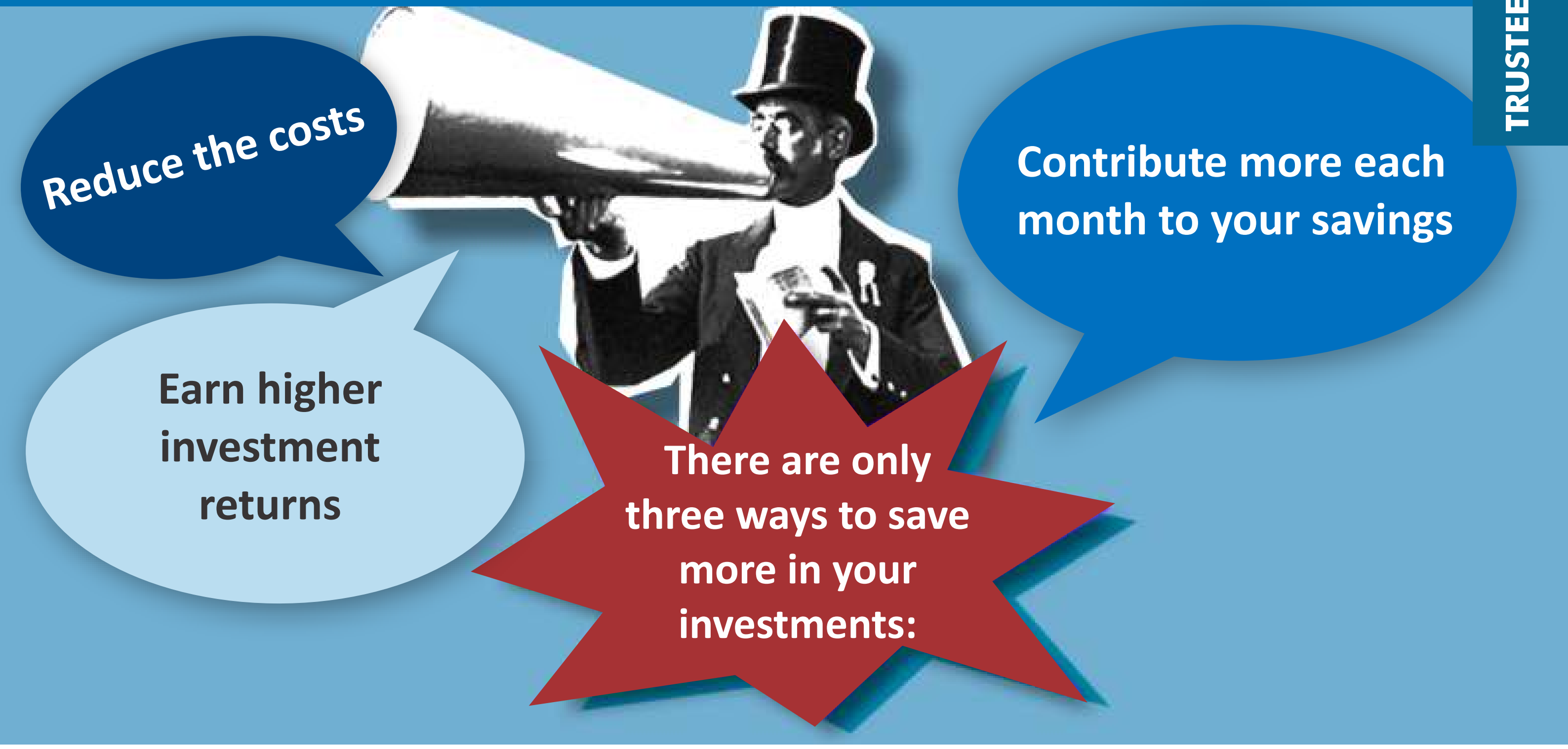
Trustee Tutor: Issue 6
The role players involved in your fund investments



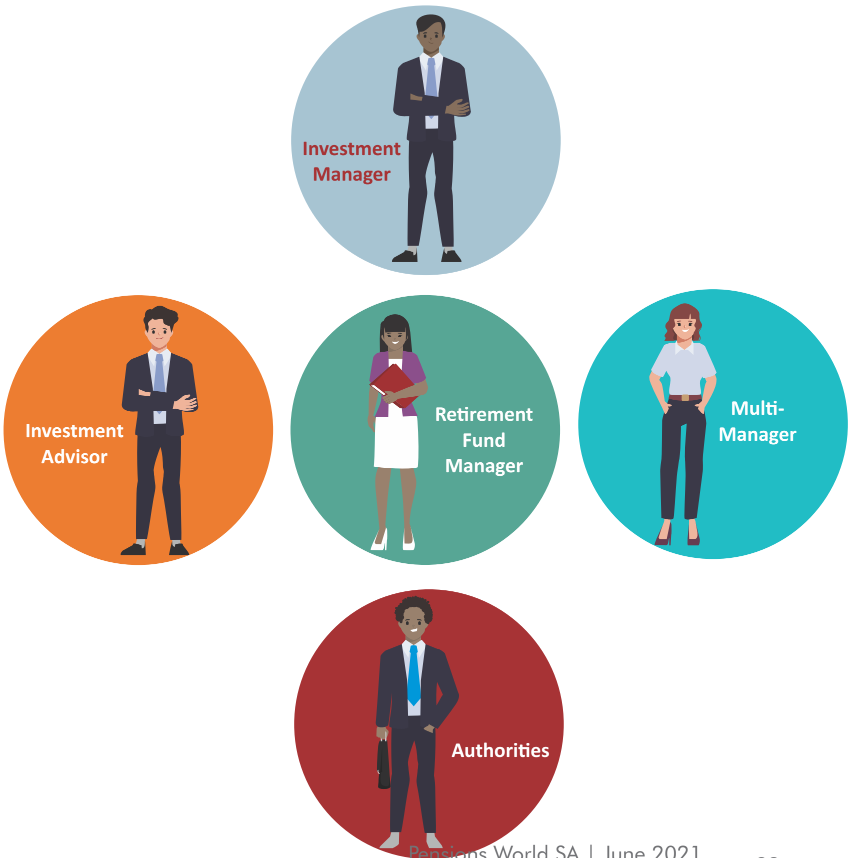
The vast majority of trustees oversee defined contribution funds, meaning that it is not possible to insist that members contribute more. This leaves the reduction of costs and the maximising of investment returns as the remaining two levers trustees can pull to ensure the best outcomes for their members.

Most often trustees are budget-wise in managing the fund's costs. They regularly test administration (and other service) fees as well as insurance premiums against the market and negotiate with providers to keep these costs as low as possible.

What trustees possibly don't understand in great detail are all the role players involved in the investments of their funds and what value these parties add to members' ultimate benefits.

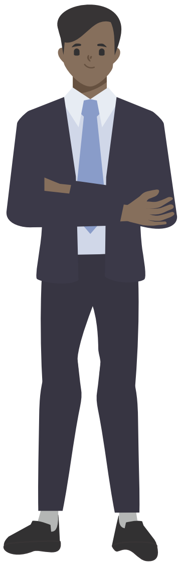
Let's look at these role players in detail to understand the expertise they bring to the table.

Fig 1: The retirement fund investment ecosystem



The investment manager

Also known as an asset manager or a fund manager.



The investment manager is the entity responsible for implementing a retirement fund's investment strategy. These are the professional experts who research and decide the most appropriate shares, bonds and other assets to invest in that best fit the strategy of the chosen investment portfolio. And then they trade (buy and sell) them. The investment manager handles all the activities associated with the management of investment portfolios, from the day-to-day buying and selling of shares to portfolio monitoring, transaction settlement, performance measurement, and regulatory and client reporting.

Some investment managers may be selected for their specialist skill in managing a particular asset class (specialist mandate) while other managers may be chosen to invest across various asset classes (balanced mandate).

An investment manager must be licensed as a Financial Services Provider (FSP) under the Financial Advisory and Intermediary Services (FAIS) Act and needs to comply with many legal requirements in order to manage investments on behalf of the man in the street. These licensing requirements means that investment management is a very specialised and onerous activity and trustees need professional investment managers to invest their retirement fund's assets.

The local investment manager

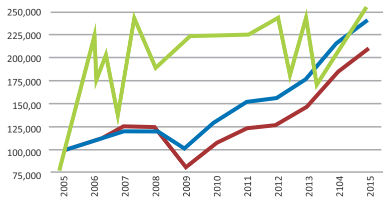
These are investment managers who invest in shares and other asset classes in the country in which they are based. In this portfolio, you would find a South African investment manager invested (or trading) in South African shares, bonds, cash, property and other assets in the local economy.

It is unusual for your local team of investment professionals to also have the required skills and experience to manage the offshore portion of a retirement fund's investment portfolio. Most often, there will be a separate team within the local investment manager who focus on offshore (overseas) investments, or the local investment manager will partner with an international investment manager.

The offshore investment manager

The offshore investment manager invests in asset classes outside of the retirement fund's local jurisdiction, in other words, investments made outside of the country in which the retirement fund operates.

Investing overseas is complicated as local managers and their clients need to understand the regulatory and market environments outside of their "home base". For this reason, specialist offshore management teams will be set up within the local manager's team or strategic partnerships with overseas investment managers will be formed. It is usual for a retirement fund's offshore portion to be invested in similar asset classes overseas, as the local portion of the portfolio.

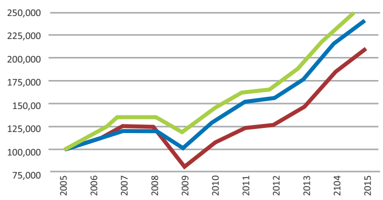


The active manager

In an investment portfolio with an active mandate, the investment manager will actively trade shares and other asset classes in an attempt to outperform a specific benchmark. The success of the portfolio depends on the expertise and experience of the investment team in using detailed research and market forecasting.

Active managers take into account market trends, changes in the economy, shifts in the political landscape and the myriad of factors that affect the companies in which they invest. This information is used to buy or sell the underlying assets in the investment portfolio.

These managers assert that their processes result in higher returns than can be achieved by an investment portfolio that simply invests in an index.



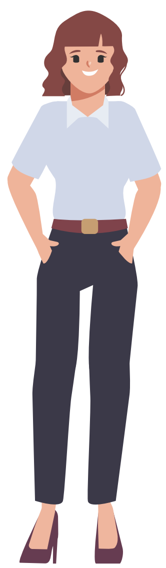
The passive manager

Also known as an index tracking investment.

The passive investment manager designs a portfolio to track the returns of a particular market index or benchmark as closely as possible. For example, each stock listed on an index is weighted and the passive manager will use the same weights in their investment portfolios.

The purpose of a passive investment portfolio is to generate a return that is the same as the chosen index.

The multi-manager



A multi-manager is a manager of investment managers. They offer value to trustees (and members) by reviewing and selecting the investment managers to use for various investment mandates. The multi-manager pools the investments they receive and splits them across a number of investment managers they believe are best placed to meet those mandates. This offers trustees meaningful diversification not only across asset classes, but also across different investment managers who, when blended together, provide the optimum combination of skills to meet an identified investment objective.

Using a multi-manager strategy shifts the responsibility for researching, choosing and monitoring investment managers from the trustees to an expert multi-manager who has resources to dedicate to this process. Many retirement funds invest in portfolios set up by multi-managers.

The investment mandate - segregated or pooled

An **investment mandate** is an instruction to manage a pool of capital—a particular pile of funds—using a specific strategy and within certain risk parameters.

All retirement fund investments are either in segregated or pooled investment portfolios.

A **segregated portfolio** is an investment portfolio structured by the trustees for their retirement fund's investments only. In a segregated investment portfolio, the trustees mandate the investment manager on exactly what type of investments they wish to invest in. These investments are in the retirement fund's name and the investment performance is specific to that retirement fund. In a segregated portfolio the trustees have a considerable amount of input and are responsible for monitoring that the investment manager keeps to the mandate that has been set and is not taking excessive risk (or taken any decisions outside of the set mandate).

Because segregated portfolios are personalised and specific for each retirement fund, investment managers have a minimum value of investment they require from a fund. This minimum investment value is usually quite substantial and therefore generally only larger retirement funds will have the ability to set up their own personalised segregated investment portfolios.

Pooled investment portfolios are "off the shelf" portfolios offered by investment managers either through a life license or a unit trust license. These licenses allow the investment manager to bring together (or "pool") various investors' assets and invest them together under one common mandate. Trustees usually look for a mandate that meets their fund's needs and invest with a particular manager, rather than structuring their own mandate. In a pooled portfolio, the investments are held in the insurer or the investment manager's name and each investor in the pool earns the same return.

There are generally no entry or exit costs to investors in pooled portfolios and the costs of the portfolio are split amongst the larger pool, making them generally more cost effective than segregated portfolios (unless you have a very large retirement fund). This makes pooled portfolios very attractive to retirement funds.

The custodian

A custodian or custodian bank is a specialised financial institution that holds customers' shares for safekeeping to prevent them from being stolen or lost. The custodian may hold these shares, and other assets, in electronic or physical form. (most companies have dematerialised and are therefore held electronically)

The custodian keeps proper records of ownership, valuation, accounting and reporting of assets owned by an investment manager. They also process trades, which involves tracking, settling and reconciling assets that are bought and sold by the manager.

The authorities

South African Reserve Bank

FSCA
Financial Sector
Conduct Authority

In South Africa we have a twin peaks model of regulation of financial services.

The **Prudential Authority (PA)** is tasked with overseeing the system wide safety and soundness of financial institutions.

The **Financial Sector Conduct Authority (FSCA)**, the market conduct regulator, is tasked with overseeing system wide efficiency and integrity of financial markets and affording greater financial consumer protection.

Between these two authorities, investment managers are regulated and monitored to ensure that they remain financially sound as financial institutions and that they conduct themselves appropriately in the marketplace. The FSCA monitors whether retirement funds comply with the prudential investment guidelines set out in Regulation 28 of the Pension Funds Act, and issues guidance notes to the industry on best investment practices.

The investment consultant, and other expert advisers

In the context of retirement funds, an investment consultant (also known as an asset consultant) is an investment professional who advises the trustees on the most appropriate investment strategy for their retirement fund, the most suitable investment managers and portfolios to select and the ongoing monitoring and evaluation of performance to objectives. In addition, the investment consultant will assist the trustees in drafting their Investment Policy Statement (IPS) to meet the requirements of PF 130.

The trustees should also expect their employee benefits consultant to have some experience and expertise in investments. A trustee could reasonably expect the fund's consultant to draft the IPS and provide high level feedback on the fund's investments, particularly if the fund's assets are invested in pooled portfolios.

Please always check the categories of products your advisors are accredited to advise on as well as the signed mandate you have in place with them setting out your expectations of services to be provided.

Fees

Investment managers are paid a fee for their work, which is a percentage of the fund's average assets under management (AUM).

Fees may be fixed as a percentage of the value of assets under management or linked to performance - where the investment manager earns a higher fee for outperforming a particular benchmark – or a combination of the two. The complexity of the investment mandate will also have an impact on the level of the fees. It is reasonable to assume that a more complex, actively managed mandate with more complicated investments (like hedge funds, or offshore investments) will be more expensive for investors.

To achieve the aim of greater fairness and transparency in the South African investment space, standardised disclosures and ways of reporting these costs have been developed.

Total expense ratio (TER) - is a measure of the *total* costs of managing and operating an investment portfolio. These costs consist primarily of management fees and additional *expenses*, such as trading fees, legal fees, auditor fees and other operational *expenses*. TER is the global standard used to measure the impact that the deduction of management and operating costs has on a portfolio's value. The TER does not include the investment portfolio's transaction costs.

Total investment charge (TIC) – is a more comprehensive calculation of charges that takes into account the TER and the transaction costs (TC). The TC includes things like VAT, brokerage, securities transfer tax (STT) and exchange rate costs. The TIC expresses the total value of an investment portfolio that is lost to fees.

Trustees are encouraged to make sure they understand all the fees paid in respect of investment services provided to their retirement fund. Obviously the more complicated their investments (segregated, offshore, active mandates) will be more expensive than simpler pooled or passive type investment portfolios.

Furthermore, investment consultants or advisors will also charge the fund for the advice and monitoring services they provide.

Trustees should also regularly review an investment manager's performance, preferably over a period of at least five years to understand the manager's performance in the context of various market environments.

By looking at both the fees and the performance, trustees will get the full picture of how the investment manager adds value to fund members – to enable them to achieve the financial outcomes they are wanting at retirement.

A **benchmark** is a standard against which the performance of an asset class, an investment portfolio or and investment manager can be measured. A simple example, would be to consider how the local equities in your retirement fund performed relative to the JSE index.