September 2009

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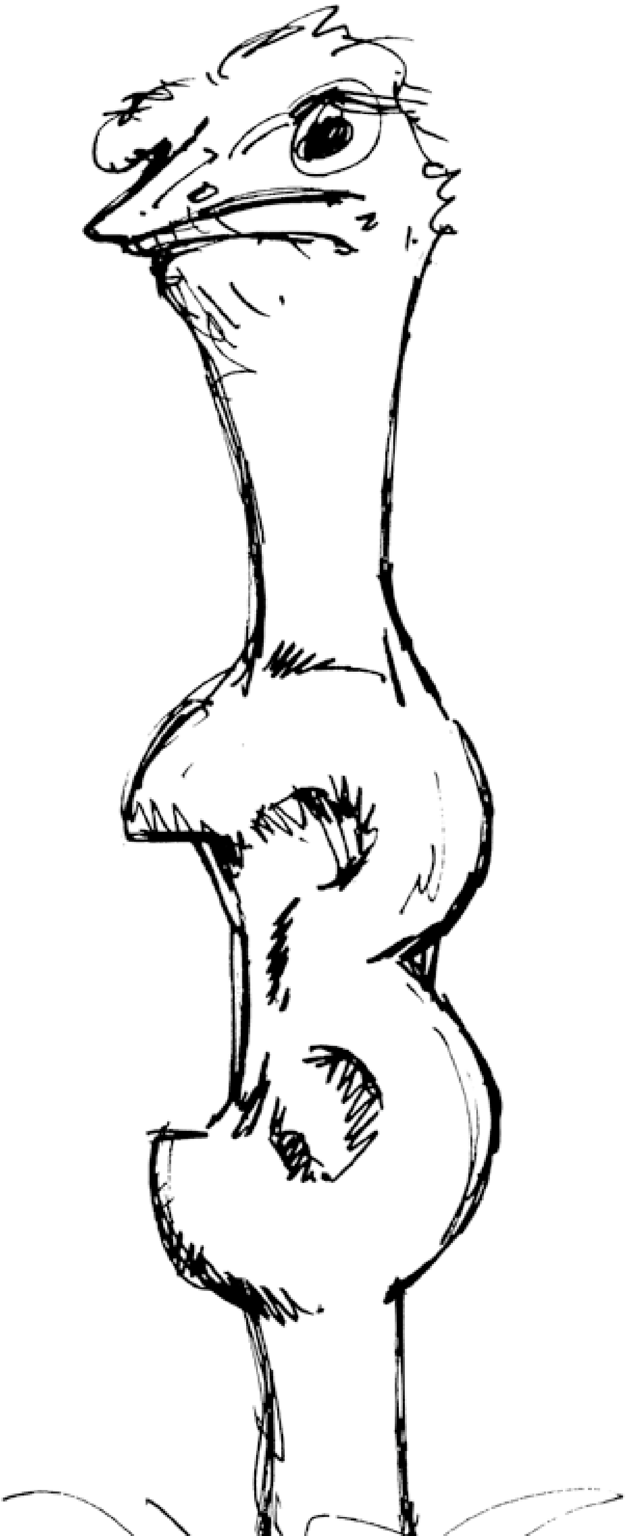


By Claire Rentzke
Head of Manager Selection
at RisCura Consulting

The investment industry is fixated with performance numbers. Trustees are bombarded each month by numerous surveys listing the performance numbers for each manager. The press provide comparisons of performance numbers and even the asset managers are quick to punt their short and long term outperformance. In the search for asset managers who can deliver performance excellence, the numbers paint a multitude of different pictures. The way you choose to interpret and analyse numbers can be more important than the numbers themselves.

By taking a closer look, we illustrate the range of conclusions that may be inferred from a number and demonstrate why it's always important to consider performance beyond the numbers.

The past can't predict the future

One of the trickiest components of manager selection is determining whether past performance is any indication of future results. The key is to determine whether the manager has true skill or if periods of outperformance are merely due to luck. Conversely, if the manager has underperformed, does this really imply they lack skill? So, we are concerned with consistency of performance as well as skill.

Be aware of the period

The first aspect to consider is the circumstances surrounding the evaluation period. Chart 1 shows the rolling 12-month performance of Equity Manager A relative to the universe of equity managers. The shaded areas indicate the performance of the other managers in the universe, split into quartiles. The bars show the 12-month performance for Manager A for each rolling period. When we look at this manager's performance over the period shown, we may choose to select this manager based on their consistent upper quartile performance.

Now consider Chart 2 showing Equity Manager A over an extended time period. If we look at what transpired in the subsequent periods, a different picture emerges. If we had selected the Manager A based purely on their past performance history, and allocated assets to them at the end of the first period shown, value would have been destroyed over the following year.

Chart 1 - Equity Manager A: 12 month rolling outperformance relative to the equity universe average for the period December 2004 to December 2007

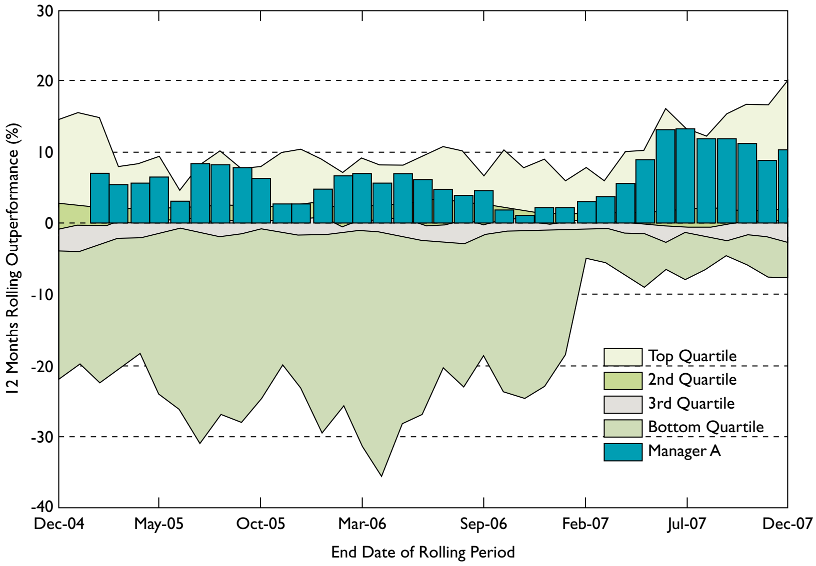
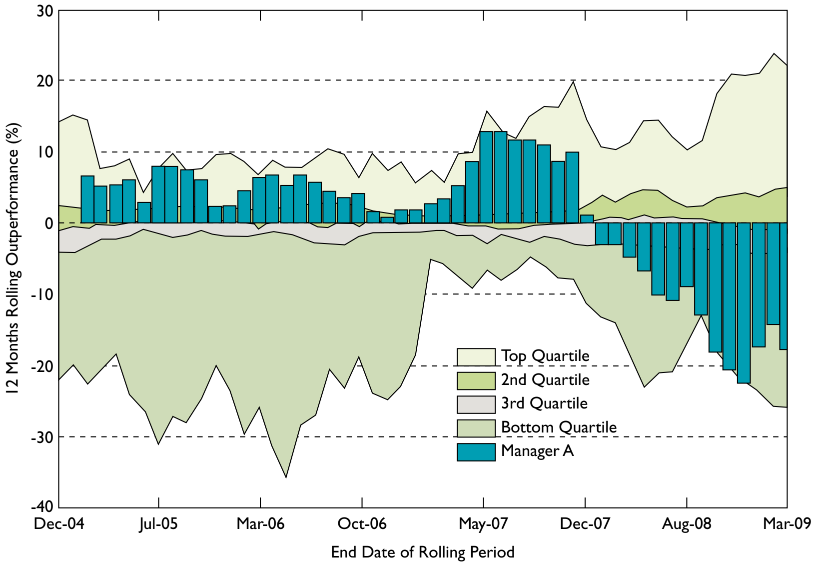


Chart 2 - Equity Manager A: 12 month rolling outperformance relative to the equity universe average for the period December 2004 to March 2009



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In this case, there was more to the story than just the numbers and without the full picture, a costly mistake could have been made. Equity Manager A underwent a fairly significant change to their team and as performance is primarily determined by the investment process and the people driving that process, changes here may impact on future performance. In this case, an evaluation of these qualitative factors prior to any appointment would be appropriate.

The period is also of relevance when various products are compared through different economic climates.

Consider the risk-return scatter plot in Chart 3 which looks at the performance and risk characteristics of guaranteed products against standard balanced funds. In this graph, we not only display the level of return generated by a portfolio, but also reflect the risk that was taken in the portfolio to achieve that return. Investment theory, in the form of the capital asset pricing model, infers that any additional risk taken by an investor should be rewarded with additional return. Chart 3 clearly demonstrates that over a 12-month period we would select a guaranteed product over a balanced product with certainty if we looked at the numbers in isolation.

While changing market conditions may create opportunities within different areas that can be exploited at the time, retirement funds tend to have long term horizons and this same comparison over an eight year period gives a somewhat different picture [Chart 4].

Again, the numbers alone don't reflect the whole story. Guaranteed products are not generally easy to move in and out of and often have expensive exit clauses if not held to maturity. Even if these exit costs are not high, most of these funds have market values lower than the guaranteed values, and clients will have to accept the lower value as the policy documentation mostly serves to protect the vendor. When investing in longer term products, performance needs to be considered over longer time frames as shorter time frames can tell a very different and incomplete story.

Chart 3 - Guaranteed vs Balanced Products:
12 months scatter for the period ended March 2009

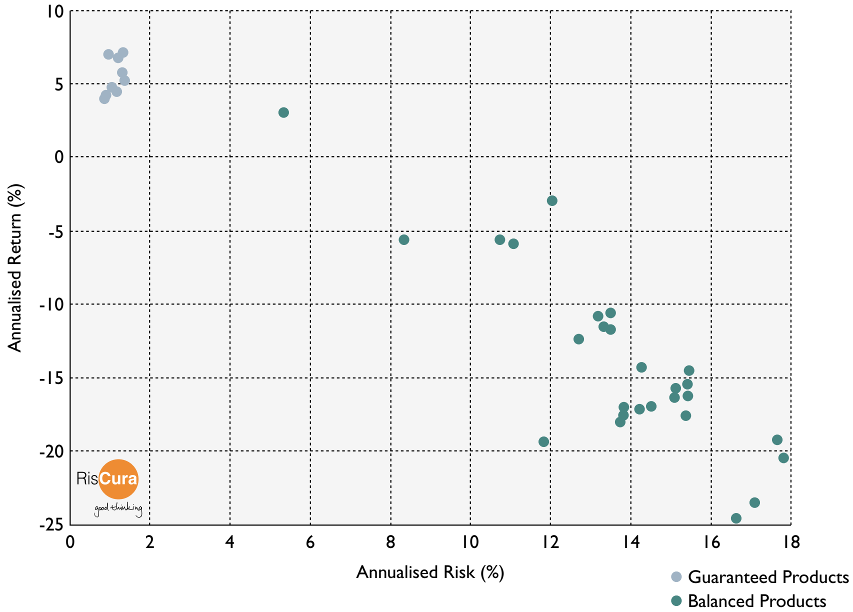
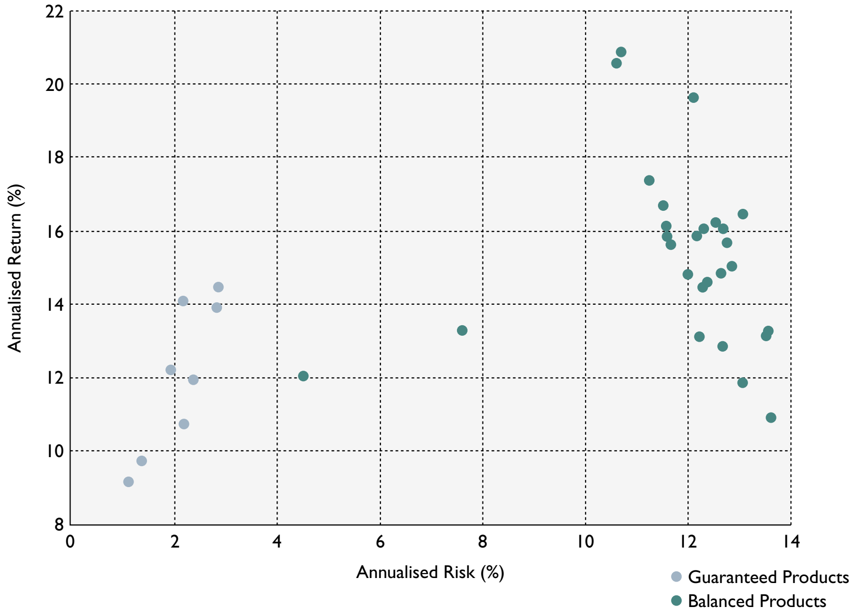


Chart 4 - Guaranteed vs Balanced Products:
96 months scatter for the period ended March 2009



Investment philosophy can vary over time

In looking at time series data, we need to be aware of the statistical errors that can creep into the analysis and affect conclusions. The nature of retirement fund investing is long term, and when selecting asset managers it would make sense to look at performance data over as long a period as possible to ensure that the manager has the ability to perform consistently. Any manager may have a period in which they outperform. This outperformance may well be a result of the manager being lucky and making the right guesses, but luck only extends so far and to be lucky over long periods of time takes a level of skill. If the manager has no skill, it is unlikely that they would be able to outperform the benchmark and peers over an extended time frame.

Extending the time period over which we analyse manager returns may help to eliminate the short term luck that anyone managing money can experience. However, when we do extend our time series we need to be sure that there has been no change in investment style, philosophy or professionals over the period. Any changes mean that the past history becomes irrelevant and should not be factored into the decision-making process.

In looking at past returns, there is a trade-off between looking at a period that is too short and may contain a significant proportion of luck (or bad luck for that matter) and a longer period that may reflect skill but the reason that the skill was present may no longer exist.

The decision-making framework

When we look at selecting managers from within a universe of their peers, it is important to ensure we compare like with like and the decisions are made within the correct framework.

The universe of managers

Markets move in cycles and during these cycles specific investment styles may outperform other investment styles. It has been found that over the long term, a value-based style will be the best performing style but over time there may well be periods when a growth-based style will deliver superior performance. The outperformance of a value-based style was uncovered in research conducted by Fama and French*.

Let us again look at a risk-return scatter plot of asset manager returns [Chart 5]. Over the period shown, we would not select Manager B on the numbers alone as their return has been below average and it appears there are a variety of alternative managers we could select instead that would have delivered better performance.

If, however, we are constructing a portfolio that requires a manager with a specific investment style, then we have to compare like with like. If we want a value manager we should select a manager from within the value universe and the same would apply for all other styles.

Chart 6 looks at Manager B over the same time period, but in this case within a universe in which the manager is compared with other products which are managed is a similar style. Now the picture is significantly altered and Manager B would be a natural pick.

Chart 5 - All equity managers:
24 months risk & performance scatter for the period ended March 2009

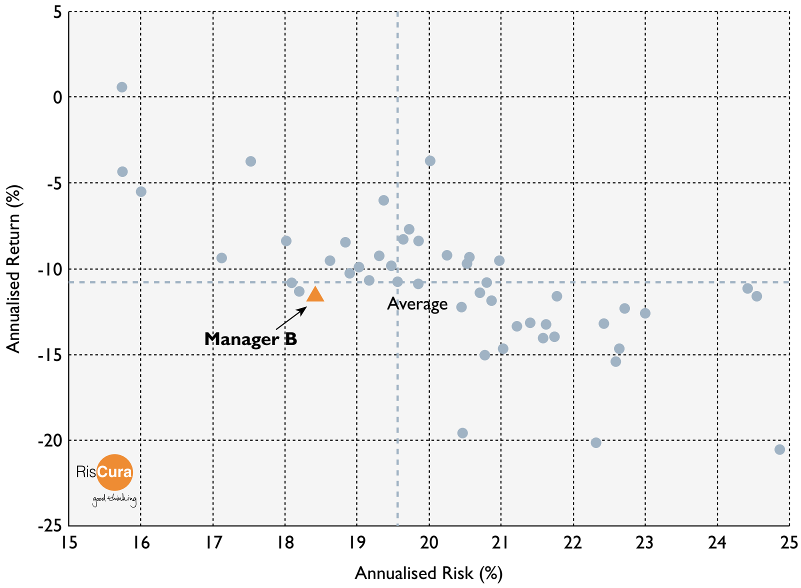
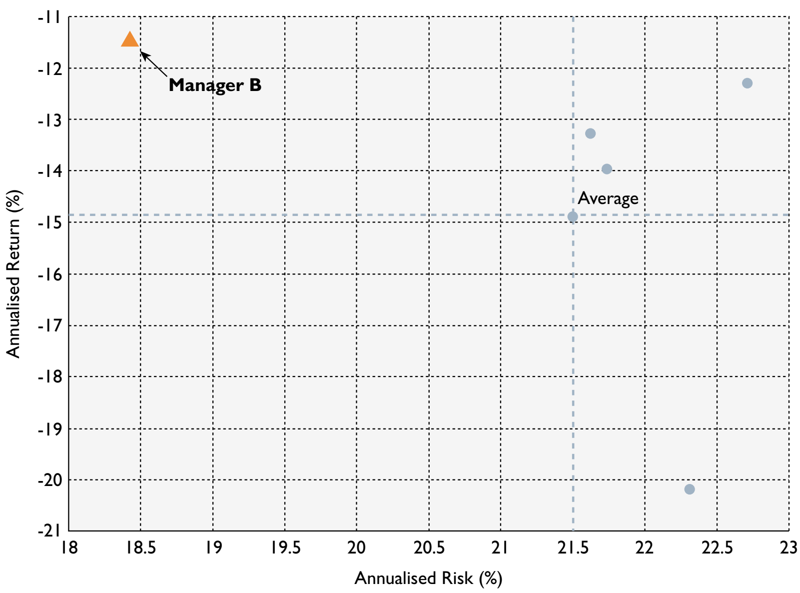


Chart 6 - Growth managers:
24 months risk & performance scatter for the period ended March 2009



* *Fama, Eugene F.; French, Kenneth R. (1992). "The Cross-Section of Expected Stock Returns". Journal of Finance 47 (2): 427–465*

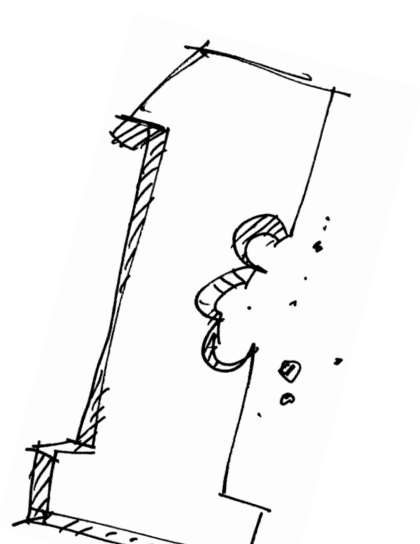
Number crunching: Chew before you swallow.

Calculation methodology can vary

Preconceptions held by the firm or Fund performing the manager analysis can also play a role in manager selection decisions. Many different statistics can be used to analyse manager returns and if an analysis is to be objective then it should be free of any predeterminations that could lead to data mining. Data mining involves sifting through large amounts of data to find something that justifies any conclusions that may have been drawn before the analysis was even conducted. For example, if someone really likes Manager A, they may look for performance that supports the positive view of Manager A's performance and ignore several months of negative performance.

With a large data set and a large range of statistics to choose from, it is possible to match the most suitable statistics to a preferred manager rather than selecting a manager on a predefined set of criteria. Even when we look at risk-adjusted measures, different statistics can give different results. Manager A may come out at the top of the field using statistic 1, but may rank very differently using statistic 2.

Even when we just consider absolute performance of various asset managers, these numbers can be manipulated through a choice of comparing returns either on a gross (before fees) basis or on a net (after fees) basis. A manager might deliver great performance and be the top performer, but if their fees are exorbitant compared to their peer group, then the net of fees picture could be totally different.



Consistent calculation methodology is important

Even the methodology of monthly performance calculations can vary. Monthly returns can be calculated using either a money-weighted or a time-weighted method and depending on the cash flows in and out of the portfolio during the month, these methods can produce different results. While the introduction of Global Investment Performance Standards (GIPS) has served to bring all managers into alignment, and to give investors a measure of comfort in comparability, not all asset managers are GIPS compliant yet.

With so many varying measures and calculation methodologies used to evaluate managers, it's important to have insight into the method of the calculation used, as well as achieve consistency in the methodology.

And so?

Analysing performance numbers is inherently difficult as one is essentially using the past to predict the future. However, performance numbers do have value, but the key is to understand how those numbers inform a bigger picture. The numbers alone do not tell the whole truth. They need to be combined with an analysis of the qualitative factors - i.e. the story that lies behind those numbers. Who are the people making the investment decisions, what is the investment philosophy, what is the investment process and how is it implemented?

An analysis of the qualitative factors that power the product should be the key to performance as performance is ultimately driven by the transfer of these factors. In addition, well defined criteria, specified in advance and rigorously applied, should be put in place for analysing numbers. As shown, the interpretation of the numbers involved is just as important as the actual figures.

As Fund Trustees consider various manager performance numbers, it's important to keep in mind the long term nature of the Fund and its mandate. It is worth taking the time to outline and define the criteria for performance excellence from the Fund's unique perspective and use these criteria as an anchoring point for performance analysis.

Use the numbers, but use them wisely.

2

Even B-BBEEtter.

We're proud to announce our new B-BBEE status as a Level 2 Contributor, making us one of the most empowered financial services companies in the country.

This means that any company making use of our services can claim 125% of our fees as BEE spend. The rating has been confirmed by Empowerdex.

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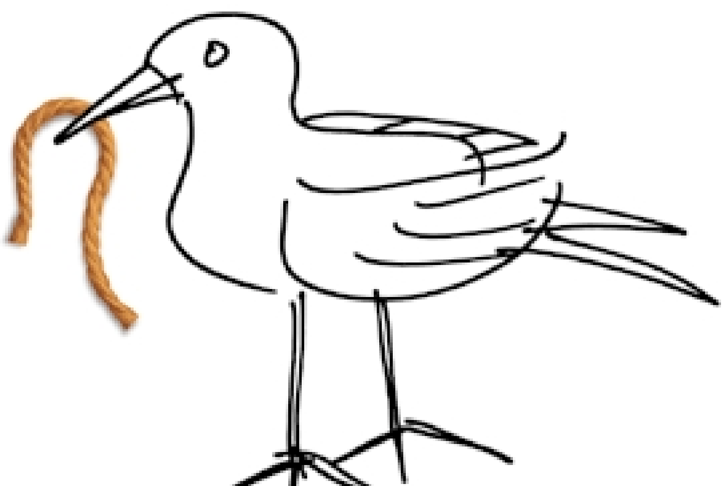


RisCura Analytics' valuation and pricing service.

Investment transparency is becoming essential and institutional investors are increasingly focusing on the importance of third-party, independent valuation and pricing. RisCura Analytics' valuation and pricing services create a more transparent and investor-friendly environment for all investors in unlisted, derivative and OTC instruments. Our solutions in this area have been backed by South Africa's leading pension funds, private equity funds and fund of funds.

Our 7 years of industry experience gives you access to proven skill in valuing a wide variety of unregulated assets. We are experts in the valuation of unlisted equity, mezzanine, hybrid and other debt instruments, as well as independent pricing of fixed income, derivatives and other OTC instruments.

RisCura Analytics offers comprehensive valuation and pricing services to pension funds, private equity funds and hedge funds.

You'll have access to:

- **Independent valuations of private equity and mezzanine debt portfolios**
  We provide our clients with independent third party valuations of their unlisted equity and debt investments. We apply the International Private Equity and Venture Capital Valuation Guidelines to achieve reliable and independent valuations. Our capabilities stretch over the wide variety of financial instruments invested in by private equity and mezzanine funds.
- **Independent valuations of private equity fund of fund investments**
  We provide private equity fund of funds (PE FoF) with independent valuations, in line with International Private Equity and Venture Capital Valuation Guidelines, of the fund of fund's investments in private equity funds.
- **Independent pricing of derivatives and OTC instruments**
  Whatever new investments come to market, our pricing models make use of publicly available data and are not reliant on the issuer of the instrument to generate a price. This process allows us to determine truly independent prices on a regular basis.
- **Independent high level property valuations**
  We provide indicative valuations of commercial property based on market benchmarks, allowing us to value large property portfolios on a regular basis.

For more information on this service, contact Rory Ord on rord@riscura.com or 021-6736999.

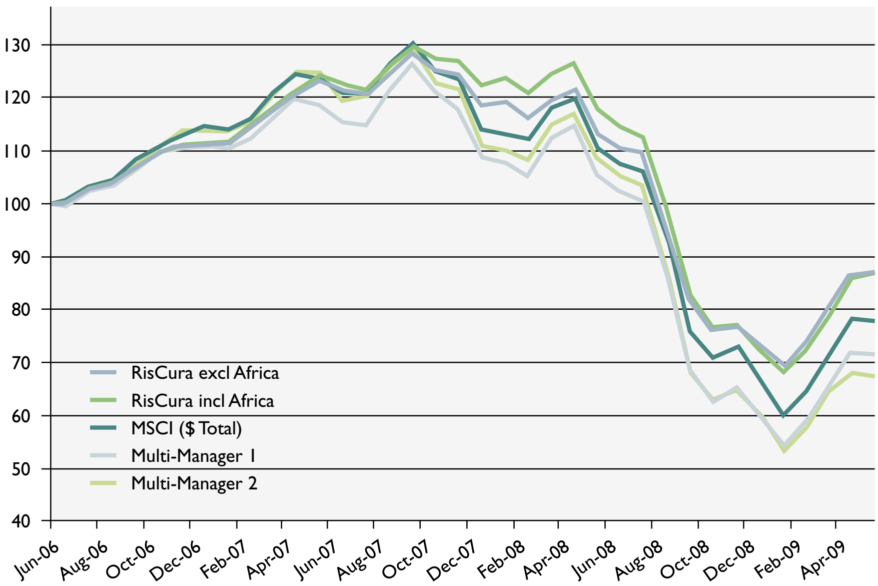
RisCura's International Manager Selection Service – a blossoming value add.

RisCura is responsible for the offshore fund structuring and manager selection of over R40 billion in client assets. Although South African pension funds can only invest 20% offshore, we strongly believe skilled offshore manager selection adds significant value to a fund over time. International manager selection has become a key RisCura offering to South African institutional funds. To facilitate the growth of our offshore manager selection service to South African pension funds, we have established a London office. This allows us to be even closer to the international asset managers making interactions with them a little easier.

Our international manager selection maintains the same level of rigour and process as our domestic manager selection service.

While there may be some economies of scale in partnering with an offshore consultant or multi-manager, RisCura uses a very specific and detailed process when it comes to researching the multitude of products and managers available offshore. We have yet to identify a partner that we believe does justice to our process or adds the required value.

Graph 1: Cumulative 3-year return comparison for related equity offshore fund performance to end June 2009



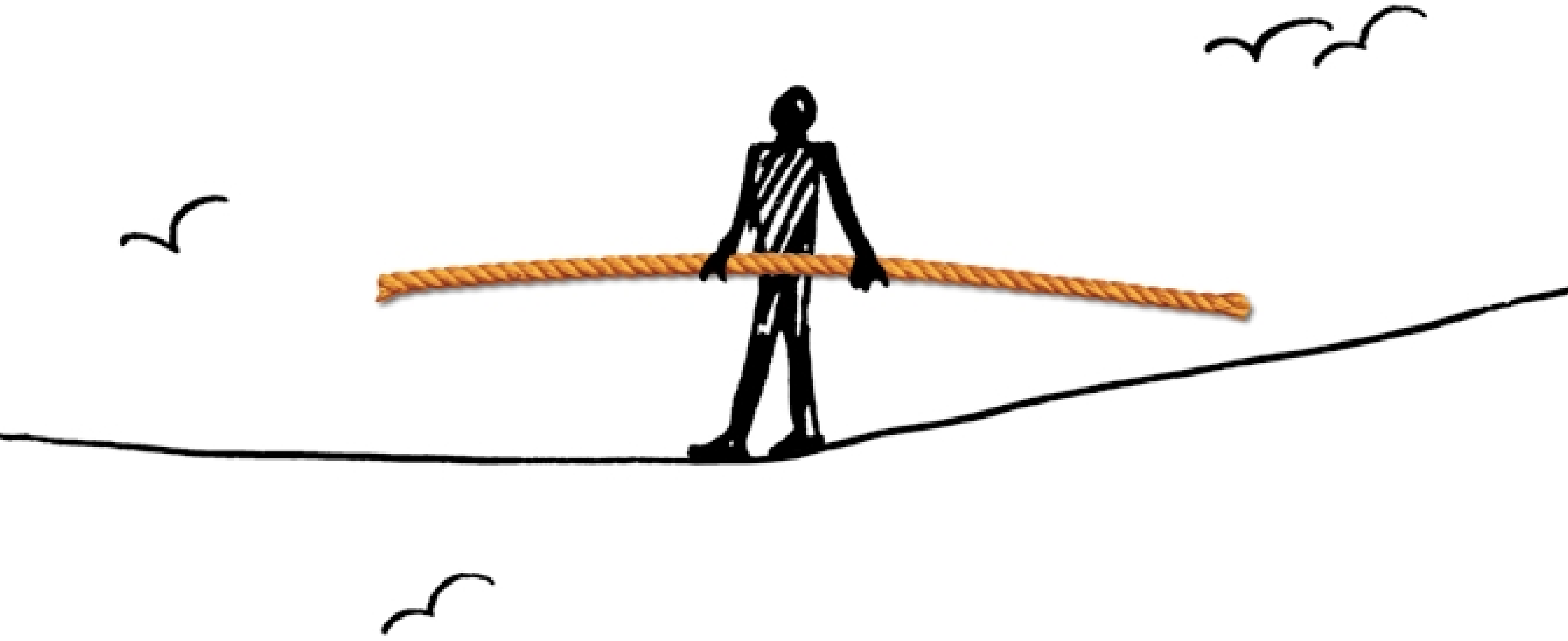
Graph 1 shows a comparison of a RisCura client's offshore portfolio's (which consists of a variety of equity portfolios) performance to the MSCI index as well as to 2 of the largest multi-managers in the world. As can be seen, the client has outperformed the index and both the multi-manager portfolios. It's important to note that the asset liability model output of this particular client called for global equity.

We believe this outperformance has been facilitated by our approach which includes a rigorous due diligence process including hundreds of due diligence meetings with managers, strong conviction of views and significant experience in understanding foreign managers' specialist skills.

A unique characteristic of SA portfolios, despite currency restrictions, is an additional allowance to invest in African assets outside of South Africa. Graph 1 indicates both series.

If you are interested in hearing more about our international selection process, contact Claire Rentzke at crentzke@riscura.com.

RisCura's International Manager Selection Service – a blossoming value add.



Investing through uncertainty.

It's stormy out there. Predictions on the good times (the end of the cycle is nigh, bail-outs are finally helping, markets are turning) and the bad times (it's worse than we expected, we're in for a prolonged recession, etc.) change everyday.

What should trustees do? Baton down the hatches and remember the basics.

Have an investment policy statement

Set the goals. Write them down. Having a detailed plan in place helps moderate investment actions motivated by fear or greed and cultivates "firmness of character" – a valued investor quality in uncertain times.

A typical IPS should cover your Fund's objectives, its investment time horizon, return expectations, risk tolerance, optimal asset allocation, rebalancing policy, return expectations, the types of investments the Trustees are comfortable investing in and your benchmarks.

Although IPS's should be reviewed over time (for example, as members get older and Fund objectives change) and when markets get bumpy, don't be tempted to stray from the plan without clear reasons. There's no need to change your strategy if you've based it on your Fund's long term needs.

Remember the cycles

Markets move in cycles, meaning that they go up, peak, go down, hit a bottom and then start all over again. When one cycle is finished, the next begins. It is very difficult to pick the top or bottom of these cycles. However, understanding the nature of cycles is essential if you want to understand how and why investments change over time.

Some famous market bottoms that you might have heard of:

The Great Depression: In the U.S., a string of terrible days in the market from the beginning of September 1929 until July 1932 when it bottomed out with investment values down nearly 90%.

The Asian Crisis: Starting in mid-1997, the drastic depreciation of Thailand's currency kicked off a weakening of currencies in other Asian countries like Japan and South Korea. The crisis lasted through 1998, with countries like the Philippines experiencing zero economic growth.

The "dotcom" boom & bust: From March 11, 2000 to October 9, 2002 with the growth of the internet, a lot of money was invested in internet and technology stocks before investors really understood the true value of those companies. When many of these companies failed to make a profit, the market downturn was sharp.

Banking crises have developed many times throughout history – in fact 112 episodes of systemic banking crises have occurred in 93 countries since the late 1970s! Prominent examples include the bank run that occurred during the Great Depression, the U.S. Savings and Loan crisis in the 1980s and early 1990s, the Japanese banking crisis during the 1990s, and obviously the sub-prime mortgage crisis in 2008.

What's the message? You have to be patient and wait. Things will turn around.

Don't try and time the market

It's a question we have all asked in times of late. Why not just put all of our investments in cash, for a little while, until things calm down? Market timing is the strategy of making buy or sell decisions of financial assets (often stocks) by attempting to predict future market price movements. The efficient-market hypothesis suggests that financial prices often exhibit "random walk behaviour" and cannot be predicted with any consistency.

If you're tempted to make a big move to cash in times of market downturns, you're actually participating in market timing. It's an implied statement that you've figured out the right point to get out of equity — and will also know the right time to get back in. Most people don't and the fact is, any peace of mind you gain by being on the sidelines during volatile equity times will turn into a headache of note once you see how much you can harm your Fund over time by missing any bit of the rebound, as markets have recently shown us.

If you do want to try and time the market, and some have more success than others, limit the size of your bet so that any error does not fundamentally prejudice the Fund.

Keep inflation protection in mind

Every person investing for retirement asks a key question – how much income will I need when I retire to maintain my current standard of living? Retirement investing is essentially therefore about protecting member income rather than their capital payout. Protecting income implies you must invest retirement assets to outpace inflationary income growth.

Cash certainly protects capital but does not adequately protect against interest rates and inflation and therefore cannot be considered low risk. With cash, the risk of not meeting your goals – that is, to maintain an expected standard of living on retirement, is high. Because CPI (Consumer Price Inflation) plays a large role in determining pension income, assets that over time are able to provide real returns (i.e. returns above inflation) should always form part of your retirement fund portfolio. Also, if interest rates drop, cash does not protect income levels as the capital values do not increase. This protection is better provided by inflation-linked bonds.

Remember also, that life does not stop at retirement. Members have the chance of living 20 to 30 years into retirement and will continue to need inflation protection through retirement. So, don't ditch all higher risk assets when members move close to retirement.

Look at your asset allocation

It's likely that with the drop in markets, your Fund's equity allocation compared to its set strategic asset allocation in your IPS has dropped. Consider rebalancing your equity portion back to its set levels. The long term returns of equities cannot be matched anywhere else and they remain the best protector against inflation. The right exposure to equities now will also help your Fund's assets to recover as markets regain some gloss. Remember that retirement investing is not about getting short term market timing right, but rather about positioning a portfolio to generate real returns over time.

Nose out opportunities

The most revered of all investment prophets Warren Buffet eyes bear markets with a special gleam in his eye - for it's at such times that buying opportunities are abound. Assets are available at a deep discount to their intrinsic value.

You've probably already heard of a friend or an associate who has bought a house or a car at a ridiculously low price because it was part of a liquidation sale. The same is true of potential investment assets for your Fund. The equity and bonds of certain companies listed in stock markets around the world present fantastic buying opportunities. Buying more equity near the bottom of the market can be a good strategy if your Fund members have a time horizon which allows them to ride through the bumps.

Communicate with your members – encourage them to stay put

It's worrying times for pension fund members at the moment - we have been through one of the worst equity performances in living memory where more than ever, Trustees need to keep in contact with their members. Most members will be stressing over their lower Fund credits and need to be reminded that retirement investing is for the long term and that their Fund is well structured to ride out these tough times.

Members will also have seen recent positive movement in the market, and need to understand that this, if sustained, will still take time to filter through to a more positive fund credit.

Stay calm

Uncertainty is a fact of life and there is nothing we can do to predict or control markets. We can simply stay calm, keep practising patience and know that "this too shall pass".

Profile

Vusi Khumalo

Business Development, RisCura Consulting

Describe your job? I am responsible for generating new business leads on the consulting side and building relationships with potential clients. It's hard work but fun.

Why RisCura? An opportunity to work with some of the most prestigious funds on the continent.

What is your idea of perfect happiness? I think happiness is so elusive that it's impossible to define. I'm perfectly happy with it that way though because I keep searching.

What is your greatest fear? Not being able to help my loved ones when they need me.

What do you consider the most overrated virtue? Abstinence.

On what occasion do you lie? When it is absolutely necessary.

What is your greatest regret? Not doing more and appreciating blessings.

What or who is the greatest love of your life? My mother; she raised three boys alone for the past fifteen years.

What is your current state of mind? I'm excited to be living in our country.

What do you consider your greatest achievement? My degree. Now to finish that Honours…

What is your most treasured possession? I have flu right now so my health.

What do you most value in your friends? Honesty and loyalty.

What is it that you most dislike? Deceit.

Who are your heroes in real life? Anyone who is making an effort to improve our environment deserves their dues.

RisCura

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