

**Do you know if your assets are
appropriate to your liabilities?**

And just what does that mean exactly?

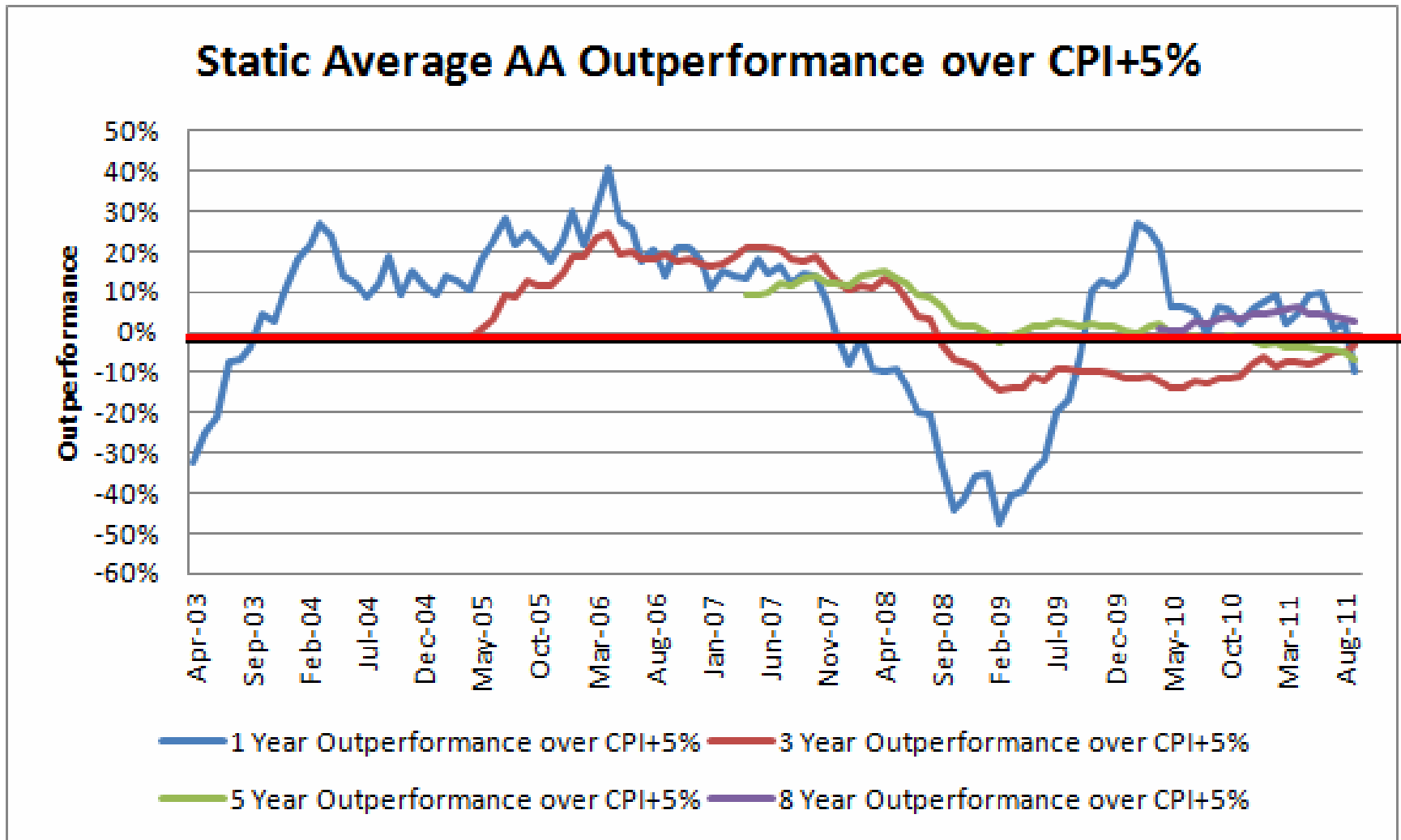


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Which investment strategy would you select as “appropriate to your liabilities”?

1. A balanced “best investment view” strategy?
2. A CPI+5% targeted strategy?
3. None of the above?
4. Either of the above?

Although – without stock selection only 8 year performance would have delivered





**How well do you clearly understand:
where value is destroyed....
and value is potentially created...**

in the delivery of benefits to members of pension funds?

Research in the Australian superannuation fund industry suggests that there is as much as 3% pa in value destruction in retirement funds

- We are not even discussing the issue of fees or costs
- Let's really get to the heart of the active/passive debate

The Skill / Luck Continuum and Asset Management



Source: Michael Mauboussin 2010

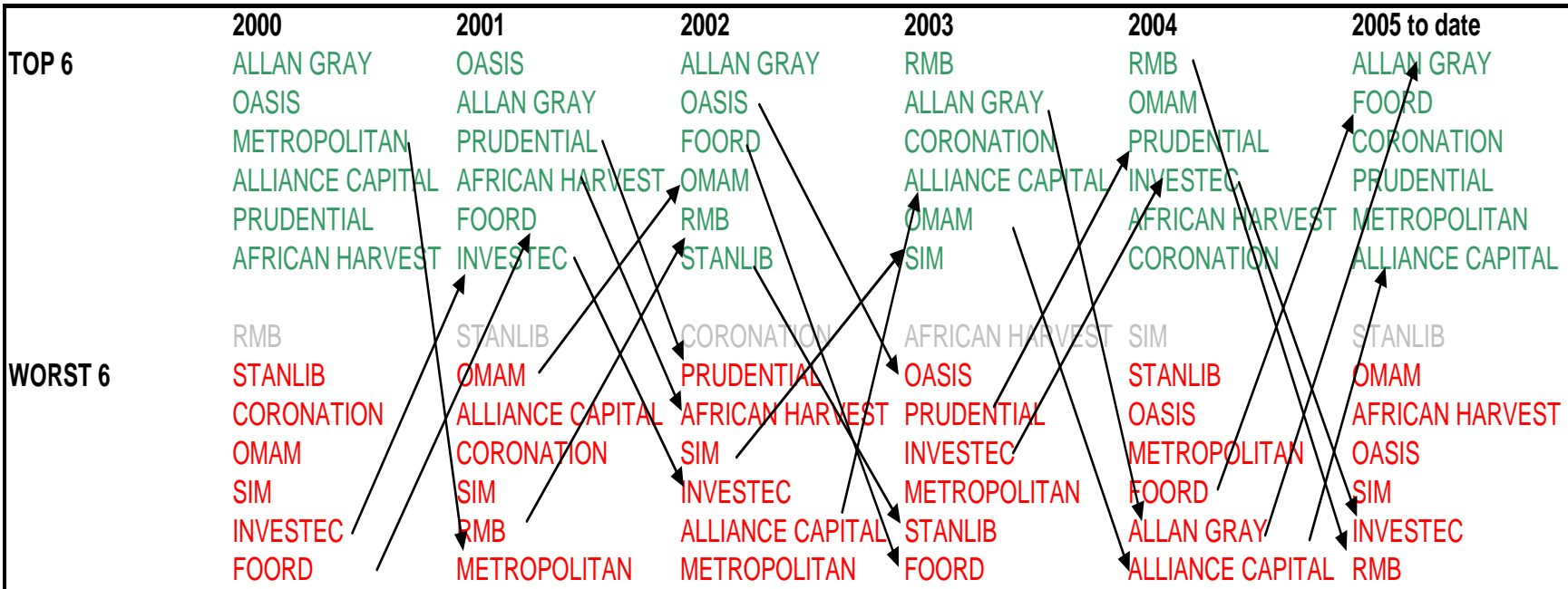
What factors determine whether activity driven more by skill or luck?

- Can you intentionally lose? If so...indicates skill required
- Does practice improve outcomes?
- Is there evidence of transitivity? If “A” beats “B” and “B” beats “C” then “A” should beat “C”
- Do outcomes revert to the mean? If so....luck element high
- Number of conditions that stand between skill and delivery to goal



I'm not sure many South African investors believe this:

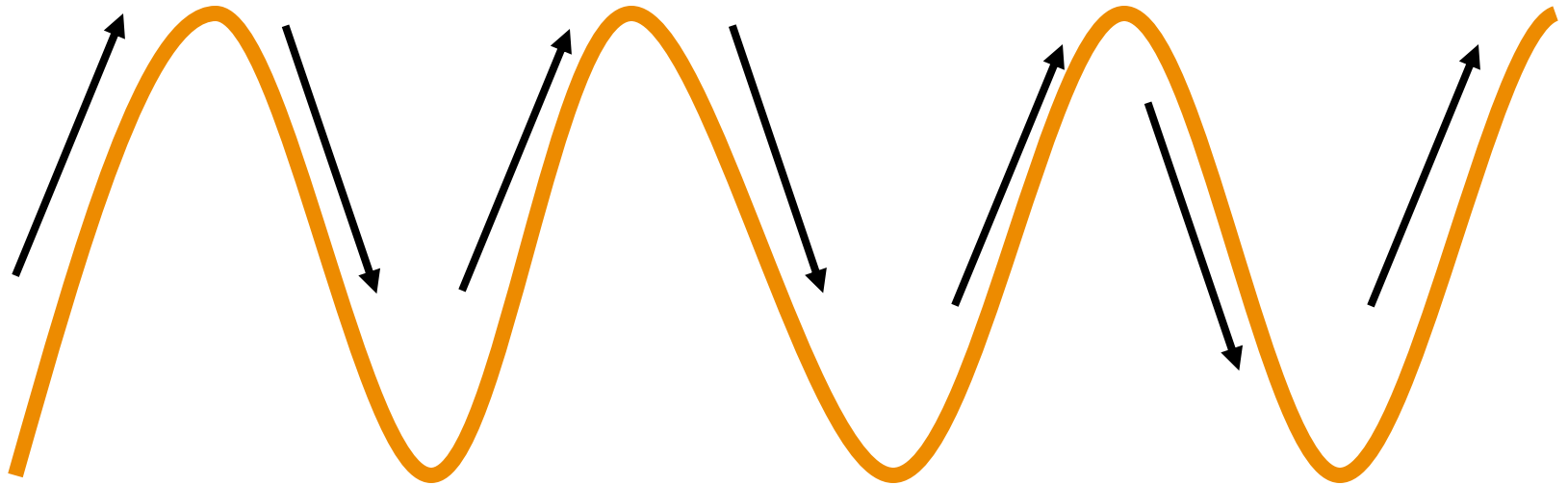
Why is it that no single manager can deliver top performance in all market conditions?



Sources: Alexander Forbes

The Dilemma of Manager Performance

Is skill really the issue?



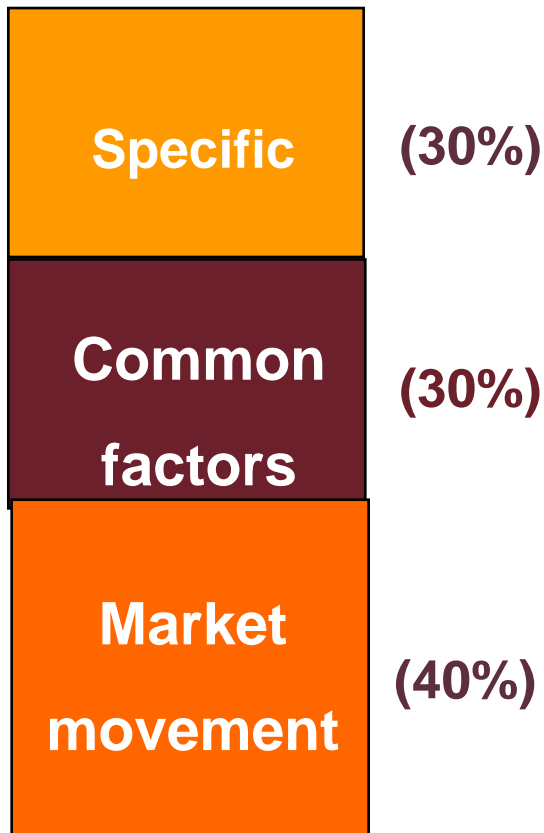
William Sharpe – 1992

**90% of performance
differentials a function of
style**

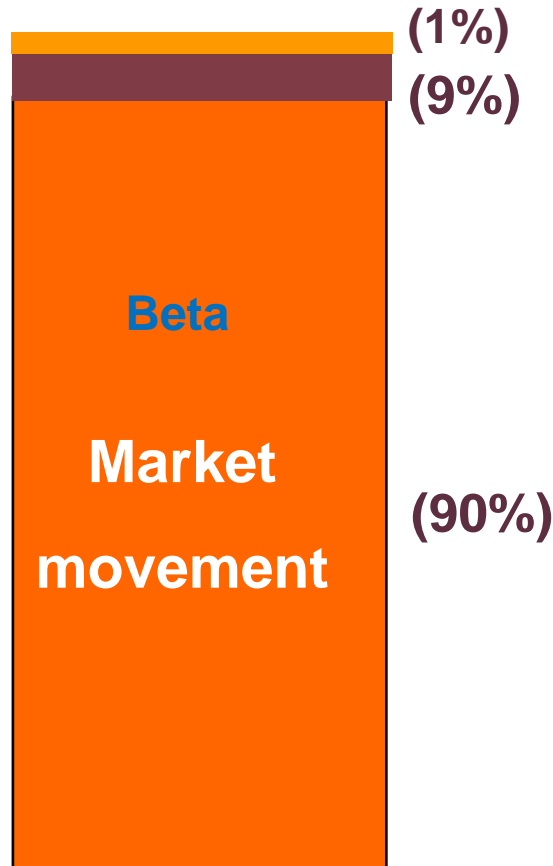
What really drives performance?

Some basic building blocks of Portfolio Theory

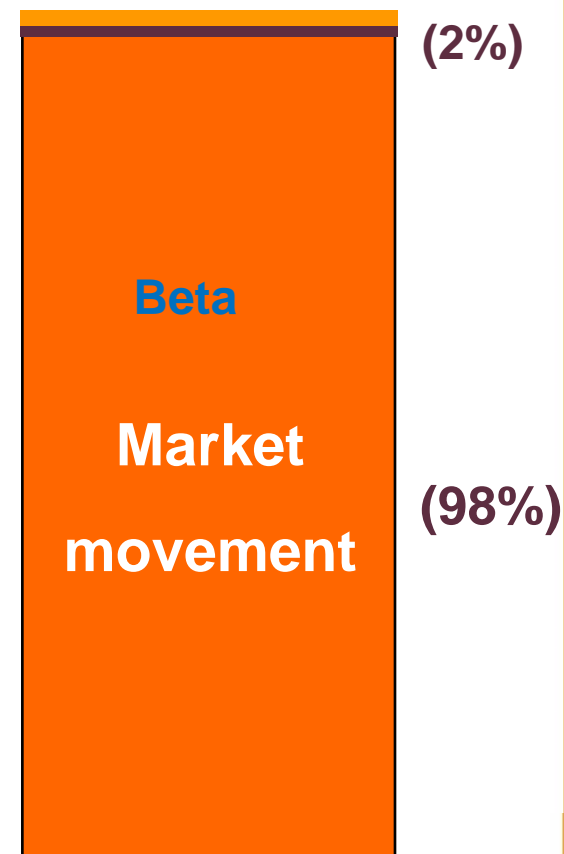
Average share



Average portfolio



Multiple portfolios



Source: Barr Rosenberg

The Skill / Luck Continuum and Asset Management



Source: Michael Mauboussin 2010

What factors determine whether activity driven more by skill or luck?

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It's simply not an issue of getting the highest risk-adjusted returns for members!

Just what do we mean by “liabilities”?

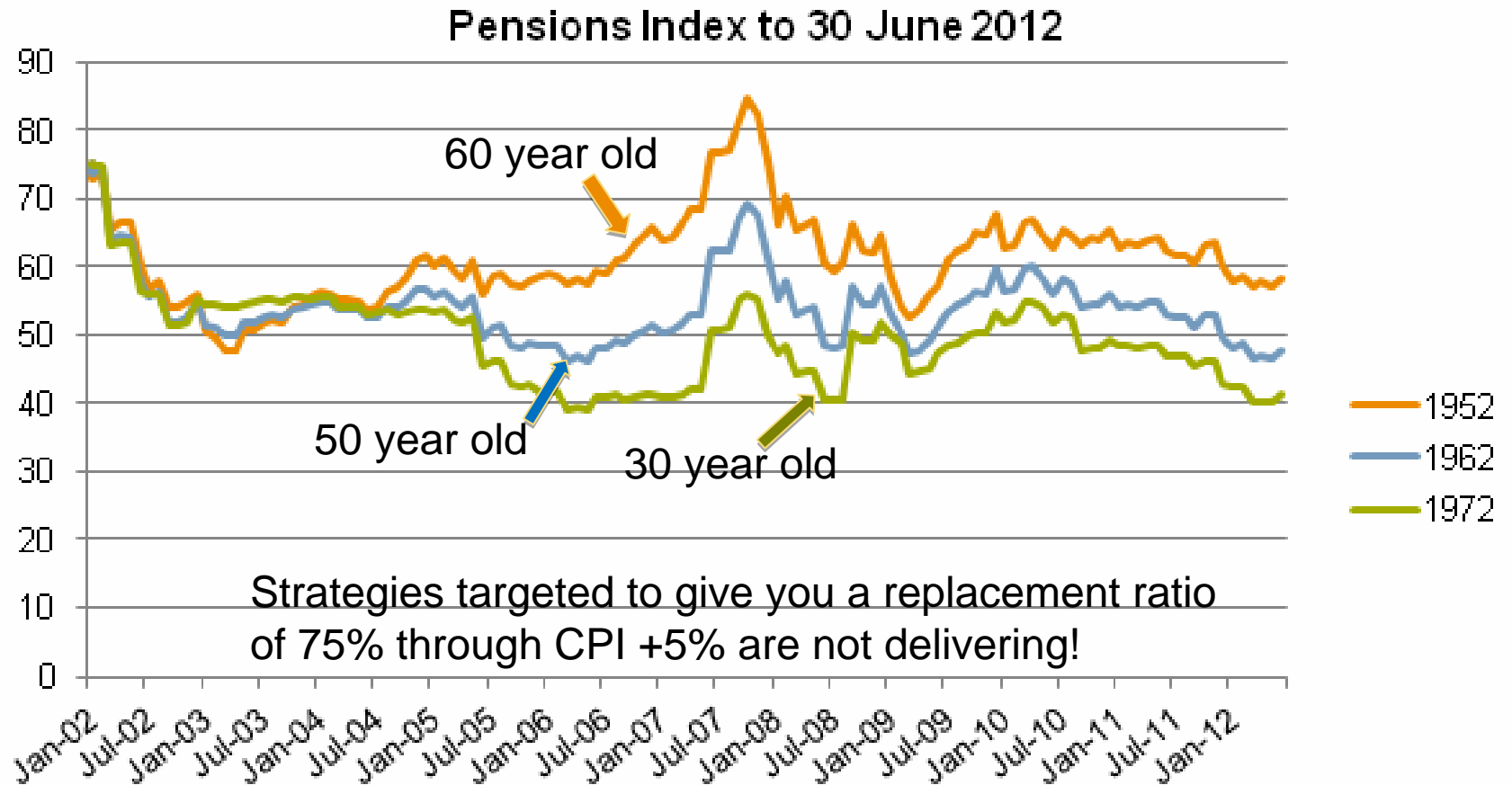
- Liabilities in a defined contribution context actually does have meaning!

What the FSB says:

“reasonable *income* expectation of member for retirement”

- **What members really need to care about is the retirement income they can purchase - not necessarily the real return**

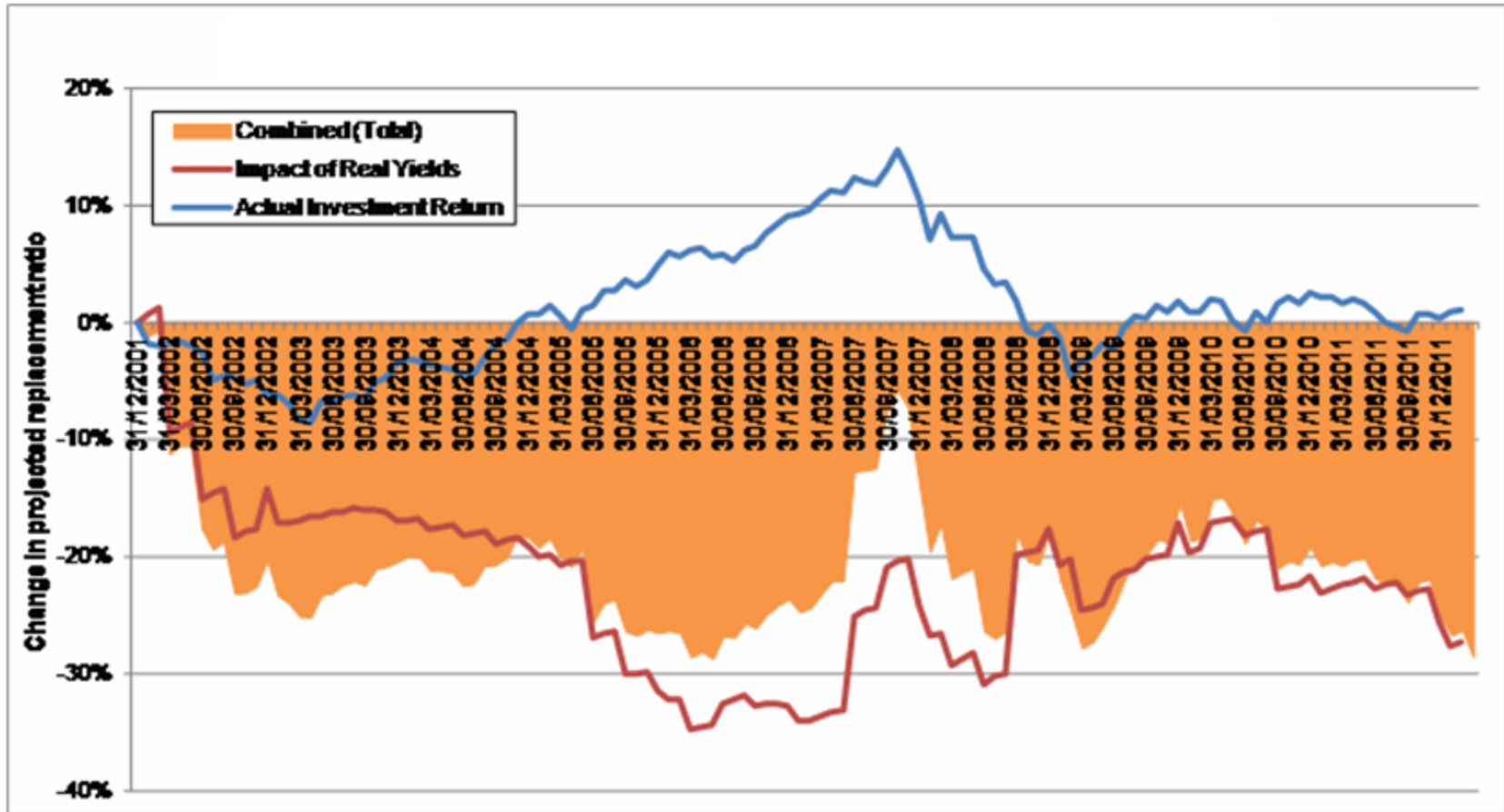
A chart to make you stop and think:



Index Value as at	1952-born	1962-born	1972-born
30 June 2011	62.3	53.0	47.0
30 June 2012	58.4	47.8	41.4

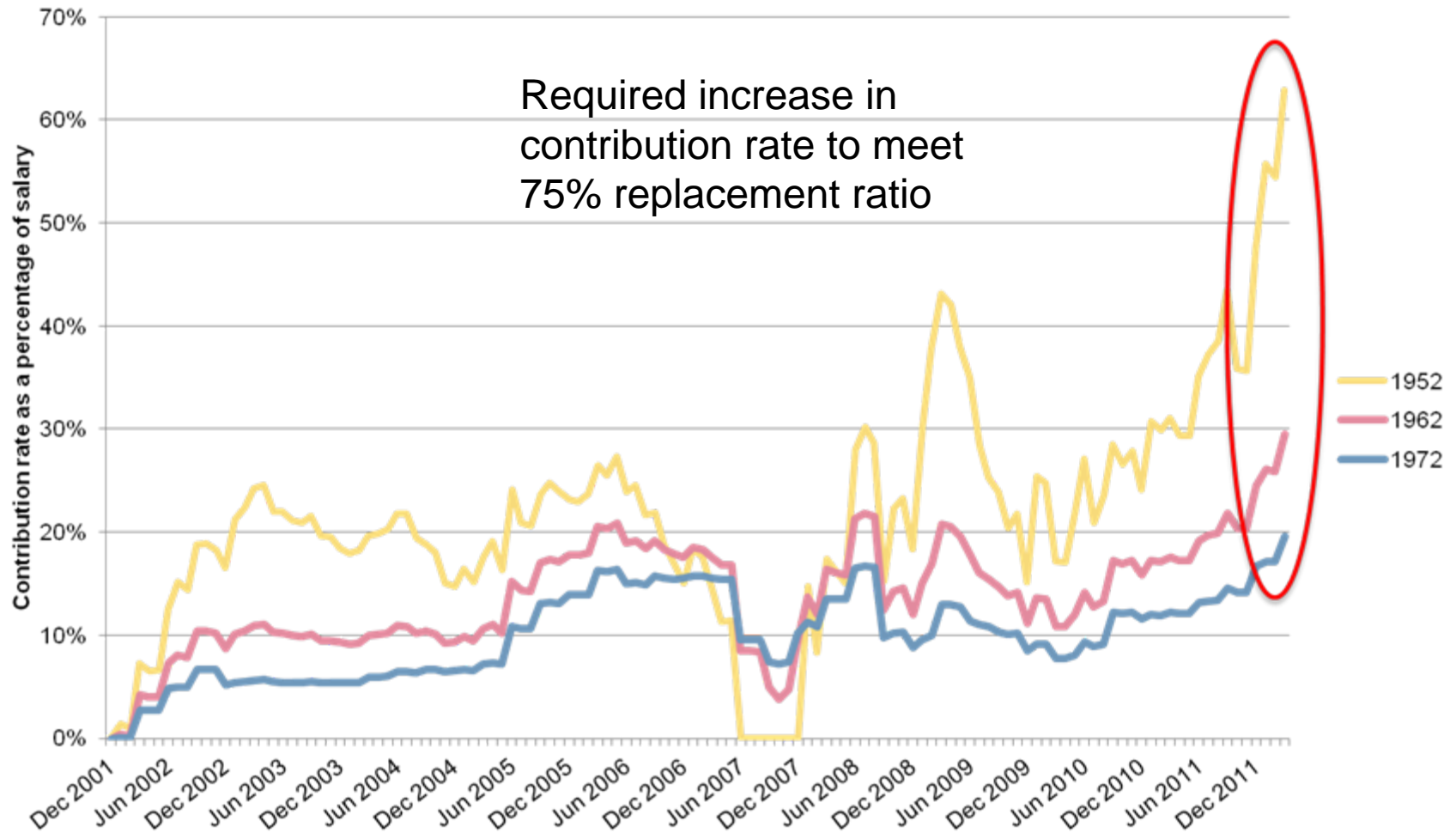
Impact of Returns and Bond Yields

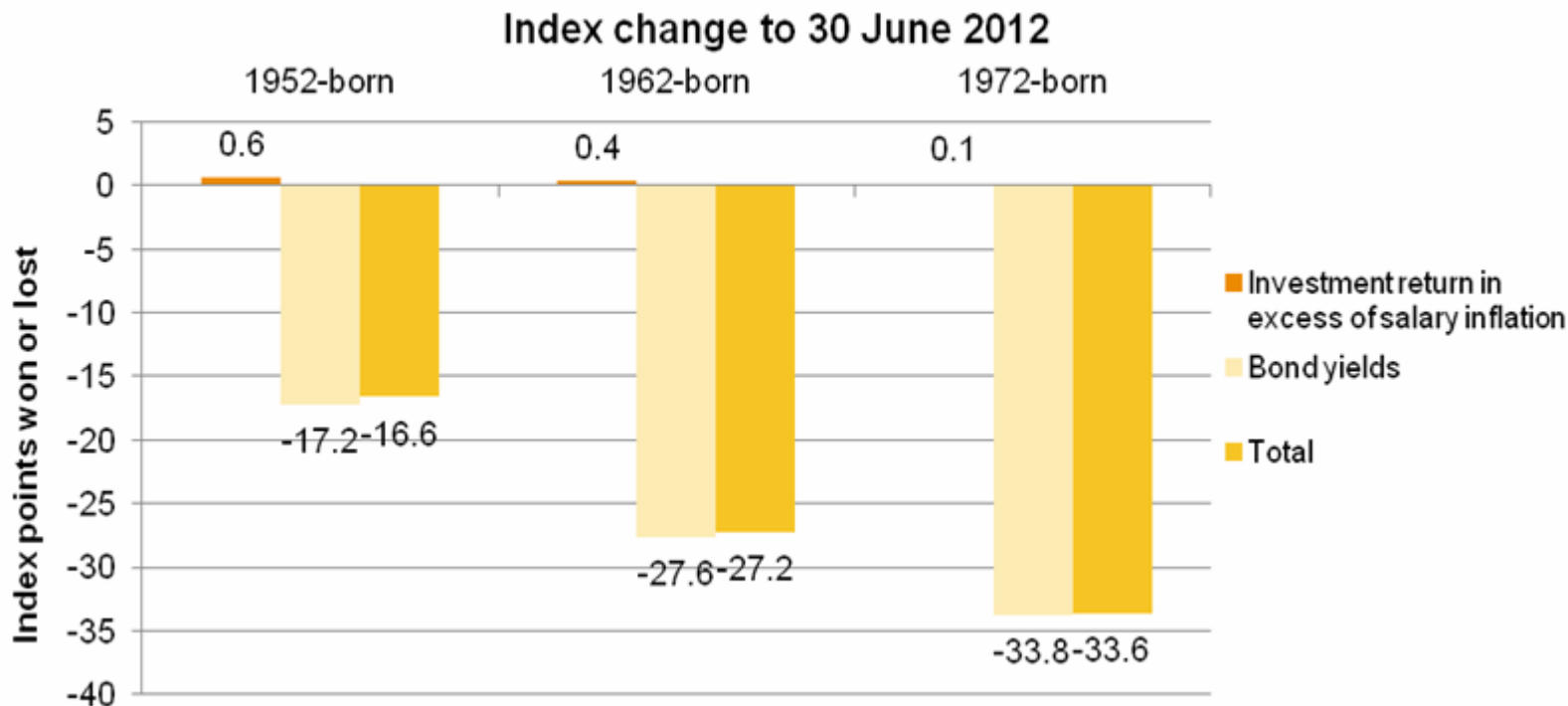
- Drivers for the 1962-born



Situation rapidly gets out of control

Additional Contribution Rate





- Bond yields impact on the Index in two ways.
 1. Lower bond yields drive up the price of the annuities that we expect each of our three members to buy with their accumulated capital at retirement.
 2. Also - lower bond yields can signal lower investment returns going forward which reduces the amount of capital we expect each of the three members to have when they retire.
- The investment return has generally been in line with salary inflation which means that retirement funds have grown in line with spending power to date.

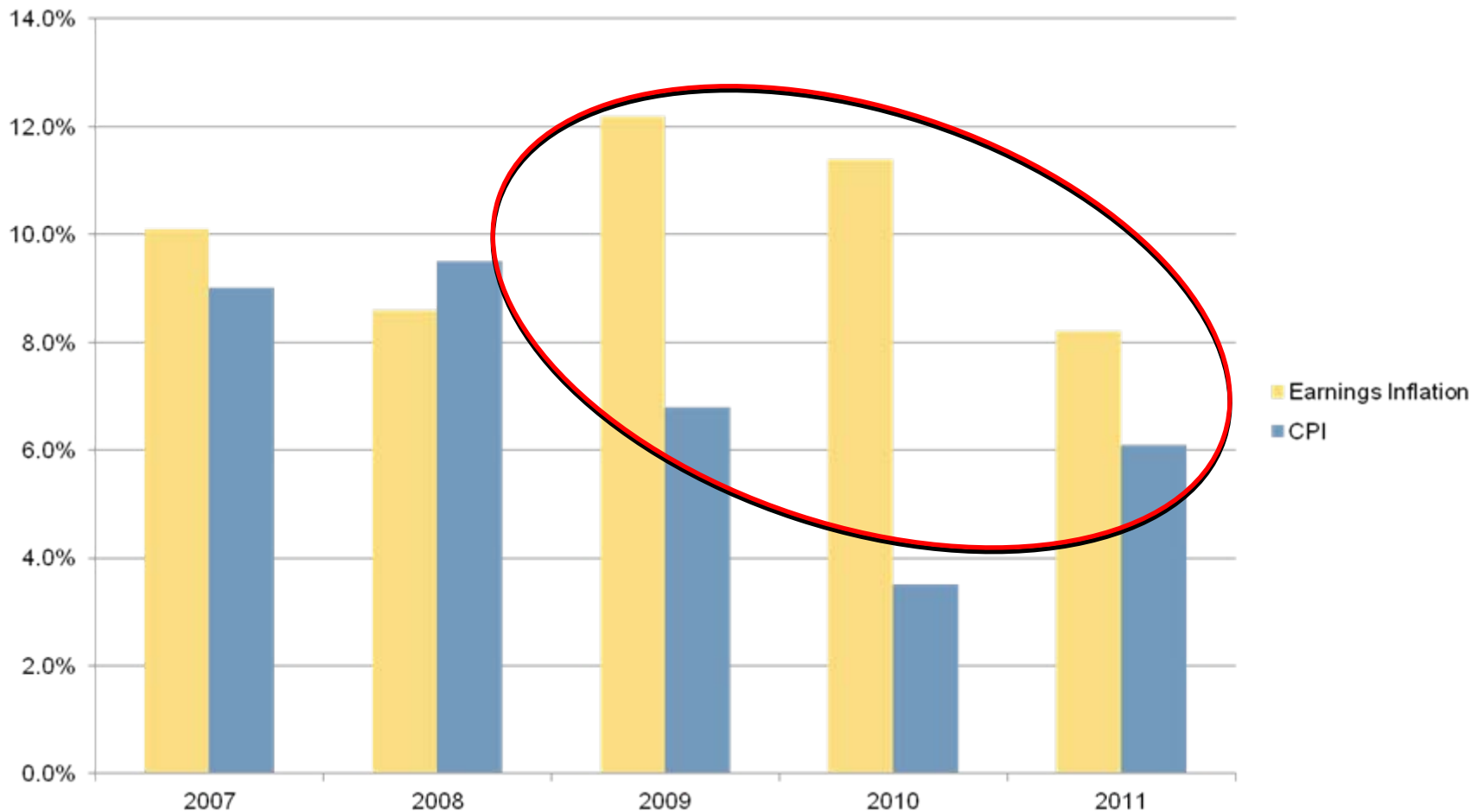
Members of retirement funds might not be aware of the fact that their projected retirement benefits are expected to be so low.

Investors can be protected against shifts in bond prices by ensuring that the investment strategy is structured around a retirement benefit as opposed to simply maximizing return for a given level of risk.

Investing to meet a retirement goal can be called asset-liability management or liability-driven investing.

(2) Salary inflation not well-behaved

Average monthly earnings Increase (yoy) for formal non-agricultural sector



Source : Statssa

Factors that effect the RR outcome

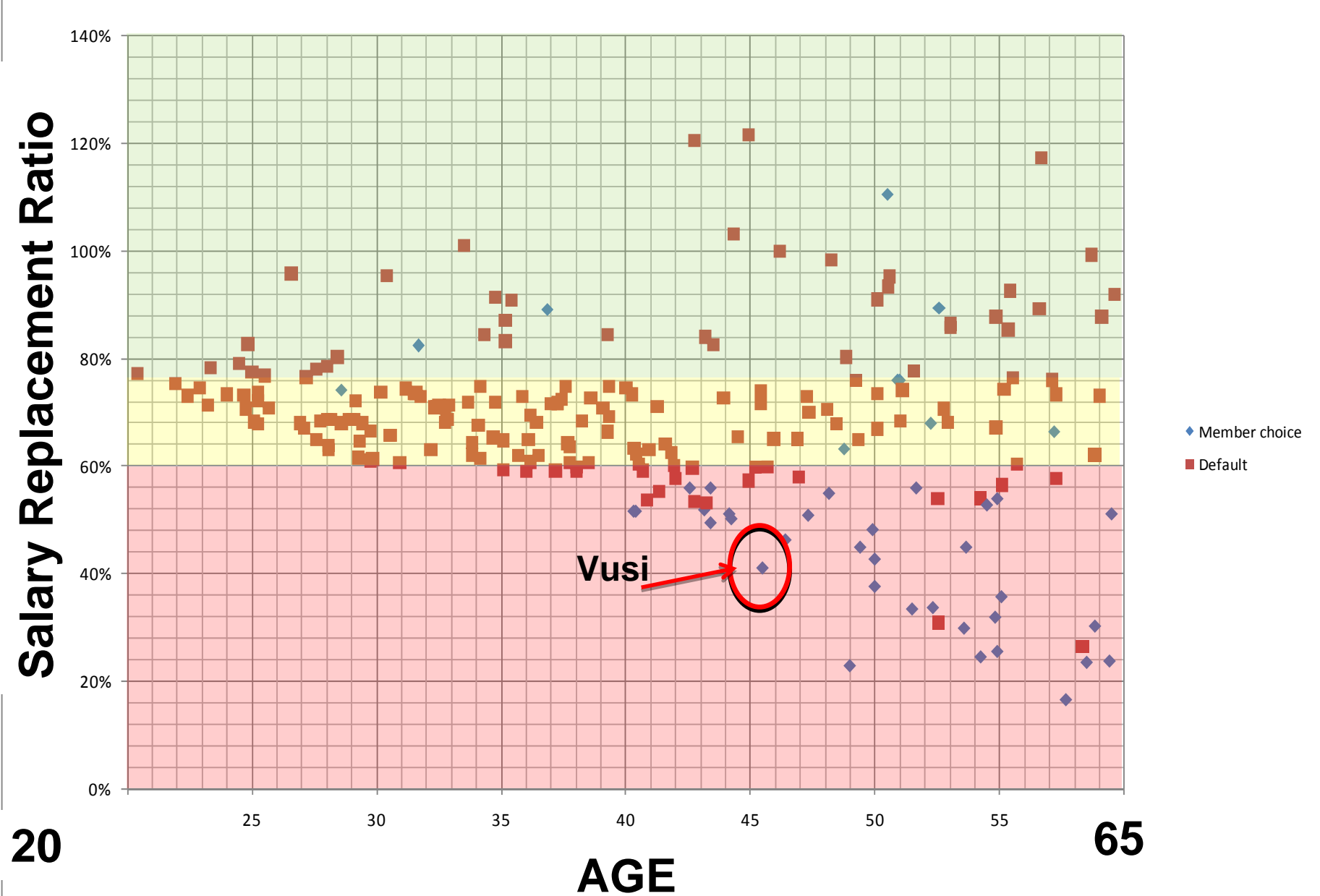
- Cost of purchasing an annuity
 - Longevity
 - Type of annuity
 - Expected returns/bond yields
- Mortality/Longevity
- Investment returns

Factors accounted for
in the AF Pension
Funds Index

-
- Preservation
 - Salary Progression
 - Increases
 - Definition of pensionable salary
 - Contribution rates

Factors not
accounted for in the
AF Pension Funds
Index

The slide that could change your member's life

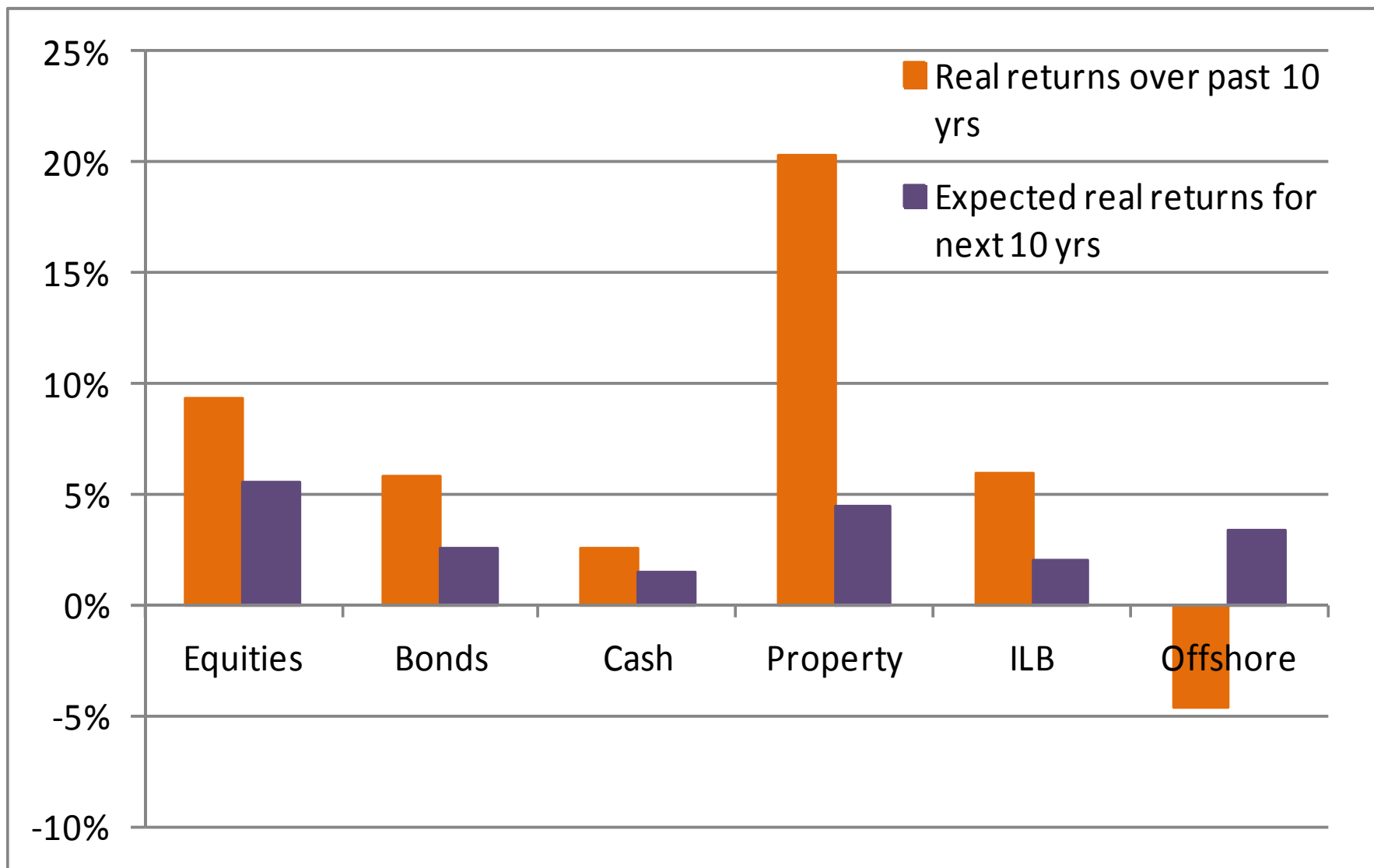


Sleepwalking to retirement?

What	Level of control
Investment returns	Influence
Preservation	Control
Mortality	None
Salary increases	None
Annuity choice	???
Price of annuity	None
Contribution rate	Control

- There are so many things over which members have no control, unless they manage the things they can control or influence, they are unlikely to have a comfortable retirement

And on top of that ... Returns likely lower going forward



How do these insights change the dynamic of what's required of trustees?

- It's not about picking the right fund manager
- The liability manager (consultant) is the more important choice
 - But here the FSB missed a critical point when it addressed the due diligence requirement

Why managing assets to liabilities is like using a GPS

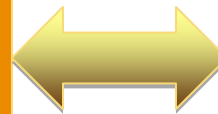
Asset manager focuses on:

Outperforming funding requirement (CPI +, or SAA benchmark)

Peer Group

Highest return for defined risk

...and does not typically have member liability insights



“Liability” manager focuses on:

Changes in factors that impact liabilities

- cost of annuitization
- interest rate changes
- changes in salaries or contribution rates

Allocations to risk benefits

How members are progressing over time

This must become an integrated process

Factors that effect the RR outcome

- Cost of purchasing an annuity
 - Longevity
 - Type of annuity
 - Expected returns/bond yields
- Mortality/Longevity
- Investment returns

-
- Preservation
 - Salary Progression
 - Increases
 - Definition of pensionable salary
 - Contribution rates

The hard truth

- Saving a fixed amount of salary and meeting your return objectives over the long term alone does not guarantee a good income in retirement
- Members and Funds should regularly reassess the progress they are making and make necessary adjustments timeously!
- A 25 year old needs to contribute 19.7% of their salary for a 75% replacement ratio
- There isn't going to be a simple, generic answer
 - Need to understand what trustees can and can't control
 - Industry pressures
 - Employer concerns



Trustees can do so much to address these issues.....

But it demands a rethink of where their obligations and actions begin and end.

1. The time has come for us to start recognising our obligations to the individuals in these funds
2. The time has come for employers to re-engage
- 3.- and to collaborate with trustees
4. The time has come to recognise that we can do so much more to add value than through the assets alone

Which factors are in the Trustee Board's control?

In Trustees control	Not in Trustees control
Choice of default solutions and nature of member choice if on offer	<i>Non - Preservation</i>
	<i>Investment returns (affected by market performance)</i>
	Annuity factors
	Salary progression

Here are some little understood investment facts:

- Member choice options typically do not relate to member liabilities either
- Members make investment choices based on their perceptions about current market conditions....
- ...and not on what they require to retire on 20 years into the future
- Once members make investment choices 90% of them do nothing further
- A choice that might have been appropriate in 2012 may not be appropriate 5 years before retirement

How do lifestage portfolios approximate a liability management focus?

Portfolio 1 – High Growth

High Growth Portfolio for first 35+ years

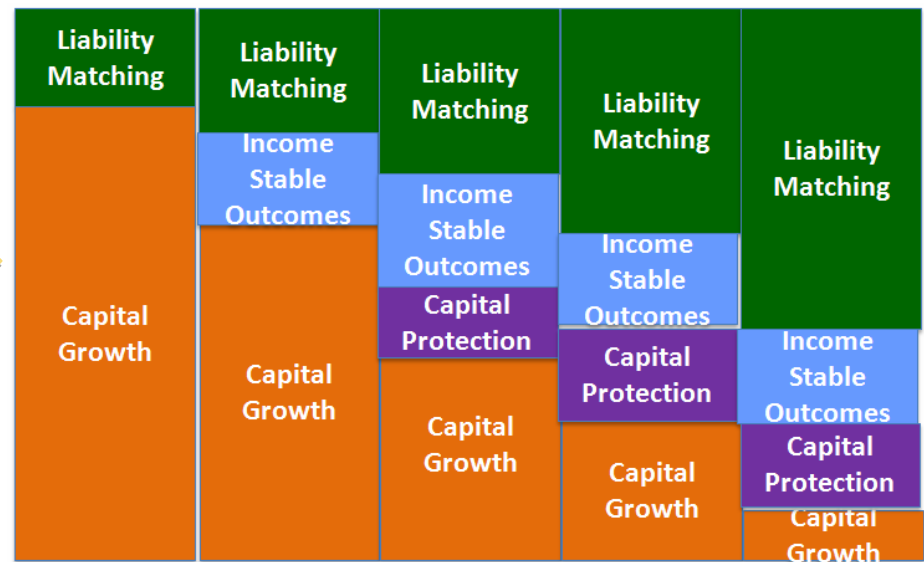
Can basically accommodate any growth investment strategy

- Specialist managers
- Balanced Managers
- Passive managers

Liability manager can refine asset mix to address significant changes in factors influencing liabilities

Portfolio 2 – De-risk to meet liability

How de-risking portfolio focus shifts over 7-10 years before retirement



This is a philosophical decision – what are you most comfortable with?

But...the choice of de-risking portfolios **must** relate to member demographics and preferences

What are the key issues for lifestage solution choice?

- No one lifestage solution will meet all member needs
- The issue is what choice of vehicle will member make to create required post-retirement income stream?
 - Level annuity?
 - With-profit annuity
 - Living annuity
 - Inflation-linked annuity
 - Hybrid?
 - Cash?

Each choice requires a different de-risking strategy

Ironically though.....

- The choice of the strategy behind high growth portfolio (that investors will be exposed to for at least 35 out of a 45 year strategy) is more a function of philosophical preference than definitive solution.
- Impossible to prove that one or another strategy has a higher probability of delivering better performance.
 - Balanced vs. Specialist manager solutions
 - Multiple vs. Single manager solutions
 - Active vs. Passive

Trade-off Continuum for Retirement Fund Investment Strategies

Strategies that target Liability-driven target

Strategies that Maximize return



Strategies that target specific objective

Strategies that target maximum returns

The Trade-off Continuum in Balancing Financial & Non-Financial Criteria



Strategies that target funding requirements

Strategies that target maximum return

Higher probability of meeting a specific funding requirement

Low variability around funding target

Risk management means less dependency on manager skill

Manager skill easier to assess but depends on solution

Potentially lower cost but depends on solution

Performance highly dependent on getting strategic asset allocation right

Higher possibility of performance but less certainty about potential outcomes

More dependence on manager skill

Manager skill more difficult to assess

Performance attribution more difficult to pin down

Difficult to know in advance what cost will be incurred for outperformance

Performance highly dependent on manager selection and mandates

How do we start assessing any investment strategy?

- Every investment strategy choice involves “betting” on someone’s skill set



- You need to feel comfortable that the skills you require are likely to be there in the solution
- Managing to liabilities is as much a skill set as asset management
- Asset management strategies can be made to address the liability matching issue – but with varying degrees of precision

Summary

- Matching your asset strategy to your liabilities is an on-going dynamic
- The asset manager typically does not have member liability insights
- As such...CPI +5% or BIV balanced solutions may not totally address the problem over time.
- A lifestage-type solution is a close proxy to liability management over the critical wind-down years
 - But getting the right solution means knowing your member requirements

Summary (cont.)

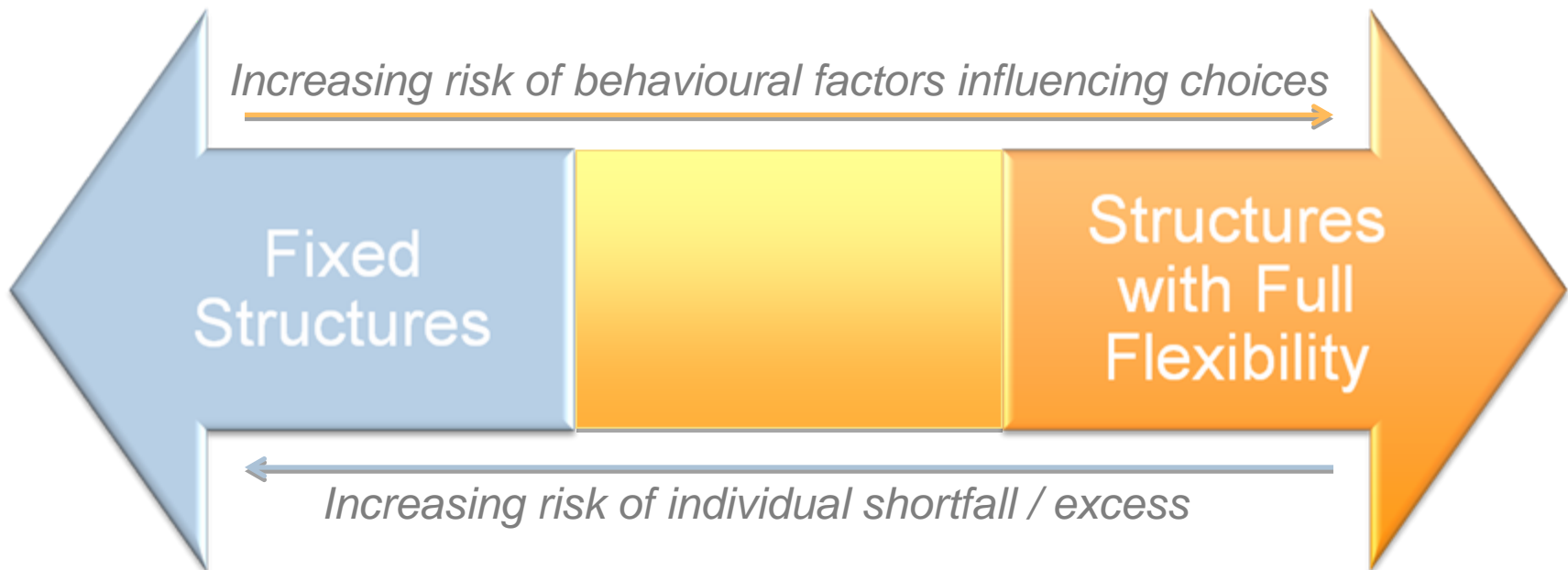
- Selecting the optimal investment strategy for the “high-growth” portfolio in the lifestage solution is a matter of personal preference/ investment beliefs
- All strategies require some level of skill – whether it be managing the liabilities or managing the assets.
 - Trustees need to decide if they are happy with the trade-offs.
- Bottom-line: matching assets to liabilities demands trustees are as vigilant with their liability manager as they are with their asset manager

Which factors are in the Trustee Board's control?

In Trustees control	Not in Trustees control
Choice of default solutions and nature of member choice if on offer	<i>Non - Preservation</i>
Dynamic life-cycle benefit exposure as a return enhancer	<i>Investment returns (affected by market performance)</i>
	Annuity factors
	Salary progression

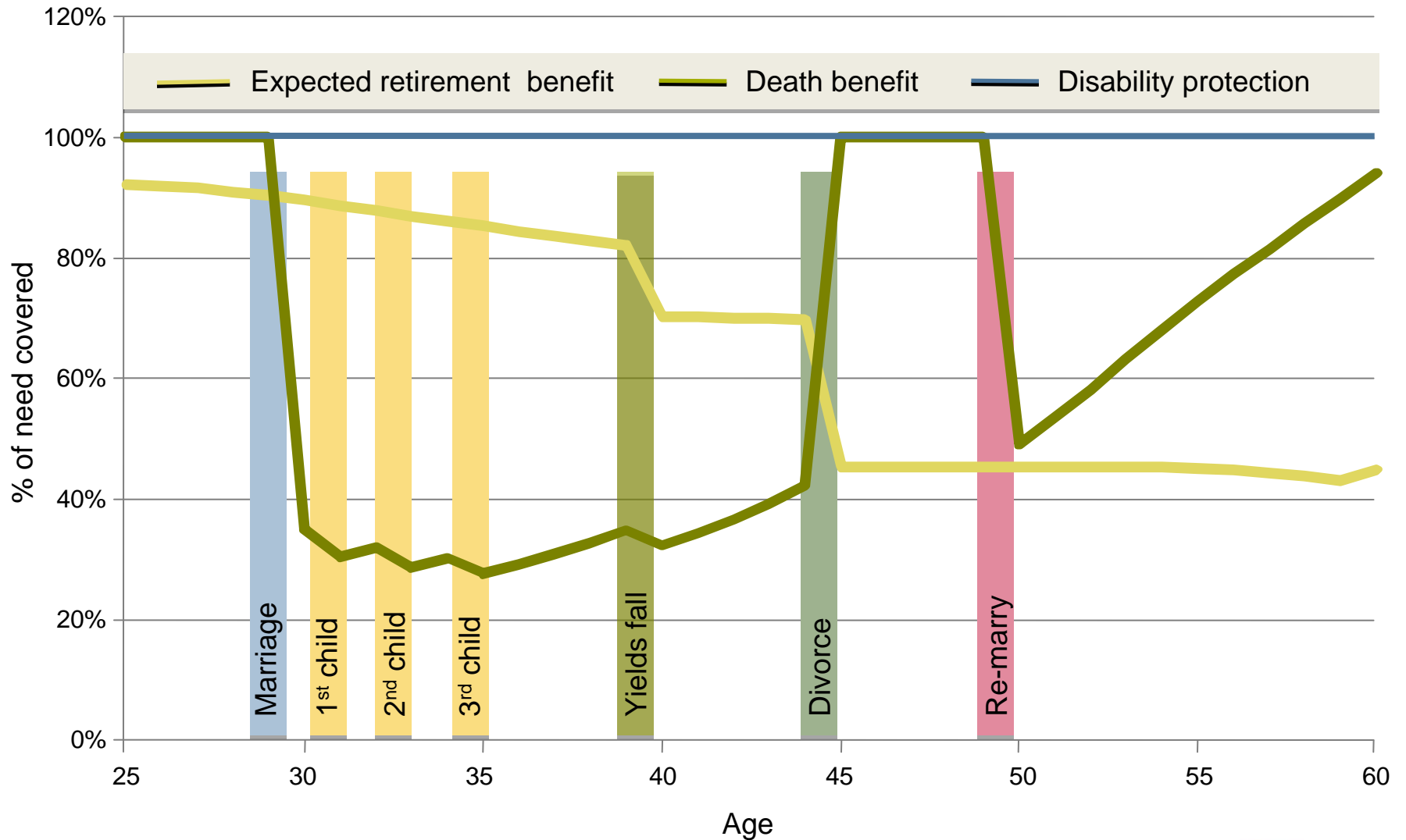
Dynamic vs. static structures

- Historic: DB → DC
- Currently no flexibility except for AVC's
- Member flexibility – why in DC environment?
 - Member takes all the risk (not the employer)
 - Individual needs

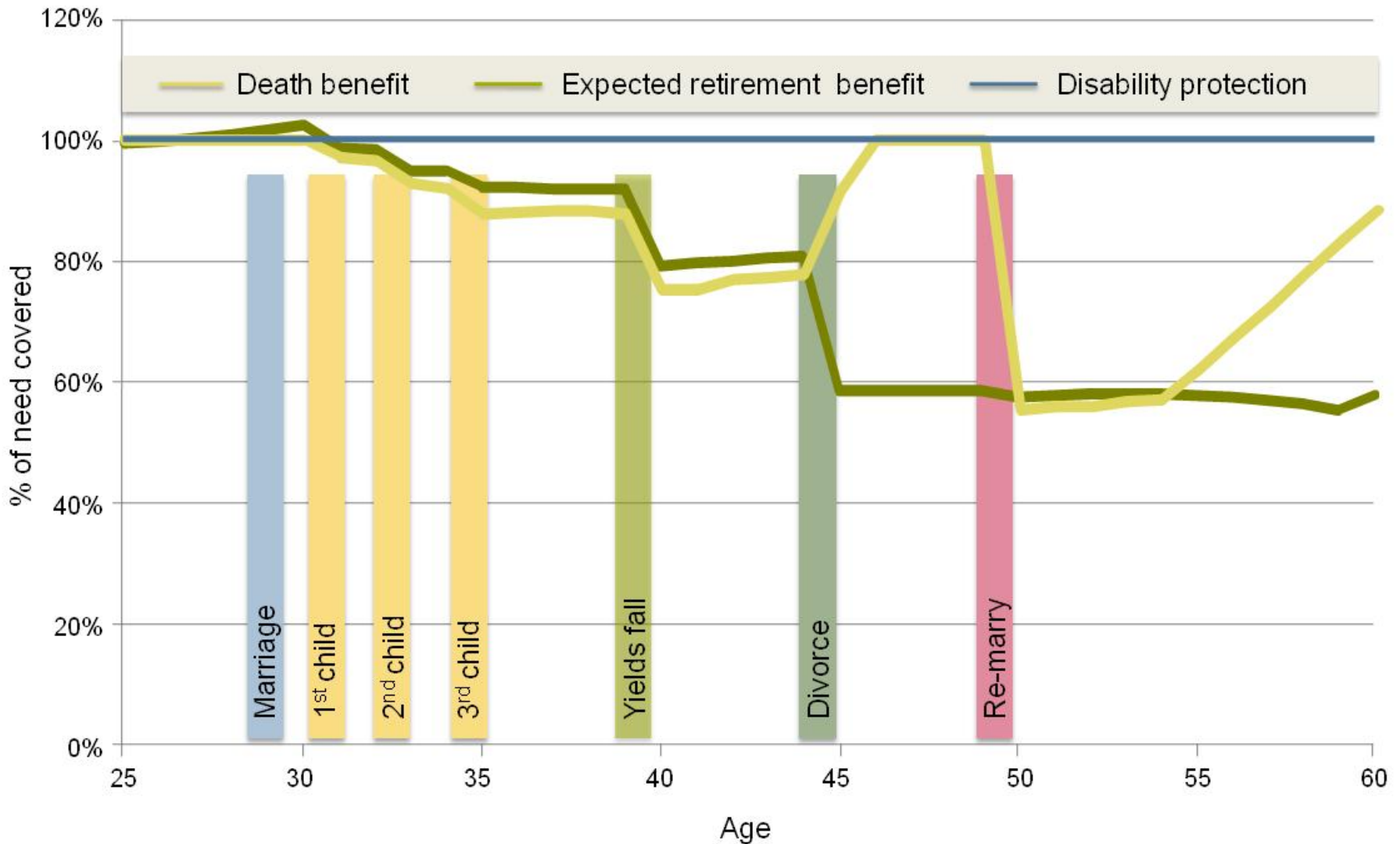


- Ideal structure is along this spectrum
- Fixed / Auto-targeting defaults – must be **appropriate!**
- Life cycle of individuals (applied to investments, contributions & group insurance cover)

A Fixed Benefits Design affects members' lives



A FLEXIBLE BENEFIT WITH AUTO-TARGETING MECHANISM MEETS MEMBER NEEDS BETTER



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In-fund solutions to control costs	Annuity factors
Costs (group risk and expenses)	Salary progression

-
- It means trustees need to understand the dynamics at individual member level that have a far greater impact on whether members can meet those critical income demands
 - Which means to do get the job done, we (trustees?) need to consider what actions need to be taken beyond the fund

Which factors are in the Trustee Board's control?

In Trustees control	Not in Trustees control
Choice of default solutions and nature of member choice if on offer	<i>Non - Preservation</i>
Dynamic life-cycle benefit exposure as a return enhancer	<i>Investment returns (affected by market performance)</i>
In-fund solutions to control costs	Annuity factors
Costs (group risk and expenses)	Salary progression
Keeping HR/FD abreast of member progress	
Contribution rates	
Normal retirement age's (number of contributing years)	
Employee engagement around financial education	



Trustees can do so much to address these issues.....

But it demands a rethink of where their obligations and actions begin and end.

1. The time has come for us to start recognising our obligations to the individuals in these funds
2. We need to engage with the employer to really get what members need
3. The time has come to recognise that we can do so much more to add value than through the assets alone
4. We need to prepare for more complexity – but delivered as total simplicity in decision-making

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