JANUARY / MARCH 2018 VOL 21 No 1

# Pensions World

## SOUTH AFRICA

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ISBN: 978 0409 07063 7
*Printed by C P W Printers*

Subscriptions:
Customer Services 0860 765 432

(1) Ordinary rate – 4 issues ..... R410.00
(excluding VAT & handling)

(2) For bulk copies contact:
Customer Services 0860 765 432

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# Comment

**David Weil**
Managing Director
Investment Consulting and Trustee Services

As we all breathed out a collective sigh of relief to see the end of a very volatile and difficult 2017, it seems 2018 has already made itself known in a big way. Markets are a roller coaster of sentiment and uncertainty, political leaders are changing and even the Regulator seems to be churning out new legislation at an unprecedented rate. New words and phrases are being coined daily to describe our environment – to help us accurately capture the outlook and the happenings of our time. Of all these expressions, Day 0 – referring to the day Cape Town's taps will run dry – seems eerily to come straight out of a science fiction movie from the 1980's. And seems to encompass more than just the water crisis.

In his article, "No time for Complacency", Fabian de Beer contemplates the implications of Day 0 in the current investments cycle and what investors should be doing to mitigate the impact on their investment portfolios when this cycle turns. Anne Cabot-Alletzhauser and Lesiba Mothata, from Alexander Forbes, ask whether the current employee benefit packages for staff haven't already reached Day 0 and contemplate the reality that it may be time to come up with a new way of doing things in the face of the Fourth Industrial Revolution. Continuing with employee benefits, Viresh Maharaj from Sanlam Employee Benefits sets out the importance of an excellent consultant in guiding Trustees through the complicated process of selecting and transferring to an umbrella fund – thus bringing into being Day 0 for their stand alone, privately administered fund.

Andrew Davison looks at a possible Day 0 dawning should any of the rating agencies drop their ratings further and how investors should be managing their investment portfolios. And Guy Fletcher, from Sanlam Investments, encourages investors to avoid less than 0's in their returns by using portable alpha in their passive portfolios. In their article "Fiscal pressure – tax hikes are not the solution", Joon Chong and Wesley Grimm from Webber Wentzel encourage the tax collectors to add 0 to the current tax rates.

Trevor Abromowitz sets out the financial implication of your Day 0 being extended as life expectancies increase due to advances in technology … the reality being your personal savings will need to last longer. Some of us may feel our personal bank accounts are stuck on R0 and we're constantly battling debt. Piet van der Walt from Sanlam, talks us through the pros and cons of two ways of dealing with your debt – debt consolidation and debt counselling.

And lastly, in our legal roundup for this quarter Mpho Kgomongoe from Alexander Forbes summarises the recent directives and notices issued by the FSB. Trustees are encouraged to accept 0 in the forms of gratuities! And Gavin Smith of deVere Acuma deals with the 0 nonsense approach expected to be followed by the new regulatory model.

As South Africans we are eternally optimistic and robust in our approach to life. If you're worried that all 0's are bad, read this issue over a cappuccino with a round donut in your other hand! ❐

# South Africa's response to the Fourth Industrial Revolution – an emerging economy responds

**Lesiba Mothata**
Chief Executive Economist
Alexander Forbes Investments

**Anne Cabot-Alletzhauser**
Head
Alexander Forbes Research Institute

Lately the World Economic Forum (WEF) has attracted governments of emerging market countries to its stage. This year, it would mark the first attendance of an Indian Prime Minister since 1997 after Narendra Modi opened the gathering of world CEOs and politicians in Davos, Switzerland. The previous year, it was the Chinese President Xi Jinping who for the first time graced the WEF stage to defend globalisation. While a regular attendee, South Africa, which has never made presentations in the same way as India and China, arrived at WEF with a seemingly clear message and a determination to "attract those US dollars back into the South African economy" as exclaimed by the Deputy President of South Africa, Cyril Ramaphosa.

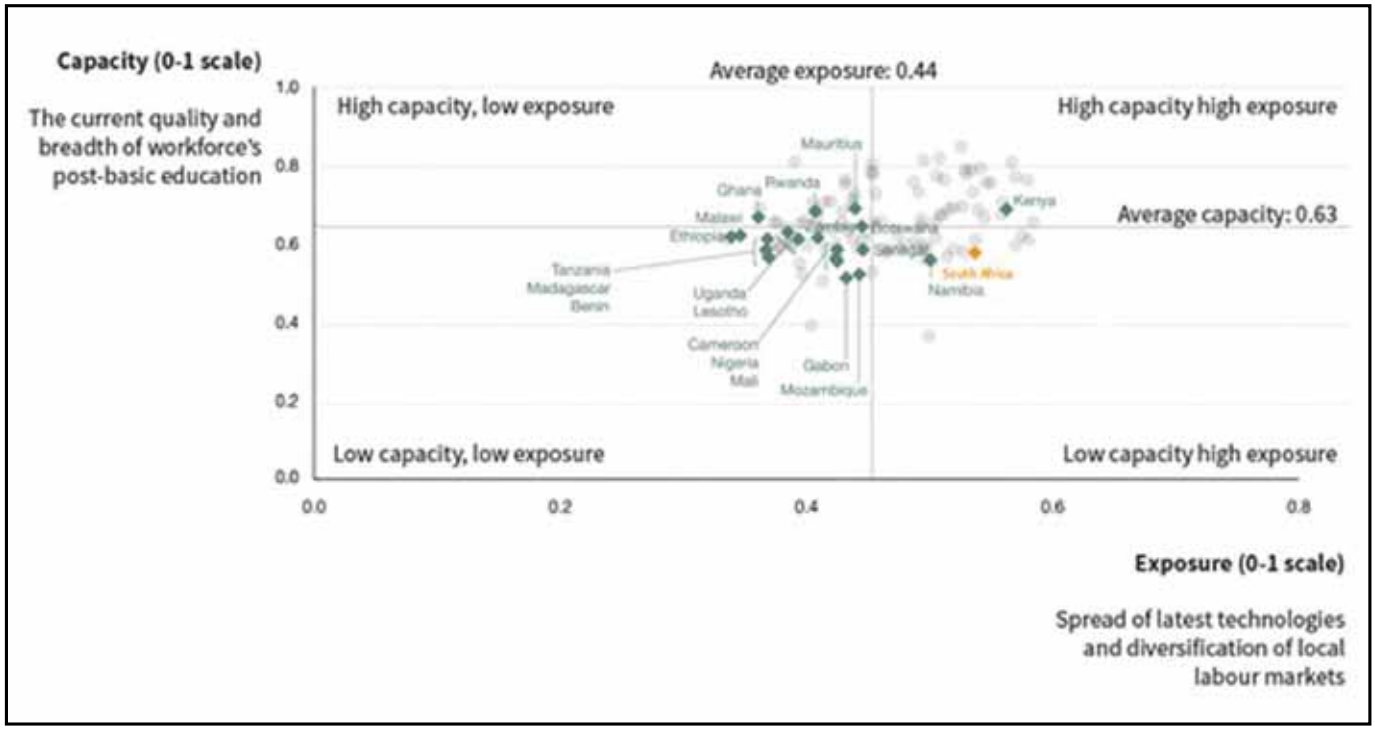
South Africa's future success will be inextricably intertwined with the success of its private sector. Addressing issues such as unemployment and economic growth will mean that South African companies will need to be able to hold their own in a rapidly changing global workplace. And this will have to occur at a time when social cohesion and social mobility are being seriously challenged. According to the 2018 WEF Inclusive Development Index, South Africa has sunk to a ranking of 69th among the emerging economies globally, primarily because of the increasing contributions to this rating from unemployment, its wealth and income inequality, its life expectancy and its carbon footprint. And while a five year trend analysis suggests that health care and our carbon intensity levels appear to be improving, our per capita growth and labour productivity are still on a downtrend.

In addition, whether we like it or not, the South African workplace will be directly (and indirectly) influenced by the disruptions that are occurring as a result of the Fourth Industrial Revolution. This is the next phase of technological development that is currently introducing such challenges as automation and robotics, artificial intelligence, machine learning and the type of biotechnological advances that will be increasing the longevity of our work lives.

But perhaps, because of our own unique history, the response of South Africa to this changing world of work will need to be substantively different.

As the graph below highlights, South Africa is in a particularly unenviable position when compared

## Africa's capacity to adapt and exposure to the future of jobs




Source: World Economic Forum

to other African nations. According to the WEF, SA is highly exposed to the global technological trends given its sophistication but possesses the lowest capacity to deal with such tectonic shifts. Due to its second-to-last position on the continent in terms of the quality of our education and the level of unemployment, South Africa is poorly positioned to meet these global challenges. The WEF has estimated, for example, that as many as 77% of our current jobs stand to be impacted by these changes. A critical question will be, how ready will our workplaces be for such destabilising influences?

It's not just the issue of job skills required for this future world of work that will be problematic. Concepts such as the rise of the gig economy (where employees elect to hold multiple jobs or jump from one job to the next), the emergence of the sharing/collaborative economy (where the whole value chain of production is likely to be disrupted) and the emerging reality that workers are still highly productive long after they have reached their mandated retirement dates, all point to a world where "retirement benefits" and "employer/employee relations" will need to be completely reconceptualised.

## The corporate world – and a changing model of employee benefits – may fill a critical gap.

Perhaps it's time that both policymakers and corporates consider a complete rethink of the role employers can play in bridging the chasm in social mobility and inequality that was created by both the apartheid years and the subsequent years of corruption and administrative mismanagement.

Consider the simple concept of "employee benefits". Tax and pension reform, when combined with a strong aversion to the kind of "paternalism" that may have been historically present in many corporations, have led us to a point where most employers have reduced their benefits offerings to the bare minimum of retirement funding, risk coverage for income loss and, for some, but not all employers, medical benefits. The fiduciaries responsible for managing and distributing these benefits will be the first to point out though, that employees are progressively becoming disengaged with the value of these protections. Employee concerns are far more immediate, and as such, when crisis hits, these benefits are the first to be dispensed with. And therein is the message: Exactly why do we have "employee benefits"?

Retirement funding stands high on the global agenda for social protections. Prioritising retirement savings though, presupposes that over the course of an individual's working life, they have been able to redeploy their income to solve for such basic needs as housing, education, health, asset accumulation and risk protection. As such, retirement savings simply solves for that last phase of funding for needs above and beyond that. For historical reasons, this has simply not been possible for the bulk of the South African population. For multiple generations asset ownership and asset accumulation have been precluded. As such, when talented young South African professionals enter the job market, the more likely redeployment of their income is to solve for a much wider "lens of multi-generational responsibility" – our so-called "black tax" problem. Worse, access to income has meant access to credit, and South African income earners have tried to bridge the asset accumulation chasm by over-borrowing their way to social mobility.

With this in mind, should we not be asking some critical questions as to how compulsory savings and employee benefits could be reconceptualised to better address these issues? We need to create a much clearer win-win here – where solving for what employees need and want most actually translates into a South African corporate world that is both more productive and profitable and hence, more globally competitive.

Ask South African employees what they want most from their employee benefits and the answer is unequivocal. What they require most is:

- The kind of job security that comes from knowing that they can develop the skills that will be relevant for the workplace of the future.
- The kind of financial security that comes from knowing how best to redeploy that income to allow them to navigate their lifelong funding and aspirational challenges.
- The kind of well-being security that ensures that should health or financial or emotional challenges emerge for themselves and their families, they will be safe-guarded.

Getting this right could mean that we begin to address exactly the factors both South African businesses and policymakers need to meet the challenges of a rapidly changing workplace globally:

- Skills development and promotion would need to become an integral part of the "employee benefit" on offer. Employers who play a far more active role in using the workplace to reconceptualise education and skills development would be ideally placed to address their future resourcing issues. In turn, South Africa could use this route to redress the significant shortfall of education and skills development policies to date. But policymakers need to be more responsive in terms of making these initiatives economically viable to employers.
- Employee benefits programmes that place financial well-being and security for both the employee and

their families can go a long way in terms of shifting South Africa to a culture that promotes fiscal responsibility and self-sufficiency. By addressing an employee's day-to-day financial needs, employers should see a significant reduction in their absenteeism and payroll wastage. This payroll wastage has been estimated by our research to be as high as 35% in South Africa.

- The current strain on the South African fiscus suggests that a comprehensive policy of social security is still far beyond our reach. For the meantime, employers could go a long way in terms of helping South Africa close this gap, but this will only work if the ambit of the debate is framed differently and expanded dramatically.

## The demographic reality for South Africa – why it's not about retirement

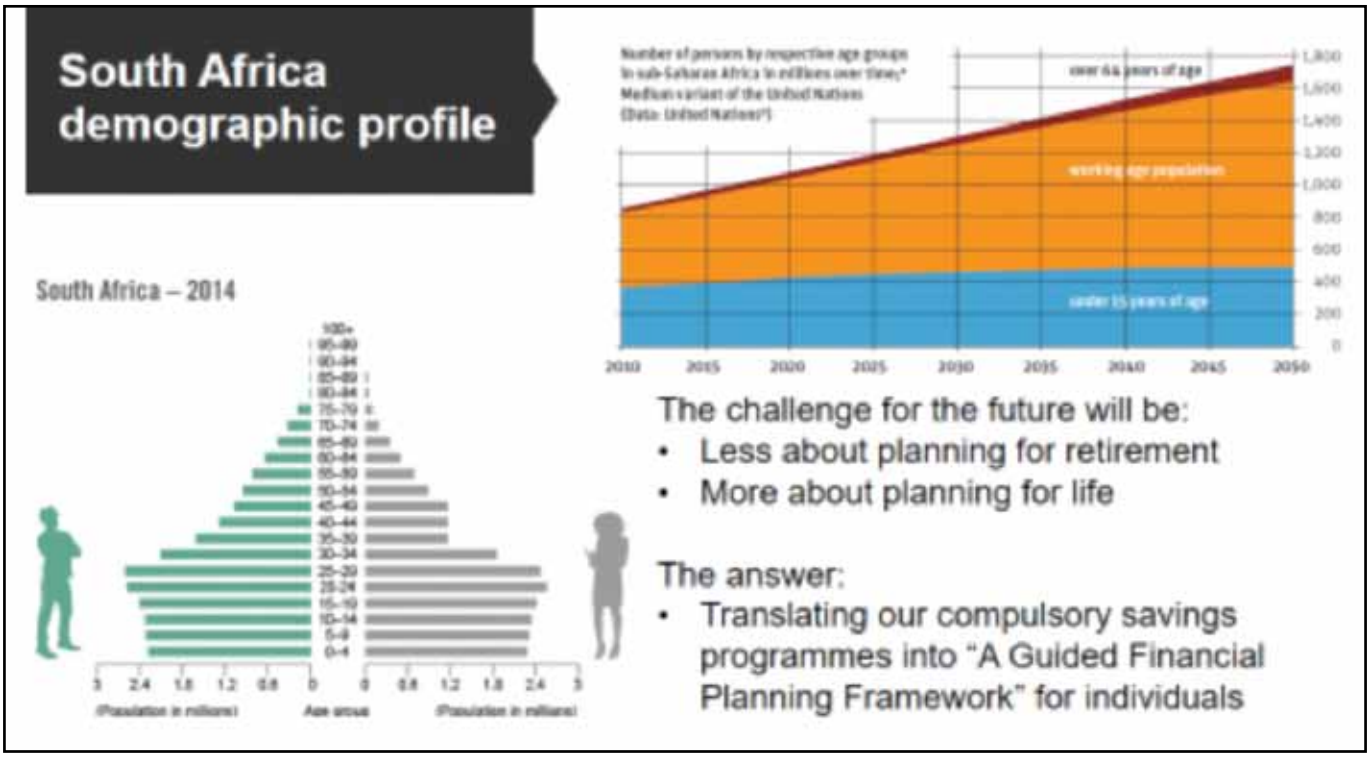
But there is one final point that deserves mention in this discussion. As the United Nations data in the graph below highlights, the demographic challenge for South Africa (as it is for much of Africa) is less about our elderly and funding their retirement, and far more about our youth and providing for their employment. In the African cultural context, caring for the elderly is still understood to be a family affair and responsibility. But what will that picture look life in 30 years' time? The surprising answer here is that critical demographic bulge to emerge will be among our working-age population. If we fail to find financial stability and viability within that demographic grouping, then social unrest will surely follow. By securing financial stability and job security over an individual's working lifetime, this could provide a critical underpinning for long-term care of the elderly.

*South Africa's future success will be inextricably intertwined with the success of its private sector*

We believe that in this dramatically changing world of work, there is so much more that can be done under an expanded vision of "employee benefits" that speaks to what matters most to both employees and employers. What's needed is a framework that addresses the issues of effective financial decision making not just in retirement, but throughout an individual's lifetime financial journey. Help members solve for the travails of that journey, and this in turn helps sort out the issues around retirement, income protection and health.

The South African world of work needs to ready itself for the challenges posed by the Fourth Industrial Revolution. We can do that... and so much more....if we can get employers, unions, policymakers, and employees to collectively re-optimise and re-organize what we currently have to work with to create this win/win/win situation.

This could be the powerful message that we provide to our leaders at Davos. ❐



# The critical role of an excellent consultant when considering umbrella funds

The commercial umbrella fund market has played a highly disruptive role in the South African retirement funding landscape resulting in a more dramatic shift in the landscape than the DB to DC transformation. This is largely due to the rapid transition of smaller and medium sized standalone funds into such structures as well as the convenience and affordability of the umbrella option amongst SMME's across the country.

**Viresh Maharaj**
Sanlam Employee Benefits

This market creates a challenging dynamic due to the lack of pricing standards, transparent pricing and variations in disclosure amongst providers. The 2016 Sanlam Benchmark survey indicated that 57% of participating employers polled found it difficult to factually and objectively compare costs between providers and another 19% said that it was very difficult to do so.

As such, we can infer that high quality guidance is required to enable employers and funds considering the umbrella route to understand the material qualitative differences between the available commercial umbrella funds and to then be able to quantify and compare the actual charges being levied. This is the domain of the excellent consultant. An excellent consultant displays a combination of the following characteristics:

## They are passionate about moving more members towards better outcomes

An excellent consultant is able to evaluate the current retirement funding position of members, apply a target and implement the necessary corrective measures at fund level to move more members towards such a target. This necessitates being knowledgeable about the various products available so as to make qualified judgement calls on how to best achieve one's targeted goals. Unfortunately, Trustees are often engaged many intermediaries who are comfortable with understanding a very limited range of providers' products and these intermediaries are not willing to explore credible alternatives. This is often to the detriment of fund members.

## They are able to understand, unpack and compare all costs

As discussed, umbrella fund charges are not transparent across the industry and an excellent consultant needs to apply professional analytical ability to trawl through the fine print to translate the layers of fees into a measure that can be compared across providers. The incoming Effective Annual Charging standard greatly assists with being able to better compare quotes but employers are currently entirely reliant on the consultants' ability to apply their expertise to assist them. Canny providers have sought to arbitrage this situation and have often succeeded where consultants have not unpacked hidden layers of net prices asset based fees, expensive guarantee fees on default portfolios as well as a host of other practices. An excellent consultant will do so in order to enable high quality decision making.

## They are able to communicate qualitative differences in value provided

Warren Buffett once said, "Price is what you pay, value is what you get". The umbrella fund choice is not an exercise to determine the cheapest provider but, once again, intermediaries are often willing to risk their reputations by recommending a particular fund simply because it is the cheapest with no regard for the host of qualitative differences between funds. Such practices may have hugely detrimental effects on employees' abilities to create long term wealth as, while fees are important, they are but one component of an ecosystem of other components that collectively move members towards better outcomes. An excellent consultant is able to compare value and discuss the dynamic between the cost and value of different providers by evaluating the ecosystem rather than just a single component. Consultants who merely compare costs are redundant.

## They provide independent advice

Consultants who are inextricably linked to a particular umbrella fund may have an inherent conflict of interest as they effectively act as tied agents of the relevant sponsor. Such consultants typically have very limited insight into competitor products and would therefore not be in a position to recommend alternatives to their native solution even if such alternatives were a better fit to the clients' needs. There is an inherent conflict of interest when the consulting firm is also the umbrella sponsor as employers face the risk of receiving advice that is driven by business interests rather than by the financial needs of their employees. It is perhaps worthwhile to ask one's consultant whether they have ever considered alternative providers for your own fund as well, whether they have ever conducted a market test for your fund and whether they have funds at other providers to get a sense of their degree of independence. Employers and funds that currently utilise such consultants have increasingly contracted independent consultants to conduct objective reviews of their retirement funding structures with a view to understanding the alternatives available.

## They apply influence

Independence allows a consultant to objectively compare alternatives but this alone may not result in the best deal for the client. An excellent consultant is able to apply influence to providers to enhance the value proposition to clients in order to improve the deal being offered. Thus, an excellent consultant moves beyond the role of a quantitative and qualitative aggregator and is able to differentiate themselves by enhancing the value delivered to members by negotiating rates, structures and conditions with providers for their clients.

Given the rapid growth in this market, excellent consultants are required for funds and employers considering the switch to umbrellas as well as for existing participating employers within umbrella funds. Employing excellent consultants can materially improve outcomes for members and should be considered as a priority action. As an employer or trustee, one must evaluate whether the consultant attached to your retirement arrangements fulfils the criteria of excellence and then act accordingly. ❐

# A further downgrade and what it means

**Andrew Davison**
Head of Investment Consulting
Old Mutual Corporate Consultants

On Black Friday (27 November 2017), a day when consumers plan to go shopping in the pursuit of bargains and retailers traditionally expect to go into the black (in other words, tip from loss making to profitable for the year to date), South Africa received the latest assessment of its financial health by the global credit ratings agencies.

Following the previous downgrades by the three ratings agencies in early 2017, the latest ratings provided more cause for concern about the state of the South African economy. On the Thursday night Fitch left their rating unchanged with a stable outlook. This was followed on the Friday night by Moody's who left their rating unchanged but with a negative outlook S&P took the decision to downgrade both the local and foreign currency ratings.

The table below shows the current local currency credit ratings as well as the previous ratings of the three agencies. The (new) current rating is highlighted in orange (with the previous rating in grey). The blue shaded areas indicate unchanged ratings.

| S&P | Moody's | Fitch | |
|---|---|---|---|
| AAA | Aaa | AAA | Investment grade |
| AA+ | Aa1 | AA+ | |
| AA | Aa2 | AA | |
| AA- | Aa3 | AA- | |
| A+ | A1 | A+ | |
| A | A2 | A | |
| A- | A3 | A- | |
| BBB+ | Baa1 | BBB+ | |
| BBB | Baa2 | BBB | |
| **BBB-** | **Baa3** | BBB- | |
| **BB+** | Ba1 | **BB+** | Sub-investment grade |
| BB | Ba2 | BB | |
| BB- | Ba3 | BB- | |
| B+ | B1 | B+ | |
| B | B2 | B | |
| B- | B3 | B- | |
| CCC | Caa | CCC | |
| CC | Ca | CC | |
| C | C | C | |

The Medium Term Budget Policy Statement seems to have been one of the triggers for this further downgrade as it essentially abandoned the policy of fiscal consolidation and portrayed a deterioration in the deficit and debt ratios yet indicated no cohesive plan to stabilise government's finances.

The key for South Africans now is not to dwell on the downgrade. A downgrade by the ratings agencies is an assessment of our creditworthiness as a country. Although the downgrade does have implications for the cost of government borrowing and the ability to continue servicing existing debt, the downgrade itself is not the issue. Rather we should focus on the underlying problem, which is that our financial affairs as a country aren't in good shape. To regain our status as an investment grade country we need to focus on how we can grow our economy, on each doing our bit to ensure that we are competitive in relation to other countries. This is critical in order to reduce the possibility of having to consider an IMF bailout in the future, as this may affect the State's ability to pursue its developmental objectives.

## Impact for investors

As always, it isn't simple to predict the impact of these downgrades on various investments. The short term impact is sometimes quite different to the medium term impact. As a result of the fact that downgrades relate to our ability to repay our debt, bond markets are always impacted and this in turn affects the Rand. Bank shares are also often impacted because of the potential impact on interest rates. However, trying to react to events like this by switching or making changes to one's investments is not advised and while it may be difficult to keep emotions in check, it is far better to stay focused on the long term objectives and leave it to the asset manager(s) to navigate your investments through this environment.

## IMPORTANT CONSIDERATIONS FOR INVESTORS

### Diversification

During times of heightened uncertainty like we are experiencing, it's essential not to take excessive risks by investing heavily in any one investment. Spreading your investments across different types of assets that might react differently to the events as they unfold, will protect your savings from large fluctuations and hopefully allow you to ride out the volatility and any short term dips in values. Diversification ensures that you have exposure to growth assets like equities and property and not only conservative assets. These investments might feel risky but they offer protection against inflation, especially in the longer term. If your investment strategy isn't sufficiently diversified then you should consider introducing some investments that are likely to behave differently to the ones you already have.

### Global Bond indices

Unfortunately we are now a step closer to a removal of our bonds from the Citi WGBI (World Government Bond Index). It requires both Moody's and S&P to rate our local currency debt as junk. This latest downgrade by S&P means all it will take is a one notch downgrade by Moody's. If this happens it could lead to potentially large outflows from South African bonds (anything up to R140bn) as index tracking funds are forced to liquidate holdings of SA government bonds. Although this would have an impact, it is also important to remember that other global investors, those seeking higher yields among the countries that are sub investment grade, are likely to be buyers of our re-rated bonds so the net impact will be less significant. Indeed unconstrained active managers who recognise that yields may stabilise at lower levels may embrace the opportunity that these forced redemptions provide.

### The Rand

As South Africans we are used to a volatile currency. The Rand may also be impacted by a weak economy and ratings downgrades as global investors allocate less money to South African assets and government debt grows. Although your ability to travel overseas or afford imported goods may be diminished by a weaker Rand, your offshore investments will benefit. This is why it's important, as part of your diversification strategy, to allocate money to offshore investments too.

### Improve your personal financial resilience

Irrespective of downgrades the South African economy is not in good shape. Downgrades are likely to make things tougher as they place additional pressure on government finances, which in turn trickles down to corporates and individuals. Building resilience into your own financial situation will make you able to withstand potential shocks. Things that you can do include saving more, in a short term, liquid investment that you can access in emergencies, cutting back on non-essential expenses, paying off debt and not taking out new debt.

### Take advantage of the tax breaks available to you

One of the possible implications of the credit rating downgrades, compounded by the growing fiscal deficit facing South Africa's government, is higher taxes. In light of this, taking full advantage of the tax breaks available to you is a sensible move. You can invest in a tax free savings account to shield your investment returns from tax. You can also contribute up to 27.5% of your salary towards a retirement fund (subject to a cap of R350 000 per year).

### The bottom line

The South African economy is in a weak state. This is a tough environment and it is likely to give rise to increased volatility across most asset classes. It's essential not to let your emotions interfere with your decisions in relation to your investment strategy. Remaining focused on the long term and resisting the urge to take action will most likely allow you to sail through the storm and emerge on the other side in a sound financial position. Importantly, don't lose faith in your savings if they perform poorly from time to time, keep diligently allocating more money to savings and you'll benefit over the long term from the 'sale prices' on any assets whose prices may have fallen. ❐

# EBSphere offers full HR & EB integration solution

***Brian Rosen***
***Founder, EBSphere***

*Everest.net enhances employee experience and payroll and employee benefit administration*

EBSphere's integrated accounting and administrative workflow software solution, Everest.net, has been digitised and overhauled to enable HR to collaborate both internally with staff, and externally with related institutions, including banks, SARS, asset managers, fund administrators, and insurers.

The Everest.net product suite allows, via a single-view dashboard, real-time, simultaneous fund accounting, and fund and investment administration, which delivers immediate transacting capabilities and fully reconciled accounts. It verifies bank accounts in seconds, and an integrated finswitch investment mechanism delivers automatic pricing and trades, while the automated claims process shifts the focus to client service rather than production.

The solution hosts fund accounting, fund and investment administration, built-in workflows, document warehousing and communication capabilities. Built with a secure, intuitive interface, the solution caters to all types of funds, group risk policies, pension and provident funds, funeral plans, trusts and annuities payrolls, including the deduction of PAYE tax, additional tax, medical aid subscriptions, and housing loans.

> "It's administration and employee benefits made easy, no matter your industry or the size of your organisation. Everest.net gives you the peace of mind of a time-saving, all-in-one management, administration and accounting system with real time reporting and exceptional user support from an easy-to-use platform," says Brian Rosen, founder of EBSphere.

Additionally, the upgrade includes improved user experience for employees. The employee experience (EX) system design elements included in Everest.net include integration with a smartphone app, which gives employees who use Apple and Android devices the ability to easily access their profile details.

> "EX is an important emerging workplace trend as it materially impacts on employee satisfaction, productivity and efficiency. It has therefore been a key design element incorporated into the upgrade, in line with global trends that aim to create a social, mobile, and consumer-centric experience for employees," explains Rosen.

> "The online web portal offers even greater functionality, with easy, intuitive access to important and pertinent information, such as latest fund values and benefit statements."

> "Our employee benefits administration solution is specifically designed to meet the unique needs of the local market, with additional functionality that simplifies the role of HR management. In addition, our web-based Everest Payroll Integration of Contributions and Claims (EPIC) enables HR to upload company payroll files for the online reconciliation of data, including new entrants and increases," says Rosen.

He says HR teams can submit claims online, which significantly speeds up the submission processes. The intuitive interface works with any payroll system and ensures accurate, thorough and up-to-date data which is used to eliminate manually inputting data that could result in costly mistakes.

Flexible communication between clients and the HR departments and employees is made more effective with SMS, USSD and e-mail functionality, creating clear channels for the sharing of pertinent information.

> "Everest.net's latest iteration runs on a streamlined platform that is faster and more secure. Security is paramount, which is why we contracted SensePost to perform extensive penetration tests to ensure security of the web application," explains Rosen.

Everest is compatible with Microsoft SQL Server 2005 to Microsoft SQL Server 2016. Integration with the Windows Lightweight Directory Access Protocol, or LDAP also allows users to utilise the same password as their Microsoft computer, which updates automatically with changes for added ease of use.

The platform's currently being tested before it goes live in March 2018. For more information, visit www.ebsphere.com.

# Using portable alpha to enhance a passive strategy

The debate between active and passive investing has long been topical. The passive premise is built on the benefits of lower management fees and, very often, associated lower turnover costs. Actual excess returns through active stock selection has proven to be difficult to sustain and the vast majority of active managers, locally and internationally – particularly if one takes survivorship bias into account – underperform typical benchmarks.

**Guy Fletcher**
Head of Research and Client Solutions
Sanlam Investments

So, 'go passive' case closed?

The flipside of this argument is human emotion. Most investors dislike being consigned to the (albeit marginal) underperformance scrapheap when stories of excellence abound. Everyone likes a winner. And being associated with one (through your investment strategy) is next best to being one, even though it's hard to find and often cyclical. So, you have to have some active in the mix, right?

But what about a third option? (And we're not talking smart beta here – that's for another chapter).

**Instead of simply replicating a given benchmark as closely as possible, derivatives give us an added dimension to enhance returns, without using leverage. This is with the addition of portable alpha.**

## Let's explain

Portable alpha involves seeking the market return (commonly referred to as beta) from one asset class and excess return (commonly referred to as alpha) from a different one, and then merging the two. And the best form of portable alpha is the one that is completely uncorrelated to the beta we want to enhance.

The one area of investing in which alpha has persisted is in the money market spectrum. If one observes the performance surveys over time, almost every money market manager has delivered in excess of their benchmark, implying that alpha is not in elusive supply in this part of the market (unlike the equity market). In comparison to returns on short-term deposits, the money market funds deliver returns some 70 basis points (bp) to 150bp higher. And the enhanced yield funds can be up to double this! To put this in perspective, if you were able to consistently achieve these sorts of returns above an

equity benchmark after costs, you would be a very happy investor.

So, how do the money market guys do it? Well, they have the term structure of interest rates on their side (you get a higher yield for longer maturity). They use their understanding of interest rate cycles to good effect by choosing fixed vs floating rate notes, plus they can put aside some of their investments in higher-yielding credit instruments (under stringent controls), all of which adds up to better returns.

## So how does the "porting" process work?

First, we replicate as much of the benchmark as possible with derivatives. In the case of a SWIX Top 40 index, there are futures contracts that are designed to expire at EXACTLY the same level as the index on specific dates. Prior to that date, the future will trade at a value that is different from the index. This is because, as a contract, it has different attributes to a normal investment.

In other words:

1. It requires only approximately 10% collateral against the exposure to the market that it purchases – this money must be placed with SAFEX (South African Futures Exchange) as a buffer against severe market movements and will earn a typical short-term deposit rate.

2. It must make good on the daily profit/loss of the contract (called margining) – if the contract owner is unable to do this, SAFEX will close out the position.

3. It receives no dividends (since it is not actually invested in the market, merely in a contract that derives its value from the market).

4. The balance of the monies not required for collateral are assumed to be invested in cash.

So the value of the contract is a function of four elements, namely:

1. The current spot price of the underlying index (S).

2. The expected future amount of dividends (d).

3. The expected cash return (r).

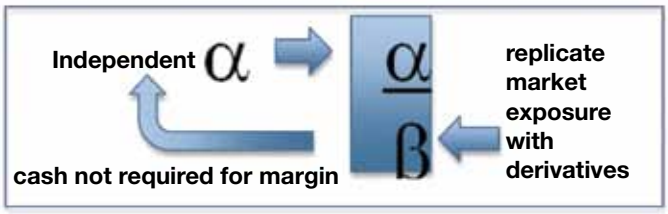
4. The term (in days) to expiry of the contract (t).

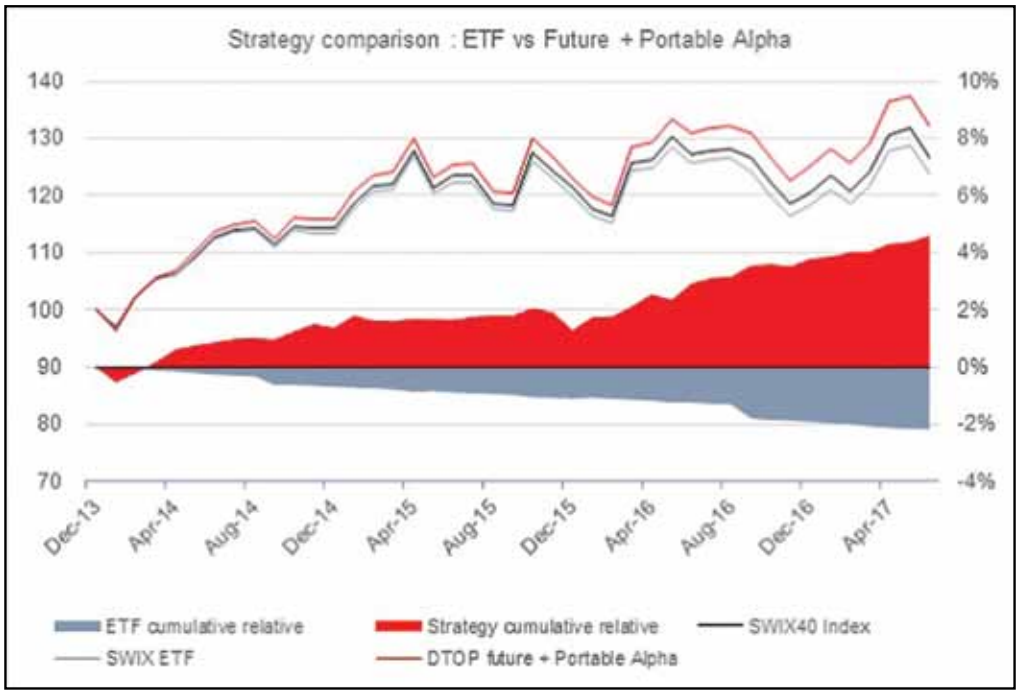
This can be written as:

Fair value = $S * (1-d+r)^{t/365}$

Portable alpha essentially maximises the return for the third element (cash) – as we have seen above, money market managers pretty much all add positive value.

Diagrammatically, the process can be represented as follows:



Most individuals will understand that markets can move aggressively (think of market crashes in 1969, 1987, 1998, 2002 and 2008) so one has to be diligent in managing these positions, particularly having additional capital available for extreme events. However, even with 20% put aside on an immediate call in addition to the initial margin at SAFEX (we have never had a negative market move of >15% in one or two days), we can still invest some 70% in enhancing activities.

Since we will contractually receive the exact return on the index, the additional return over the expected short-term deposit that we will receive from enhancing the cash is all "alpha" and is portable (moveable) onto the index return!

Let's have a look at some charts (for illustrative purposes, we are only looking at the last 42 months):

1. Adding value to a pure index investment

   The cumulative impact of this portable alpha strategy is profound:

   a) A pure passive approach (using ETFs) would have delivered index -217bp since December 2013 (an implementation and management fee cost of some 0.62% p.a.)

   b) The portable alpha strategy indicated above would have delivered index +459bp (1.29% p.a.)

   c) This is a swing of 676bp or 1.88% p.a.

2. Positioning an index plus portable alpha strategy against active managers

   a) Most active managers use the larger SWIX index as their benchmark. Thus, only approximately 80% of this index is represented by the SWIX40 (or large cap component) analysed above.

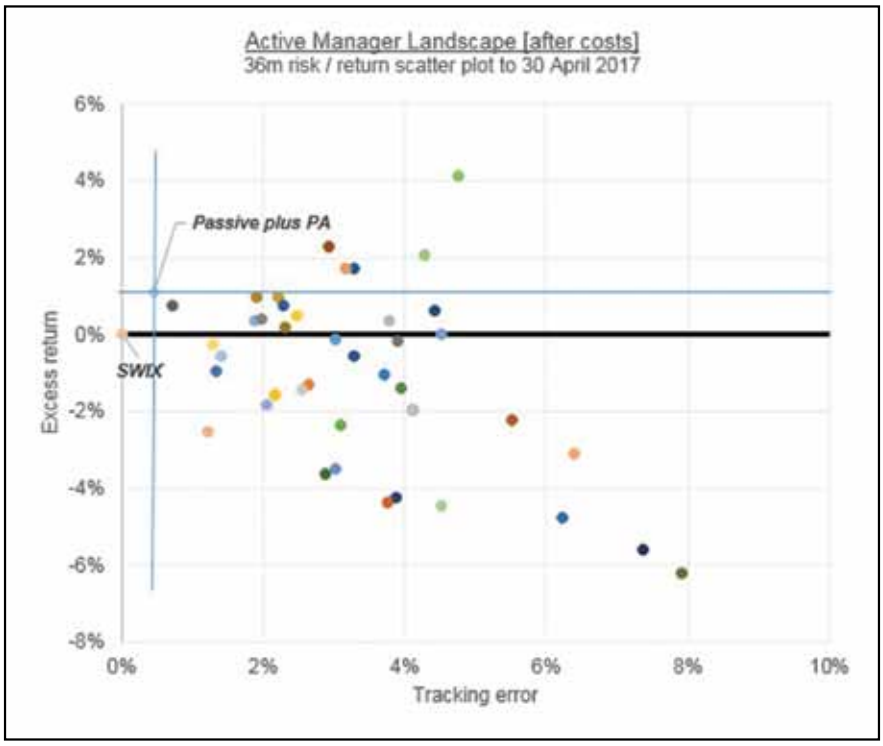
   b) For ease of reference, we assume that the "tail" (or non-large cap element) can be replicated at a cost of 62bp p.a. (as per the ETF experience above).

   c) Hence the added value of the portable alpha element to the full SWIX will be closer to 110bp (80% * 151bp + 20% *-62bp).

   d) Below is a scatter plot indicating the results of all active managers within institutional surveys in the 3 years to the end of Apr 2017 (the middle of our period). The scatter plot uses the full SWIX benchmark and shows the annualised excess return of that manager vs his tracking error (risk). All managers are estimated to have a 45 bp p.a. management fee.

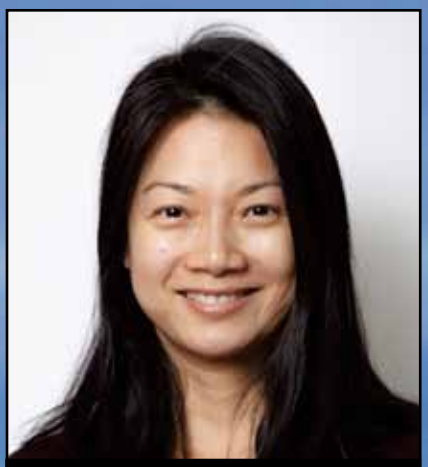
   e) The cross-hairs on the Passive plus Portable Alpha portfolio show that, during this period, only five funds delivered a higher return than our strategy (fully 43 delivered lower returns) and everyone did it with higher risk.

The concept of portable alpha has been around for decades and is a highly effective strategy in delivering excess returns over benchmarks. It is particularly appropriate in higher yielding environments (such as South Africa) where money market instruments deliver vastly improved returns over cash on deposits at commensurately lower risk. ❐



# Fiscal pressure – Tax hikes are not the solution

South Africa suffers from a trifecta of social challenges, namely: inequality, poverty and high levels of unemployment. This, when coupled with the state of economic stagflation, rampant government expenditure and bureaucratic paralysis is creating unprecedented fiscal pressure.



Joon Chong, Partner and Wesley Grimm, Candidate Attorney at Webber Wentzel


Tax revenue, as described in the Medium Term Budget Policy Statement, is projected to fall short of the 2017 Budget estimate by ZAR 50.8 billion, the largest under-collection since the 2009 recession. The shortfall can be reduced either through fiscal consolidation or by increasing taxes and cutting costs.

On Friday, 24 November Standard & Poor's Global Ratings lowered South Africa's rand debt to "junk-status" and cut the foreign-currency rating to two levels below investment grade. In response, President Jacob Zuma tasked the Minister of Finance and Presidential Fiscal Committee to cut spending by ZAR 25 billion in next year's budget and find ways to add ZAR 15 billion to the nation's revenue. Given South Africa's narrow and deep tax base, where a limited number of people are highly taxed, further increasing taxes is a contrived solution.

It has been suggested that the capital gains tax (CGT) rate be increased further so that the full capital gain realised on disposals is taxed. The CGT inclusion rates are currently 40% in respect of individuals and special trusts; 80% in respect of companies and 80% in respect of other trusts. The CGT rates stated above were only introduced on 1 March 2016.

Moreover, due to the recent increase in the maximum marginal income tax rate for individuals and trusts to 45%, the effective CGT rate increased from 16.4% to 18% for individuals and special trusts and from 32% to 36% for other trusts. The effective CGT rate for companies remains unchanged at 22.4%. In our view, the benefits of the above increases are yet to be fully realised and any further increases in the effective CGT rates now would only serve to reduce the appetite of investors and make it

more expensive for companies to conduct business. We submit that the cumulative effect of the above revisions should first be fully taken into account before additional taxes are introduced to overburden the already strained South African taxpayer.

It is pertinent to note that only a small concentration of people and firms pay the bulk of the personal income and corporate taxes in South Africa. The South African Revenue Service (SARS) data for 2016 reflects that approximately 1% of the South African population pays 60% of the South African personal tax which is collected by SARS and less than 600 companies pay 60% of the corporate income tax. It is self-evident that these two relatively small groupings are fundamentally responsible for shouldering the responsibility to play a key role in growing the South African economy on the one hand and, on the other hand, contribute the bulk of fiscal contribution in relation to personal income tax and corporate tax.

Capital formation is one of the foundations of economic growth in a country. CGT reduces the availability of capital and makes it more expensive for companies to conduct business. Further increases to the CGT rate would discourage the above participants from contributing to growing the economy which would reduce jobs and lower wages. A further problem with increasing CGT rates is that it encourages investors liable to pay CGT to defer realising their investments for as long as possible. Where CGT rates are increased, people owning capital assets become more reluctant to sell these assets as the ratio of benefits to CGT burden becomes disproportionately skewed away from realising the assets.

In view of the above, and in the context of several countries including New Zealand, Switzerland and Hong Kong not taxing capital gains, it is hard to conceive why South Africa would consider increasing the CGT rates further. Furthermore, many countries adjust CGT rates to exclude the influence of inflation and only subject the "real capital gain" to tax. When CGT was introduced in South Africa it was argued that the low inclusion rates (at the time) militated against the need for making adjustments for inflation. That argument is now unsustainable and South Africans may now, in effect, be taxed on inflationary gains made. Further upward revisions of the CGT rate would only exacerbate this situation.

As recently as 2015, it appears that no BRIC (Brazil, Russia, India and China) country had an integrated capital gains tax rate above 40%. Among the Organisation for Economic Co-operation and Development (OECD) countries, France had the highest integrated capital gains tax rate (75%), followed by the United States of America and Denmark (56%) and Portugal and Japan (50%). No OECD country has a 100% CGT inclusion rate. Research suggests that the global trend is in favour of decreasing rather than increasing CGT tax rates.

Alternatives to increasing the CGT rates include: (i) increasing the Value-added Tax (VAT) rate, (ii) introducing a form of wealth tax, (iii) implementing further Special Voluntary Disclosure Programmes (SVDP) and/or (iv) increasing the donations tax rate. These alternatives, considered jointly and severally, should not detract from the fact that the fundamental problem in South Africa is rampant government expenditure.

Increasing the VAT rate will have a direct and profound impact on all people in South Africa but it is the poor and working class who would be most affected. South Africa already imposes taxes which tax the transfer of wealth in the form of estate duty, donations tax and CGT. Global experience seems to support the view that an independent wealth tax results in relatively low yields but administrative costs associated with implementing such a tax are high. Wealth taxes are currently levied in Spain, Norway, Switzerland and France but have been discontinued in Austria, Denmark, Finland, Germany and Sweden. SARS' most recent SVDP programme had, at the time of the 2017 Budget Speech, resulted in the disclosure of ZAR 3.8 billion which will yield approximately ZAR 600 million in additional tax revenue for the fiscus.

We submit that increasing the CGT rates or VAT rate or introducing a form of wealth tax will further impede the growth of the South African economy in addition to the difficult economic environment South Africans currently find themselves in, encourage evasion and avoidance of tax, contribute to the flight of capital and skills, likely result in higher indebtedness and further disincentive to save amongst South Africans, and shrink the existing, overburdened tax base.

It is also trite that economic stimulation and growth is a far greater catalyst for increasing tax collections. In our view, government should rather consider bolstering property rights, boosting efficiency and lowering costs of public service, expanding essential infrastructure, more efficiently employing resources employed in education, reducing crime and domestic violence, particularly in poor communities, and becoming more effective in reducing wasteful expenditure and the widespread abuse and theft of state resources.

In summary, we submit that it is flawed to argue that a country can be taxed into prosperity and that increasing the CGT rates, increasing the VAT rate and/or introducing a further wealth tax may be viewed as an attempt to do so. Winston Churchill once said that: "*I contend that for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift* himself up by the handle". In short, overburdening an already narrow and highly-taxed tax base will not improve South Africa's position. ❐

# No time for complacency

2017 turned out to be a better year for the stock market than many investors expected, in fact much better. And now, in early 2018, upside risk in markets could be further bolstered by the generally positive mood and expectations for the year, an extended bullish trend and the fear of missing out. Have pity for the "perma-bears" for whom the rally in stock markets since the lows of 2009 has been a painful ride. There have been anecdotal cases of capitulation by some as they belatedly joined the rally in markets.

Fabian de Beer
Director: Investments
Mergence Investment Managers

Ultra-easy monetary policies in developed economies have led to significant growth in central bank balance sheets as they implemented quantitative easing (QE) as a key policy tool coupled with cutting interest rates. This has led to suppressed volatility and very low interest rates that have disrupted the normal pricing mechanism and term premiums in markets. It is undeniable that markets have been major beneficiaries of these highly supportive monetary policy measures, which have caused a surge in asset prices. Since the Great Financial Crisis was triggered by debt problems, it is telling that global debt levels have since continued to rise and are even at higher levels.

The following provides a reflection of this in the US market:

- Low interest rates have enabled the Federal government to increase its total debt by 113% since 2008 – interest payments rose by a mere 5%.
- Large amounts of debt to fund stock buybacks and increases in dividends have been borrowed by corporations. Non-financial corporate debt is about 79% higher today than it was in 2008.
- US households have a total of $12.96 trillion in debt outstanding according to the New York Fed's latest quarterly report on household debt. That is around $280 billion higher than the previous all-time peak in Q3 of 2008.

It is not surprising therefore that a number of investors are worried about a potential reversal. Monetary policy is likely to be normalised quicker by the Fed in the face of a large fiscal stimulus via the proposed cut in US taxes, and other developing market central banks are likely to follow the Fed in tapering asset purchases and winding down their ultra-accommodative policy settings.

The global economy is in a synchronised upswing for the first time in a long while with market sentiment and outlook quite positive among most pundits. Leading economic indicators in most major regions are supportive. In the US and Europe, the purchasing managers indices (PMIs) are at multi-year highs. And so one wonders how markets are going react into the new year, given the ongoing resilience in the US economy, the Fed tightening policy, the US Treasury yield curve flattening, equity markets registering new highs, extreme low volatility, complacency and a high mood among investors, valuations reaching expensive levels across most asset classes, and exceptional strength in US labour markets.

Below are some strands of thought that emerged from market pundits who, as always, spent December and early January inundating the investment community with analysis and predictions. Studies have shown that forecasts in general are inaccurate, but it is interesting to see what pundits are saying, if for no other reason than to see how widely views diverge.

- The consensus generally extrapolated 2017 conditions into 2018, with solid global growth, a modest pickup in inflation and gradual monetary tightening expected. Central bank policy normalisation is expected to be a major issue as anticipated tapering and rate hikes are implemented. A key question is whether or not markets and economies are strong enough to survive the withdrawal of liquidity on which they have so heavily depended since 2009.
- There is no consensus on whether the main danger for markets will be a strong rise in inflation (forcing long-term interest rates higher) or an inverted yield curve.
- There is a view that continued easy credit terms on the back of a maturing economy/market, rising leverage and deteriorating credit quality could create bubbles.
- **Bull or bear?** Extreme sentiment and volatility indicators, media commentary and reports corroborate the heightened optimistic mood and outlook. Some believe the bull market still has room

to run, yet extremes in sentiment indicators also point to an increasing risk of a market pullback at these levels.

- One market expert remarked that when the last bear capitulates and joins the bullish herd, there will be no one left to buy. When this occurs, the aftermath is anything but pretty – for the bulls, that is. Presently, the critical market evidence (sentiment and related indicator extremes) is piled so high that investors cannot afford to ignore it.

- "...expect a year where volatility re-emerges as an investable theme, after spending much of 2017 so dormant that you have to go back to the mid-1960s to find the last annual period of such an eerie calm – look for some mean reversion on this file in the coming year." ("We Are 90% Through The Cycle", David Rosenberg's 2018 Outlook, Gluskin Sheff, 10 Jan 2018)

- **Recession** – some do not foresee the possibility of this as factors that usually trigger recessions – inflation or the perceived threat of inflation, a profit slow down, monetary tightening and/or overinvestment – are largely absent.

- However, others feel most of the good news on the economic front is already priced into the capital markets. Investors should therefore not expect strong performance based on robust economic data or the absence of a recession.

- **Geo-political** – Some anticipate that 2018 could be a testing and potentially chaotic year for the global economy. Key global themes expected to play out during the year include US-led conflict over trade and potentially with North Korea, and a regulatory backlash over disruptive technologies. Furthermore, Brexit negotiations may be problematic and euro problems may flare up again. Add to this that neither the United Kingdom nor Germany has a decisive government at present.

- "The global economy will confront serious challenges in the months and years ahead, and looming in the background is a mountain of debt that makes markets nervous – and that thus increases the system's vulnerability to destabilising shocks. Yet the baseline scenario seems to be one of continuity, with no obvious convulsions on the horizon." ("The Global Economy in 2018" by Michael Spence of Project Syndicate, Nov 28, 2017)

The above shows that while there is currently a general sense of optimism regarding the global economic outlook, experience suggests it prudent to be mindful of ever-present risks.

It cannot be ignored that the unwinding of eight years of unconventional monetary accommodation and stimulus by central banks will reduce the liquidity which has been a fundamental underpin and the lifeblood of the markets.

The current economic/market cycle is estimated to be the third longest ever and almost double what is normal. The market could continue to rally much higher. Nonetheless, the cycle is maturing and is at a late stage. Investors should be alert and very mindful of risk by increasingly focusing on the quality of portfolios and underlying securities.

An apt closing remark is provided by Steven Roach, former chairman of Morgan Stanley Asia and chief economist at Morgan Stanley, who recently commented: "Yes, the global growth climate seems to have improved recently. Conditions are depicted as strong and synchronous, with frothy financial markets providing the icing on the cake. Don't be fooled — a decade of tough global problems has not miraculously vanished into thin air. And, as always, new problems appear to be on the horizon. This is no time for complacency." ❐

# Embrace artificial intelligence to avoid retirement check mate

Artificial intelligence is changing the face of investing and will have a profound impact on how risk is priced and investment returns are achieved as we build up the capital to meet our liabilities while we transition into retirement – and live longer lives.

The game-changing nature of Artificial Intelligence (AI) became evident in chess. Thirty years ago, Garry Kasparov, the world chess champion at the time, managed to beat 32 of the most advanced chess computers simultaneously within the space of five hours. 12 years later, in 1997, a single computer called "Deep Blue" famously defeated Kasparov in a heavily publicised match that Newsweek called the "Brain's Last Stand". Today, any one of the world's leading chess computers would defeat a room filled with 32 of the world's grand masters of the game.

More recently, in 2017, an AI computer algorithm called AlphaZero learnt to play chess in four hours and subsequently went on to beat the world's leading chess computer. In those four hours, it learnt the rules of chess, taught itself to play and assimilated all the chess data possible. And in beating the leading computer, AlphaZero revolutionised the chess world by playing moves never seen before in the 1500-year history of chess.

These developments have powerful implications for investing, not least because medical advances are likely to further increase longevity.

AI is being trialed in cancer diagnosis and experts say that it should be able to teach itself to read scans more quickly and accurately than doctors. This is incredibly exciting for the treatment of cancer. AI is, in fact, being used throughout the medical world to provide us with better quality lives and, importantly, longer lives.

From an investment perspective, this means that our savings will need to be stretched over a longer period of time to meet our future cost of living. We refer to this future cost of living as a "liability".

As we expect to live longer, our liability increases, in other words we need more capital now to fund our cost of living in the future. For example, a 65 year old expected to live 20 years and requiring R20 000 per month to

Trevor Abromowitz
Head of Old Mutual Investment Group's Liability Driven Investment's boutique

live adequately, would require capital of approximately R3.7m. If the individual is expected to live an additional 10 years, the capital required increases to about R5m. This represents an increase of roughly 35% in the capital required to fund this individual's lifestyle.

The question is, can AI be used to boost individual's savings to ensure that they have enough to last for their entire lifetime, especially if they are likely to live longer?

In answering this question, let's consider how AI is currently being used in the investment industry:

- Chatbots: which are programs designed to converse with humans, engage with customers and provide answers in a manner similar to Apple's Siri.
- Robo-advice: provides financial advice with little or no human intervention.
- Fraud detection: by analysing patterns of consumer spending, AI can set a behavioral baseline against which it will quickly compare and score a new transaction, thereby performing early fraud detection.
- Underwriting: wearable devices such as smartwatches and fitness trackers provide real-time insight into policyholder behavior. This real-time data is then fed into an AI system to understand and even predict policyholder health.
- Investment analysis: collect and assimilate annual financial statements, analyst reports, JSE announcements and media statements to make efficient, real-time investment decisions.

While the verdict is still out on its effectiveness, the aim of these AI engagements is to enhance customer experiences, offer more accurate pricing of risk and ultimately generate better investment returns for investors. However, while these applications are highly innovative, they are unlikely to meaningfully boost the capital required to meet the increased liability associated with a rise in life expectancy.

So what can be done?

## 1. Better match your future liabilities

Employ a liability-driven investment (LDI) framework to understand how your liabilities (or future financial obligations) drive your investment strategy. This includes, amongst other things, investing in assets that provide inflation-linked returns such as infrastructure, property and renewable energy as these are likely to provide a better match for your future liabilities (these assets are more likely to increase in value with inflation) without excessive capital volatility.

It is very important point to understand that if you experience negative returns, then you have to earn even higher returns just to get back to where you started. For example, if I have R100 and I lose 10% of my investment (say over one year) then I need to earn 11.1% the next year to get back to my original R100. This is even more difficult if you are drawing an income from your capital base. Extending the example further, if I lose 10% over one year and also have to pay living expenses of R5 over the year, then I will need to earn 17.6% the next year to get back to my original R100.

## 2. Better budgeting

Consider deferring current spending in favour of funding your future cost of living and meeting your future liabilities, inasmuch as you are able to. Key to this is drawing up a personal budget and understanding how it is likely to evolve with age and how it may change in the case of a life-changing event.

## 3. Keep earning

In a country like South Africa with a significant skills shortage, individuals with life and work experience have immense value to provide to the country by transferring their knowledge to the younger generation through formal training and mentorship programs. The government could play a role here too and reward educators with tax rebates on their retirement income.

## 4. Invest with AI savvy asset managers

Employ investment managers that embrace AI. Combining human intelligence and AI is likely to lead to a better outcome than only using human intelligence or only using AI. The ultimate success of combining human intelligence and AI, however, depends on the process employed.

## 5. Keep an eye out for innovative longevity products

Financial Service Providers (FSPs) could develop products like longevity swaps and reverse mortgages. Longevity swaps reward investors if they live past their life expectation. Reverse mortgages release the equity built up in individual's homes by paying them an income while they are alive, with the FSP being reimbursed from the proceeds of the sale of the home on the death of the individual (or his/her spouse, if later).

While these ideas may not be ground-breaking, adopting any one – or all – of them may keep your investment plan on track to avoid checkmate and give you the best chance to comfortably afford retirement. ❐

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# Why capital preservation is your best bet in uncertain economies

It's been a torrid time for the South African economy. Political instability, coupled with credit downgrades and rising levels of unemployment have paved the way for increased uncertainty. In uncertain times the typical inclination of most investors is to sell shares and move into cash, thereby minimising any further risk to their investment portfolios.

However, a better strategy is that of capital preservation. Liquidating a portfolio is often a knee-jerk reaction. It's also an action that comes with its own risks. This includes the monetary loss associated with liquidating a portfolio and the opportunity cost of placing money in low yielding bank accounts and money market funds. Despite the market's lacklustre performance in the first half of 2017, it recovered in the second half of the year with the JSE All Share Index posting a positive return for the year. Had investors liquidated their stock portfolios mid-year, they would have missed out on the market's growth in the last few months of the year.

Pulling out of the markets entirely is betting against financial history, as markets do recover. Rather than liquidating portfolios in uncertain or volatile times, capital preservation is a better strategy. The goal of capital preservation is to preserve capital and prevent loss in the portfolio by investing in a fully diversified portfolio, which protects against market volatility.

Sitting tight and riding out short-term market shocks – and leaving the portfolio as is – is not as risky as it sounds, as long as the portfolio is correctly constructed and sufficiently diversified in the first place, and regular rebalancing is done to ensure the intended balance of assets remains in place. With the right mix of assets, and taking into consideration the overall long-term rising market trend, it's often the best way to ensure capital preservation. Being able to sit still, and ride out a period of volatility without feeling the necessity to sell while re-investing dividends back into the market, is a key element of long-term wealth creation.

Volatility targeting, which prioritises the estimated risk an investor assumes, rather than an estimated return, is a relatively new financial innovation that helps to reduce risk by matching a client's risk tolerance with a particular mix of equities and bonds. Volatility target strategies outperform equity on a risk-adjusted basis according to a recent study on the subject by Stanlib investment manager, Bhekinosi Khuzwayo and Eben Maré of the Department of Maths and Applied Maths at the University of Pretoria.

Despite some positive economic indicators including a recovery from the second quarter's technical recession, a recovery in agricultural output and expanded manufacturing outputs, Standard & Poor's announcement that it had reduced South Africa's local currency debt to one notch below investment grade caused the rand to lose further value. Ratings agency Moody's has threatened a further downgrade in the new year indicating that South Africa's economy remains in a precarious position with further market volatility a given.

Caution is still the word of the day. Political instability is the biggest driver of low business confidence, slow GDP growth and dwindling future investment should the country be further downgraded.

Extreme knee-jerk reactions to market conditions can, and should, be avoided. It's a good idea to consult with a financial advisor for personalised financial advice that is tailored to your specific needs and then to configure your investments in the best way possible to maximise your personal wealth. ❐

**Gavin Smith**
Head of Africa
deVere Acuma

# Deep in debt? Here are your options!

Short-term debt is stressing out many South Africans and the recessionary environment is making it increasingly difficult for people to meet debt repayments or pay off debt.

This is clear from the latest Sanlam Benchmark research, where more than 70% of the 1317 South Africans surveyed confirmed high levels of financial stress, with 54% attributing their stress to short-term debt and 27% acknowledging that they find it difficult to meet debt repayments or pay off debt.

Piet van der Walt, Head of Sanlam Personal Loans says, "If you consider that every single item bought on credit ends up costing you far more than the original price-tag, it (credit) is something that is best kept to an absolute minimum, particularly during a recession."

To avoid sinking deeper into the debt spiral you should take firm action to get your debt under control. "You should work with a financial planner to manage your debt as part of a holistic financial plan to ensure you do not get into trouble. He or she will holistically assess your monetary situation and advise on the best road to financial recovery."

If the levels of debt are very high, the financial planner may advise that you consider one of two strategies to help manage repayments and secure the best possible interest rates on debt. "Debt consolidation is the first option. Here an individual's debts are consolidated under one larger debt – usually a personal loan or add-on to a home loan – that has a lower interest rate than multiple debts. The second option is debt review, where a debt counsellor or payment distribution agent negotiates with creditors on the consumer's behalf to reduce interest rates and set an achievable payment plan."

Which of the two approaches is best will depend on an individual's set of circumstances. Here Van der Walt considers the pros and cons of debt consolidation and debt counselling.

## Debt consolidation

Debt consolidation means using one loan (ideally one that offers lower interest and longer terms such as a home

Piet van der Walt, Head of Sanlam Personal Loans

loan or personal loan) to pay off multiple smaller loans (typically high interest, short-term debts), such as those accrued from store cards, vehicle repayments and credit cards. This loan can either be taken out with the express purpose of doing this or an existing loan can be extended to absorb the other debts.

### Pros:

- Having only one monthly repayment has many advantages. It means an effective monthly budget can be set and there is less likelihood of missing a payment, so a positive credit profile can remain intact.
- The total monthly repayment should be lower. Short-term, unsecured debts generally have high interest rates, whereas once all debts are consolidated, the respective debts will have been paid off. The larger loan is paid off over a longer term which generally means a lower interest rate.
- The service charges, debit order charges and fees mounting up from numerous debts are avoided.
- You won't be flagged as over indebted. Credit remains accessible. This could be a pro or a con depending on how responsibly it is used.

### Cons:

- Financial discipline is required to make this option work. When taking out a new loan to consolidate debt, often the loan is paid directly into the recipient's bank account rather than to the creditors' accounts. This increases the temptation to spend. If the loan amount is not used to settle debts, you may face a new debt repayment and will still have to pay off the smaller existing debts.
- If you are not deeply committed to becoming debt-free you may be tempted to access new avenues of credit once you feel your debt is under control.
- If credit repayments have already been defaulted on, you are unlikely to receive a consolidation loan. In this case, debt review may be the only option.

## Debt review (also known as debt counselling)

If you get into a position where you can't pay off your creditors then you can apply for debt counselling with a respected debt counselling company. Your financials will be rigorously assessed and, if you meet criteria, you'll be accepted into the programme and a debt counsellor will negotiate with creditors, get them to agree to a final repayment plan with fixed terms and obtain a legal consent order form. The repayment plan is submitted to a payment distribution agent who takes a monthly lump sum from you and distributes it among creditors according to the fixed terms agreed.

### Pros:

- The debt counsellor can negotiate lower rates and longer terms with creditors on your behalf.
- Your assets cannot be touched and legal action cannot be taken against you while you are receiving debt counselling.
- Once the creditors have signed the repayment agreement they can't individually change any of its terms.
- Someone works with you to manage your debt, giving you a clear plan to follow and executing it on your behalf.
- You can no longer access credit – this can be a pro or a con depending on your situation. Once all debt is paid, you will be cleared to access credit again.

### Cons:

- There are fees involved, namely: an application fee, rejection fee (should your application be unsuccessful), restructuring fee, small monthly fee and legal fee for the consent order. There's also a withdrawal fee if the person prematurely withdraws from the process.
- You will be listed as undergoing debt counselling on credit bureaus. During this listing, it is illegal for any organisation to loan you money. This measure is in place for the good of the individual and once all debts are paid they'll be issued with a clearance certificate and all records will be removed.
- The process can be long – short-term debts can take five years or longer to clear – and the monthly fee to the debt counsellor can rack up.
- A regular salary is compulsory before this process will be entered into.

Van der Walt believes that if you can afford to consolidate, it should be the preferred option as it keeps your name clear and allows you to retain access to credit. However, if this option is not workable due to the extent of the debts, then debt review assists with creditor negotiations and achieving better interest rates.

"Before making a decision, it's best to consult a financial planner who can help guide the person towards an optimal path of long-term financial wellbeing," he concludes. ❐

# New release

## Essentials of Retirement Fund Management 2018

A concise guide for trustees of retirement funds. It includes the Pension Funds Act and regulations.


Essentials of Retirement Fund Management explains in clear and practical terms the various aspects of retirement fund management.

An essential guide for trustees of retirement funds, this work was originally developed from retirement fund training course material. It covers everything from the documents and legal principles governing retirement funds to the duties and responsibilities of retirement fund trustees. It also deals with the rules that control the inflow and outflow of money in a retirement fund as well as investment performance surveys and investment principles without going into any great depth on investments.

It offers easy reference material and the style of writing and presentation appeals to all levels of trustees. It includes the full text of the Pension Funds Act and regulations.

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# Legal Update

**Mpho Kgomongoe**
Legal Advisor
Alexander Forbes Legal Services

## Financial Services Board gives direction to funds on how to implement Treating Customers Fairly

The Financial Services Board ("FSB") has issued a publication putting the TCF framework into the context of retirement funds to give guidance to trustees on implementing the principles of TCF. The guidance document sets out how each of the six TCF outcomes must be applied from a fund perspective.

The FSB reiterates that Trustees remain ultimately accountable for the implementation and adherence to TCF within their retirement funds. When reviewing policies, processes and procedures, Trustees must make sure that TCF is appropriately addressed, implemented and continuously monitored. TCF is ultimately about a commitment to a culture of fair treatment – something which can only be achieved by the board itself. Although operational actions to achieve this can be outsourced to another party, it should be noted that, even where some actions are outsourced, the board remains ultimately accountable for the implementation and adherence to TCF.

To support Trustees in embedding the principles of TCF, the FSB has developed an online self-assessment tool for funds and administrators to gauge their TCF readiness

Importantly to note, the FSB expects retirement funds to be implementing the TCF principles already.

## Financial Services Board gives direction to funds on how to implement Treating Customers Fairly in respect of complaints management

The FSB issued a Draft Board Notice dealing with Complaints Management Framework for Retirement Funds ('the draft Notice') and comments have been submitted in respect of the draft Notice.

TCF Outcome 6 states that:

*"Customers do not face unreasonable post-sale barriers imposed by firms to change product, switch providers, submit a claim or make a complaint".*

Effective management of complaints by funds is a vital component of TCF. It helps Trustees see if they are meeting their responsibilities as set out in the Pension Funds Act ("PFA") and if the benefits provided by the fund and the quality of the services provided by its service providers are appropriate.

The draft Notice contains definitions, including complainant, complaint, goodwill payment and compensation payment. Importantly, this Notice does not replace the formal external complaints process of the Pension Funds Adjudicator.

In terms of the draft Notice:

- Every fund must establish, maintain and implement an adequate and effective complaints management framework.
- Complaints must be categorised and reported on in the format contained in the draft Notice.
- The draft Notice has a template report, which needs to be submitted to the FSB quarterly, within 60 days of the quarter end.
- Funds must submit their first complaints report to the FSB for the quarter January to March 2018.

Comments on the draft Notice were submitted at the end of November 2017.

## Prohibition of Inducement and Acceptance of Gratification (Section 7C – Object of Board)

The Registrar of Pension Funds ("the Registrar") issued a draft Directive on the Prohibition of Inducement and Acceptance of Gratification. The purpose of this Directive is to determine conditions to be imposed by the Registrar in order to combat and prevent bribery and corrupt conduct by principal officers, deputy principal officers, board members, valuators, auditors, administrators, or other officers or other service providers to funds.

A board member, principal officer, deputy principal officer, auditor, valuator, administrator or service provider

to a fund must not be involved in any conduct which constitutes bribery, fraud or corruption. It goes further to state that any such involvement will have a bearing on such person's fitness and propriety to hold office.

The Registrar defines what constitutes "gratification" and insists that the defined types of gratification may not be accepted at all by fund officials and service providers, unless the Registrar agrees in advance they can be accepted.

The Directive sets further out a duty to report to the authorities. A board member, principal officer, deputy principal officer, auditor, valuator or administrator of a fund already has a duty under the Pension Funds Act, on becoming aware of any matter relating to the affairs of the fund which in their opinion may prejudice the fund or its members, to inform the Registrar in writing of that issue. Any report to the Registrar can be a protected disclosure, which gives protection to the person submitting the report.

Supporting this duty, the Prevention and Combating of Corrupt Activities Act requires fund officials and service providers to report corrupt transactions to the South African Police Service.

Comments on the draft Directive were submitted by 11 December 2017.

## How does Broad-Based Black Economic Empowerment apply to retirement funds?

From 1 December 2017, an amended Financial Services Sector Code ('Code') was issued by the Minister of Trade and Industry in terms of the Broad-Based Black Economic Empowerment Act ('B-BBEE').

The Financial Sector Code was initially released in 2012. The aims of the Code are to actively promote a transformed, vibrant and globally competitive financial sector that reflects the demographics of South Africa, provides accessible financial services to black people and directs investment into targeted sectors of the economy.

The Code applies to retirement fund service providers, such as administrators, insurers, asset managers and brokers. It does not apply to retirement funds, except the top 100 funds, including umbrella funds, in South Africa.

The Code consists of various Statements. Each Statement has its own objectives and principles. Entities need to measure themselves against these Statements when completing their scorecards.

The Code suggests that those large funds annually complete a scorecard focusing on preferential procurement and management control.

## Information Circular 1 of 2018 – how to submit disclosure reports to the Financial Services Board

The Registrar has become aware of instances where people are uncertain how they should report or disclose information that they consider necessary to bring to the attention of the Registrar. Information Circular 1 of 2018 explains how people should submit reports or disclose this information.

Fund officials need to submit a report to the Registrar explaining why they believe they have been terminated from office or if there is an issue which may prejudice the fund or its members.
Administrators need to submit a report to the Registrar if they are aware of an issue which may prejudice a fund or its members.

The person submitting a report can identify themselves or do so anonymously. If it is an anonymous report, the disclosure must clearly indicate it is a protected disclosure.

## Notice No 1 of 2018 – Penalties imposed in terms of Section 37(2) of the Pension Funds Act

The Financial Services Board issued Notice 1 of 2018 stating that the administrative penalty for the failure to submit information requested in terms of the Pension Funds Act ('the Act") will increase from R1 000 to R4 000 for each day that the non-compliance continues on 1 March 2018.

The current maximum penalty is R1 000 for every day the non-compliance continues. This maximum administrative penalty amount has remained the same since 2008, and non-compliance continues from some funds in the industry.

The Registrar considered it necessary to increase the maximum penalty amount, as it seems that the R1 000 maximum penalty was not a deterrent for entities to encourage compliance with the requirements of the Act.

Administrative penalties can be imposed for the failure of a fund, administrator or third party to submit information required under the Pension Funds Act.

Before imposing a penalty the Registrar must in writing:

- Inform the administrator, pension fund or third party of his or her intention to impose a penalty;
- Specify the particulars of the alleged non-compliance;
- Provide reasons for the penalty intended to be imposed;
- Specify the amount of the penalty intended to be imposed;
- Invite interested persons to make representations within a period specified by the Registrar. For example, a closing fund may request the penalty be reduced or waived based on its own specific circumstances.

If the Registrar, after consideration of representations made, decides to impose an administrative penalty, he or she must by written notice inform the administrator, pension fund or third party that it may, within 30 days after the date of the notice, pay the penalty or lodge an appeal to the FSB Appeal Board.

If an administrator, pension fund or third party fails to pay an administrative penalty the Registrar can institute civil action to recover the penalty amount.

The R4 000 per day is the maximum that could be levied. The Registrar has the discretion to determine the amount to be charged depending on the circumstances of the non-compliance. ❐

# Twin Peaks: greater protection for consumers

Service providers will be obligated to make sure that their clients know and understand the products that are being offered to them, putting a greater emphasis on the importance of financial literacy.

**Gavin Smith**
Head of Africa
deVere Acuma

This, following the signing into law of the Financial Sector Regulation (FSR) Bill in August last year, aimed at ensuring the financial services sector is more resilient, that consumers are protected and treated fairly by service providers, and that large firms are not a risk to the financial system. The finance minister is yet to announce when the Bill will come into effect.

South Africa's financial services sector is bracing itself for a regulatory shake-up with the implementation of the Twin Peaks legislation, ushered in by the Bill.

The Twin Peaks model will be comprised of a double-silo regulatory system. One silo will comprise the current Financial Services Board under a new name – the Financial Sector Conduct Authority (FSCA). The FSCA will oversee issues around consumer protection and will manage business conduct in the sector. Under this umbrella, the FSCA will supervise services related to financial products, local and offshore, provided by institutions and those in the securities business. By extension, infrastructure and payment systems will also fall under the FSCA's list of duties.

The move to better align products and services brings the Treating Customers Fairly (TCF) measures in the non-bank financial services sector. Here, Retail Distribution Review (RDR) will come into focus, and this is where consumers need to pay close attention.

RDR is aimed at promoting transparency and it will affect the way clients pay for advice.

Previously, the cost of financial advice was incorporated into a monthly fee structure. Under RDR, clients will pay for services upfront – and will be billed only for services they requested.

## Current financial advice not sustainable

Caroline Da Silva, deputy executive officer at the FSB, said in a recent statement that RDR was necessary as financial advice in its current form is not sustainable. "We want RDR to shape the environment to ensure that fair and affordable advice is available. In order for that to happen, the advice given to clients must be sustainable."

The FSCA will also be in charge of licensing for service providers who deal with giving financial advice, are in charge of retirement and pension funds, credit rating agencies and collective investment schemes.

The second silo, which will be overseen by the South African Reserve Bank (SARB), will be the Prudential Authority (PA). The PA's ambit relates to oversight and maintenance of financial stability in the financial system.

Its main priority will be maintaining the safety and soundness of systems of financial institutions that deal with the provision of financial products, various market infrastructures and the security of payment systems. A close eye will be kept on the larger institutions that are considered to be a systemic risk to the financial system.

Licensing for deposit taking institutions and insurance providers – both short and long term – also falls under the scope of the PA's oversight. The PA will set and enforce prudential standards.

## Consumers put first

When the new two-pronged regulatory approach is introduced, it is hoped that the regulatory authorities could have 'more teeth' than ever before – to actively ensure that clients of financial services companies are always put first.

It is crucial that service providers are positioned to support this move as its objective is to create confidence, increases accessibility to advice and raises standards. Everyone – the clients, the advisers and the industry itself – reaps the enormous, tangible benefits of successful financial planning. ❐

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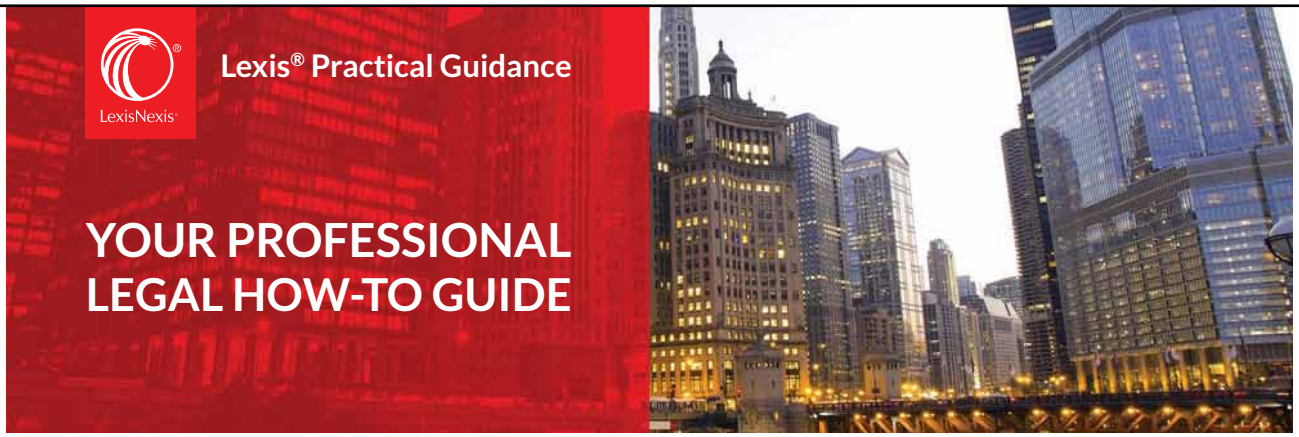


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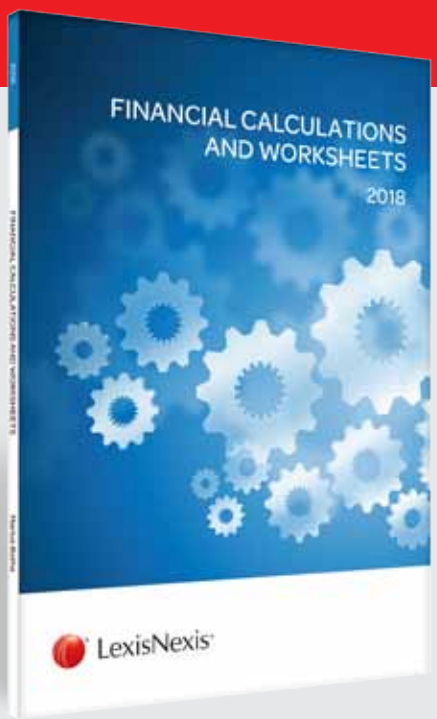


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