THE art OF SENSIBLE INVESTING

FIRSTGLOBAL GROUP

GLOBAL BRIEF

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Editorial comment

John Swart
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The third quarter brought relief for South Africans in a number of ways. First it was the good news that SA came out of a techninal recession by surprising with a 2.5% growth in GDP (year on year to end June 2017). This was followed by good rains which brought the end to devastating droughts in many parts of the country while the Rand remained strong – at least until the middle of the third quarter - and markets performed exceptionally well to end the quarter 8.9% higher (inclusive of dividends).

Deeply concerning issues remain the growth prospects for the remainder of the year, a projected shortfall of 25% in tax revenue for the 2017/18 tax year, continuing political uncertainty, financial crises in state-owned enterprises reaching untenable levels and signals that government is taking aim at PIC funds.

Unsurprisingly, the Rand finally lost ground against all major currencies which again emphasized the importance of offshore investing. Emerging markets are enjoying a particularly strong growth year (also helping along SA market sentiments) and the global recovery, by and large, is still well on track.

We, along with all concerned citizens, will watch in anticipation what happens at the ANC national conference which will be held between 16 and 20 December, the outcome of which will have a significant impact on the future of our beloved country.

As from this edition of GLOBAL BRIEF, we will again incorporate the FIRSTGLOBAL ASSET MANAGEMENT QUARTERLY REPORT into the newsletter and we trust that you will enjoy reading this as much as you will enjoy and get value out of the three articles selected for sharing with our valued clients.

Regards

John Swart

Emerging markets are enjoying a particularly strong growth year (also helping along SA market sentiments) and the global recovery, by and large, is still well on track.

Resolving the underfunding problem for retirees

Lesley-Ann Morgan
Global Head | Defined Contributions and Retirement at Schroders UK

It's a common mantra in South Africa: preservation, preservation, preservation. The universal problem is that individuals do not preserve their retirement savings during the course of their working lives, particularly when they change jobs, and is widely accepted to be the major contributor to underfunding at retirement, said Lesley-Ann Morgan, global head of defined contributions and retirement at Schroders UK, presenting at the Sanlam Investments Institutional Insights conference in Johannesburg in September.

Being underfunded implies simply that you have insufficient capital at retirement to support your future withdrawals for the rest of your years. So, how do we get to a workable post-retirement solution for South Africa, asks Morgan?

Morgan laid out a variety of workable annuity structures for trustees, principal officers and investment committee members. Governments the world over, including South Africa's, have stressed the need for a "default solution". Default funds are simply investments that employees' retirement savings are placed into should they choose not to make a decision themselves about where they wish to invest.

But remember that certain risks have to be taken into account, says Morgan. Life expectancy has risen. Lower investment returns are a fact of life at present. Higher inflation in South Africa means expenses in terms of consumption expenditure during retirement have gone up. Add to this the need for certainty about stable investment outcomes and flexibility with choices, and it is obvious that investment professionals, fiduciaries and asset consultants all have a major challenge on their hands.

How do we take the most "efficient risk"?

Weigh up the needs and the wants:

Morgan said that the needs people have in post-retirement are very different to their wants and tend to pull in opposite directions. For this reason it can be very challenging to find the appropriate investment solution.

At retirement, said Morgan, people have three fundamental "wants":

- A nominal predictable income,
- An easy to understand structure that provides adequacy, and
- inheritance benefits in terms of their fund's legacy that they can pass on to their beneficiaries.

But this has to be balanced with their "important four needs": longevity protection, inflation, simplicity and flexibility of choice.

To effectively address these opposing needs and wants, there is certainly no 'one-size fits all' solution. Actuaries need to be aware that life expectancy often differs with income level and a buffer is needed to create a solution is needed to work out a solution that won't leave anyone out.

Different countries provide different solutions, shared Morgan. In Hong Kong you are given cash, to do with what you will. In the EU, people tend to expect a guarantee. In the UK and US, you are given a choice, but with no advice attached. Australia is considering a post-retirement default package, specifically designed to protect against longevity. And then you have combinations of the above, as it applies to the likes of South Africa and Chile.

No killer answer, but a hybrid solution could be it

The three traditional ways to provide for retirement include a cash lump sum, a guaranteed annuity, and a living annuity, while other obvious options include:

- You can take as little capital risk as possible, put it all into bonds, and eke out a living (risk: it won't last me my retirement but at least it will be safe)
- OR maximise your risk and put as much as possible into growth assets such as equities (75%) and put the rest into something else and hope for the best (risk: you could suffer potential irrecoverable capital losses if the markets fall in the early stages of retirement).
- OR you can take a punt on multi-asset active management and hope to close the funding gap (risk: attempting to time asset class switches can similarly erode your nest egg).
- Or do you take the certainty of an income from a guaranteed annuity (risk: it gives you a level of income below the level of consumption required by most people).

All of the above options grapple with the basic challenges of providing investment growth and downside protection, while at the same time guarding against spikes in inflation that can erode retirement income.

"Some sort of hybrid between cash, living annuity, and guaranteed annuity would have to be devised if governments ever want to introduce a workable default retirement solution…", said Morgan.

The hybrid model

At Schroders, Morgan used 'model scenarios' to determine what a nominal savings amount would provide in terms of targeted income, and how this would affect the drawdown on the lump-sum savings. For instance, a diversified portfolio made up of 40% South African equities, 10% global equities and 50% local bonds came close to meeting targeted requirements.

"However, it was still not quite right," she said. "So we constructed a hybrid model that contained 30% in a guaranteed annuity and 70% in a diversified basket of assets in a living annuity". Although the target income was met, the model could not withstand market shocks and hence carried heavy longevity risks. Additionally, although inflation-linked guaranteed annuities looked attractive, they were very expensive and people underestimated both their longevity and the effects of inflation on their post-retirement lifestyles.

"There is still no single solution," said Morgan, who stressed that underfunding remained the biggest problem worldwide. Even in Australia, which she calls "the poster child" for the industry, people are not fully funded despite reasonably high, mandatory contributions during their working lives.

Resolving the underfunding problem for retirees

Lesley-Ann Morgan
Global Head | defined contributions and retirement at Schroders UK

Different defaults for different groups

In South Africa, the most workable solution would probably be to have different default portfolios for different groups according to their post-retirement needs and wants, she said. Those with extended families, for example, may require an annuity structure based on a benchmark that is different from someone whose target is funding their projected longevity.

Morgan concluded by reiterating that tweaking a diversified portfolio was relatively simple, which involved certain ‘add-ons’ depending on the retiree’s basic wants and needs for guaranteed income and protection against risk. Less easy to solve was the underfunding problem.

What we’ve come to realise, says Morgan, is that investment alone is never going to save the day. At best it can help make up some of the shortfall. People have to recognise that saving is important. The most successful financial education has been shown to happen at the point of decision (ie, close to retirement) rather than early on when you sign up to a job, and it is important to note that many young people currently don’t grasp the basic fundamentals. This education should also include an essential element that creates an awareness of the role debt plays.

Obviously, contributions also have to be a big part of the picture. But there are problems with compulsory savings due to the low socio-economic status of some. So the ideal would be to introduce ‘compulsory with opt-out’, like in the UK. Interestingly, this has been a popular option and opt-outs have been surprisingly low. This could be especially favourable for those at the lower end of the income scale who may not be able to afford to contribute at all stages of their life. You have to start, but at least you can choose to opt out.

“Clearly we all have to work longer and defer retirement, but the reality is that while we can keep on extending the retirement age, we just never catch up because we’re too far behind.”

In an ideal world, says Morgan, the answer would be to maximise returns prior to retirement age, ie getting people to take as much risk as possible when they are younger, and this could mean allocating to non-traditional asset classes and perhaps even using leverage in the early pre-retirement years.

However, the ultimate and most workable solution for South Africa, says Morgan would most likely be different defaults for different people, taking into account all the different needs, wants, income and socio-economic status.

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Strategies for drawing income - the fine art of retirement planning

Carl Roothman | Head: Retail, Sanlam Investments
BCom (Law); LLB; LLM (International Banking and Financial Law)

'When you enter retirement, there are three important unknowns,' says Michael Finke, dean and chief academic officer for The American College. 'You have no idea what investment returns are going to be in retirement. You also don't know how long you're going to live. And you don't know how much you're going to have to spend.' It's exactly because post-retirement decumulation strategies are so complex that Finke started the Retirement Income Certified Professional designation for The American College.

Locally, with the rise of the ILLA the burden has shifted to the investor to sustain his or her annuity income in retirement, and most investors would rely on an adviser to do the calculations for them. According to the Association for Savings & investment South Africa (Asisa) in 2017 about 88% of South African pensioners opted for an ILLA rather than other retirement options – thereby increasing the market and longevity risks to which they're exposed. These clients would need sophisticated financial planning and portfolio construction to make their capital last.

In this article we're not attempting to tackle all the changing aspects of retirement planning. We'll be focusing on only one previously held belief, which our findings show might not hold true: the belief that one needs to move to a money market fund that portion of the client's funds that he would need in the next year.

With an ILLA, the financial planner needs to make provision for adequate income to sustain his/her client's standard of living in the short and longer term (mitigating against inflation risk) and ensure that the remaining capital continues to grow at an inflation-beating pace so the income is sustainable throughout the client's lifespan (mitigating against longevity risk). All the above risk factors mean that a good post retirement financial plan should have sound portfolio management to ensure capital is protected and grown for future consumption. Is there a place for a zero-growth money market fund in such a portfolio?

Four strategies for drawing from a retirement portfolio

To begin with, we assume that the adviser has identified the client's risk profile and has identified an investment allocation in line with that risk profile. Further we assume that the client requires a rand-based income that grows at inflation. The question now is from which fund(s) should the client draw income? Secondly, how should one manage the other portion (growth fund) of the investment to ensure sufficient growth for future consumption?

In our study we considered four strategies that are typically used in the retail market:

Take income proportionally from all funds

- Take income from the least volatile fund in the portfolio (target fund)
- Take income from a money market fund; decreasing the risk profile of the portfolio
- Take income from a money market fund; increasing the risk profile of the portfolio

INCOME PROPORTIONALLY FROM ALL FUNDS

Income Strategy

- Equally take income from all funds

Portfolio Management

- Aims to maintain constant investment allocation (depending on rebalancing frequency)
- Reltively good strategy for low volatility portfolios

INCOME FROM TARGET FUND

Income Strategy

- Take income from the least volatile fund in the portfolio

Portfolio Management

- Maintain or increase portfolio's risk profile (depending on rebalancing frequency)
- Should be good strategy for all risk profile portfolios

INCOME FROM MONEY MARKET FUND (DE-RISKING)

Income Strategy

- Take income from the Money Market fund
- Topping up Money Market fund with required Rand income until next rebalance

Portfolio Management

- Decreases the risk profile of the portfolio
- Aims to ensure adequate income (not 'actively' considering portfolio management)
- Potential of performance drag on the total portfolio

INCOME FROM MONEY MARKET FUND (RE-RISKING)

Income Strategy

- Take income from the Money Market fund
- Topping up Money Market fund with required Rand income until next rebalance

Portfolio Management

- Increases the risk profile of the portfolio
- Aims to ensure adequate income and actively manage the portfolio
- Requires thorough research to ensure portfolio is not too risky

Strategies for drawing income - the fine art of retirement planning

Carl Roothman | Head: Retail, Sanlam Investments
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Which strategy best sustains the portfolio?

To compare the above strategies, we assumed that a client retired in July 2007 with R1 million rand and needed to draw down 7%. Which of the four strategies would have left the client with the highest portfolio value at the end of July 2017?

We constructed a cautious, moderate and moderate aggressive portfolio for the three most likely risk profiles of the hypothetical client. The portfolios for the different risk profiles looked as follows:

Table 1: Composition of portfolios with different risk profiles

RISK PROFILE	CAUTIOUS	MODERATE	MODERATE AGGRESSIVE
• Composite funds	Four low equity funds, incl. SIM Inflation Plus Fund	Mix of low and high equity funds, incl. SIM Inflation Plus	Four high equity funds, incl. SIM Balanced Fund
• Target fund	SIM Inflation Plus Fund	SIM Inflation Plus Fund	SIM Balanced Fund

Source: Sanlam Investments | August 2017

In all three risk profile scenarios, by taking income from the target fund while rebalancing the portfolio back to its long-term investment allocation, our research found that the investor was able to receive income without sacrificing long-term capital protection and growth.

Results for the moderate profile

For brevity's sake we only discuss the results of the moderate profile here.

As shown in the table below, drawing income from the target fund (the least volatile of the funds in the portfolio composite, the SIM Inflation Plus Fund) has resulted in both the most income over the past 10 year's for this client (R737 848) and in the highest remaining market value after the 10-year period (R1 263 931). Drawing income proportionally would have resulted in a marginally smaller income pay-out over the period and a smaller remaining market value. An ostensibly benign action such as placing the next year's income needed by the client annually in a money market fund would have penalised the client significantly, resulting in not only a smaller income payout over the 10-year period but also in nearly R29 000 less in terms of remaining market value compared to drawing income from the target fund.

Table 2: Results for moderate risk profile

INCOME STRATEGY: DRAW INCOME	REBALANCING FREQUENCY	PORTFOLIO VALUE AT 31 JULY 2017	INCOME GENERATED FOR 10 YEARS TO 31 JULY 2017
• From target fund (SIM Inflation Plus Fund)	Quarterly	R1 263 931	R737 848
• Proportionally across all funds	Quarterly	R1 263 186	R737 493
• From money market fund	Annualy	R1 235 039	R732 572

Source: Sanlam Investments | August 2017

Conclusion: drawing income from the target fund works in the client's favour

In conclusion, comparing the four strategies, we found that using the least volatile fund (target fund) in the portfolio to fund the client's income gives better results than any of the other strategies. This strategy ensures that the portfolio remains within the clients' stated risk profile and does not decrease the risk, causing a potential drag on growth. It also does not increase the risk, which could have led to a potential capital loss of the magnitude that the client would not be comfortable.

Importantly, our findings also dispel the belief that funds from which a retiree will draw down in the coming year needs to be held in a money market fund. Our research shows this strategy gave the worst results for the client.

The sure way to get rich quick

Patrice Rassou | Head of Equities
Sanlam Investment Management

There are fortune tellers and powerful Sangomas out there who can address all your money problems, sort out delicate relationship issues, and even counter the evil eye. I perhaps missed the decolonised tertiary syllabus at varsity but there is always an element of mysticism which grips the human spirit. It also is this penchant for the supernatural perhaps that often leads us to believe that not everything in the world comes with a rational explanation.

In the financial world, the label of bubbles gets attached to many difficult-to-explain phenomena but few have come close to the current euphoria surrounding crypto currencies. This prompted the highest paid banking CEO in the world, Jamie Dimon (CEO of JP Morgan Chase) to recently portend that he would fire anyone who traded in bitcoin or similar currencies.

In South Africa, we have witnessed a proliferation of Ponzi schemes with the latest MMM scheme being another high profile example of the adage that if it's too good to be true…it probably is. Nearly all Ponzi schemes have the same modus operandi: investors are promised eye-watering returns over short periods of time. Early investors tend to do well and word-of-mouth leads to a growing number of investors being suckered in, but the actual investment strategy underlying the scheme always remains very obscure. In the end, the pyramid collapses when the payouts to investors inevitably exceed the new investment proceeds, preventing the scheme from robbing Peter to pay Paul.

The first question is why so many of us believe in 'get rich quick' schemes. I guess this is the same reason we have a series of adverts, every January, ranging from medicinal remedies to exercise regimes, which claim to be able to get rid of our December over-indulgences effortlessly within weeks. While the majority of people will give up by March, there is always the one spectacular example of success, that unique someone who is prepared to testify to the validity of the formula – "I tried the fat-kill remedy and I lost 20 pounds in 3 weeks!" Similarly in the financial world, there is nothing more convincing than an acquaintance claiming that they invested x and got 2x within a month. Who doesn't want to look good? Who doesn't want to get rich, quickly, effortlessly?

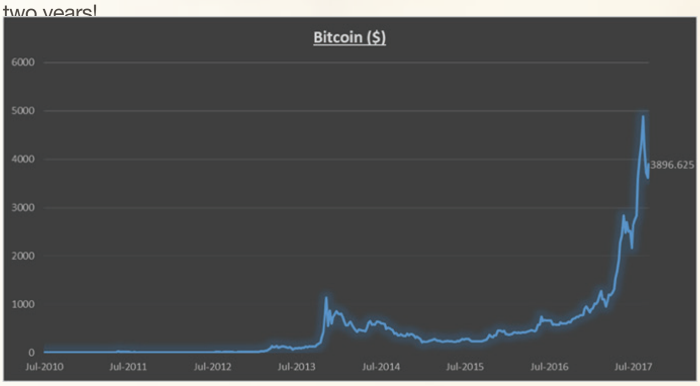
Sign me up!

In the financial world, bubbles are always based on some shred of truth. Yes in a digital world, crypto currencies have a place. A medium of exchange, a currency accepted by major nations which can circumvent onerous financial regulation and be transacted securely – for now – and cheaply across borders, makes for an attractive alternative currency. The recent online fanfare that Pick n Pay was accepting bitcoin in its store proved a damp squib when the company clarified the fact that a pilot project had been on trial at its canteen store at its head office! In a world where Central Banks have printed over $10 trillion since the global financial crisis, there has been a growing distrust of fiat currencies. Well instead of trusting central bankers and governments who issue currency legally – you would have to place your faith in a complex web of computers. The bears have felt gold could be the answer, but then if the financial system is going to collapse, it's pointless storing your gold booty in a bank safe. Enter crypto currencies – gold-like qualities but stored in ledgers safe from the doomsday of a global banking collapse. What's not to like?

One of the key problems to bear in mind is that most crypto currencies are not regulated and are not legal tender per se in South Africa. Hence if you pay for a transaction using a crypto currency and the goods are never delivered, it is next to impossible to get the transaction reversed and even trace who the payment has gone to. In the cybersphere, no one can even hear you scream!

Starting off as 'currencies', the digital currencies have become favourite instruments of speculation. One of the key attributes of some the crypto currencies – for instance, no more bitcoins will be produced after 2025 – has made them susceptible to a short squeeze by speculators, whereas other fiat currencies depreciate over time due to constant printing of money.

Perversely, the fear of rampant inflation caused by quantitative easing initiated by global central banks, pushed many speculators to seek alternative currencies. However, the alternative is far from safe. The current bitcoin bubble is in fact one of the most extreme examples witnessed in current time. Over the past few decades globally, we've seen a number of bubbles: the global property bubble in the mid-90s, the dot com bubble, the silver bubble of 2001, etc. In nearly all of these cases, asset prices increased 1000% or more – the common trait is that took at least a decade to inflate. In the case of Bitcoin, prices went up by over 1000% within a mere two years!



Source: Bloomberg | August 2017

Just like at the peak of the financial crisis, financial engineers came up with derivatives of mortgage backed products – infamously known as CDO Squared. Now we have MMM trying to relaunch their Ponzi scheme in South Africa and elsewhere with bitcoin as its currency of choice! So while block chain technology is here to stay and has an increasingly wide range of applications, it is a case of buyer beware if you start believing that crypto currencies are a sure way to riches, rather than – at best – another transaction mechanism. The recent investment by Rand Merchant Investment in Luno, a Bitcoin exchange, reminds me of the old adage that in the gold rush the people who got rich were the ones selling the shovels to the gold prospectors!

I may not be a Sangoma but I think I can help you with one financial matter – if you don't want to become poor, don't think of crypto currencies as the easy way to accumulate wealth.

My first consultation is, by the way, free.

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