have identified and categorised the fund's risks, consider the likelihood and the possible impact on the fund. This will assist the board in focusing time and resources on managing the most important and severe risks that are present in the environment. Risks can be assessed as:



For example, if the trustees of the fund do not have the required level of experience and skill to manage the fund, this would be considered to have a severe impact on the fund and could be considered highly likely to occur as key decisions need to be made all the time. This may then result in the risk being assessed as a critical risk.



### ***Step 3 – Risk management and mitigation***

Once the priorities have been revealed through risk identification and assessment, consider the actions the fund can take to manage and mitigate the likelihood or the impact of each risk. Risk mitigation includes diversification as discussed earlier, clear lines of authority, service level agreements where tasks are correctly specified and delegated, appropriate levels of insurance, understandable communication to members, amongst others.

### ***Step 4 – Documenting the process***

We have discussed earlier the regulatory requirements that the fund has a documented risk management policy or process. Documenting the risks and the processes to be followed will ensure that identified management and mitigation actions are implemented.

Make sure that your fund's risk management policy includes all the requirements of PF 130.

### ***Step 5 – Monitoring and review mitigation strategies***

A key step in the risk management process is to regularly review the risks that the fund faces and the mitigation strategies in place to lessen the likelihood and impact of these risks should something unfortunate happen. This will enable the trustees to continually refine their thinking and strategies, leading to members becoming increasingly confident in their fund. Formal review should take place at least one a year, but might be required sooner should there be a material change in the regulatory or compliance requirements, or in the nature of the fund.

Risk management is a complex topic and process. Trustees need to ensure that they understand all the risks that their fund faces and are able to put appropriate strategies in place, or appoint the correct experts, to manage and lessen the possibility of something bad happening.

