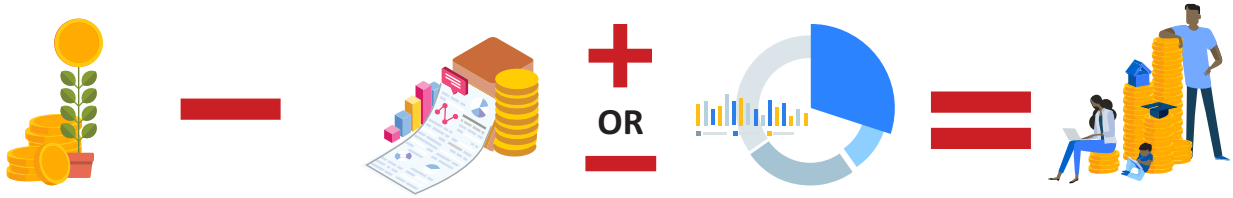
Trustee Tutor: Issue 2 Understanding Investments

Most of the retirement funds in South Africa are defined contribution funds, meaning that the percentage of a fund member's salary that is saved for retirement is set and can only be changed if the rules of the fund are changed.

In a **defined contribution fund** the contribution percentage that is paid to the fund is defined and set out in the fund's rules.

The formula of a defined contribution fund

Members grow their savings balance in the fund (fund credit) by way of the following formula:

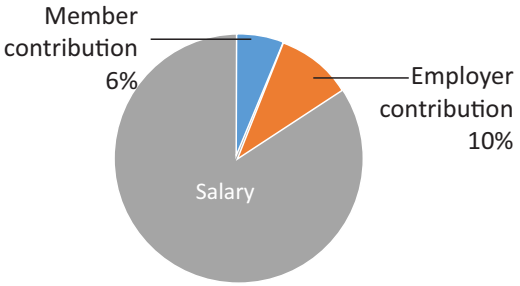


Contributions | Costs | Investment return | Fund credit

Let's look into these in a little more detail ...

Contributions

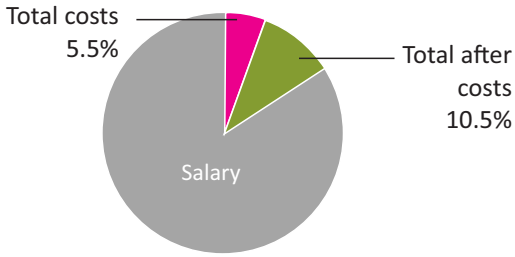
In a defined contribution fund, both the member's and the company's contribution rates are set in the rules. These are usually a percentage of salary.



% of salary paid to the fund = 16%

Costs

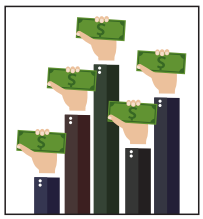
Retirement funds have a number of costs. These are the costs of running of the fund (administration, regulator fees, auditors' fees) and also the costs of insurance for benefits like death and disability benefits. Costs are deducted from contributions.



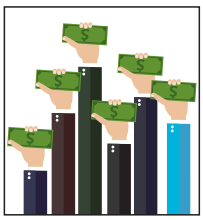
% of salary invested in savings/fund credit to the fund = 10.5%

Investment return

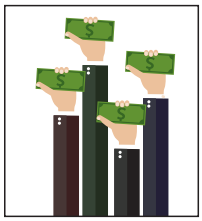
The trustees of the retirement fund decide on the investment strategy of the fund. This strategy sets out the investment portfolios where contributions are invested. These investments either perform well or perform poorly (depending on what types of investments they are and on what is happening in the wider market) which means that investment returns either add to members' fund credits or reduce them.



Member has a fund credit of R10 000



Investment earns a positive return of 3%, fund credit grows to R10 300



Investment earns a negative return of 3%, fund credit reduces to R9 700

You can see in the above formula that in a defined contribution fund, the most important areas that trustees should focus on if they want to grow members' savings as best they can, are to:

- limit the costs of the fund and
- set a meaningful investment strategy

This module of Trustee Tutor looks at setting a meaningful investment strategy.

Three key investment principles: risk, reward and time

Risk (volatility)

Investment risk is the level of uncertainty that an investment's returns will be different to what they were expected to be. Some investments have higher risk than others, in other words, in some investments, investors take a chance that the return may be very different to what they expected. Risk is measured by volatility. 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.

All investments have some risk.

Reward (return)

Investment return is the money made or lost on an investment over a period of time. A positive return is very simply a profit made on an investment and a negative return is a loss.

All investments provide returns. They key for investors is to look not only for positive returns, but for positive *real* returns. A real return is the return more than inflation. In other words, it is the difference between the investment's total return and inflation. As a trustee, you need to make sure that members' fund credits grow by more than what the cost of living grows at.

Time (term)

It is important to remember that a retirement fund is a long term investment for your members. The average person starts working at the age of around 20 and retires around the age of 60; that means they have 40 years to save for retirement. We therefore say that retirement funds are a long term investment. Even if a member leaves the company he works for, he is still on a journey to retirement and should keep saving his money. In other words, his term remains around 40 years.

Types of investments

There are four building blocks (asset classes) of investments in retirement funds:

Equities (shares)

Shares are units of ownership of a company. In order to raise capital, companies sell shares in their business. Investors buy these shares with the hope that the value of the company will rise in the future and the value of their investment will increase. In South Africa, shares are traded on the Johannesburg Stock Exchange (JSE).

The price of a company's share changes regularly and can be quite difficult to predict. This makes shares a volatile (or risky) investment. Over the long term, however, shares generally outperform the other asset classes. Because retirement funds are long term investments, this makes shares a very attractive investment. Trustees will most often have shares in their fund's investment portfolios and you could expect to find 30% to 75% of a retirement fund invested in shares (depending on the trustees'/member's investment goal).

Bonds (gilts)

A bond is a debt instrument that contains a promise to repay a loan. A bond could be thought of as an I.O.U ("I owe you") between a lender and borrower that includes the details of the loan and its payments. The details of the bond will include the date at which the capital must be paid back as well as the interest that will be paid. In the example of a government bond, the government borrows money for a specified period of time at an agreed interest rate and guarantees to pay both the interest and capital at a certain point in time.

Bond prices are inversely correlated to interest rates, in other words, when interest rates go up, bond prices fall and vice-versa. Over time, bonds will not provide as high returns as shares but they are less likely to lose money, meaning that bonds will lose less money than shares when share markets drop. In addition, bonds pay interest regularly generating a steady, predictable stream of income making them an important part of a retirement fund's investment portfolio.

A retirement fund will typically have between 15% and 30% of its investments in bonds.

Property

Property investments are investments in buildings, for example, shopping centres, office parks, hotels or industrial property.

Retirement funds invest in property in two ways:

- **Direct** property investment – where the retirement fund owns the buildings or land itself.
- **Indirect** property investment – through shares called Real Estate Investment Trusts (REITs) which are listed on the JSE.

It is quite unusual for a retirement fund to invest directly in property – typically only the very big retirement funds are able to do this. Generally, retirement funds invest in property through REITs).

Like bonds, the investment return earned on property investments are made up of two parts:

- Rentals (income portion)
- Capital gain or loss on the value of the property

Historically property was regarded as an excellent hedge in balanced portfolios, but derivatives now give retirement funds an alternative way to hedge risks.(I am not sure that the last part of this sentence be included)

Cash (money market)

In retirement funds cash not only refers to the holding of physical money but to a wide variety of short term money market instruments. These include call deposits, fixed deposits, notice deposits, negotiable certificates of deposit (NCD's), treasury bills and bankers acceptances.

Money market instruments earn an interest return. There is no capital growth in these investments meaning that over the longer term they are unlikely to earn a real return (over inflation). This makes these types of investments inappropriate for a long term investor, like a younger member in a retirement fund. This type of investment does have a place in a retirement fund however, because money market investments are highly unlikely to incur a capital loss, they may be appropriate for members very close to retirement or for benefits that are pending payment – like a death benefit.

Typically, a retirement fund will have no more than around 10% of its investments in the cash or money market.

In summary, there are 4 broad types of investments that retirement funds can invest in: shares, bonds, property and cash. The next question is, how do trustees go about blending these investments to achieve their members' investments goals?

Diversification

An investment portfolio is a collection of investments. A retirement fund's investment portfolio is made up of different types of assets, likes shares and bonds.

If trustees were able to pick the best performing investment strategy every time, retirement fund investing would be easy! Unfortunately, it is impossible to predict which asset class will perform the best in the future. Add to this the context that investing takes place in an investment market (local and global) which is also changing all the time.

This makes it very difficult to pick only one asset class or only one strategy. And if trustees pick the wrong one, it has dire consequences for members' fund credits in the fund. Therefore, trustees need to spread the fund's investments over a number of asset classes, investment styles and investment managers to spread the risk. This is called diversification.

Diversification is a technique that reduces risk by splitting investments among various asset types, industries, investment managers and other categories. Trustees would diversify a retirement fund's investments to reduce risk and maximise returns by investing in different areas that would each react differently to the same event.

We've already looked at the different types of assets trustees can diversify across. There are a number of other types of diversification options available to trustees.

Pooled or segregated portfolios

All retirement fund investments are either in segregated or pooled investment portfolios.

A **segregated portfolio** is an investment portfolio structured by the trustees for their retirement fund's investments only. In a segregated investment portfolio the trustees mandate the investment manager on exactly what type of investments they wish to invest in. These investments are in the retirement fund's name and the investment performance is specific to that retirement fund. In a segregated portfolio the trustees have a considerable amount of input and are responsible for monitoring that the investment manager keeps to the mandate that has been set and is not taking excessive risk (or taken any decisions outside of the set mandate)

An investment mandate is an instruction to manage a pool of capital—a particular pile of funds—using a specific strategy and within certain risk parameters.

Because segregated portfolios are personalised and specific for each retirement fund, investment managers have a minimum value of investment they require from a fund. This minimum investment value is usually quite substantial and therefore generally only larger retirement funds will have the ability to set up their own personalised segregated investment portfolios.

Pooled investment portfolios are “off the shelf” portfolios offered by investment managers either through a life license or a unit trust license. These licenses allow the investment manager to bring together (or “pool”) various investors' assets and invest them together under one common mandate. Trustees usually look for a mandate that meets their fund's needs and invest with a particular manager, rather than structuring their own mandate. In a pooled portfolio, the investments are held in the insurer or the investment manager's name and each investor in the pool earns the same return.

There are generally no entry or exit costs to investors in pooled portfolios and the costs of the portfolio are split amongst the larger pool, making them generally more cost effective than segregated portfolios (unless you have a very large retirement fund). This makes pooled portfolios very attractive to retirement funds.

Single manager or multi-manager

In a single manager investment portfolio, the trustees choose one investment manager to manage all or a portion of the fund's assets. One of the difficulties facing trustees who follow this approach is choosing which investment manager will best meet their fund's needs. Investment managers are not always consistently in the top rankings and being able to compare investment managers in terms of their strengths and weaknesses is an extremely difficult and time consuming process.

A multi-manager helps trustees by reviewing and selecting the investment managers to use for various investment mandates. The multi-manager pools the investments they receive and split them across a number of investment managers they believe are best placed to meet those mandates, making these pooled portfolios. This offers trustees meaningful diversification not only across asset classes, but also across different investment managers who, when blended together, provide the best combination of skills to meet an identified investment need (objective).

Using a multi-manager strategy shifts the responsibility for researching, choosing and monitoring investment managers from the trustees to an expert multi-manager who has resources to dedicate to this process. Many retirement funds invest in portfolios set up by multi-managers.

Specialist or balanced mandates

Within a specialist investment mandate, trustees choose investment managers to manage a specific portion of the retirement fund's investments based on the investment manager's area of proven expertise. For example, trustees may allocated the equities portion of their investments to an investment manager who has a proven skill and track record in investing equities. Similarly, the trustees would then allocate the bonds to an investment manager who is a specialist with bonds. In a specialist mandate, the trustees decide how much of the fund's total assets will be invested in the various asset classes and then appoint specialist managers to invest in these specific asset classes.

Within a balanced mandate, trustees would allocate their retirement fund's money to investment managers who then invest in a range of asset classes in the proportions they deem appropriate.

The argument of fixed versus tactical asset allocation is a complex one and is much debated by boards of trustees. Your board of trustees would need to consider the advantages and disadvantages of each in the context of the needs of your fund's members.

Active or passive investing

Active investing is practiced by most investment managers trying to find the best value in the various market sectors and asset classes, in order to provide investment returns above the relevant index return.

The opposite is known as passive investing, which involves investing in an index or an index tracking fund. In this scenario, the investment manager makes no active investment decisions over where to invest and because this is ostensibly “easier” the investment fees are lower than for active investing mandates. There are numerous index tracking funds available to trustees.

As with balanced versus specialist mandates, the advantages of active versus passive investing are hotly debated by trustees. Again the board must consider the retirement needs of members and make the best decision to meet those needs.

Once you understand the types of investments available and the diversification strategies most commonly used by retirement funds, it's appropriate to look at the legislative framework around investments.

Legislative framework for retirement fund investments

Trustees are responsible for setting the investment strategy of a retirement fund. The aim of the legal framework is to ensure that retirement fund investments are made in a prudent and responsible way. This is to support not only the members' retirement goals, but also the development and sustainability goals of the wider economy.

Regulation 28

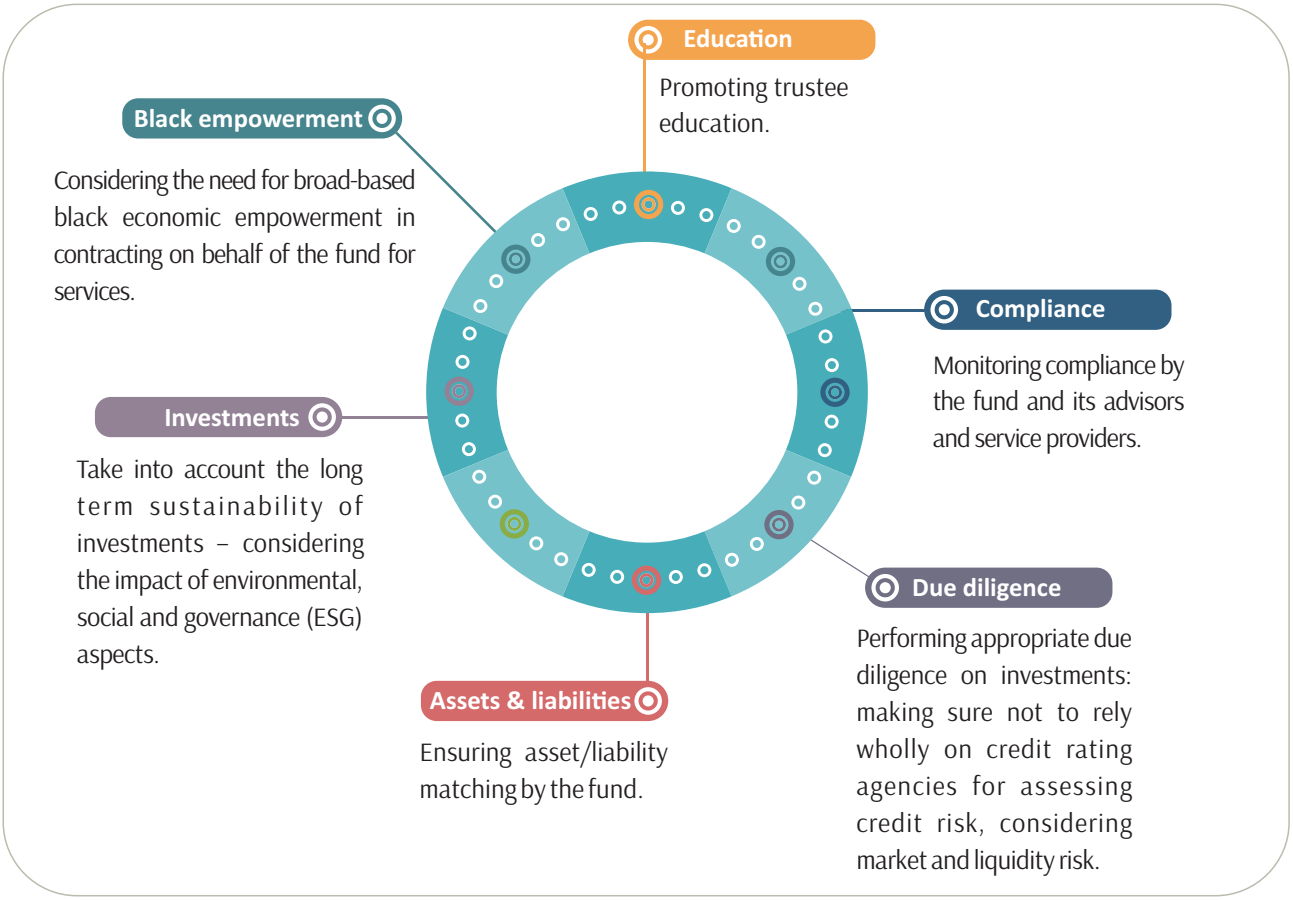
Regulation 28 is primarily rules based. It sets out the parameters within which retirement funds must invest in limits, called the prudential investment guidelines. By setting maximums that retirement funds may invest in various types of investments, Regulation 28 ensures that retirement funds diversify their investments to make sure that members are not exposed to too much, or inappropriate, risk.

Mindful that individual member protection is as important as fund sustainability, retirement funds should comply with Regulation 28 not only at fund level but also at member level.

At a high level, in terms of Regulation 28, a retirement fund may not invest more than 75% of total investments in equities, 25% in immovable property, 30% offshore (excluding Africa) and 10% in Africa. Up to 10% of total funds may be either be invested in hedge funds or private equity. Combined exposure to both of these asset classes is limited to 15% in total.

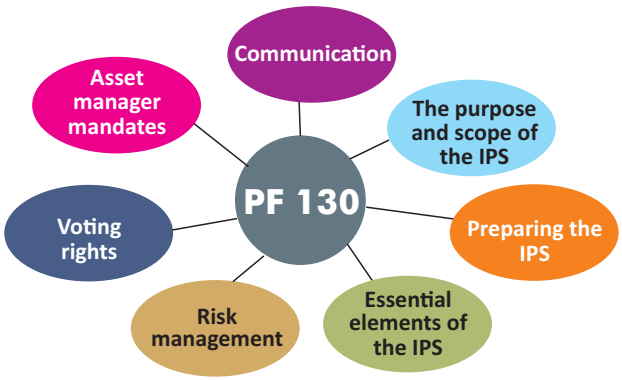
Regulation 28 also sets out a number of principles to strengthen the investment decision making process and to improve transparency and accountability to members. These principles inform a retirement fund's investment approach and should be captured in the fund's investment policy statement (IPS).

These principals include:



Annexure B to FSCA Circular PF 130

Circular PF 130 provides comprehensive, good governance guidelines for a retirement fund's investment policy statement (IPS), including:



The guidelines set out in PF130 highlight specific issues that trustees must consider when putting together their fund's IPS. The guidelines should be adapted by each fund to suit their particular obligations, objectives and its ability to meet its primary obligation to its members (of investing their retirement savings in a risk appropriate way to maximise their chances of a comfortable retirement.

FSCA Communication 1 of 2019

Guidance notice: Sustainability of investments and assets in the context of a retirement fund's investment policy statement

This guidance note issued in June 2019 sets out the FSCA's expectations of retirement funds when it comes to sustainable investing:

The investment philosophy and objectives of the fund's trustees, as reflected in their IPS, are to ensure the sustainability of investments and assets. The FSCA requires trustees to consider how they intend to monitor and evaluate the ongoing sustainability of the assets which it owns, including the extent to which ESG factors have been considered.

If the retirement fund has investments that limit the application of ESG factors, the IPS should state the reasons and set out the remedial action the retirement fund will take to rectify the position. If no remedial action is taken, the retirement fund should give reasons therefore.

The retirement fund's sustainability approach should be reflected in the relevant investment mandates.

In Summary

In this issue of Trustee Tutor we have looked into the foundation principles of retirement fund investments. These include:

- The importance of investment returns in the build up of members' fund credits,
- The three key investment principles of risk, reward and time,
- Types of assets retirement funds can invest in,
- How important it is to diversify, and different ways of diversifying retirement fund investments, and
- The legal framework of retirement fund investments.

In our next issue we will build on this foundation, and look into various investment strategies and defaults retirement funds may put in place, as well as the details that need to be included in an investment policy statement.

Trustee Tutor: Issue 2 – Understanding Investments

For an on-line version of the required reading material as well as electronic CPD Submission form, go to https://www.pensionsworldsa.co.za or https://www.ebnet.co.za

How to?

Answer all the questions by inserting the correct answer into the block provided next to each question, scan the pages and email to Toni Cantin at ICTS, using cpd@icts.co.za

1. In a defined contribution fund:

a. The contribution rates, expenses and risk premiums are defined in the rules.
b. The contribution rates and investment returns are defined in the rules.
c. The contribution rates, auditors' fees and regulators fees are defined in the rules.
d. The member contribution and company contribution rates are defined in the rules.

2. Investments are very important in a defined contributions funds because the investment return directly impacts a member's retirement benefit.

a. True
b. False

3. The three key investment principles are:

a. Volatility, return and term.
b. Balanced, specialist and passive.
c. Equities, bonds and cash.
d. Tactical asset allocation, index tracking and derivatives trading.

4. Inflation risk is:

a. The risk that prices will not increase.
b. The risk that investment returns will not at least be the same as inflation, meaning that over time even though you may have a positive investment return, you may not be able to buy the same amount of goods and services.
c. The risk that you will lose a portion of your capital investment.
d. The risk that you won't be able to access an inflation beating annuity when you retire.

5. Volatility is:

a. A measure of risk.
b. The movement of an investment's return, compared to its average.
c. Usually measured by standard deviation.
d. All of the above.

Trustee Tutor: Issue 2 – Understanding Investments

6. Most if not all retirement funds have investments in shares (also called equities). Equities are:

a. Debt instruments used by companies or governments to raise capital.
b. A part ownership of a company that allows you to participate in the growth of that company.
c. Usually quite illiquid and can't be converted to cash for benefit payments easily.
d. Traded on the BESA.

7. Diversification is:

a. A key success strategy of any retirement fund, protecting members from underperformance of any one asset class or strategy.
b. The practice of putting all your eggs in one basket.
c. Investing in shares only because we know that shares outperform the other asset classes over the long term and retirement funds are long term investments.
d. Not possible in a pooled portfolio.

8. Regulation 28 prevents retirement funds from investing all of their assets in the money market.

a. True
b. False

9. A retirement fund's investment policy statement:

a. Sets out the trustees' investment philosophy.
b. Outlines the trustees' approach to selecting their investment service providers.
c. Expand on the trustees' environmental, social and governance (ESG) practices.
d. All of the above.

10. Annexure B to FSCA Circular PF 130 provides:

a. The limits that retirement funds may invest in shares, bonds and other types of asset classes.
b. A template scorecard of criteria to consider when selecting an investment manager or multi-manager.
c. Good governance guidelines to trustees on investments.
d. A template IPS.

Email to Toni Cantin at ICTS, using cpd@icts.co.za