

# New freedoms set to impact sector

Emerging markets are assuming increasing significance among institutional investors, writes DAVID JACKSON

A NEW freedom in the regulatory environment affecting the asset management and pension fund industry, along with a further relaxation of exchange controls, is set to have a notable impact on retirement fund investment strategies into the future.

Within this new regulatory environment, emerging markets are said to be assuming increasing significance among institutional investors.

Against this backdrop of change, local funds are now allowed to invest up to 5% in Africa. Cobus Strydom, head of consulting for Absa Consultants and Actuaries, points out. This is in addition to the new 25% offshore investment allowance.

The new draft of the long-standing Regulation 28 — now released for industry comment — will impact on issues such as the manner in which different asset classes will be categorised and how differing limitations will apply to those classes.

"The consensus is that emerging markets over the next 10 years or so will provide better investment opportunities compared to developed markets," says Strydom.

With regards to opportunities in Africa, he adds: "There has been a huge improvement in the macro-economic state of many of these countries. Companies should not necessarily at this stage make use of the full 5% exposure to African countries — possibly about 2% to 3%. Even with a small exposure such as this, it should be possible to add up to about 0.5% in terms of 4% real return objective."

Strydom says that in a retirement fund scenario, it is assumed that members will remain on a fund until retirement age and will pitch their investment portfolio strategy accordingly.

To reach the objective of a 70% to 75% replacement ratio, a real rate of return in the order of 4% (ie. a return exceeding salary inflation by 4%) is required. Other factors are how long a member will contribute to the fund as well as the quantity of contributions.

Strydom's view is that equities remain the most important asset class to get close to a 4% real rate of return.

"Young members should have the maximum exposure to equities as an asset class. Investment risk is more about the risk of not beating inflation than the risk of short- to medium-term volatility. It makes sense for members to remain within a balanced portfolio for most of their membership of a retirement fund.

"If members believe they have sufficient capital in the fund to opt for a living annuity arrangement, such members can afford to remain in a balanced



Cobus Strydom ... equities remain the most important asset class.

portfolio up until retirement age. People are living longer — as much as 20 to 25 years after retirement. With an investment horizon of this duration the need for adequate exposure to equities remains to match this increased longevity."

Strydom argues that it would be advisable for a living annuity in a balanced portfolio to be extended well beyond retirement age. "In this living annuity scenario, the need to beat inflation becomes even more important. We should not forget the real challenge of medical contributions after retirement, given that medical inflation exceeds normal inflation and an increasing number of employers are not subsidising those contributions.

"If members opt for a conventional life annuity, where

the investment risk is carried by the insurer, then within five years of retirement, members would be advised to opt for a more conservative strategy when capital preservation becomes important."

He cautions: "Members should not switch regularly between investment portfolios. Only if members' risk profiles change close to retirement and they wish to choose a conventional annuity, should they switch from a relatively aggressive portfolio to a more conservative one."

Says Francois Viljoen, head of asset consulting for Absa Consulting and Actuaries: "We see the challenge as achieving real return objectives. But we are experiencing a lower yield environment so trustees, asset managers and consultants need to be more active in looking at different asset classes to reach inflation-plus requirements on a total portfolio level."

Kirshni Totaram, head of institutional business for Coronation Fund Managers in Cape Town, says the South African asset management and pension fund industry has had to live with a set of artificial constraints for some time.

**“It would be advisable for a living annuity in a balanced portfolio to be extended beyond retirement age**



Kirshni Totaram ... constraints are now being lifted.

"What we are seeing with the revised draft of Regulation 28 is that many of those constraints are now being lifted."

Regulation 28 was promulgated more than 50 years ago and was last amended in 1998.

"Amid widespread concerns about its continued relevance and loudly-voiced frustrations around its limitations, given market developments and innovations, the overhaul of Regulation 28 has been one of the most anticipated pieces of financial reform in SA over the past decade," Totaram says.

The further exchange control relaxations — now eased to 25% for offshore investment plus the 5% allocation for Africa — bring this closer to the desired benchmark for many investors.

"About the 30% to 35% mark

(for offshore investments) is probably where prudent investors would like to be positioned over the long term. We are close to the stage where investors feel they will have reached the optimum level. As a result, investment strategies can now be approached differently, in that asset managers and pension funds have more tools with which to achieve the desired level of real return at retirement," Totaram says.

"Skill and judgment in areas that are probably new to the market are going to be key. This is likely to make a difference over the next few years."

The changes also put the spotlight firmly on the specialist mandate regime, she says. Five or six years ago, balanced mandates were out of favour.

But with the 2008 financial crisis — and even more so now, given the prevailing economic uncertainty — the assumptions used to determine strategic asset allocation could be wrong over, say, a 10- to 20-year period, Totaram argues. "This is quite conceivable in a market where there is a high level of economic volatility and risk. This means a substantial amount of value could be lost in the process, without some element of tactical asset allocation," she cautions.

"That level of opportunity cost, especially to South African pension funds and members, could be quite significant. It all depends on the terms of reference and expectations. It is important to choose a strategy that is right and relevant for you, given the types of new opportunities that may arise."