thinktank

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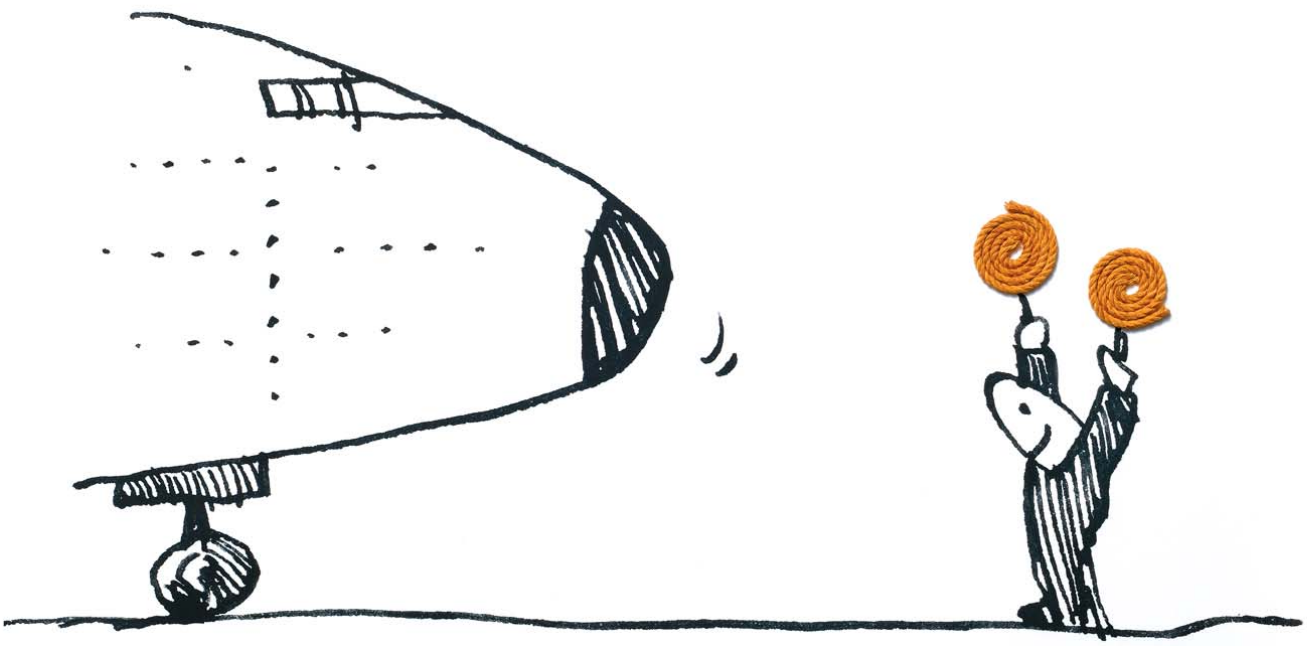
In case of misdirection, misapplication, fogginess or just plain risk navigation, we'll help you find a way.



RisCura

good **thinking**

Jarred Glansbeek, CEO

The independent consultant: An endangered species?

At the recent IRF conference, trustees were exposed to some revealing discussions relating to "one stop shop" service providers and the potential conflicts of interest that can arise when such a "shop" acts as both advisor and product provider. Trustees were made aware of the importance of getting independent, objective advice that they could be certain was in their funds', rather than the product providers', best interests.

Understanding conflicts of interest

How do trustees determine whether the advice they receive is truly independent and free from potential conflicts of interest?

The primary factor is whether the advisor receives any covert or indirect financial benefit as a result of their advice due to it: -

- pushing the fund towards their other fee paying services or products;
- receiving royalties or kickbacks from any service providers included in their advice /recommendations;
- having a shareholding in the recommended service providers.

Some examples of potential conflicts of interest that may result in skewed or biased advice include:-

- using an actuary, consultant and product provider from the same group company. In this case, it's very difficult for trustees to know if the advice and strategies developed by the actuary and consultant are weighted towards the fund's long-term interests or towards the product structures/ services that are available within the broader company.
- an asset or multi-manager giving advice on a fund's investment mandate and portfolio construction process (including asset liability management, asset allocation and benchmark setting), especially if the solutions fall within their own range of product options.

Checks and balances

In cases where potential conflicts of interest exist, there must be clear checks and balances put in place to prevent these conflicts from resulting in poor decision-making. It is the responsibility of the trustees to ensure that these checks and balances are in place. A recent trustee report revealed that only 19% of trustees are formally checking the ethical standards of their service providers. One potential check is for trustees to request a formal statement from their service providers stating that the provider has not received any third party financial benefit whatsoever as a result of their advice or relationship with the fund (unless the fund has instructed them to help in third party affairs).

Cheaper isn't necessarily better

Trustees often make use of one-stop shop services because these are marginally lower in cost relative to an independent specialist advisor's services. The independent's cost base is often as high as the one-stop shop's, given that they provide a very specialist service that requires sophisticated infrastructure and a considerable level of expertise. Their income however, is not fueled by a collection of other services and the sometimes ample financial rewards attached to these services. It's therefore easier for one-stop shops to price advisory services at a lower level, given that they are able to make up financial reward through other, more core (and lucrative) services like asset or multi-management. What trustees often forget is that independent consultants specialise in helping funds prevent massive "blowouts" and avoid inappropriate products/ structures that are not in line with Global Best Practice, all of which have much higher potential implicit costs to the fund.

Independents need support

Trustees have a role to play in supporting the independent advisors and ensuring their long-term viability. Without this support, these companies won't be able to grow or even survive, which will have a very negative impact on retirement fund members and the industry over the long-term.

The benefits of supporting the independent consultants include: -

- All information obtained from any service providers can be tested for a "second opinion", thereby ensuring that the advice is really in the fund and members' best interests and that the fund is following Global Best Practice.

- There is increased protection for trustees if things go wrong – if the trustees used an independent advisor where no conflicts of interest exist, they are less likely to be held accountable for poor decision-making. If decisions are made based on the advice of the service providers where conflicts of interest may exist, it will be very difficult for trustees to justify their decisions to members.
- Funds get access to the best specialist skills in a particular area, rather than using the sometimes diluted skills and focus of a one-stop shop. For example, RisCura has a specialist team focusing on asset liability modeling (ALM) for retirement funds. ALM theory has advanced to include stochastic modeling, which primarily falls into the domain of physicists rather than actuaries. Accordingly, RisCura has invested considerable resources and appointed two individuals with doctorates in physics to its ALM team. Asset or multi-managers performing ALM for a retirement fund, on the other hand, are unlikely to be able to draw on these highly specialist skills given that their primary focus and area of skill is asset management. Trustees therefore need to question whether the quality of an ALM performed by an asset manager is the same as that done by an independent consultant that specialises in this field.

As the need for prudency in the retirement fund area grows, it's becoming increasingly important for trustees to use independent, objective consultants that provide advice and solutions based wholly on the funds and members' best interest. Although this advice may come at a marginally higher cost, the long-term benefits (and potential cost savings) for a fund cannot be questioned.

Petri Greeff and Andrew van Biljon, Research analysts

Looming liabilities: Are funds headed for disaster?

One of the big concerns RisCura has in the retirement fund industry is the way assets and liabilities are being modeled for pension funds. Most of the methods do not adequately incorporate liabilities into the asset structures, resulting in flawed models that over time may prove disastrous for funds and members.

We are all aware of the financial problems that some of the US and UK's largest companies are experiencing due to poor pension fund management. It's said that some of the large motor companies defined benefit funds' deficits exceed the total market capitalisations of the companies. This is clearly very serious and has resulted in a change in offshore accounting standards to try and manage the impact of this on the companies' income and balance sheets.

The root

The root of the problem lies in the way liabilities are being valued. We generally measure the value of assets based on their market value (i.e. the price of the asset on the stock exchange). Actuaries however, have traditionally valued a retirement fund's financial position on an estimated view of future asset performance so as to smooth out the vagaries of stock market movements. This approach has resulted in the nature and true value of liabilities being lost and has affected risk management.

Valuing liabilities

A stream of liabilities is valued in the same way that a bond or fixed interest instrument is valued. The price of a bond is inversely related to its yield (or interest rate). If interest rates go down, the price of the bond increases, and vice versa. Interest rates also have an inverse relationship to the value of pension fund liabilities. The lower the rate used, the higher the present value of the pension liabilities.

An example

If you own a bond with a 15% yield and the next day the yield drops to 10%, in normal asset valuation practice, the value of your bond will go up. If you assume that the drop in yield is a short-term effect and will rise again to 15%, you might not immediately revalue the bond to higher levels. If rates however never return to 15%, at some point you will have to revalue the bond based on current levels. Now this doesn't seem too interesting, except when applied to pension fund liabilities. The liabilities of a pension fund are basically cashflows (like bond coupons) paid from the fund to members, and when the rate drops, the value of what the fund owes (i.e. the future cashflows) increases. However, if the adjustment in rates is not made to the actuarial assumptions, the fund will be unaware of the huge potential deficit in its structure.

The role of interest rates

Over the last 2 decades, interest rates worldwide have decreased to unprecedented levels with rates in developed countries reaching between 3%-4%, and in South Africa, falling as low as 7.5%. This general lowering of rates has been stable, without any significant bounces back to higher levels. Accordingly, fund liabilities have been steadily rising with asset liability models still incorporating old valuation methods. As a result, fund structures, which are based on these models, are potentially very flawed.

The South African experience

Many people don't believe this valuation problem will have a serious impact on the South African industry. We do however need to recognise the following: -

- There are still a large number of defined benefit pension fund structures in both government and non-government businesses. Although many believe these structures are most susceptible to this problem, defined contribution structures are also at risk, simply transferring the problem from the company to the individual, who may then receive a lower income stream during retirement.
- South Africa's focus on HIV/Aids may have masked the prospects of a longer life for lower risk members and pensioners. This means that pension payments (liabilities) will take place for longer than expected, requiring a larger asset base.
- Interest rates at 7.5% are clearly not as dire as interest rates at 4% and funds have some time to restructure their portfolios before (and if ever) rates go that low.
- Conservative portfolios recommended by some multi-managers and consultants will not protect funds from lower rates. Most conservative portfolios for those close to retirement, as well as pension portfolios, use cash (which does not revalue when interest rates change) rather than fixed interest instruments to reduce the risk of the portfolio relative to the liabilities. In these cases, it is clear that an appropriate ALM has not been done.

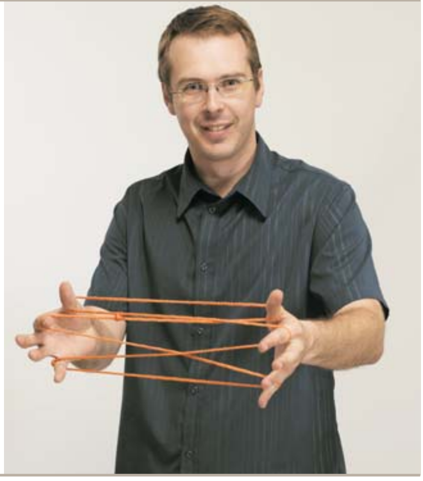
Locally, there is an ongoing tendency for trustees to focus on asset management rather than asset liability management. In cases where liabilities are considered important, the valuation methods are often outdated and don't take into account the significant theoretical improvements in asset liability modeling that have taken place over the last 5 years. Again and again, when taking on new clients, we see the historic approach still endemic in funds' asset structures and processes.

The RisCura way

RisCura models pension fund liabilities using a stochastic process based on leading academic and actuarial trends that are adapted to include the South African market's unique circumstances as well as specific client needs. Our model aims to capture the future evolvement of liabilities and assets as processes governed by suitable statistical functions. In tailoring a solution, we find the optimal asset allocation to suit the fund rules, membership base and liabilities. We see this method as an improvement on the traditional, deterministic approach since the stochastic method is a more appropriate mathematical representation of the real-life dynamics and uncertainty inherent to pension funds. This approach is enhanced by financial asset theories, which recognise that the liabilities can be replicated with assets and insurance purchased in the market, so all risk can be eliminated at a price.

In order to avoid potential disaster for pension funds, similar to international proportions, asset liability modeling in South Africa must change and move in line with recent theoretical and practical improvements. Trustees must drive this for their funds, ensuring that the asset liability modeling process is done by parties that fully understand the theoretical and practical improvements and have incorporated these changes.

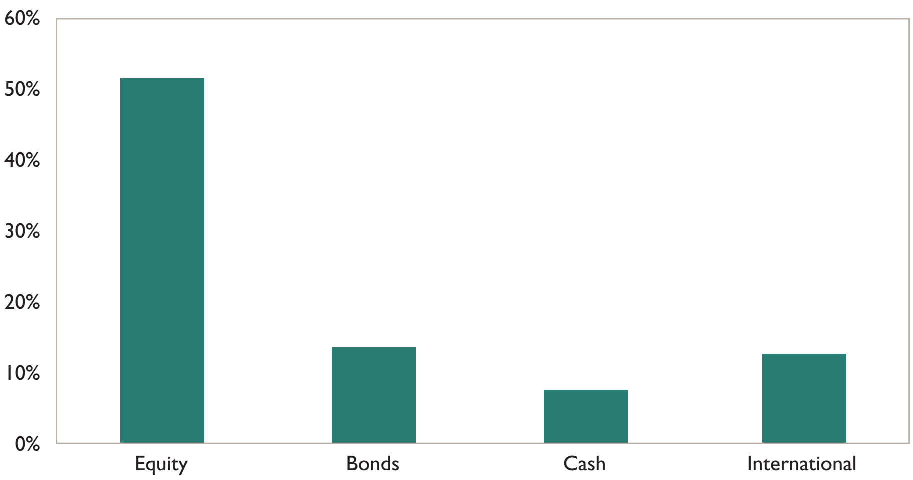
Niël van der Merwe, Head of transition management



Stick to the map:
The importance of fund rebalancing

Over the last year, investors have enjoyed the returns from what has been a very fizzy local equity market. The equity party may or may not be over, but after such a period, it's become very important for trustees to review how their funds are positioned for the next 12 months. Most funds' asset mix (i.e. the amount of bonds, cash and equities in their portfolios) would have changed markedly over the last 12 months, with the biggest increase in the equity allocation, due to its excellent performance relative to other asset classes. The following table shows the performance of the different asset classes over the last 12 months ended 30 September 2005.

Asset class returns for the 12 months ended 30 September 2005



Higher equity allocation leads to higher potential risk

An increase in equity exposure, on a relative basis, will directly affect the risk return characteristics of a fund. Most funds would have moved away from their long-term optimal asset mix leading to potential inefficiencies in the fund structure. This may result in a potential shortfall in meeting members' investment objectives or expose members to higher than expected risk.

Although it's impossible to predict where the equity market will be in 12 months, it is possible to understand today where a fund is placed from a risk return point of view. If the optimal asset mix is not correct, a short-term market correction may increase the fund's downside risk (i.e. increase the risk of larger negative returns than the fund strategy allows for). This can also create unplanned biases towards asset classes, investment managers or markets, relative to a fund's long-term target allocations. These biases will typically be toward the outperforming asset class, managers or markets.

Most fund strategies will derive a significant amount of their long-term performance from periods of upward momentum in the market. However, markets move in cycles and after a run, will correct to a level of "fair value" (sometimes referred to as mean reversion). Funds that perform ongoing rebalancing exercises will benefit from a market's upward momentum without exposing members to undue risk, when the market corrects.

Why rebalance?

For the fund to remain neutral to its strategic asset allocation (in terms of risk/return and style), from time to time, a fund will need to rebalance its portfolio. The reasons for this are as follows: -

- The fund's performance is continuously compared to a benchmark. Any deviations from the fund's target allocation can result in underperformance of this benchmark. If we assume that the benchmark is the optimal "answer" in efficiently reaching the fund's investment objectives, underperformance will therefore equate to "negative value-add" for members.
- Rebalancing tends to lead the fund to "sell high/buy low". Maintaining the strategic asset allocation will introduce discipline to the process, and result in the fund selling/downweighting outperforming

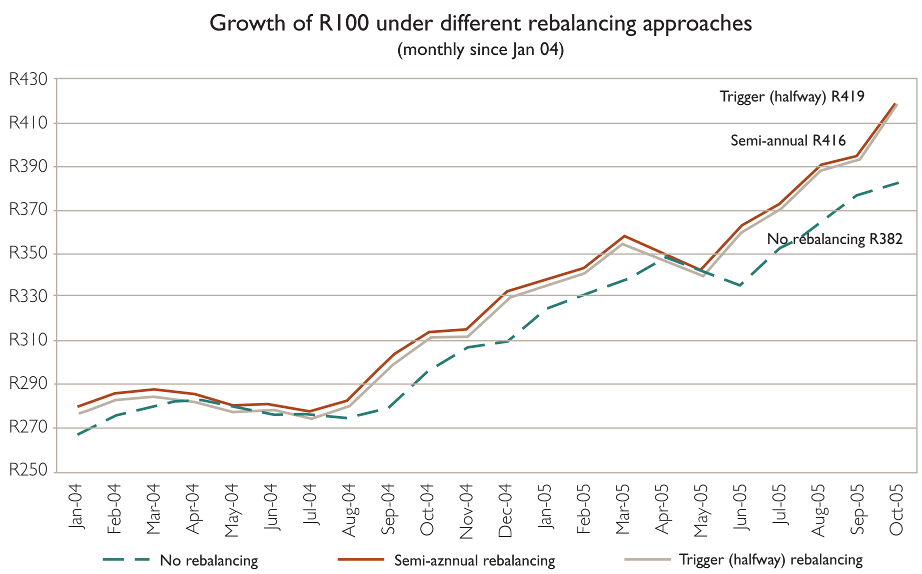
assets and buying/upweighting under-performing assets.

- If a portfolio is left to drift in line with market movements, it may become inefficient. This could lead to a higher level of risk than was originally approved by the members in their choice of portfolios. Rebalancing will ensure that the fund's risk levels remain in line with the original objectives, restoring the portfolio to its desired position on the efficient frontier.
- Long-term performance can be attributed to both market "momentum" as well as "value" derived from mean reversion in the market. Rebalancing effectively reduces the risks associated with "momentum" while increasing value bets in the fund, thereby capturing returns from both sources over the long-term.

How and when to rebalance

There are a number of rebalancing triggers, based either on time (e.g. rebalance back to the strategic asset allocation every year) or on relative-valuation levels (rebalance when asset class weightings move above or below a certain target).

For funds with low targeted returns (and therefore more conservative asset allocation strategies), a simple annual rebalancing approach works well. For funds with higher target returns, however, it makes more sense to use a relative valuation–based approach.



The graph below illustrates the value of both a simple timing and relative value–based process compared to performing no rebalancing. In this example, we have selected a 60% SWIX and 40% ALBI allocation and on a compound basis, the rebalancing process added more than 9% in return over the period.

Avoiding unnecessary costs

As part of its rebalancing process, a fund will have to trade some assets, which will incur costs. The only way to effectively manage these costs, especially if rebalancing takes place on a regular basis, is to employ the services of a transition manager. The transition manager will aim to manage costs via:

- Reducing direct costs: Rebalancing trades are non-information based (i.e. the trade is not based on share expectations or outlook, but on maintaining a long-term strategy). Trading assets on this basis should attract preferential rates from brokers, thereby reducing direct costs.
- Centralisation: When rebalancing, it's sometimes necessary to reduce exposure across more than one underlying investment manager. Centralising this process will ensure overall management of the "mismatch" on a total fund level. Issues such as timing delays and managers inadvertently competing against one another in the same shares will also be avoided.
- Managing market impact costs: Funds undergoing rebalancing can have a significant impact on the local market if the information regarding this rebalancing is not controlled. For example, if the fund instructed multiple managers to buy or sell shares, they in turn will instruct multiple brokers to execute orders in the market. Managers may be giving the same trade orders to the same brokers, resulting in a stampeding effect. Controlling the information to the market via a transition manager will avoid this, thereby reducing impact costs.

A fund's failure to regularly rebalance its portfolio, particularly after big shifts in asset performance, may result in risk exposures that are not appropriate for members or in line with the fund's long-term strategy. A disciplined approach to rebalancing however can help enhance long-term returns and ensure that the objectives of the fund and members are being met.

Fezekile Jebese, Risk analyst

Profile:

Qualifications and experience: I have a National Diploma in Information Systems and am currently completing my BCom in Financial Management.

Day to day my job involves: making sure that the unit trust reporting process runs smoothly and attending to unit trust requests and queries.

I believe that: hard work and perseverance, more often that not, pays dividends.

I wish I: had the means to travel the world!

The best book I have ever read was: The Long Walk to Freedom by Nelson Mandela.

I think people need to know: that hope is what keeps us going, it's one thing that we cannot afford to lose.

I make a difference because: I think rationally.

Working at RisCura means: hard work, always something to learn and the opportunity to work with brilliant people.

When I leave work I: go to gym, and for relaxation, I read or watch TV.

Holidays are spent: at home with my parents and friends, with just a bit of partying.

In a recent "get to know you better" teambuild, staff were asked to reconstruct their childhood ambitions with string. "Doctor" Fez with stethoscope pictured below.

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