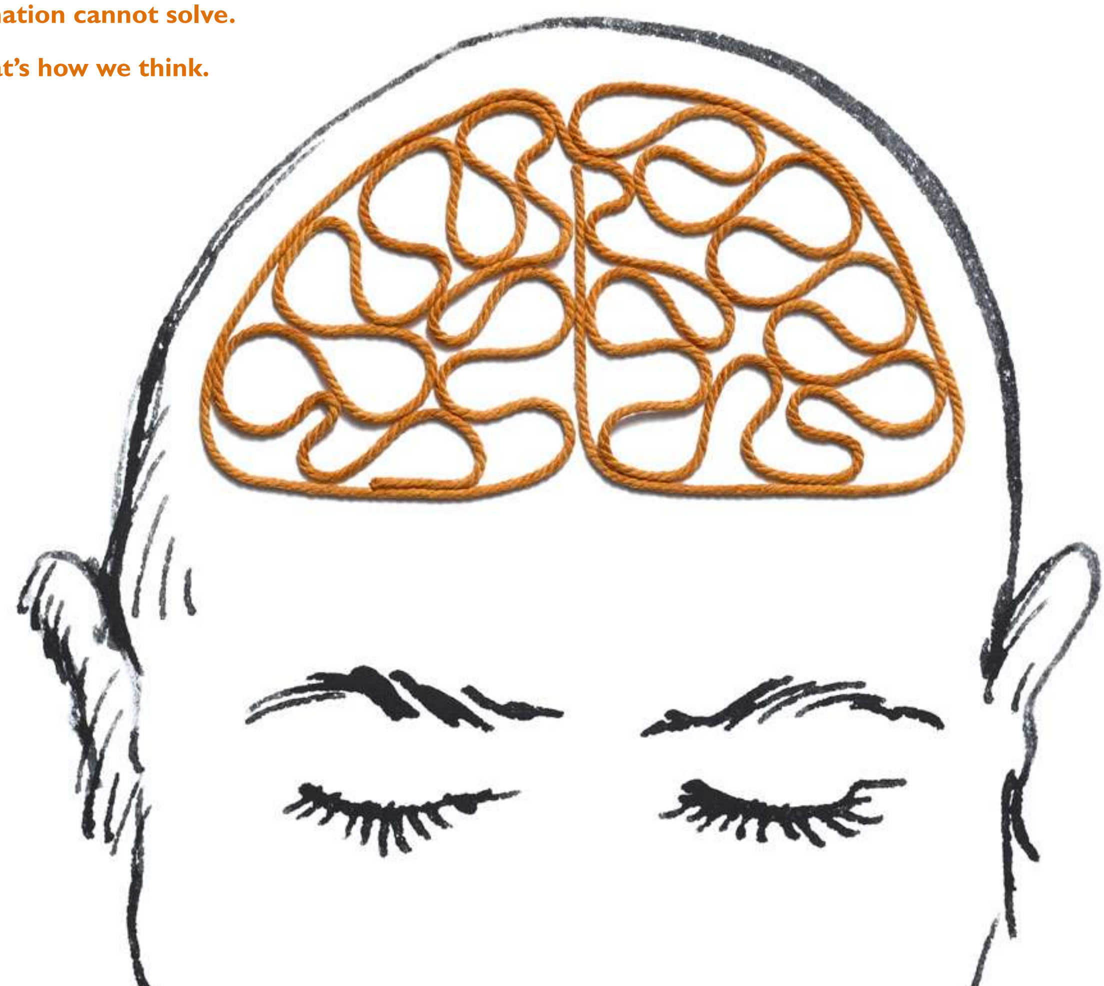
RisCura

good **thinking**

There is no problem that considered thought, intelligence, applied knowledge and imagination cannot solve.

Well, that's how we think.



thinktank

May 2005

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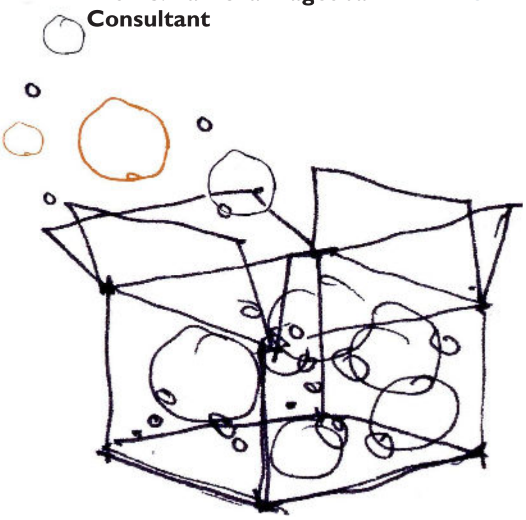


Putting a lid on retirement fund costs

By Mandisa Mbilini

Recently the National Treasury discussion paper on the new Pension Funds Act highlighted concerns about the increasingly high costs of saving for retirement.

Government noted that the increase in insurance premiums and administration fees is a worrying trend that requires attention. The National Task Team, established by Government to make recommendations regarding the new Pension Funds Act, believes that retirement funds should be subject to more frequent and thorough disclosure requirements.

The importance of greater disclosure

Retirement funds should, on at least an annual basis, provide information to each member regarding the portion of their contributions that were used to pay administrative and risk benefit costs. The team also states that a key part of a trustees' fiduciary duty is to ensure that commissions and fees paid to service providers are fully justifiable and not disproportionate to the value of the service or product provided.

RisCura's role

RisCura has always maintained that high costs could have a big effect on a member's final retirement benefit. Accordingly, we have done significant research on the various costs involved in retirement fund management, including the often-ignored and underestimated, transaction costs. We have put together an extensive database of fees for all types of mandates, which together with our large client base and strong understanding of retirement fund administration, is very useful in negotiating competitive fees across all services providers for our clients.

Managing investment and transaction fees

In this article we take a closer look at investment manager fees and transaction costs. Transaction costs are often referred to as "hidden fees" as they are deducted from a fund's return. Although investment manager fees are more negotiable than transaction costs, trustees have a responsibility to ensure that transaction costs are not unreasonable and where possible, effectively managed.

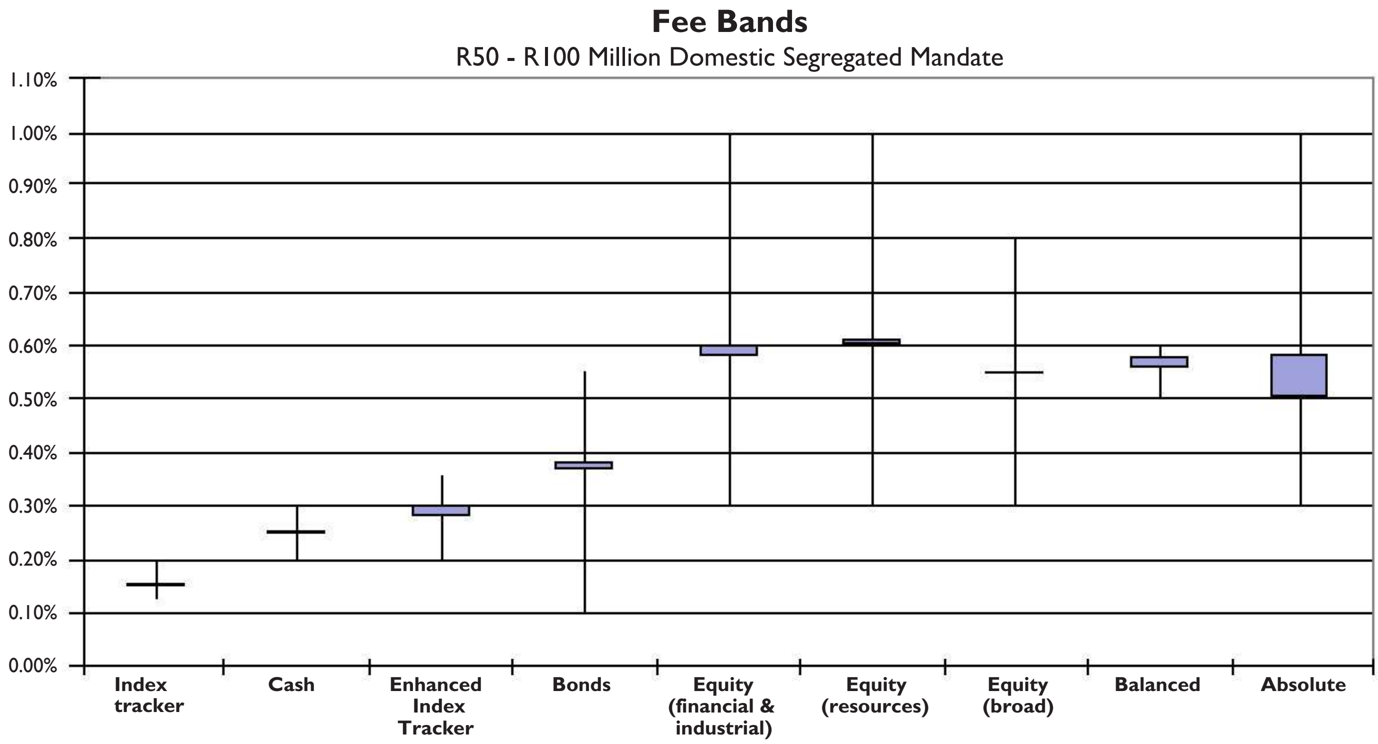
Investment manager fees

Investment manager fees are generally either flat or performance-based. Most managers offer their clients both options.

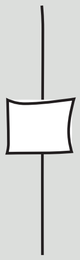
Flat fees

A flat fee is a fixed percentage calculated on the market value of a retirement fund's assets. RisCura has conducted research on these fee bands across a range of asset classes/sectors and for different asset sizes.

The chart on the next page shows the maximum, minimum, average and median fees in the industry for various types of mandate products for domestic segregated funds of between R50 -R100 million.



How to interpret the RisCura candlestick diagrams



The top of the vertical line represents the maximum fee.

The box shows the average and the median fee for that category.

The bottom of the vertical line represents the minimum fee.

Below, we highlight some interesting points:-

- The costs associated with pooled mandates are higher than those of segregated mandates. The fees on balanced pooled products range between 0.45% - 0.85%, whereas the fees on balanced segregated mandates are between 0.5% and 0.6%.
- Specialist products are generally cheaper than balanced products. Specialist mandates are therefore considered to be optimal from a cost perspective.
- The variance in fees for specialist mandates (such as Findi and Resi) is the highest, although the average fee on these funds is quite low - indicating that a couple of managers are charging very high fees on these mandates relative to the rest of the industry.
- Absolute return funds charge the highest fees, with balanced and core equity second and third respectively. Investment managers justify this by saying that in equity-only and specialist equity funds, clients are paying for stock selection and/or sector rotation only, but in absolute and balanced funds, clients are also paying for asset allocation, thereby justifying the higher fees.

Performance-based fees

The following structure applies to performance-based fees:-

- A base fee is charged on assets under management, which is totally independent of how the fund performs.
- On top of this base fee, a performance fee is charged should the fund outperform an agreed upon benchmark.
- A cap is sometimes put in place whereby the base fee plus the outperformance fee cannot exceed a predetermined percentage of assets under management.

Some broad observations from our research:

- The base fee is generally lower than the flat fee by 10 to 20 basis points.
- The outperformance fee ranges from 10% to 30% of outperformance of the benchmark, with the average being around 20%.
- The capped fee is generally around 1%, but some are as high as 3%.

Points to keep in mind:

- Flat fees are easier for retirement funds to administer.
- We strongly recommend that a cap be placed on performance-based fees.
- There is a danger that performance-based fees could be more expensive than flat fees, if the benchmark is too low and the market has a strong run.
- We recommend that the performance-based fee is related to peer group performance or to a targeted return over and above the benchmark return, for example, ALSI + 3% per annum.

Transaction costs

Transaction costs include both direct and indirect fees. Historically, emphasis has been placed on direct fees (e.g. brokerage and taxes), however RisCura has recently, via its research, drawn more attention to indirect fees, which can account for up to $^2/_3$ of the total transaction cost.

This research has helped us effectively monitor investment manager and broker implementation strategies.

Although the tax portion of the transaction fee is fixed, trustees can negotiate lower management and brokerage fees. Brokerage fees can be reduced by using a blend of execution-only brokers and research-and-execution brokers. Execution-only brokers charge between 5 to 18 basis points while research-and-execution brokers on average charge 25 basis points.

RisCura offers transaction cost reporting to a wide range of clients, including retirement funds, investment managers and stockbrokers. We have compiled a transaction cost benchmark, unique to the South African market, which is designed to help funds understand how their investment managers and stockbrokers perform relative to their peers in executing similar trades on a monthly basis.

A conservative example of flat and transaction fees for a R100 million equity fund.

Equity Fund Size		100,000,000
Annual Turnover		80%
Management Fee	**0.60%**	**600,000**
Transaction Fees	**0.34%**	**340,000**
Brokerage Fees	0.25%	200,000
UST on Purchases	0.25%	100,000
VAT on Brokerage	0.04%	28,000
Other Fees	0.02%	12,000
Total Direct Fee	**0.94%**	**940,000**

Other fees include: Insider trade levies, STRATE fees, settlement charges etc.

Below, we outline some of the analysis reflected in our cost report:

- Direct and indirect trading costs
- Purchases and sales, including overlap
- Trading and turnover
- Manager trading analysis and broker allocation
- Broker analysis

These reports and analyses enable funds and trustees to evaluate the trading costs incurred and thereby identify the means to effectively manage these costs.

This will play a key role in helping trustees manage rising retirement fund costs and ensure the provision of greater service value within the industry.

Investing in a better future

A case for socially responsible investing and the support of smaller investment managers

By Laurett Jardim

In a previous edition of thinktank, we defined socially responsible investing (SRI), looked at the various ways that investors can make a difference through their investments, and dealt with some of the performance and risk concerns that investors might have about these funds.

In this article, we provide a brief history of socially responsible investing, explain some of the strategies, and take a more detailed look at performance issues, and the range of products available. We also look at the importance of supporting smaller investment managers as we believe they also play a key role in the empowerment and development of this industry.

SRI - growing rapidly

Although SRI is a relatively young phenomenon in South Africa (and for that matter globally), the significant need for infrastructural and social development in this country seems to be driving its rather rapid growth. This growth is also being supported by the increase in available information, recent corporate scandals in the US, a wider range of products, women's affinity for SRI and some very acceptable performance track records.

Looking back

At the height of the Great Depression in the 1930's in America, president Franklin D. Roosevelt said, "We have always known that heedless self-interest was bad morals; we know now that it is [also] bad economics."

The concept of SRI was developed by investors who wanted to avoid investing in companies that profit from products or services that they believe may, directly or indirectly, negatively affect people and/or the environment. Many SRI products have religious roots, such as the Muslim Shari'ah Law, which prevents Muslims from investing in shares associated with alcohol, gambling, pornography, non-halaal foodstuffs or interest bearing instruments. In the US, the Methodists and Quakers have been strong promoters of this concept for the past 200 years.

During the 1960's and 1970's, the sensitivity towards SRI was heightened by concerns regarding the Vietnam war, civil rights and the women's liberation movement. South Africa's apartheid regime is mentioned in almost all SRI material as a key issue in the 1980's. More recently the environment has become more prominent in terms of SRI with issues around global warming.

SRI strategies

Avoiding harmful industries such as the tobacco, gambling, pornography, weapons and nuclear energy industries.

Investing in profitable companies that make positive contributions to society.

Shareholder activism involves direct debate with companies and voting on shareholder resolutions. Action is focused on positively influencing corporate behaviour.

Community investing encourages investment into local and rural communities, where capital is not readily available, to create jobs, affordable housing and environmentally friendly products and services.

Performance and risk issues

The primary focus of trustees in terms of SRI should be to maximise returns at an acceptable level of risk and at reasonable fees. Key trustee concerns relate to the performance of these funds relative to unrestricted investment products, their potential risk as many of the underlying investments are unlisted and fall within the private equity sector, as well as the correct way to value these investments, given that they are unlisted.

In terms of smaller investment managers, trustee concerns are more focused on the fact that there is no sustained performance track record in place, and that many of these managers have underdeveloped risk management capabilities.

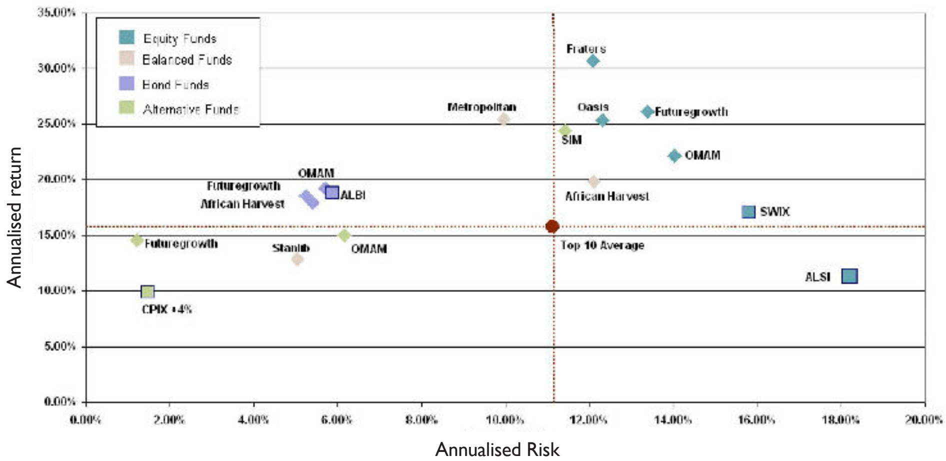
In May 2004, the FTSE JSE launched the Social Responsibility Index to serve as a benchmark for what they term "sustainable businesses". It is not an ethical index, as it does not exclude companies involved in potentially harmful products such as tobacco. It does however include around 51 companies that fulfil criteria based on their economic, social and environmental and corporate governance practices.

A number of investment managers offer SRI products. The below charts show the performance of these products as reflected by the RisCura SRI survey over 1 and 3-year periods. The charts illustrate that performance of these products is acceptable given the relevant benchmarks for each asset class.

We believe retirement funds should consider a 5% to 10% allocation to SRI and smaller investment managers. This however will require careful selection and in-depth monitoring of any performance and risk issues.

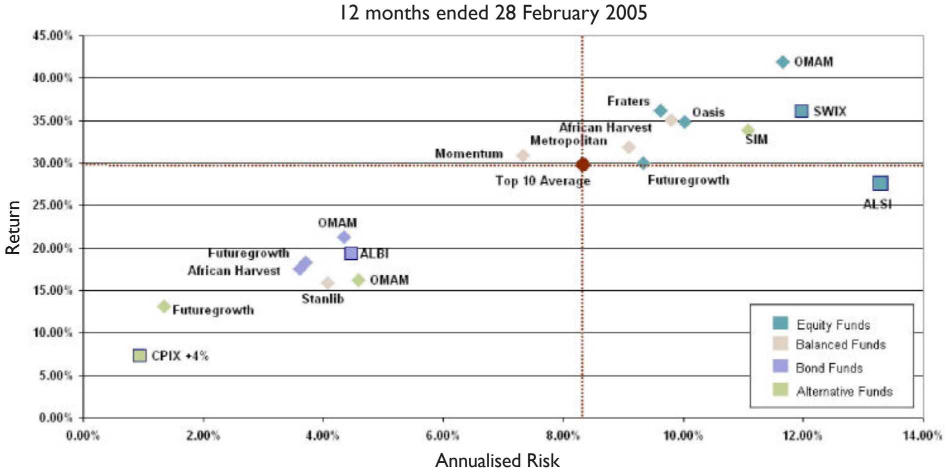
SRI Scatter

36 months ended 28 February 2005



SRI Scatter

12 months ended 28 February 2005



Fund	Description
Balanced	
African Harvest Balanced Benevolent	Provides an income stream, via the donation of a portion of African Harvest's fee on this product, to community projects involved in the prevention of violence against women and children.
Metropolitan Futurebuilder	Invests in businesses and projects that contribute directly to economic growth, capacity building, skills transfer and job creation, and that also comply with good corporate governance procedures.
Momentum Supernation	Invests in the Fraters Earth Equity Fund, the Futuregrowth Infrastructure Bond Fund, the Futuregrowth Community Property Fund as well as cash. (All 3 of these funds are listed on this survey. Please see their respective investment philosophies.)
STANLIB Wealth Development	Invests in empowerment ventures leading to wealth creation and the general upliftment of previously disadvantaged communities.
Equity	
Fraters Earth Equity	Promotes awareness of corporate responsibility (including environmental management, social responsibility, economic empowerment and corporate governance) through engagement with the management of the companies in which the fund invests.
Futuregrowth Albaraka Equity	Managed in accordance with Shari'ah law and therefore does not invest in shares associated with alcohol, gambling, pornography, non-halaal foodstuffs or interest bearing instruments.
Futuregrowth SRI Equity	Based on the SRI principles of the JSE SRI index and invests in listed companies that integrate corporate social responsibility with their business activities.
Oasis Crescent Equity	Managed in accordance with Shari'ah Law and excludes shares associated with alcohol, gambling, pornography, non-halaal foodstuffs or interest bearing instruments.
OMAM Community Growth	Invests in companies that are concerned with job creation, training and skills development, employment equity, economic and social empowerment, good conditions of employment, high health and safety standards, sound environmental practices and effective corporate governance.
Bonds	
African Harvest Infrastructure Bond	Focuses on the provision of infrastructure and services (including energy, water, sanitation, transport, communications, housing, health, education and security) to disadvantaged communities.
Futuregrowth Infrastructure Bond	Focuses on the provision of infrastructure and services (including energy, water, sanitation, transport, communications, housing, health, education and security) to disadvantaged communities.
OMAM Community Gilt	Focuses on institutions and projects that contribute to the development of South Africa, through meaningful social impact, commitment to development, community participation and support.
Alternative	
OMAM Ideas	Invests in development assets (includes funding of projects, construction of infrastructure etc.) with the objective of contributing towards the further expansion of the South African economy.
SIM Development	Invests in small loan financing companies, empowerment special purpose vehicles, black economic empowerment companies, infrastructure and private equity.

Power to the people

The BIGGER, better role of the pension funds adjudicator

by Ramitha Mahesh

New to the RisCura team is Ramitha Mahesh who has taken the position of legal and compliance officer. Ramitha will be updating us on regulation changes and other legal issues in thinktank on a quarterly basis. This quarter she covers the expanded role of the pension funds adjudicator, which is already creating a rumpus in the industry.

The adjudicator's role

The role of the pension funds adjudicator was established in January 1998, and its functions are regulated by the Pension Funds Act. The adjudicator must, in terms of the Act, be an attorney or advocate. His or her role is to resolve a variety of complaints by parties (such as members, beneficiaries, trustees and employers) that have an interest in retirement funds registered under the Pension Funds Act. Resolutions must be reached in a procedurally fair, inexpensive and expeditious manner, and the adjudicator's determinations have the power and force of a court of law.

New responsibilities

Since its establishment, the jurisdiction and procedures of the adjudicator's office have remained largely unchanged. Recently however, the government has considered increasing the adjudicator's powers and jurisdiction to help alleviate the burden placed on the Financial Services Board (FSB).

In the recent Principles of Retirement Fund Reform discussion document released by National Treasury, it was noted that a range of bodies are currently being used to resolve disputes relating to occupational retirement funds. These include, among others, the CCMA, the Labour Court, the High Court, the FSB's Appeal Board, the Ombudsman for Long Term Insurance and the FAIS Ombudsman. The document suggests that to help reduce consumer confusion, a single avenue be established to help resolve these matters. The document recommends that a special tribunal be established under the jurisdiction of the adjudicator to deal with retirement disputes for all funds, including those not registered under the Pensions Fund Act.

The adjudicator in the meantime has given the retirement fund industry a shake.

Lambasting a life insurer

In a recent case involving the Art Medical Equipment Fund, Mr MG Thobois, the sole trustee, was found to be "grossly negligent, if not dishonest" and flagrantly in breach of his duties as a trustee when he allowed a group life assurance policy to lapse. The adjudicator ordered Mr Thobois to pay (out of his own pocket) death benefits to the spouse of a deceased fund member.

The above determination has set a precedent that the adjudicator will now hold trustees personally liable, if applicable, for negligence, and has adopted a stance of zero tolerance for trustees who breach their fiduciary duties and look after their own interests rather than those of their fund members.

Employer vs. employee

In another recent determination, the principal officer and participating employer of the Mitchell Cotts Pension Fund were lambasted for their secrecy and lack of transparency, which prevented the adjudicator from addressing serious allegations of asset stripping by the family-controlled employer and trustees.

The adjudicator ordered the Fund to appoint an independent auditor to probe these allegations and until the audit is complete, the fund's substantial surplus cannot be distributed.

In this judgment the adjudicator emphasised that the good governance of a fund depends on an arms-length relationship between the employer and the Board of Trustees.

Fees are targeted

The recent De Sousa vs Lifestyle Retirement Annuity Fund case highlighted the adjudicator's disapproval of the "horrendous" fees levied by retirement annuities.

In this highly publicised case, the life assurer applied penalties to Mr De Sousa's retirement annuity, resulting in a loss of R32,000 to him. The adjudicator ruled in favour of Mr de Sousa and ordered the life assurer to repay the amount contributed by De Sousa, less the charges disclosed in the fund rules.

This landmark decision saw a life assurer being ordered to pay back fees deducted on a retirement annuity policy, which is a first for the industry.

Better member protection

Although the new pension funds legislation is still in its discussion phase, the adjudicator's office has already beefed up on its service delivery and has given "clout" to its determinations. In addition, a "good governance for retirement funds" document is currently being drafted. Both should hopefully lead to enhanced member protection and increased responsibility and accountability by retirement funds and their trustees.

A new, improved risk measurement tool

The Omega Ratio

By Petri Greeff

Never heard of it? Well, put your good thinking cap on and here goes.

Old ratios

When it comes to quantifying a fund's risk/return properties, most people will have used the well known risk adjusted ratios such as the Sharpe and Information ratios. Although widely used and regarded as informative, their apparent simplicity hides some serious drawbacks. In this article, we point out some of the drawbacks and introduce the Omega ratio, a more comprehensive and modern measure of a fund's risk/return properties.

Introducing the Omega ratio

Although all of the ratios above rely on a fund's actual return series, it's the way in which this return distribution is interpreted that sets the Omega ratio apart. Sharpe and Information ratios assume that a fund's returns are normally distributed, even though this is quite often not the case (think hedge funds with their highly skewed returns), and calculate the mean and standard deviation based on this "normal" distribution. There are 2 problems with using a normal distribution: (1) it's symmetrical, and therefore assumes that the upside and downside probability is the same, and (2) it assumes that extreme events do not occur very often, both of which we know is not always the case.

Omega ratios work with implied distribution, capturing all the higher order moments (skewness, kurtosis etc), which distinguishes returns from being "just normal."

Tailored to chosen risk profiles

It's important to know that while they have different names, the Information ratio is really just a generalisation of the Sharpe ratio. Both measure the risk-adjusted return of a fund relative to a benchmark. The Information ratio uses a generalised benchmark, while the Sharpe ratio uses a specific benchmark - the risk free rate. The Omega ratio uses a benchmark, which is defined by a certain return threshold, based on an investor's risk appetite. For example, very risk-averse investors would only expect a "bare minimum" return on their investments, while less risk-averse investors would expect more return. By being able to specify this threshold value, the Omega ratio has value for investors with different risk profiles.

Using the ratios

So what does the Omega ratio actually measure? Without becoming too technical, it simply measures the probability weighted ratio of returns above and below an investor-defined return threshold. The ratio can be used as follows: suppose you have to make an investment decision between two funds. As an investor, you will have a minimum required return, as determined by your risk-appetite. Given this return threshold, you can then calculate Omega ratios for both funds. The ratio with the highest value indicates which fund is more likely to achieve returns above your return threshold.

It's important to note that a fund selected in this way, does not necessarily have the lowest risk associated with it. Rather, the choice is a function of your risk-appetite: For example, if you have a high return threshold, the only fund that may be capable of achieving returns above this threshold might well be the riskiest of them all.

Want to know more? Please contact Petri Greeff from our research department on (021) 683 7111 or pgreeff@riscura.com

Profile:

Pam Magcoba

Consultant

Qualifications and experience:
I qualified with a BCom (Hons) in Financial Analysis and Portfolio Management at the University of Cape Town and went on to do a National Diploma in Accounting at the Peninsula Technikon.

Prior to joining RisCura as a Risk Analyst in 2003, I spent 3 years with Brait Management Company and 3 years with Ernst & Young as an accountant.

Day to day my job involves putting together our manager risk and performance surveys as well as doing other quantitative and qualitative research on investment managers.

I get up in the morning because I'm grateful for my job and the opportunity to participate in our economy.

Best place I ever visited is Port St Johns in the Eastern Cape.

My greatest passion is meeting new people and sharing ideas. Every person I meet teaches me something about the world, either in what they say or the way the act. I really enjoy that.

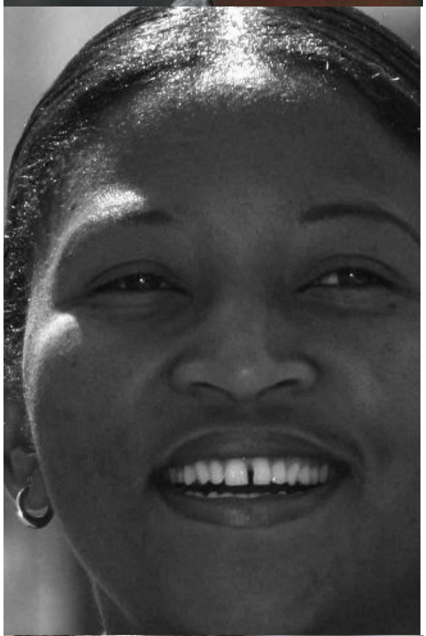
The last movie I saw was Shark Tale.

I think one of the key issues in the retirement fund industry is that a lot of fund members are not participating enough in their retirement savings - they have no idea what happens to their contributions or how their fund is performing. Increased education and communication is key.

The thing that concerns me the most is that fund trustees are lacking in education, which makes it difficult for them to communicate with and educate members.

Trustees are poised to participate more directly in the day-to-day running of retirement funds, and to challenge service providers on issues such as costs, compliance and performance.

RisCura is great at empowering our clients and using our in-depth understanding of the investment managers to make a real difference to clients' portfolios.



My family is all about love, care, trust and support.

When I'm old I want to relax, be proud of achievements, and have very few regrets.

RisCura

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