think**tank**

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Mxolisi Mbekwa
Director of Pension Fund Services
Currently studying Quantitative Management through UNISA

Mxolisi joined RisCura in February 2000. Prior to this he worked for Old Mutual Actuaries and Consultants (now Fifth Quadrant) on the investment reporting and quantitative analysis side. He completed 2 years of his BSc Engineering degree but changed to study quantitative management through UNISA. Mxolisi is responsible for managing the consultants, as well as interacting and communicating with clients.

how to be a good trustee

The human impact – a true story

Mr Jones worked for Company X for 34 years. Company X didn't pay him particularly well but Mr Jones enjoyed some great benefits such as a housing allowance and a supposedly secure defined benefit pension fund. The security of his retirement benefit was one of the reasons Mr Jones stayed at Company X for so long. In 2001, after receiving a benefit statement from the company's pension fund stating that his retirement amount was R4.1million (the actuarial value), Mr Jones decided to take early retirement.

The normal "defined benefit" (calculated in terms of the Fund's rules), which was due to Mr Jones made provision for both a lump sum gratuity and a pension. The Fund rules offered Mr Jones the choice of converting his entire pension into a gratuity lump sum or his gratuity lump sum into a pension.

Mr Jones gave notice of his retirement to the Fund, but by the time of his retirement some months later, he had still not received a final statement of his retirement benefit. The law requires that before the date of retirement, members should receive notification of their actual retirement benefit in order to make their necessary elections.

good **thinking**

When Mr Jones questioned the Fund, he was told that there had been a discrepancy between the actuaries' and the Fund's calculations of his retirement benefit and that the Fund was not yet able to release his benefit statement. On the day of his retirement, Mr Jones had still not received this benefit statement.

Due to his lack of confidence in the Fund's ability to manage its investments, Mr Jones decided that even though he had still not received his final benefit statement, he would elect to convert his entire pension into a gratuity lump sum (i.e. withdraw all his assets from the Fund). He would use this money to purchase a voluntary annuity pension from a large insurance company.

After Mr Jones' retirement, it became known that the trustees of the Fund had invested a significant portion of the Fund's assets in high risk financial instruments and that the Fund stood to lose approximately 1/4 of its value. It was announced that despite the Fund being a defined benefit structure, this loss would affect pensioners' and active members' benefits. In addition, no employer stood as security behind this defined benefit scheme. On hearing this, Mr Jones sought immediate legal advice.

Mr Jones' lawyers are contending that the investment decisions made by the trustees and the investment adviser of the Fund contravened Regulation 28 and were in breach of the trustees' fiduciary obligations. Furthermore, the trustees are ultimately responsible for the management of the Fund's investments. Accordingly, the trustees themselves should make "good" the balance of the money in order not to prejudice members and pensioners.

Mr Jones has issued final demands on the Fund. Failure to comply with these demands will mean that Mr Jones will be forced to sue, among other parties, the trustees of the Fund in their personal capacities.

The above true story highlights the need for good corporate governance by trustees. Trustees can only take proper responsibility for a Fund if they have a thorough understanding of the Fund, its rules as well as retirement fund regulations. Trustees should remember that no matter what Fund responsibilities they pass on to other parties such as asset managers, consultants or intermediaries, they are in the end ultimately responsible for the Fund's investments.

Principles of good governance for trustees include: -

- **Discipline** – acting for the Fund in a proper and ethical manner;
- **Transparency** – communicating with Fund members in a user-friendly and understandable way about any payment that trustees may receive or expenses incurred by the Fund;
- **Independence** – avoiding conflicts of interest and ensuring that all decisions made by the Fund are in the best interests of members;
- **Accountability** – trustees are accountable for investment performance, Fund information and administration systems. Every Fund should have effective internal controls in place to ensure that the trustees approve and authorise all Fund decisions;
- **Responsibility** – the Board of Trustees is ultimately responsible and accountable for any outsourced functions;
- **Fairness** – acting with objectivity and in good faith when making decisions for the Fund;
- **Social Responsibility** - not discriminating against or exploiting any members of the Fund.

A Board of Trustees must take responsibility for setting: -

- The objectives and goals of the Fund;
- A policy and strategy required to achieve these objectives.

Trustees also have a fiduciary duty to ensure: -

- Prudent investments, especially when there is individual member choice;
- Members and their dependents receive proper benefit payments;
- The Fund receives contributions;
- Stakeholders receive ongoing communication.

(*sourced from Personal Finance, 22.03.2003)

Trustees should be highly competent in all of the above issues. They must be able to understand and manage Fund risk, the actuarial principles used in valuing a Fund and its benefits as well as investment risk and strategies. If trustees are not sufficiently competent in these areas, they should use external advisers or appoint sub-committees to assist them.

Effective communication with members is an integral part of good governance. All member communication must be honest, accurate and timely. It should also be user-friendly and reliable, enabling members and pensioners to make informed decisions.

Boards of Trustees must also review the applicability and effectiveness of the Fund's governance structure to ensure that it remains in line with best practice and is able to meet its objectives.

what's new? RisCView

Launched at the end of 2002, RisCView is RisCura's monthly performance survey measuring the performance of the largest retirement fund asset managers in South Africa. There are currently four surveys available - fully discretionary global segregated and pooled surveys, a fully discretionary domestic segregated survey and an absolute return survey.

We are in the process of putting together other surveys (such as multi manager, specialist cash, equity and bond mandates) and will inform all clients once these have been finalised. Our aim is in time to cover the performance measurement of all Fund assets, large and small.

If you would like to receive a copy of these surveys which are emailed on the 20th of each month or be updated on our new surveys, please email Dean Havenga at dhavenga@riscura.com.

more about risk

Prasheen Singh

Research Analyst

B Bus Sc (Quantitative Management) - (Hons in Statistics); M.Sc. (Financial Mathematics)

Prasheen joined RisCura in March 2000 straight after completing her undergraduate degree. She is extensively involved in research and has a strong understanding of both the financial and quantitative elements of the business.

Last quarter, we introduced various types of risks (such as market, liquidity and credit risk) that pension fund trustees are likely to face when investing a Fund's money. Any trustee would expect to be rewarded for some of the risks that they take on. In this article we'll be taking a closer look at the relationship between risk and reward and introduce the concepts of risk-free return, risk reward ratio and risk premium.

Let's look at why invest in the first place? We invest for the simple reason that there is a demand for money. This means that if you don't need to use your money right now, someone else is willing to pay you for the use of it. Compare this to renting out your house. If you are not occupying your house for a period of time and there's a demand for your type of house, you could find someone who is willing to pay "rent" for the use of your house while you are away.

When you invest money however, there is always risk. The risk is that your investment may not deliver the reward or return that you expect or worse still, you may not be able to get back the full amount that you invested. We can compare this risk to the person who rented your house refusing to pay the rent, or worse, destroying your house with a series of wild parties while you were gone!

Theoretically then, a "**risk-free return**" would exist if an investment guaranteed that you would get 100% of your money back as well as the promised return. In the real world however, there are no 100% guarantees and the closest you can get to this guarantee is one given

by the government. Even though some governments are economically stronger than others, the returns offered on short–term fixed income instruments that are issued by a government are often considered a "proxy" for risk-free returns.

As discussed last quarter, the amount of risk associated with a particular investment varies. For example, you may have interviewed two potential tenants for your house. The first was perhaps a 33-year old accountant visiting your city on business whose company would be covering the rent. The second was perhaps a local, temporarily employed 18-year old student. Clearly the second candidate would be a riskier tenant, and for the same reward (rental) as the accountant is offering, your choice of tenant is clear. If however, the student offered to pay you twice the rent, as well as repaint the house and do some weekend work in the garden, you might consider him as a tenant because in this case the higher risk offers higher potential reward. The principle that an investment must offer an expectation of higher potential return as compensation for increased risk (and visa versa) is called the "**risk reward ratio**" or sometimes also referred to as "**risk-reward trade-off**".

The phrase "**risk premium**" refers to the extra return offered by "risky" investments over and above the risk-free rate of return. Let's use the example of a corporate investment (bond or share). Corporates have the inherent risk of going bankrupt, being liquidated or taken over and should therefore yield a higher return than the risk-free rate. The "premium" you are potentially getting from a corporate investment in exchange for the higher level of risk you take on is called the "risk premium".

profile

René Dodgen

Client services consultant

Education: After matriculating, I completed various diplomas: secretarial, marketing management and public relations.

Experience: After traveling through the USA, I joined RisCura in 2000 as Jarred's personal assistant. After 2 years in this role, I moved into the marketing and client services department.

Passionate about: I love being able to help others. I'm also passionate about my church and its community activities.

Dislike: When people don't maximise their potential and live life to the fullest.

Spend my spare time: I love the outdoors - swimming, hiking and picnics. Singing and playing my alto recorder are also favourites, along with learning to play the guitar.

Favourite book: The Great Gatsby by F. Scott Fitzgerald.

Best thing about living in South Africa: The positive energy that exists around me.

What motivates you: Optimistic people who have done weird and wonderful things to further themselves in life.

Where do you see RisCura going: I think RisCura will become one of the top investment and risk advisers. We not only have the intellectual capital and independence but a genuine desire to empower decision makers.

talking to duncan about

asset liability consulting

Assets are anything of value owned by a person, business or fund. Liabilities are anything of value owed by a person, business or Fund. In the case of a pension fund, assets are investments or contributions that the Fund holds and looks after on behalf of its members while liabilities are the retirement pensions or payouts that need to be made to members.

Asset liability consulting entails understanding and calculating a Fund's liabilities before decisions are made on how to invest the assets. This is important because without knowing what the Fund owes in the future, it cannot make decisions on how to invest the assets today.

The first thing all Funds need to do is "quantify" their liabilities. This forms the basis of the Fund purpose or Fund objective. Out of this Fund purpose, comes the investment philosophy or strategy, which directs the investment of assets in relation to liabilities.

A typical investment strategy would maximise portfolio surplus (assets over liabilities) subject to an acceptable level of risk (and consequences) of not meeting liabilities.

Why is asset liability consulting different from regular asset consulting?

Regular asset consultants often focus on maximising asset return without understanding what the Fund will owe its members over the long term. They base a Fund's objectives on a Fund credit analysis and the age profile of members and then apply "off-the-shelf" products or a fully discretionary best investment view (house view) of the asset managers to meet the broad expectations of the Fund. These products are not always appropriate for the specific needs and characteristics of each Fund.

A Fund strategy should take the following key elements into account: -

- Objectives of stakeholders;
- Nature and term of the liabilities;
- Funding methods used in the Fund;
- Risks to which the assets and the liabilities of the Fund will be exposed.

Duncan Theron
Director of Pension Fund Services
B Com (Hons) Dip FMI; SAFEX; Currently completing a Diploma in the Mathematical Modeling of Derivatives; Enrolled as a candidate in the CFA Programme.

Prior to joining RisCura, Duncan was a director responsible for asset manager research at Alexander Forbes Asset Consultants. Duncan has significant knowledge on the investment philosophies and processes of South African and international asset and multi-managers, as well as in-depth understanding into pension fund and unit trust products.

This will ensure that each Fund is treated according to its unique circumstances and members, and not relative to some aggregated industry or standard pension fund. We believe that this is absolutely critical for both Defined Benefit Funds (where the risk of not meeting the liabilities falls with the employer) as well as Defined Contribution Funds (where the risks fall on employees). While the risk bearer may differ in the two schemes, the ideal benefits most likely won't, making the approach valuable to both types of fund.

What are the benefits of using an asset liability consultant?

The overriding goal of each Fund must be to meet its commitment to members and pensioners within an acceptable risk framework.

Asset liability consultants enable trustees to know and understand the commitments of a Fund, so that they can plan the Fund's asset structure with a view to effectively controlling risk. Knowing the Fund's liabilities also ensures that effective customised investment solutions be found for each Fund.

What is the starting point for an asset liability consultant?

Understanding a Fund's liabilities involves researching the membership base, the legal structure and rules of the Fund as well as taking views on member contributions and inflation.

These factors are analysed in-depth to provide a working model of the liabilities, after which asset liability modeling is undertaken to derive the Fund's recommended asset structure.

It is important to see the resultant asset structure as flexible so that as contributions, liabilities and assets change, the Fund is able to adapt effectively.

next issue of thinktank:

In the next issue of thinktank, we will cover RisCura's passion for empowerment both in and outside of RisCura and take a look at the performance of the currently popular Absolute Funds relative to the more traditional Balanced Funds. We will also profile our risk analyst Vuyo Cokile.

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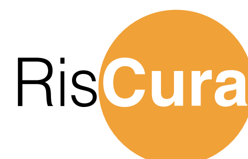

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