Today's Trustee

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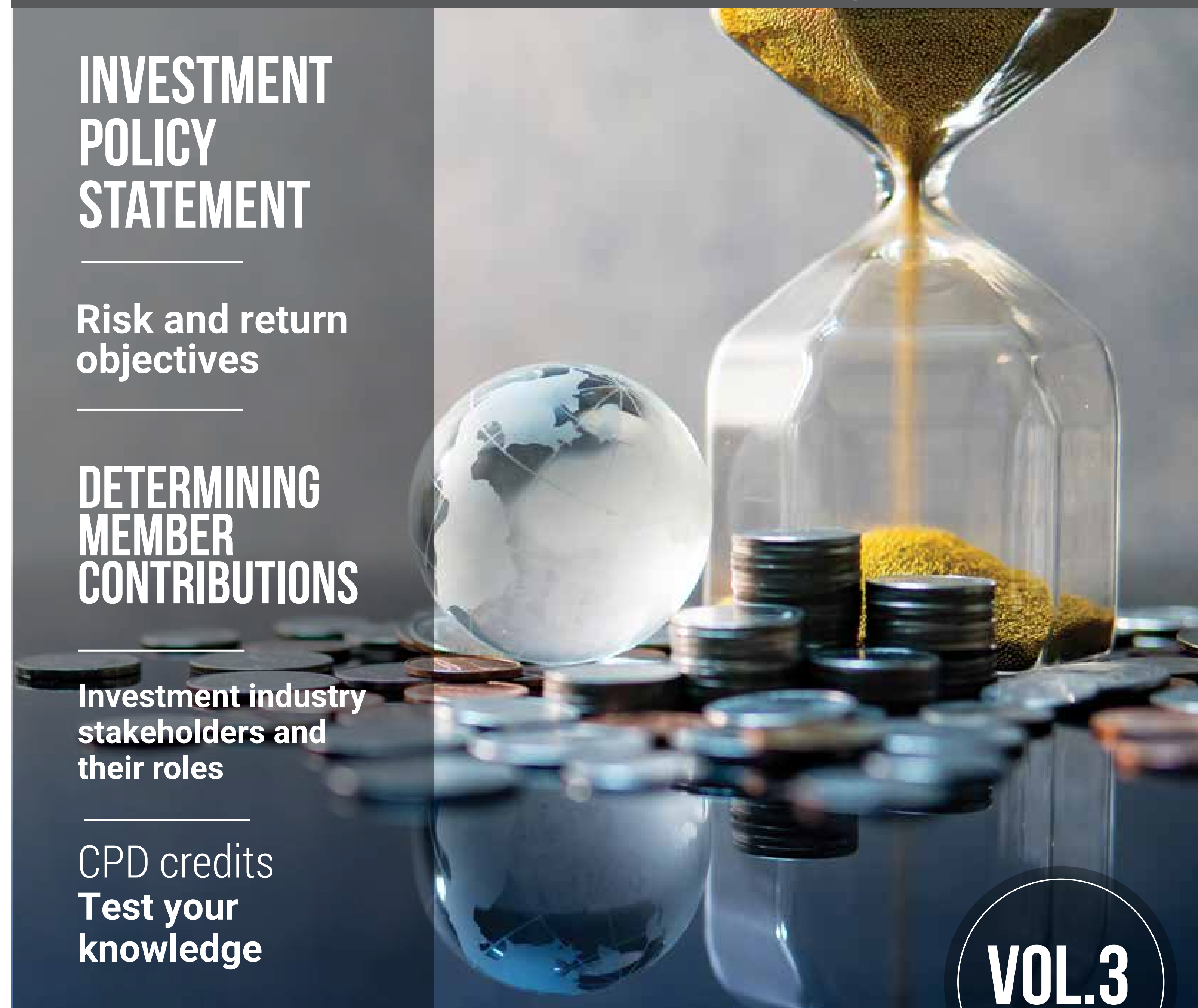

INVESTMENT POLICY STATEMENT

Risk and return objectives

DETERMINING MEMBER CONTRIBUTIONS

Investment industry stakeholders and their roles

CPD credits
Test your knowledge

VOL.3

EDUCATIONAL SUPPLEMENT

Investment Fundamentals 2

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"Brilliant, thank you. I learned so much and would definitely be reading up a bit more to try and further my understanding on investments."

"The workshop was an eye-opener for understanding the markets. I will be able to make informed contributions as well as informed decisions in the trustee meetings."

CONTACT ASISA ACADEMY
David Morris: 021 673 1627
dmorris@asisaacademy.org.za
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* The ASISA Academy is an accredited CPD provider for the Batseta Council for Retirement Funds

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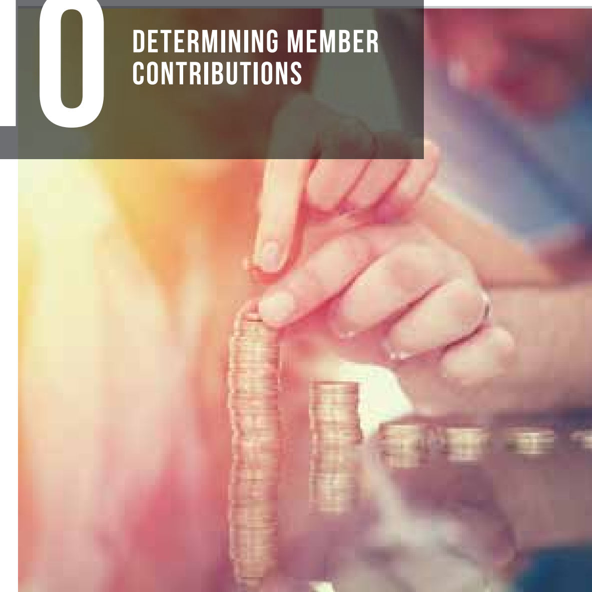

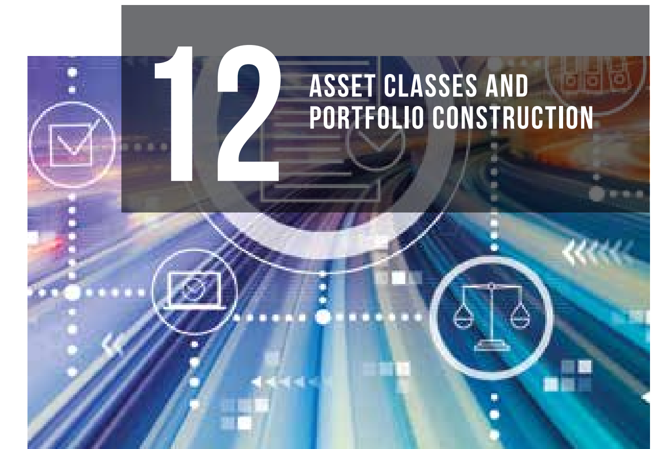

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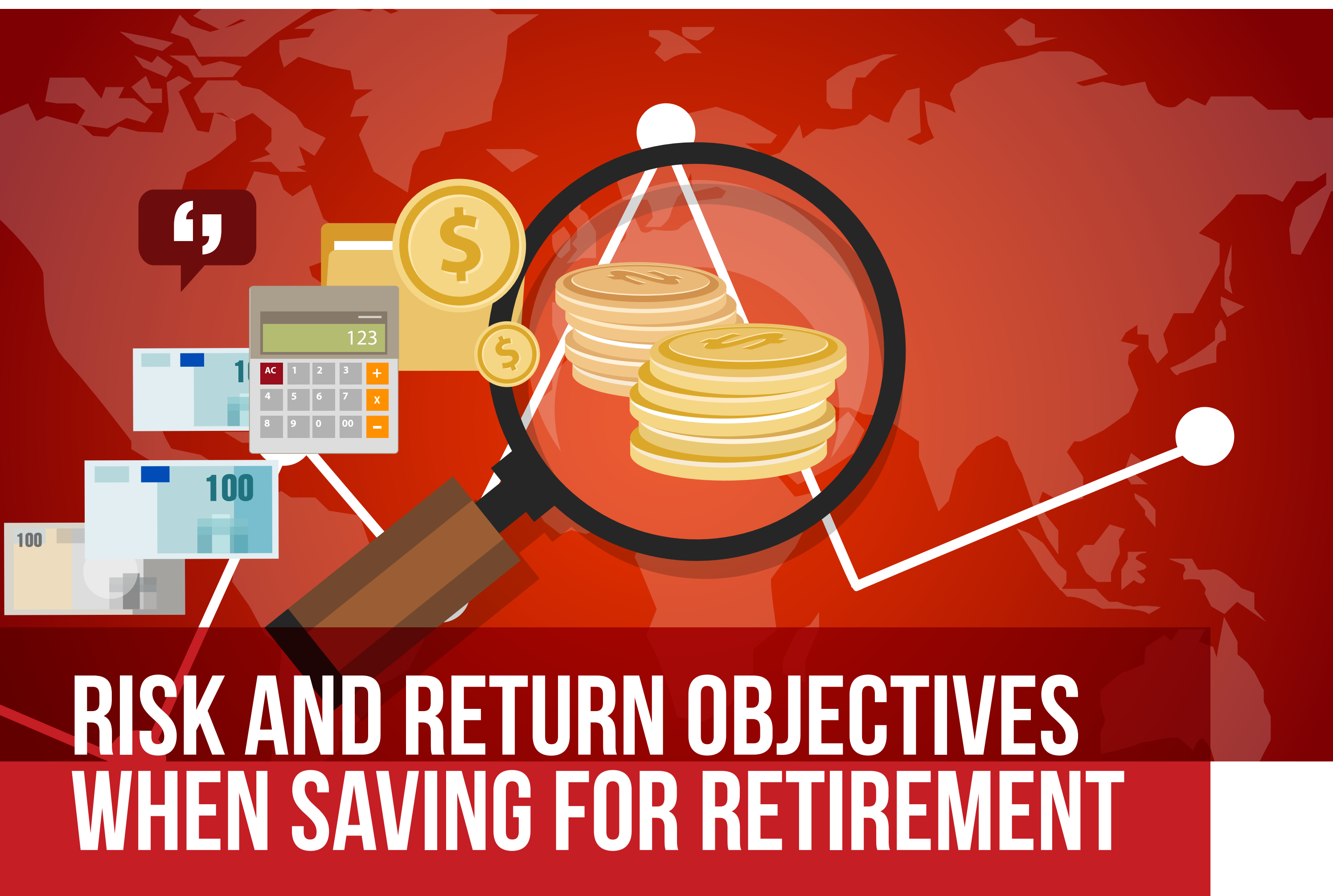

RISK AND RETURN OBJECTIVES WHEN SAVING FOR RETIREMENT

Investment strategy for a defined benefit fund

The defined benefit fund, also referred to as a liability-driven investment (i.e. ensuring there will be enough assets to cover a certain liability in the future), is typically formula-based, taking various factors – such as years to retirement and pensionable salary – into account. The investment strategy in this instance is left to the trustees of the defined benefit fund.

Risk tolerance is a function of the type of risk and the extent of risk the fund can adopt to meet its return objectives. Therefore, a defined benefit fund's long-term investment goal of return – in line with or in excess of inflation – needs to be achieved as accurately as possible with the appropriate risk budget.

Asset class diversification is a fundamental risk management tool. As a starting point, the fund needs to adopt a long-term strategic asset allocation model taking the following information, for example, into account:

- The fund's current financial position;
- The fund's future liabilities;
- The expected long-term risk/return profile of the various asset classes within the fund, such as cash, equities, bonds and property, both locally and globally.

Equities, for example, although typically offering higher returns, are far more volatile than that of cash and therefore exposure to such an asset class should be limited to reduce the potential of significant capital losses over the short to medium term (which ties into the 75% equity limit prescribed by Regulation 28).

A fund may be further diversified by ensuring exposure to different asset managers, investment styles and active and passive investments. With this in mind, funds typically outsource the management of investments to several underlying asset managers to achieve this additional level of diversification. These asset managers would be provided with a specific mandate to ensure that their strategies are aligned with the overall required objectives.

Asset managers can manage portfolios for a specific asset class (listed SA equities, for example) or for a range of asset classes (a balanced fund, for example) with a specific objective such as a required minimum rate of return or capital preservation. Added to these objectives can be environmental, social and governance (ESG) considerations or other socio-economic measurable impacts, for example.

Types of pension funds

There are two types of pension funds, namely defined contribution and defined benefit funds. A defined benefit plan provides employees with a specified amount at retirement whereas a defined contribution plan allows employers and members to contribute a certain amount over time to save for the member's retirement.

The type of plan will determine the underlying investment strategy of the fund and its risk/return profile. The risk/return profile of a pension fund's assets over time will impact a member's ultimate retirement benefit, therefore effective management of the investment strategy is vital.

Calculating the defined benefit contribution

A defined benefit fund provides a guaranteed pension benefit on retirement, which is calculated based on the member's final average salary multiplied by the years of their fund membership as an employee. The rate at which the employed member contributes to the fund is usually fixed as a percentage of their remuneration.

The employer's rate of contributions is usually calculated by the fund's valuator who works out the rate at which the employer will need to contribute to the fund to enable the fund to pay the member their guaranteed pension benefit after retirement. The employer carries the investment risk of the fund having to guarantee the member's pension after retirement.

Investment strategy for a defined contribution fund

A defined contribution plan allows the member to make the investment decisions. This plan is largely dependent on the size of contributions made, the underlying investments and the associated fees, with the member taking on the investment risk.

For a member in a defined contribution fund, the choice of underlying investments is up to them. The member would be provided with a list of potential funds to invest in with different asset managers, different objectives and therefore different risk/return profiles. The ultimate selection would be a function of the member's tolerance for risk, current age, investment time horizon, investment knowledge, personal beliefs and preferences, as well as contributions.

An assessment of risk factors

There are several important risk factors to consider when assessing and monitoring particular asset classes that a pension fund is invested in. These factors can include liquidity risk (the risk that an asset can't be bought or sold quickly in an unlisted investment, for example), counter-party risk (the probability that a party in a transaction will default on their contractual obligations in a credit investment for example) or ESG risk (non-traditional factors having financial implications).

The investment strategy of the fund should ensure that such risks are addressed and reported on. An example of this in practice would be to ensure the integration of ESG factors in an asset manager's investment process.

Calculating the defined contribution

A defined contribution fund provides a pension benefit on retirement, which is calculated based on the accumulated contributions made to the fund by the member (and/or, if applicable, the member's employer). The returns earned on the investment of those contributions, less deductions of the costs of running the fund and providing for death and disability benefits, are added to the pension benefit.

The rates at which the member and employer contribute to the fund are fixed or defined as a percentage of the member's remuneration. Importantly, the amount of the member's pension is not guaranteed, but is rather determined by the contributions made by the member and employer, combined with the fund's investment performance. This means that the member carries the risks and rewards of their final pension amount.

THIS TOPIC IS COVERED IN TODAY'S TRUSTEE **MAGAZINE:**

1. https://www.totrust.co.za/education-supplement/retirement-funds-and-investment/
2. https://www.totrust.co.za/education-supplement/why-do-retirement-funds-exist/
3. https://www.totrust.co.za/education-supplement/pension-fund-portfolios-and-climate-risk-investing-responsibly-to-mitigate- climate-risk/

REFERENCES:

1. CFA Institute: Available: www.cfainstitute.org
2. FSCA; Available: www.fsca.co.za

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INVESTMENT POLICY STATEMENT

IN BRIEF

Annexure B to the Financial Sector Conduct Authority Circular PF 130 (PF 130), published in 2007, provides comprehensive good governance guideline for a retirement fund's **Investment Policy Statement** (IPS).

These guidelines include:

- The purpose and scope of the IPS
- Preparing the IPS
- Essential elements of the IPS
- Risk management
- Voting rights
- Asset manager mandates
- Communication

The guidelines set out in PF130 contain the minimum standards and highlight specific issues that retirement fund boards of trustees (boards) should consider when drafting an IPS. The guidelines should be adapted by each retirement fund board to suit their particular obligations, objectives and all other factors that may affect the solvency and funding of their fund, and its ability to meet its primary obligation to its members – that being to invest their retirement savings in a risk-appropriate manner such that their chances of a comfortable retirement are optimised.The board must also be in a position to explain any deviations from the IPS. The IPS should be based on the standards that a reasonable person would apply to the investment portfolio of a fund – the "prudent person approach". PF 130 also recommends that some elements of the IPS guidelines should be included in investment manager mandates where appropriate.

The purpose of formulating an IPS is to:

- Communicate the investment philosophy and strategy to the fund's members and beneficiaries, as well as service providers to the fund, such as fund managers and consultants;
- Describe the investment objectives and the overall risk philosophy;
- Define how investment managers will be selected, remunerated and, where necessary, replaced in a manner that encourages compliance to the IPS goals and objectives;
- Communicate the investment strategy for evaluation purposes.

A fund's IPS must address the following issues (in conjunction with legislative and regulatory compliance), namely:

- Members' retirement needs are first and foremost
- Categories of investments
- Diversification of investments to mitigate risk
- The allocation of assets and the expected rate of return
- The liquidity requirements
- Voting rights attached to the investments
- Valuation procedures for investments not publicly traded
- Related party transactions

Investment policy and procedures

In advance of determining the fund's investment policy, it is essential that the board has first identified the profile of its members. This will enable the board to identify what portion of funds will be required for short, medium- and long-term investments and the risk profile attached to each category of beneficiary (e.g. those retiring in the short term will require low-risk, high-liquidity investment options). Given that this is an essential element of determining a fund's investment policy, the board should, where appropriate, obtain the advice and guidance of independent consultants and actuaries. Care must be taken that any advice obtained is free from conflicts of interest.

When determining an appropriate IPS, boards should consider the following aspects:

- Current investments
- Degree of risk tolerance the members wish to sustain
- Volatility of investments
- Current and future liabilities of the fund, including obligations to its members
- Structure of the pension plan (e.g. defined benefit or defined contribution)
- Liquidity and cash flow requirements
- Profiles of the members

Annual review of the IPS

The IPS should be reviewed at least annually to ensure that any changes in economic conditions or obligations of the fund are accounted for. There should also be procedures in place to monitor compliance with the IPS.

Essential elements of the IPS

1. *Asset mix and rate of return expectations*
   The IPS should stipulate the following:
   - Expected rate of return of the portfolio;
   - Anticipated volatility of the rate of returns, setting mitigating techniques;
   - Timeframe of the expected returns; and
   - Monitoring of performance against the benchmarks and targets (and actions the board will take if the stipulated targets are not met).

2. *Categories of investments*
   In order to protect the fund from investments that may be in conflict with the fund's risk profile, limits should be placed on the range of authorised investments.

3. *Diversification*
   Fund investments should build a portfolio that meets the needs of the fund and avoids the concentration of investments in any particular market sector. The risk of capital loss can be reduced through investing in diverse asset types, industries and geographic regions. A balance between the mitigation of risk and the related costs for diversification must be maintained. Investment vehicles that hold a diverse portfolio are one example of a low-cost diversification strategy. (e.g. Balanced Collective Investment Scheme, market index trackers)

4. *Liquidity requirements*
   A fund should have a clear idea of its cash flow requirements. Investments should therefore be made taking into account the fund's cash flow needs in the coming year to avoid having to liquidate medium- or long-term investments to cover short-term cash flow requirements.

PF 130 urges extreme care and caution when considering the following fund actions an IPS should also address:

5. *Pledging and borrowing of assets*
   In order to protect the fund from placing its investments at unnecessary risk. The board should manage these risks using clear risk limits and procedures. These should be established for the borrowing or pledging of fund assets – and these should be closely monitored. It should also be established whether such activities are authorised in terms of the fund's rules or subject to any regulatory or statutory restrictions. The IPS should clearly set out the circumstances under which funds may be lent against the retirement fund, for example: that of members accessing residential housing loans against their retirement benefit [PFA(19(5))]. Such policies and procedures should clearly explain the circumstances under which such lending may occur.

6. *Management fees and compensation*
   Management fees must be taken into account when mandating asset managers. Payment of fees for risk-adjusted investment returns should be linked to clearly defined responsibilities. There should also be mechanisms in place to ensure proper monitoring, including the relevant checks and balances to alert the board to any significant losses and deviations from authorised policy. Costs and fees paid by the fund to asset managers and administrators should be subject to full disclosure and transparency, and regularly communicated to the fund's members.

7. *Risk management*
   The boards' responsibility is to manage and, where possible, mitigate the investment risks (Eg. credit, investment, market, equity, currency, interest rate, inflation, ESG, actuarial and regulatory (prescribed assets)) to which the fund is exposed. For it to perform this function effectively it needs to be aware of the types of risk to which a fund can be exposed. From time to time it may be necessary to appoint an independent service provider to assess the effectiveness of governance structures, mandates, terms of reference used etc.

8. *Voting rights*
   The board of a fund should formulate and develop appropriate voting policies and incorporate these in their mandates to the asset managers, including the monitoring of and reporting on voting. The proxy voting policy should be disclosed to the members, along with the steps taken by the board of the fund to monitor the effective implementation of said policy by the fund's asset managers.

9. *General fund reporting to members, pensioners and beneficiaries*
   Retirement funds are governed by the Penson Funds Act, 1956, (PFA) and PF 130. PF 130 is not legislated, but rather comprises a set of voluntary principles and standards which are considered best practice for good governance of retirement funds. PF 130 requires all retirement funds to have a communication policy for the disclosure of fund information to members and beneficiaries. It is advised that the communication policy addresses, but is not limited to, fund operations, administration, investment performance (including investment fees), incurred by the fund. Communication to pension fund members, pensioners and beneficiaries should be informative, transparent, fair and display accountability and be disclosed in easily understandable launguage.

10. *Monitoring and reporting on IPS*
    - The IPS should be reviewed regularly to ensure that it continues to meet the objectives of the fund and any deviation or changes should be explained to the members;
    - Effective and regular communication between the board, the members of the fund, and the fund's asset managers is essential, not only for the purposes of transparency and disclosure but also to establish proper and regular monitoring of the fund performance, as well as adherence to the term of the mandate and IPS;
    - The IPS should be disclosed to fund members, pensioners, beneficiaries, investment managers and relevant regulatory authorities;
    - There should be regular reporting to the members, pensioners, and beneficiaries – preferably quarterly – in a manner and form which is easily understood, on relevant performance, risk/return and fund matters, especially relating to any changes, that they may deem appropriate.

Most recent FSCA 2019 Guidance on communicating investment decisions with members

In June 2019 the FSCA released a Guidance Note for Retirement Funds relating to the sustainability of investments and assets in the context of a retirement fund's IPS. The Guidance Note is intended to act as a guide to retirement funds to ensure compliance with Regulation 28(2)(b) of the regulations to the PFA. Of particular importance to this section is that it is intended to provide retirement funds with guidance on the content of some of the essential aspects of an IPS and the manner in which that content is disclosed by pension funds.

The section on Disclosure and Provision of Information to Stakeholders point 5.1 a – c stipulates that all funds are encouraged to:

1. Make their IPS, or a summarised version thereof, available on request and at no cost to each member;
2. Make a copy of their IPS, as well as information relating to the sustainability of investments and assets in the context of a retirement fund's IPS, available on the fund's website. A fund's investment policy should be accessible to all persons of the public, whether a member of the fund or not; and
3. Provide a copy or inform their stakeholders of the fund's IPS and any changes thereto on an annual basis. In the event of union representation as members of the fund, this communication should preferably be directed to the designated union representative.

THIS TOPIC IS COVERED IN TODAY'S TRUSTEE **MAGAZINE:**

1. https://www.totrust.co.za/article/cover-story-editorials-edition-august-october-2018/
2. https://www.totrust.co.za/education-supplement/introduction-to-regulation-28/

REFERENCES:

1. Annexure B to Circular PF 130; Available: www.fsca.co.za https://www.fsca.co.za/Regulatory%20Frameworks/Temp/PF%20 Circular%20130%20AnnxB.pdf

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MONITORING THE PERFORMANCE OF RETIREMENT FUND INVESTMENTS

The process of monitoring
What does it mean to monitor an investment manager in the context of investment performance and overall fund objectives? There are a number of ways boards can ensure this process is undertaken correctly and rigorously. This includes both qualitative and quantitative methods of monitoring.

As a starting point, the fund should request regular, and where necessary, additional ad-hoc presentations or reports from their investment managers to provide updates on these factors. These may be directly managed by the fund or via another service provider, such as an asset consultant, multimanager or other intermediary to the fund.

Qualitative

- These reviews can include assessments of investment teams such as experience and qualifications; investment process and philosophy; and any changes that may have occurred over the reporting period.
- The reports should also include feedback on investment decisions made over the period, for example, why certain buy or sell decisions were made in the portfolio.
- Current positioning is important to understand at a holdings level (what individual stocks or bonds are being held for example), and also what the asset allocation of the fund is and how it has been tactically managed over the period.
- It is also important to understand how environmental, social and governance (ESG) factors have been integrated over the period and if any of these issues had a material impact on performance.

IN BRIEF
As per the Principles of Regulation 28, funds must conduct reasonable due diligence before making contractual commitments to invest in assets managed by a third party, for both local and foreign assets. They must also understand the changing risk profile of assets over time.

Given these regulatory requirements, the onus is on the trustees to have a process in place to monitor their underlying investment managers' performance to ensure that the board's expectations are being met. Further to this, the effective management and monitoring of a pension fund's underlying investments is critical in ensuring that members receive sufficient benefits upon retirement, in line with the fund's investment objectives.

Likely examples of ESG factors could include broad based black economic empowerment, executive remuneration, environmental emmisions, exposure to climate risk etc.

Quantitative

- Trustees should assess the performance of the investments in the context of their overall objective, i.e. are they on track to meet these objectives? Depending on the nature of the fund, its objectives may vary from outperforming an index, outperforming the peer group average, outperforming a composite index, inflation (consumer price index) plus returns, or simply a cash plus return.
- The underlying investment managers should provide reporting on risk-adjusted returns, i.e. how much risk did the asset manager undertake to produce the return? Ideally investors want the highest return for as little risk as possible.
- An attribution analysis would be useful for the trustees to understand what contributed to or detracted from the performance over the period.
- Funds should assess the performance of the investments relative to their specified benchmarks. A benchmark is a reference point against which an investment's performance can be evaluated. For example, a fixed-income portfolio can be benchmarked against the All Bond Index or an equity manager can be assessed relative to the category average of general equity funds.

Trustees should also continuously monitor the fees charged by the underlying asset managers, as these will impact the total return. This would include both fixed fees as well as performance-based fees. In addition to comparing these fees to that of peer group asset managers, they must also be evaluated against the overall performance relative to the benchmark of the various portfolios.

The importance of benchmarking
Investment portfolios and asset managers come with a wide range of investment benchmarks. It is therefore crucial that trustees work toward having a more simplified and logical investment portfolio offering with regards to the underlying benchmarks. An example of this could be having inflation-plus benchmarked portfolios for the full risk spectrum; for example: inflation + 3% for a cautious investor, inflation + 4% for a moderate investor and inflation + 5% for a moderate-aggressive investor. This is not to say that alternative benchmark types must not be included, but rather that there should be a spectrum within each benchmark type included.

It is also important to highlight the role benchmarks play in active and passive investing. For active investors, investment managers would seek to outperform the benchmark, however a passive or index investor would seek to track their stated benchmarks.

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1. https://www.totrust.co.za/education-supplement/introducing-asset-classes-per-regulation-28/
2. https://www.totrust.co.za/education-supplement/retirement-funds-and-investment/
3. https://www.totrust.co.za/article/futuregrowth-expert-opinions-edition-july-september-2019/

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1. CFA Institute Available: www.cfainstitute.org
2. FSCA; Available: www.fsca.co.za

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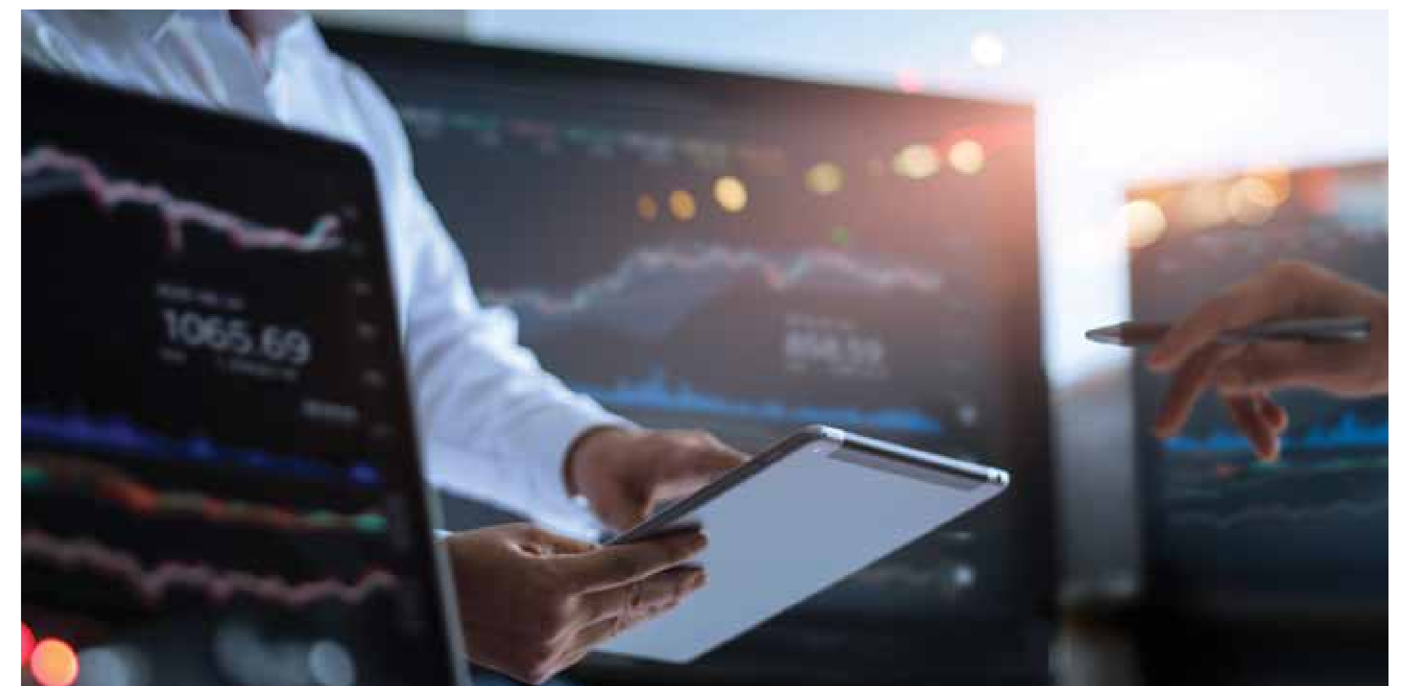

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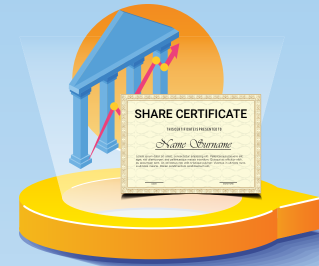
OVERVIEW OF ASSET CLASSES PER REGULATION 28

MAXIMUM INVESTMENT LIMITS PER ASSET CLASS AS PRESCRIBED BY REG.28



EQUITY 75%

THE STAKE OF OWNERSHIP OF A COMPANY'S ISSUED SHARES

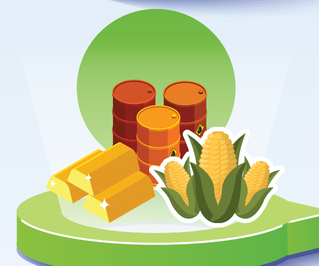
CASH 100%

NOTES, COINS OR ANY BALANCE/ DEPOSIT IN AN ACCOUNT HELD WITH A SOUTH AFRICAN BANK

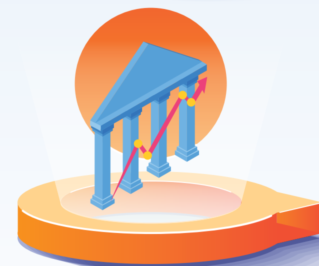
DEBT INSTRUMENTS 100%

AMOUNTS LENT BY RETIREMENT FUNDS TO CORPORATE AND PUBLIC SECTOR BORROWERS AND WHICH MUST BE REPAID BY THE BORROWER

PROPERTY 25%



COMMODITIES 10%



ALTERNATIVE INVESTMENTS 15%

FINANCIAL ASSETS THAT DO NOT FALL UNDER THE CONVENTIONAL EQUITY/FIXED INCOME /CASH CATEGORIES

ASSET CLASS SUB-CATEGORIES	ASSET CLASS AND SUB-CATEGORY INVESTMENT LIMITS
LISTED EQUITY: SHARES OF PUBLIC COMPANIES AVAILABLE FOR INVESTING INTO BY A WIDE VARIETY OF INVESTORS AND TRADED ON PUBLIC, REGULATED STOCK EXCHANGES (E.G. JSE)	REG. 28 - OVERALL LIMIT ON EQUITY (LISTED & UNLISTED) INVESTMENT BY A RETIREMENT FUND LIMITED TO 75%
UNLISTED EQUITY: THE SHARES OF PRIVATE COMPANIES THAT ARE SOLD TO ACCREDITED SPECIALISED INVESTORS RATHER THAN THE GENERAL PUBLIC AS THEY HAVE A HIGHER RISK AND ARE UNREGULATED BY AN EXCHANGE	REG. 28 - OVERALL LIMIT ON UNLISTED EQUITY INVESTMENT (INCLUDING INVESTMENT IN PREFERENCE SHARES) LIMITED TO 10%
BANKS PLAY THE LARGEST ROLE IN THE MONEY MARKET AS THEY ARE THE CUSTODIANS OF PUBLIC MONEY	REG. 28 - OVERALL LIMIT ON CASH INVESTMENT LIMITED TO 100% AND 25% LIMIT ON EXPOSURE TO ANY SINGLE BANK
PUBLIC SECTOR DEBT: DEBT INSTRUMENTS (E.G BONDS) ISSUED BY THE GOVERNMENT OF SOUTH AFRICA , AS WELL AS STATE-OWNED ENTITIES (ESKOM, SAA, DEVELOPMENT BANK, SANRAL) GUARANTEED BY THE SA GOVERNMENT. LISTED BONDS ARE TRADED ON THE BOND EXCHANGE (E.G. LISTED BONDS TRADED ON THE JSE BOND EXCHANGE)	REG. 28 - OVERALL LIMIT ON DEBT INSTRUMENTS INVESTMENT LIMITED TO 100%
PRIVATE DEBT IS SOMETIMES GUARANTEED BY A SOUTH AFRICAN BANK	REG. 28 - OVERALL LIMIT ON PRIVATE DEBT INVESTMENT LIMITED TO 25%
OTHER CORPORATE DEBT: INCLUDES LISTED DEBT (E.G JSE BONDS AND UNLISTED DEBT)	REG. 28 - OVERALL LIMIT ON CORPORATE DEBT INVESTMENT LIMITED TO: LISTED - 25% UNLISTED - 15%
LISTED PROPERTY: INCLUDES SHARES IN REAL-ESTATE INVESTMENT TRUSTS (REITs) OFFERED BY PROPERTY COMPANIES	REG. 28 - OVERALL LIMIT ON PROPERTY INVESTMENTS LIMITED TO 25% AND 15% LIMIT ON EXPOSURE TO ANY SINGLE ISSUER
DIRECT PROPERTY: IMMOVABLE PROPERTY AS WELL AS PRIVATELY HELD REITs (I.E UNLISTED REITs)	REG. 28 - OVERALL LIMIT ON INVESTMENT INTO DIRECT PROPERTY LIMITED TO 15%
THIS INCLUDES MINING, AGRICULTURAL, OTHER BASIC RESOURCES (COMMODITIES LISTED ON A STOCK EXCHANGE E.G. GOLD, OIL, IRON ORE, SUGAR, BEEF, GRAINS, KRUGER RANDS ETC.)	REG. 28 - OVERALL LIMIT ON INVESTMENT IN COMMODITIES: GOLD - 10% OTHER COMMODITIES - 5%
EXAMPLES OF THESE ARE HEDGE FUNDS AND PRIVATE EQUITY FUNDS	REG. 28 - OVERALL LIMIT ON INVESTMENT IN ALTERNATIVES: HEDGE FUNDS - 10% PRIVATE EQUITY FUNDS - 10% OTHER ASSETS - 2.5%

REGULATION 28 - HTTP://WWW.TREASURY.GOV.ZA/PUBLICATIONS/OTHER/REG28/

DETERMINING MEMBER CONTRIBUTIONS

Annexure B to the Financial Sector Conduct Authority Circular PF 130 (PF 130) recommends the following considerations be applied when dealing with specific funds and deciding on suitable investment objectives.

Defined benefit funds

The board should consider the following to properly understand the obligations of the fund, namely:

- Whether the contributions are to be increased to keep pace with the cost of living;
- Whether the pension formula adjusts to increases in salaries over time, or whether such increases need to be granted to keep the formula current;
- How fund obligations are spread among the categories of members and former members, and, within these categories, by age and time to retirement;
- Whether changes in employment levels or conditions will change patterns of retirement;
- Important ancillary benefits contingent on full or partial retirement;
- Any planned changes to the fund.

In addition, factors relating to solvency ratios and the maturity of the fund must also be taken into consideration.

Defined contribution funds

In defined contribution funds it is recommended that the following factors be taken into account when the board is discharging its investment obligations:

- Needs and reasonable benefit expectations of the beneficiaries;
- Mix of members and related growth and risk tolerance levels;
- Variation in risk tolerance levels of members of the same age group;
- Ability of members to choose investment options – in this regard, the board should consider providing ongoing information and training to members to enable them to make informed decisions.

In addition, the board should monitor default accounts for members who have not indicated an investment option, the participation rate and the investments selected by members. The purpose of such monitoring being to assess whether changes may be required in communication and/or education programmes offered by the fund to its members and pensioners.

Liability-driven investing

In recent years there has been a steady move away from defined benefit funds, where the employer carries the investment risk for the fund having to guarantee the member's pension after retirement, to defined contribution funds where the member carries the risk. This move has been driven by factors such as longevity risk, lower interest rates and increased market instability. For defined benefit plans that are still active, liability-driven investment (LDI) strategies, a specific approach to investing, has become an attractive option through which to reduce the risks associated with pension liability.

The core idea of the LDI approach is identifying the liabilities of an individual or institutional investor and then understanding the risks of any investment strategy relative to these liabilities. The objective of LDI investment is not necessarily to maximise the return of the investment portfolio, but to maximise asset performance. Thus, LDI is geared towards gaining enough assets to cover all current and future liabilities of the member.

Life stage modelling

Life stage modelling is another approach to financial planning for retirement. The objective of the life stage model is to manage a member's ability to withstand risk at various life stages over the course of their working lifetime. In summary, the model assumes that members who are just starting out their working lives, and have a longer time horizon until retirement, are in a position to take greater investment risks; whereas older members, having shorter time horizons until retirement, have a greater need for safeguarding their capital and should subsequently opt for a low-risk investment strategy.

Employer and employee contributions to retirement savings

In both defined benefit and defined contribution schemes there may be both employer and employee contributions to a member's retirement savings. Employees make deposits (contributions) to an account. Contributions are deducted from the employee's pay; some companies match those payments, while other companies contribute a fixed percentage of the employee's salary. Government gives a tax benefit to these payments in the form of rebates or tax deductions so as to incentivise employees to prepare for their financial needs post retirement.

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ASSET CLASSES AND PORTFOLIO CONSTRUCTION

In the previous educational supplement of this series, Investment Fundamentals I, asset classes as per Regulation 28 were introduced. This article focuses on how to construct an investment portfolio using the asset classes specified in Regulation 28.

Collective investments

A collective investment scheme, often referred to as a unit trust, is a professionally managed investment vehicle which pools together money from a variety of investors and uses this money to invest in different securities such as stocks, bonds and other assets.

Investors in these funds may be retail or institutional in nature. Collective investments are well-suited for retirement funds as they are structured according to certain mandates from which they cannot deviate. In addition, due to the wide variety of securities in which they invest, collective investment funds make portfolio diversification easier. There are many different types of funds to choose from, some of which will be discussed in this article.

Equity funds

Pure equity unit trusts invest primarily in listed equities, both local and foreign depending on their specific investment mandate, which may be determined by market capitalisation, industry; the investment manager's style or a specific risk-adjusted return objective.

The availability of such a wide selection of equity unit trusts makes them an ideal choice for many investors, as there is likely to be an equity fund to meet any risk/return objective and risk tolerance that an investor may have. By virtue of their higher concentration of risk assets (equities are susceptible to high volatility), pure equity unit trusts are riskier compared with bond and fixed income unit trusts, but equities have proven over the long term to be the only asset class to consistently outperform inflation.

Equity funds are practical investments for most investors because their portfolio diversification reduces risk for investors. A more diversified fund will reduce the overall effect of the movement of any one share on the fund's portfolio, as well as any movement in any one company's share price.

Balanced funds

A balanced fund is very similar to an equity fund. However, in addition to investing in shares, the fund will also invest in bonds and sometimes even money market instruments. The fund usually keeps its allotment of shares and bonds in fixed proportions.

A balanced fund is so called due to the nature of its asset allocation, which is a balanced portfolio of equity, fixed income, bonds and some cash. These funds are preferred by retirees as well as other investors with a moderate risk appetite who seek the security of a lower risk profile than pure equities, but with the prospect of still beating inflation.

Infrastructure Funds

Infrastructure funds provide investors with the opportunity to invest in essential public infrastructure assets such as toll roads, airports and rail facilities, for example. These infrastructure investments generally provide predictable inflation-linked returns for investors because the infrastructure sector has high barriers for entry and are long-term, capital-intensive investments. The returns from infrastructure funds combine capital growth and dividend income in a wide range of proportions.

Property funds

Property funds are collective investments that invest specifically in commercial property such as offices, factories and warehouses, among others. The fund will do this either by investing directly in the property asset or by purchasing shares in property companies or other property funds. Property funds should not be confused with real estate investment trusts (or REITs), as these are investment vehicles that invest directly in income-producing real estate and are traded on an exchange like stocks are. Instead, property funds can invest indirectly in REITs.

Exchange-traded funds

An exchange-traded fund (ETF) is a traded financial instrument representing ownership in an underlying portfolio of securities and has the ownership and liquidity characteristics of unit trusts. ETFs make their returns by tracking the performance of a basket of securities. These securities can be shares, bonds or even commodities. ETFs are growing in popularity because they allow investors to gain exposure to different sectors, asset classes, types of shares, commodities or government bonds. The key differentiator for ETFs is that they can be bought and sold the same way as unit trusts.

Hedge funds

A hedge fund is an investment fund that pools capital from accredited investors or institutional investors and invests in a variety of assets, often with complicated portfolio construction and risk management techniques. A hedge fund may use any strategy or may take any position that could result in the portfolio incurring losses greater than its fair value at any point in time, and which strategies or positions include, but are not limited to, leverage and net short positions.

Hedge funds have produced increasingly disappointing returns for investors in the recent past and have accordingly fallen somewhat out of favour.

Impact funds

Investors looking for investment opportunities with an overall positive result, both in terms of financial returns and positive social, economic or environmental impacts, could look at impact funds as a possible investment class. Impact funds are a conduit that impact investors use; they are funds that manage assets that have the intended result of achieving positive outcomes in society in addition to financial returns for investors.

The types of investments that impact funds make could be anything from initiatives that invest in renewable energy projects, promote access to healthcare and education, to investing in projects such as affordable housing and student accommodation, for example.

Active versus passive investing

Lastly, when investing, it is important for investors to decide on an investment strategy that will be suitable for them when choosing their investment approach.

There are two main investment strategies, namely active and passive investment management. These approaches differ in how the fund manager utilises investments held in the portfolio over time. Active portfolio management focuses on outperforming the market compared to a specific benchmark, while passive portfolio management aims to track the investment holdings of a particular index.

THIS TOPIC IS COVERED IN TODAY'S TRUSTEE MAGAZINE:

1. https://www.totrust.co.za/education-supplement/retirement-funds-and-investment/
2. 2. https://www.totrust.co.za/education-supplement/why-do-retirement-funds-exist/

REFERENCES:

1. Regulation 28; Available: www.treasury.gov.za

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INVESTMENT INDUSTRY STAKEHOLDERS AND THEIR ROLES

IN BRIEF
"The investment industry helps individuals, companies, and governments save and invest money for the future. Individuals save to ensure that money will be available to cover unforeseen circumstances, to buy a house, to cover their living expenses during retirement, to pay for college or university tuition, to fund such discretionary spending as travel and charitable gifts, and to pass wealth on to the next generation. The investment industry provides many services to facilitate successful saving and investing."

Source: Larry Harris, *Investment Foundations*, Chapter 13 "Structure of the Investment Industry" www.cfainstitute.org

A subsection of the broader financial services industry, the investment industry is made up of a multitude of stakeholders that all play a crucial, but specific role in the effective functioning of the larger financial system.

Given the fact that retirement fund members form part of the investment industry, it is important that retirement fund members understand who the various stakeholders are and the role each plays within the investment industry. For the purposes of this article, the focus will be limited to the following stakeholders: administrators, investment custodians, stockbrokers, stock exchanges, asset consultants, investment managers and the Financial Sector Conduct Authority (FSCA).

Defining the stakeholders and their role

- **Administrators:** Retirement fund administrators fulfil the critical roles of receiving contributions and distributing benefits, transferring new members into and existing members out of, retirement funds as well as providing member communication in the form of benefit statements, income tax clearances and death benefits.

  Investment fund administrators are responsible for servicing and managing a retirement fund, doing the 'back office' work, which consists of processing the financial paperwork, keeping clients up-to-date with the latest information on their fund's investment performance and ensuring that the fund complies with all necessary legislative requirements.

- **Investment custodians:** Very often a custodian, oftentimes referred to as a "custodian bank", is a financial institution that holds clients' securities for safekeeping in order to minimise the risk of their theft or loss. Investment custody services are often performed by large commercial banks.

  A custodian holds securities and other assets in their capacity, either in physical or electronic form, on behalf of their clients for convenience and security. Custodians are typically large and reputable firms that are responsible for the safety of assets and securities that may be worth hundreds of millions or even billions of rand.

- **Stockbrokers:** A broker or a stockbroker can be described as a professional who executes buy and sell orders for stocks and other securities in the context of a listed exchange.

  A broker or a stockbroker is the middleman between the investor and the stock exchange. If an investor wants to buy or sell shares on the JSE, they can't go directly to the bourse. Instead, the investor has to find a broker who will act on their behalf. This broker will follow instructions as to what the investor wants to trade in, the number of shares and the price. Stockbrokers are regulated by the JSE as well as the FSCA in order to protect investors.

- **Stock exchanges:** Exchanges acts as a marketplace for the trade of securities, commodities, derivatives, and other financial instruments. Some notable examples of local exchanges include: The Johannesburg Stock Exchange (JSE), ZARX, A2X and 4AX, and the Equity Express Securities Exchange (EESE).

  Exchanges can either provide traders with a physical location or an electronic trading platform on which to trade stocks. However, today most exchanges use electronic trading.

- **Asset consultants:** Asset consultants can be defined as consultants that assist retirement funds with framing their investment strategy and the implementation thereof.

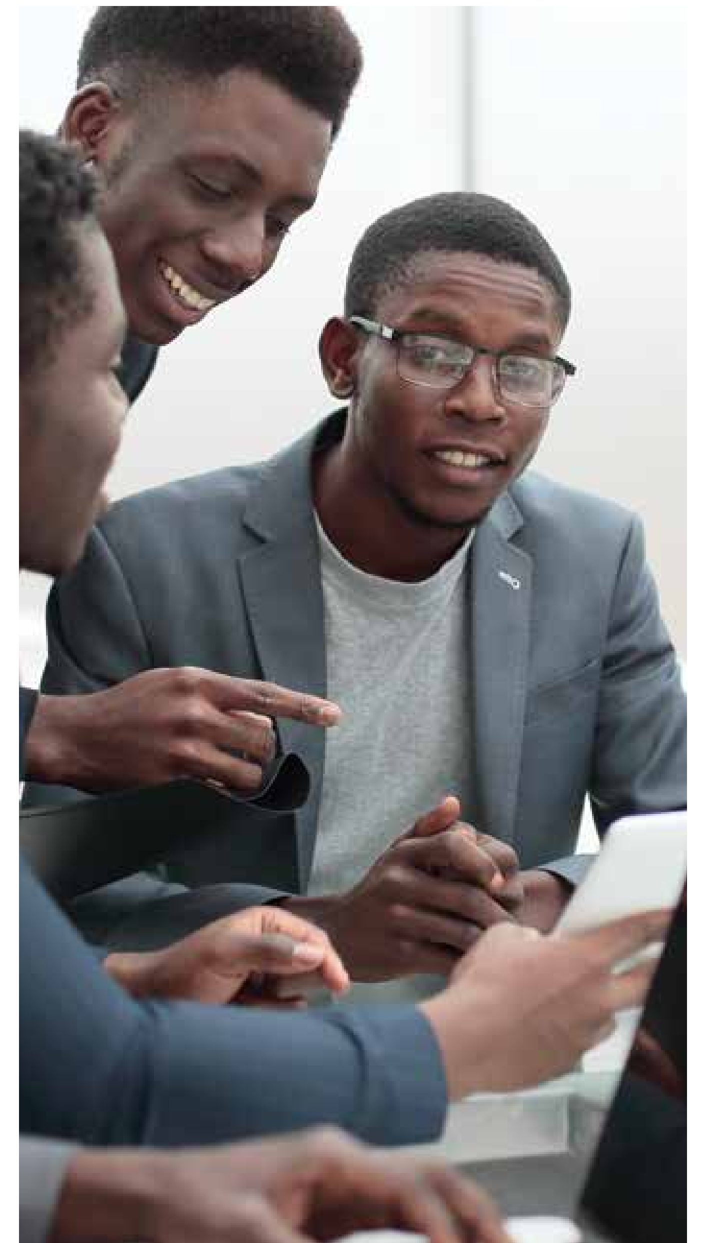
  Asset consultants form part of the investment chain and provide retirement funds with services that include strategic investment decision-making support, strategic asset allocation, and traditionally playing a key role in fund manager and strategy selection.

- **Investment managers:** An investment manager is an individual or company that makes investments in portfolios of securities on behalf of clients based on the investment mandate the client has provided the investment manager. Investment managers can range in size from one- or two-person offices to large multi-disciplinary firms with international offices.

  An investment manager will typically be involved in handling some or all of the following activities: the management of client portfolios, day-to-day buying and selling of securities, portfolio monitoring, transaction settlement, performance measurement, and reporting on legal and client matters.

- **FSCA:** The Financial Sector Conduct Authority (FSCA) is South Africa's market conduct regulator of financial institutions that provide financial products and financial services; financial institutions that are licensed in terms of a financial sector law, including banks, insurers, retirement funds and administrators; and market infrastructures.

  The FSCA's mandate is to improve the efficiency and integrity of the financial market; encourage fair customer treatment by financial organisations; provide financial education and promote financial literacy; and assist in maintaining financial stability.



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8. INVESTMENT MANAGEMENT COSTS & FEES
9. DEFAULT REGULATIONS
10. PRIVATE EQUITY

"Brilliant, thank you. I learned so much and would definitely be reading up a bit more to try and further my understanding on investments."

"The workshop was an eye-opener for understanding the markets. I will be able to make informed contributions as well as informed decisions in the trustee meetings."

CONTACT ASISA ACADEMY
David Morris: 021 673 1627
dmorris@asisaacademy.org.za
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Please select the correct answer by marking the correct box below each question.

Example: True or false? Annexure B to PF Circular 130 provides guidelines for a retirement fund's Investment Policy Statement (IPS)

- [x] *True*
- [ ] *False*

Introduction to Investment Policy Statement
Q1: True or false? Relevant sections of a retirement fund's Investment Policy Statement should be included in the fund's mandates with asset managers.

- [ ] True
- [ ] False

Risk and return objectives when saving for retirement
Q2: True or false? A defined contribution fund is when the employer or sponsor of the fund carries all the investment risk.

- [ ] True
- [ ] False

Monitoring the performance of pension fund investments
Q3: Which one of the following service providers is best placed to assist a retirement fund board of trustees monitor investment performance?

- [ ] The fund's investment manager being assessed
- [ ] The fund's stockbroker firm
- [ ] The fund's asset consultant firm
- [ ] The fund's employee benefits consultant firm

Determining member contributions
Q4: True or false? In the life stage model for retirement saving, younger members are encouraged to take on more risk, while older members closer to retirement are discouraged from taking on more investment risk.

- [ ] True
- [ ] False

Asset classes and portfolio construction
Q5: True or false? Collective Investment Schemes such as unit trusts assist with portfolio diversification for retirement funds.

- [ ] True
- [ ] False

Asset classes and portfolio construction
Q6: Which of the below investment strategies has grown in popularity in recent years due to relatively lower investment costs?

- [ ] Active investment strategies
- [ ] Passive investment strategies

Investment industry stakeholders and their roles
Q7: FSCA refers to the following organisation:

- [ ] Financial Services Commission Authority
- [ ] Financial Sector Conduct Authority
- [ ] Forum for Superannuation Councils in Africa

Q8: Liability Driven Investment (LDI) primarily seeks to achieve the following outcome:

- [ ] Maximising the investment returns of any investment
- [ ] Investing in infrastructure assets such as roads, railways and airports
- [ ] Maximising investment performance relative to the expected liabilities of the retirement fund as a whole or any single individual member of the fund

Q9: True or false? Regulation 29 sets out the asset class limits in which South African retirement funds may invest.

- [ ] True
- [ ] False

Q10: True or false? It is the Principal Officer of a retirement fund who should approve the Investment Policy Statement of each retirement fund.

- [ ] True
- [ ] False

Q11: True or false? Guidance Notice 1 of 2019: Sustainability of investments and assets in the context of a retirement fund's Investment Policy Statement serves as an update to the IPS monitoring and reporting guidance set out in Annexure B to PF Circular 130 (2007).

- [ ] True
- [ ] False

Q12: According to FSCA Guidance Note 1 of 2019, how often should the Investment Policy Statement be reviewed by every fund's Board of Trustees?

- [ ] Monthly
- [ ] Quarterly
- [ ] Annually
- [ ] Once every five years