Volume 14, No. 9
September 2018

Benchmark Retirement Fund

MONTHLY REVIEW OF PORTFOLIO PERFORMANCE TO 30 SEPTEMBER 2018

By T H Friedrich – Managing Director, Retirement Fund Solutions Namibia (Pty) Ltd

The monthly review of portfolio performance, as set out in this issue, is also available on our website at www.rfsol.com.na.

1. Review of Portfolio Performance

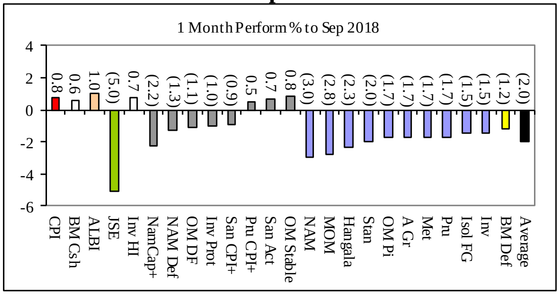
In September 2018 the average prudential balanced portfolio returned -2.00% (August 2018: 3.75%). Top performer is Investec (-1.45%); while Nam Asset (-2.97%) takes the bottom spot. For the 3-month period, Investment Solutions takes top spot, outperforming the 'average' by roughly 1.15%. On the other end of the scale Momentum underperformed the 'average' by 1.40%.

Graphs 1.1 to 1.10 reflect the performance for periods from 1 month to 20 years of a number of the most prominent prudential balanced portfolios (blue bars), 'special mandate portfolios' with lower volatility risk (grey bars), fixed interest portfolios (no color bars), the average of prudential balanced portfolios (black bar), the JSE Allshare Index (green bar), and the CPI (red bar). Benchmark investors should take note of the performance of the default portfolio (yellow bar), which represents a combination of Prudential Namibia Inflation Plus, Sanlam Inflation Linked and Allan Gray Namibia Balanced Funds.

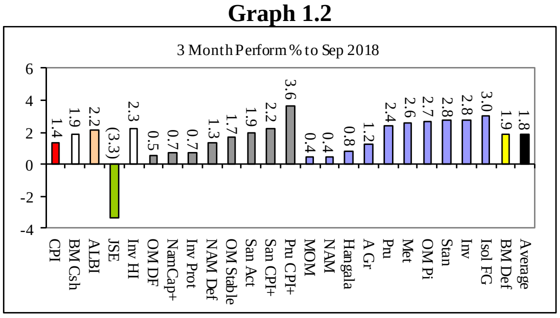
Below is the legend to the abbreviations reflected on the graphs:

Benchmarks	
Namibian Consumer Price Index	CPI (red)
JSE Allshare Index	JSE Cum (green)
Benchmark Default Portfolio	BM Def (yellow)
Average Portfolio (prudential, balanced)	Average (black)
Special Mandate Portfolios	
Money market	BM Csh (no color)
Investec High Income (interest bearing assets)	Inv HI (no color)
Prudential Inflation Plus	Pru CPI+ (grey)
Old Mutual Dynamic Floor	OM DF (grey)
Sanlam Active	San Act (grey)
Sanlam Inflation Linked	San CPI+ (grey)
NAM Capital Plus	NamCap+ (grey)
NAM Coronation Balanced Def	NAM Def (grey)
Smooth bonus portfolios	
Old Mutual AGP Stable	OM Stable (grey)
Market related portfolios	
Allan Gray Balanced	A Gr (blue)
Hangala Prescient Absolute Balanced	Hangala (blue)
Investec Managed	Inv (blue)
Prudential Managed	Pru (blue)
Metropolitan Managed	Met (blue)
NAM Prudential Balanced	NAM (blue)
Old Mutual Pinnacle Profile Growth	OM Pi (blue)
Momentum Managed	MOM (blue)
Stanlib Managed	Stan (blue)
Investment Solutions Bal Growth (multimanager)	Isol FG (blue)

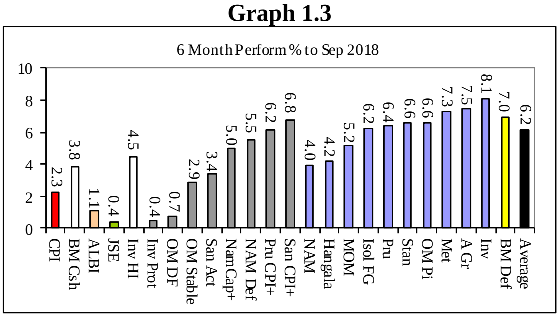
Graph 1.1



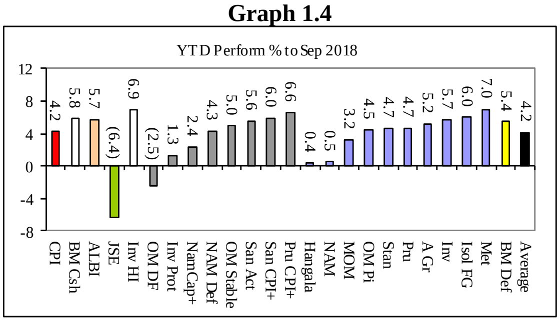
Graph 1.2



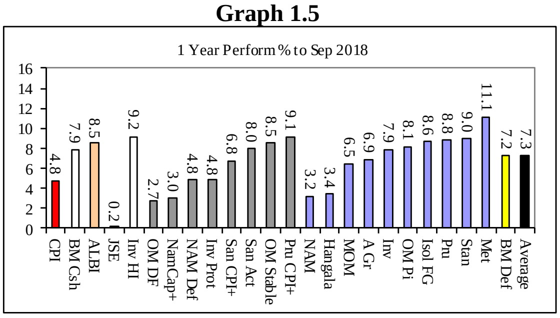
Graph 1.3



Graph 1.4



Graph 1.5



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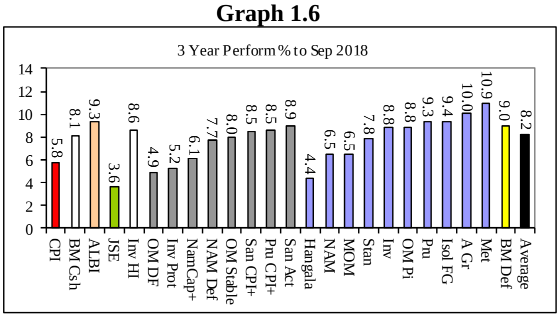
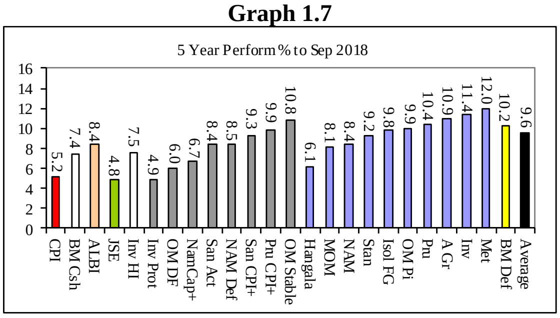
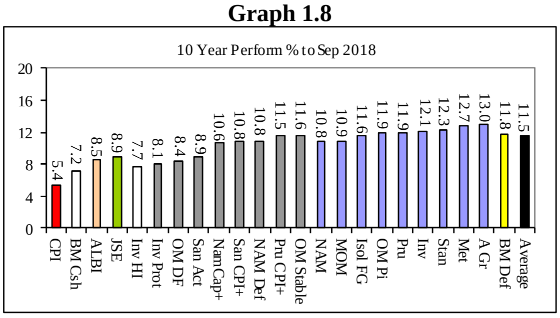
Graph 1.6



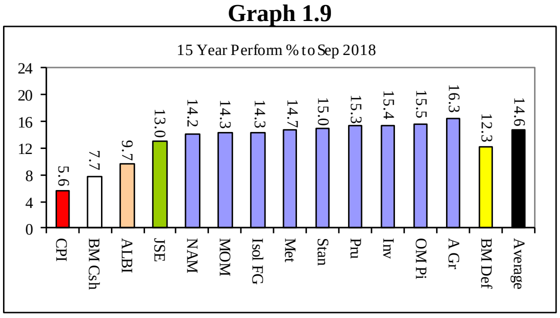
Graph 1.7



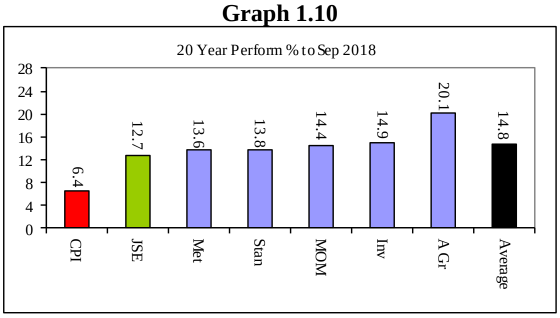
Graph 1.8



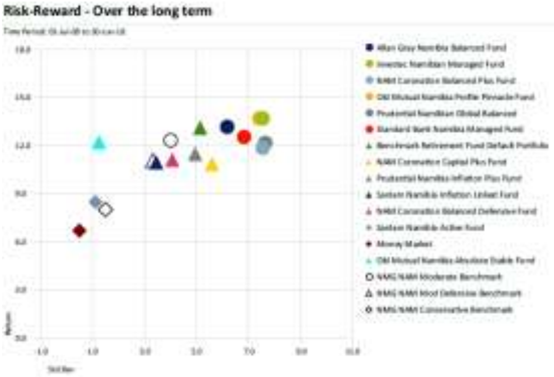
Graph 1.9

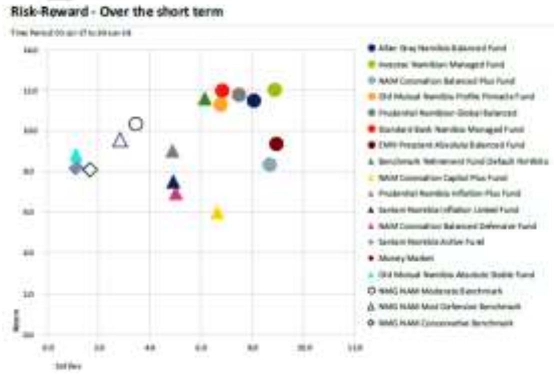


Graph 1.10



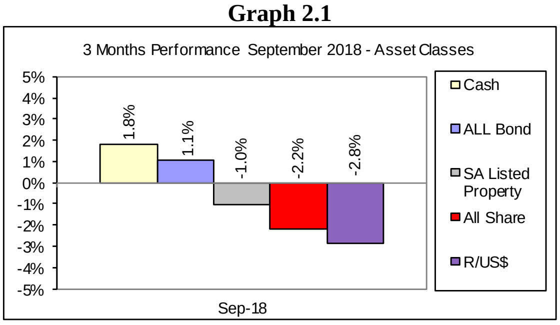
Risk/ Return



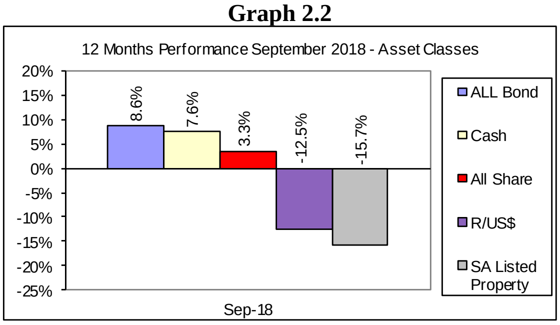


2. Performance of Key Indices (index performance by courtesy of IJG/Deutsche Securities)

Graph 2.1



Graph 2.2



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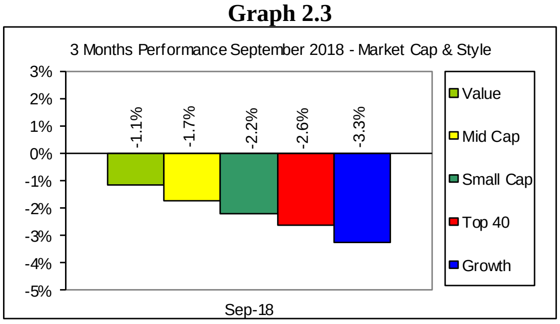
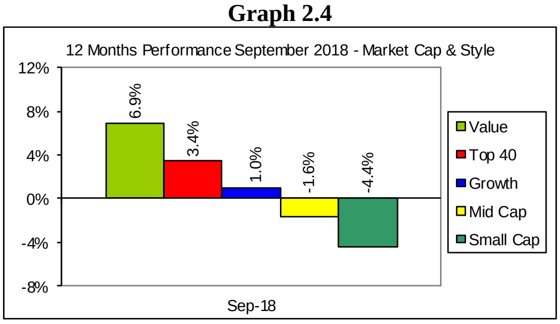
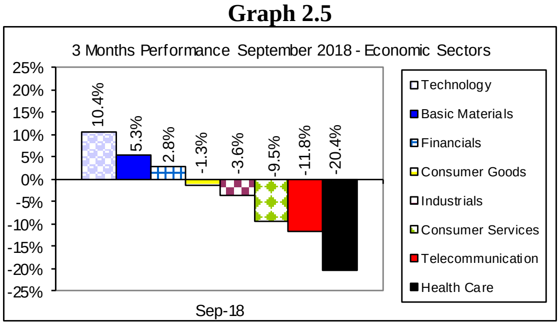
Graph 2.3



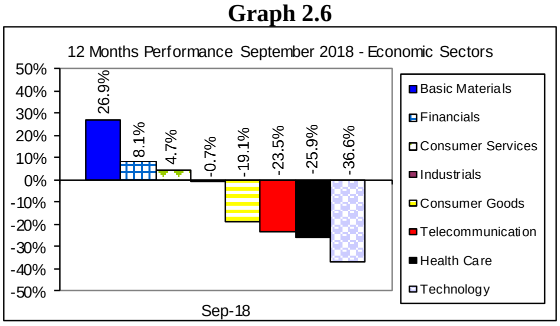
Graph 2.4



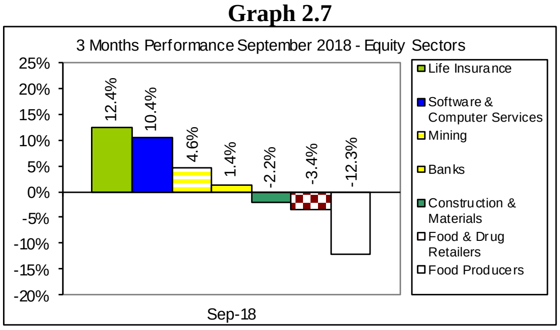
Graph 2.5



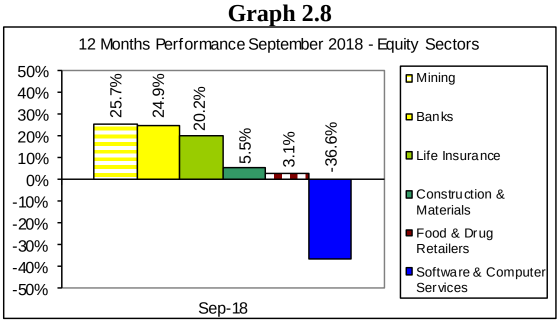
Graph 2.6



Graph 2.7



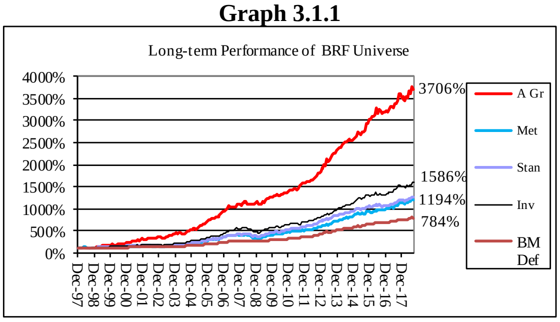
Graph 2.8



3. Portfolio Performance Analysis

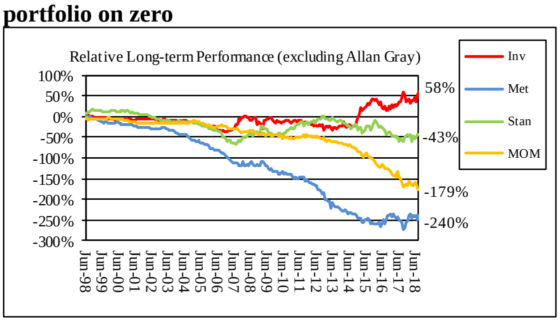
3.1 Cumulative performance of prudential balanced portfolios

Graph 3.1.1

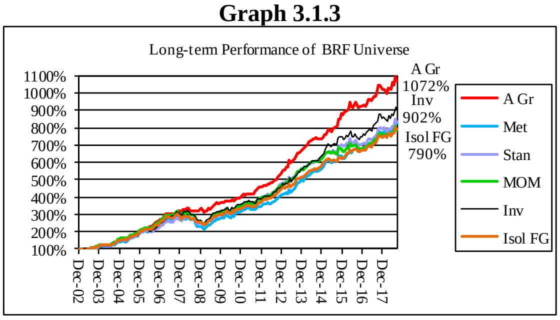


Graph 3.1.2

Cumulative performance of prudential balanced portfolios relative to average prudential balanced portfolio on zero



Graph 3.1.3



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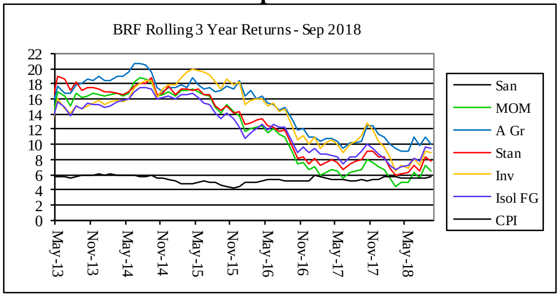
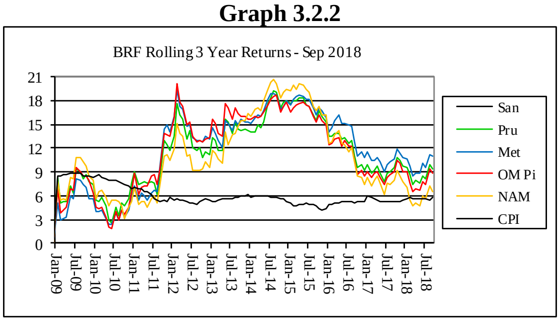
3.2 3-year rolling performance of prudential balanced portfolios relative to CPI

Graph 3.2.1

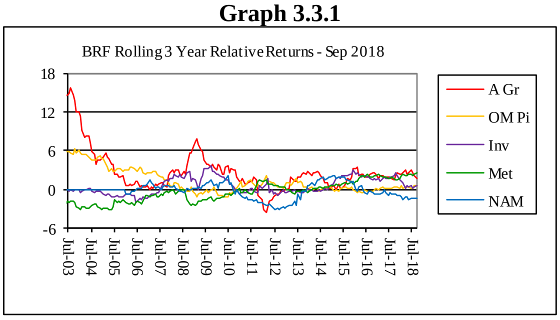


Graph 3.2.2

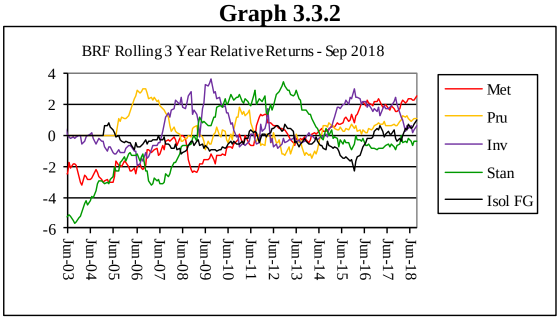


3.3 3-year rolling performance of prudential balanced portfolios relative to average prudential balanced portfolio on zero

Graph 3.3.1

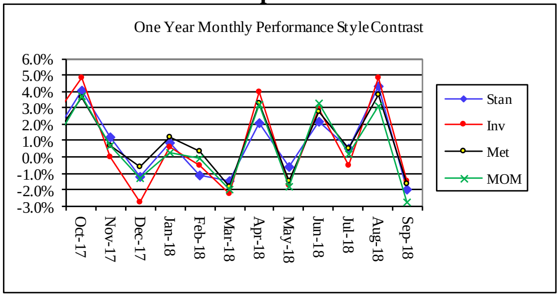


Graph 3.3.2

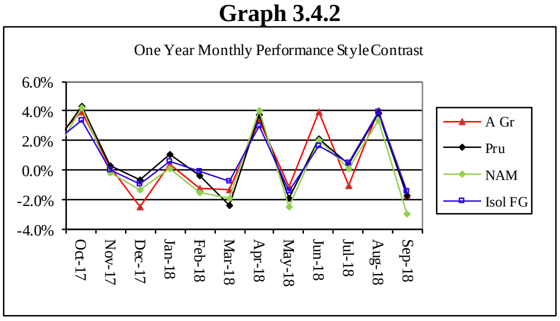


3.4 Monthly performance of prudential balanced portfolios

Graph 3.4.1

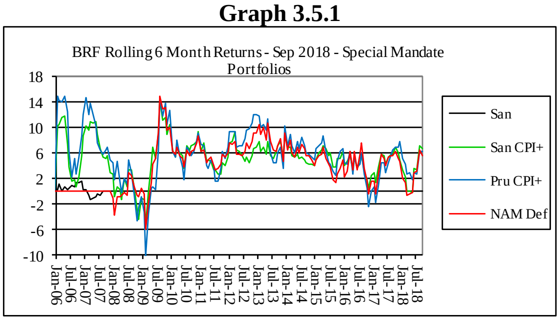


Graph 3.4.2

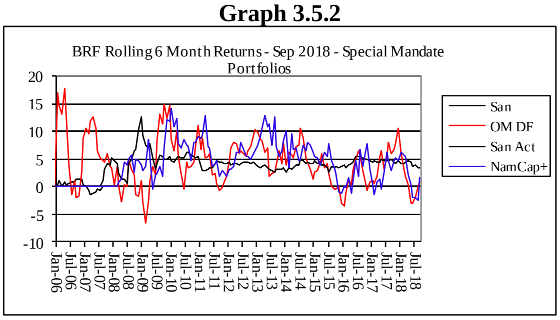


3.5. 6-month rolling and cumulative returns of 'special mandate' portfolios

Graph 3.5.1



Graph 3.5.2



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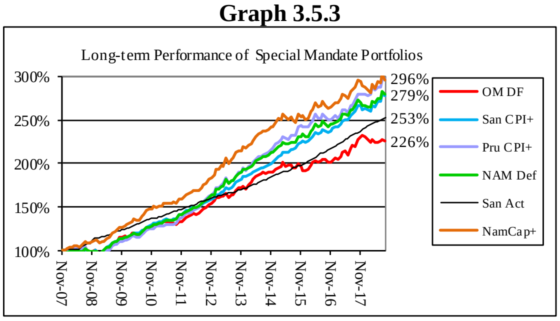
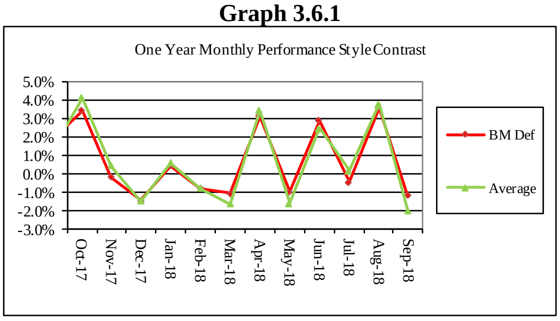
Graph 3.5.3

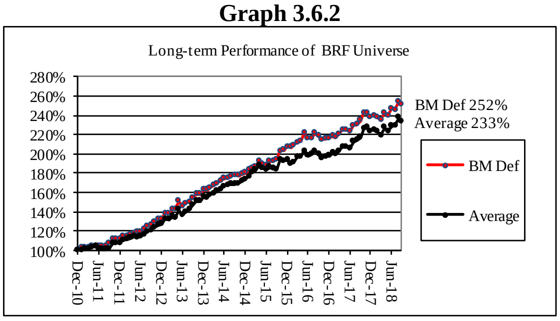


3.6 Monthly and cumulative performance of 'Benchmark Default' portfolio relative to average prudential balanced portfolio

Graph 3.6.1

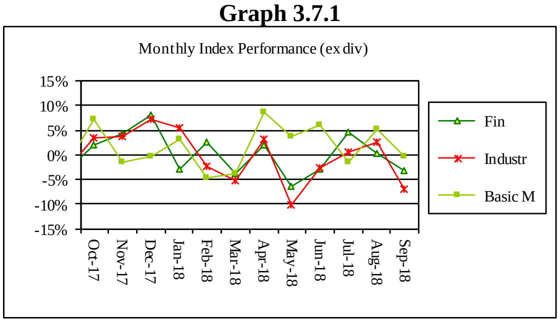


Graph 3.6.2

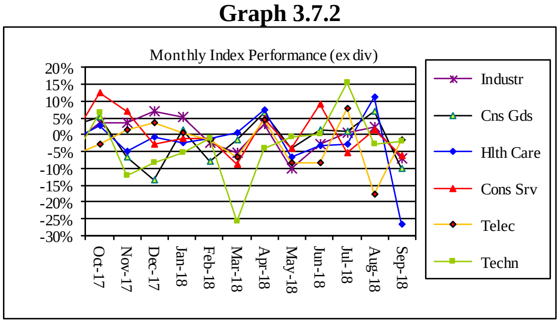


3.7 One-year monthly performance of key indices (excluding dividends)

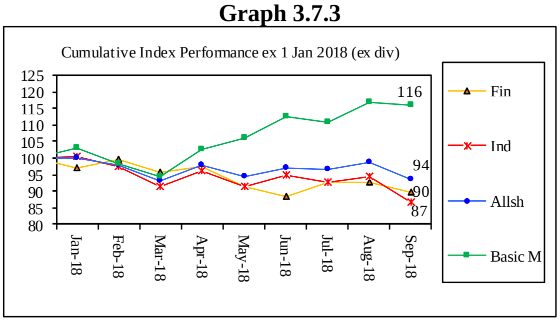
Graph 3.7.1



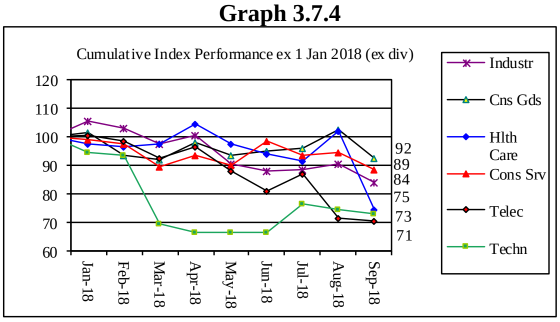
Graph 3.7.2



Graph 3.7.3



Graph 3.7.4



4. The Benchmark Default Portfolio – Facts in figures

Table 4.1

Portfolio	Default portfolio	Average Prud Bal
5-year nominal return - % p.a.	10.2	9.6
5-year real return - % p.a.	5.0	4.4
Equity exposure - % of portfolio (qtr end June 2018)	46.2	61.8
Cumulative return ex Jan 2011	151.53	132.96
5-year gross real return target - % p.a.	5	6
Target income replacement ratio p.a. - % of income per year of membership	2	2.4
Required net retirement contribution - % of salary	13.0	11.6

The above table reflects the actual returns of the Default Portfolio versus target returns required to produce an income replacement ratio of 2% of salary per year of fund membership that should secure a comfortable retirement income.

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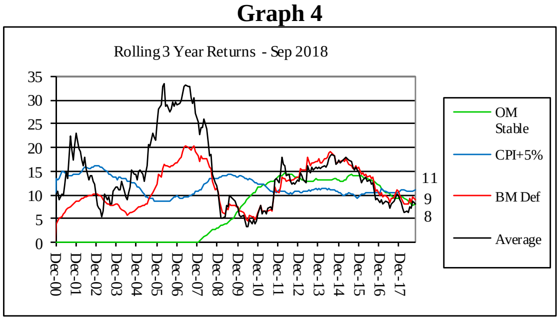
Table 4.2

Measure	**Money Market**	**Default Portf**	**Average Prud Bal**
Worst annual performance	6.0%	8.0%	6.2%
Best annual performance	8.1%	16.1%	16.0%
No of negative 1-year periods	n/a	0	0
Average of negative 1-year periods	n/a	n/a	n/a
Average of positive 1-year periods	7.2%	11.1%	10.0%

The table above presents one-year performance statistics. It highlights the performance differences between the 3 portfolios over the 3 years October 2015 to September 2018. This gives an indication of volatility of the performance of these 3 risk profiles.

Graph 4



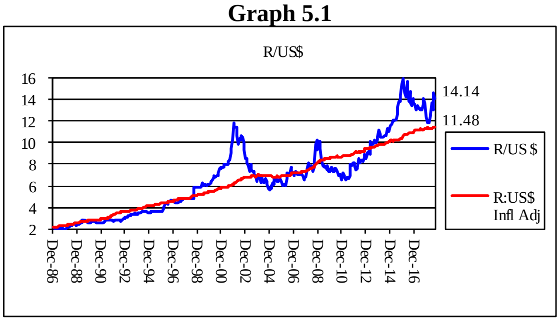
Graph 4 measures the success of the Benchmark Default portfolio in achieving its long-term gross investment return objective of inflation plus 5%, on a rolling 3-year basis. It also shows rolling 3 year returns of the average prudential balanced portfolio and rolling 3-year CPI. The Benchmark default portfolio 3-year return to end September was 9.0%, the average was 8.2% vs CPI plus 5% currently on 10.8%.

5. Review of Foreign Portfolio Flows and the Rand

How is the Rand doing?

Graph 5.1 indicates that the Rand by our measure is at fair value at 11.48 to the US Dollar while it actually stood at 14.14 at the end of September. Our measure is based on adjusting the two currencies by the respective domestic inflation rates.

Graph 5.1

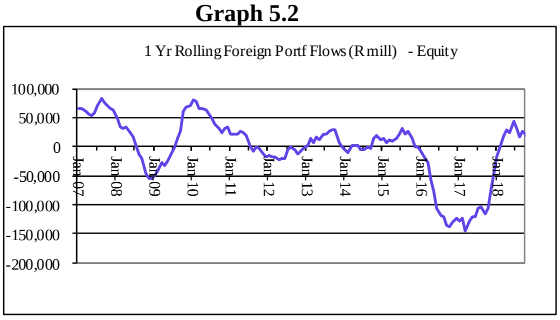


The Rand strengthened by 3.41% in September with net foreign investment outflows from bonds and equities of R 18.8 bn. Over the past 12 months the Rand weakened by 4.42%. Net outflows of foreign capital into equity and fixed interest securities over the past 12 months amounted to R 39.7 bn (outflow of R 31.5 bn to end August 2018).

Since the beginning of 2006, total net foreign portfolio inflows amounted to R 276.3bn (August R 295.8 bn).

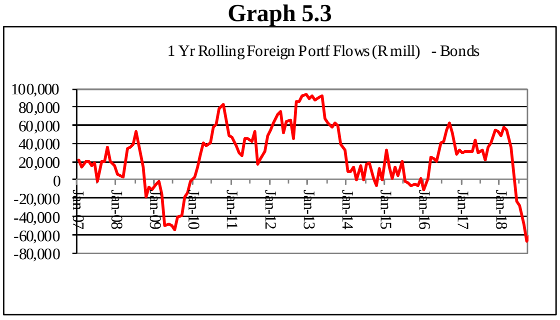
Graph 5.2 reflects a net inflow of capital into South African equities on a rolling one-year basis, of R27.5 bn at the end of September (inflow of R 16.9 bn year-on-year to end August). The month of September experienced a net outflow of R 15.5 bn. Since the beginning of 2006, foreign net investment outflows from equities amounts to R 5.9 bn (end August net investment of R 9.7 bn). This represents roughly 0.04% of the market capitalization of the JSE.

Graph 5.2



Graph 5.3 on a rolling one-year basis reflects foreign portfolio outflows in respect of SA bonds of R 67.1 bn over the past 12 months to end of September (outflow of R 48.4 bn over the 12 months to end of August). The month of September experienced a net outflow of R 3.2 bn. Since the beginning of 2006, foreign net investment in bonds amounts to R 282.2 bn (to August R 285.4 bn).

Graph 5.3



Graphs 5.4 reflects the movement of the JSE since January 1987 in nominal and in inflation adjusted terms, with trend lines for these. In nominal terms, the JSE grew by 11.1% per year since January 1987, and this excludes dividends of 3%. Namibian inflation over this period of 30 years was 8.1% per year. This is equivalent to a growth in real terms of 3.0% p.a. over this period,

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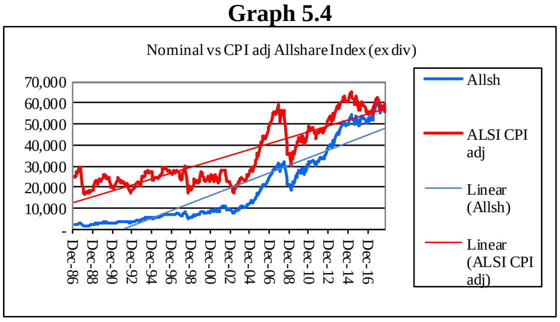
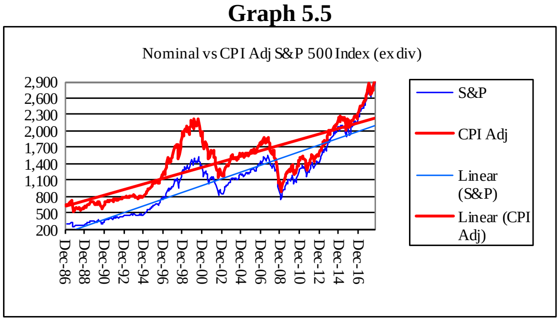
excluding dividends, or around 6.0% including dividends.

Graph 5.4



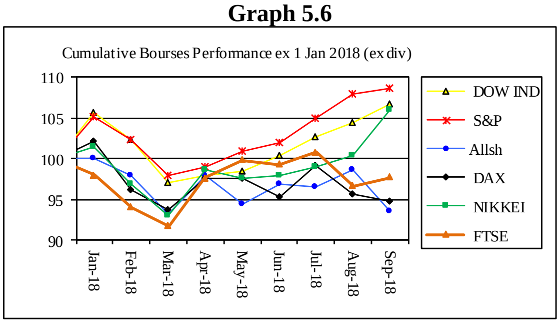
Graph 5.5 reflects the movement of the S&P500 Index since January 1987 in nominal and in inflation adjusted terms, with trend lines for these. Since January 1987 the S&P500 Index has grown by 7.7% per annum, over this period of 30 years. US inflation over this period was 2.6%. This is equivalent to a growth in real terms of 5.1% p.a. over this period, excluding dividends or around 7.1% including dividends.

Graph 5.5



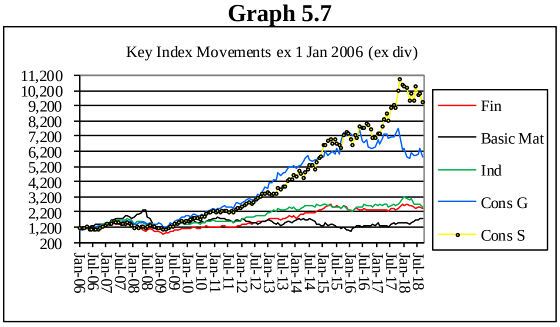
Graph 5.6 provides an interesting overview of some of the major global share indices, showing up the S&P as the top performing index since the start of 2018.

Graph 5.6



Graph 5.7 provides an overview of relative movement of the key equity sectors on the FTSE/JSE since December 2005 when these indices were first introduced. From this the investor should be able to deduce which sectors offer greater value and which one's offer less value on the basis of fundamentals. Annualised returns for these indices since the beginning of 2006 were: Consumer Services: 19.1%; Consumer Goods: 14.7%; Industrials: 7.6%; Financials: 7.2%; and Basic Materials: 4.3%.

Graph 5.7



6. **Investment regulations reduce your prospective pension by 27%**
by Tilman Friedrich

Namibian pension funds seem to have a serious problem and are unlikely to meet the implicit expectations of the retirement benefit one should expect them to provide. Typically pension funds are expected to produce an income replacement ratio of 2% per year of service. After having worked for 40 years, the expectation is that the fund member would receive a pension before commuting any portion of the retirement capital of 80% of the salary he earned just prior to retirement.

To achieve this implicit salary replacement ratio, pension fund assets should return roughly 6% above inflation, before asset manager fees. To achieve this return, it is assumed that funds would in practice invest around 75% in equity. The balance of the funds' investments would be invested in other conventional asset classes (property, bonds and cash) in varying proportions depending on investment market conditions.

We know that investment regulations place certain constraints on asset managers and this may impact investment returns. Namibian funds are for example required to have invested in Namibia at least 45% of their assets by 31 March 2019, with a maximum of 10% that may be invested in dual listed shares. In practice this means that managers will invest around 48% plus in Namibia just to make sure that they do not expose their fund clients to any risk of penalties for being below 45%. Similarly, investment managers would in practice not invest more than 70% in equities in total to avoid any penalty for exceeding this cap. History corroborates this modus operandi of asset managers, who had on average invested 41% in Namibia at a time when the minimum was still set at 35%, given that an increase to 40% was anticipated already. The constraints placed on asset managers may produce lower returns on the various typical asset classes investment managers invest in, as they cannot freely invest in the highest yielding assets that may globally be available.

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Benchmark Retirement Fund

MONTHLY REVIEW OF PORTFOLIO PERFORMANCE TO 30 SEPTEMBER 2018

By T H Friedrich – Managing Director, Retirement Fund Solutions Namibia (Pty) Ltd

The monthly review of portfolio performance, as set out in this issue, is also available on our website at www.rfsol.com.na.

Assuming Namibian investment managers were to maintain maximum equity exposure of 72% as the highest yielding asset class,, so as not to fall foul of the 75% cap too easily and assuming the asset classes would generate the returns they did from 1900 to 2016 (source – Prudential Investment Managers), table 1 shows that the managers should be able to generate a return of 6.3% before asset manager fees, typically around 0.8% or 5.5% after asset manager fees thus meeting the implicit return expectation of the traditional pension fund model.

Table 1

Asset Class	Historic Real Returns		Typical Balanced Fund Allocation	Proposed Real Return
Domestic Equity - Local	[illegible]	SA equity as proxy	[illegible]	[illegible]
Domestic Equity - Overall	[illegible]	SA equity as proxy	[illegible]	[illegible]
Domestic Bonds	[illegible]	Avg Gov & ILB Bond	[illegible]	[illegible]
Domestic Property	[illegible]	SA prop as proxy	[illegible]	[illegible]
Domestic Money Market	[illegible]	Per Prudential	[illegible]	[illegible]
SA Equity	[illegible]	Per Prudential	[illegible]	[illegible]
SA Bonds	[illegible]	Avg Gov, Corp & ILB Bond per Prudential	[illegible]	[illegible]
SA Property	[illegible]	Per Prudential	[illegible]	[illegible]
SA Money Market	[illegible]	Per Prudential	[illegible]	[illegible]
Global Equities	[illegible]	Per Prudential (US Equity)	[illegible]	[illegible]
Global Bonds	[illegible]	Per Prudential	[illegible]	[illegible]
Global Property	0.00%		[illegible]	[illegible]
Global Money Market	[illegible]	SA money market as proxy	[illegible]	[illegible]
Global Other	[illegible]	40% foreign bonds, 60% foreign equity	[illegible]	[illegible]
Total			100.00%	[illegible]

If we now use the above table but bring in the minimum Namibian exposure of 47.6%, so as to not fall foul of the 45% minimum Namibian allocation, apply the average asset allocation of Namibian asset managers to Namibian equities and allocate the balance in accordance with the spread across all other regions and asset classes that the average manager currently applies, table 2 shows that this will reduce investment returns by 21%, from 6.3% to 5.1%, before asset manager fees (typically around 0.8%) or 5.5% after asset manager fees, thus falling significantly short of the implicit return expectation of the traditional pension fund model. This is the result of the fact that asset managers will not be able to achieve a 72% exposure to equities due to the impact of the new minimum Namibian exposure of 45%.

Table 2

Asset Class	Historic Real Returns		Typical Balanced Fund Allocation	Proposed Real Return
Domestic Equity - Local	[illegible]	SA equity as proxy	[illegible]	[illegible]
Domestic Equity - Overall	[illegible]	SA equity as proxy	[illegible]	[illegible]
Domestic Bonds	[illegible]	Avg Gov & ILB Bond per Prudential	[illegible]	[illegible]
Domestic Property	[illegible]	SA prop as proxy	[illegible]	[illegible]
Domestic Money Market	[illegible]	Per Prudential	[illegible]	[illegible]
SA Equity	[illegible]	Per Prudential	[illegible]	[illegible]
SA Bonds	[illegible]	Avg Gov, Corp & ILB Bond per Prudential	[illegible]	[illegible]
SA Property	[illegible]	Per Prudential	[illegible]	[illegible]
SA Money Market	[illegible]	Per Prudential	[illegible]	[illegible]
Global Equities	[illegible]	Per Prudential (US Equity)	[illegible]	[illegible]
Global Bonds	[illegible]	Per Prudential	[illegible]	[illegible]
Global Property	0.00%		[illegible]	[illegible]
Global Money Market	[illegible]	SA money market as proxy	[illegible]	[illegible]
Global Other	[illegible]	40% foreign bonds, 60% foreign equity	[illegible]	[illegible]
Total			100.00%	[illegible]

The result of this expected decline in investment returns on pension fund investments will reduce the retirement benefit of a person who had been a member of a fund for 30 years and contributed 15% of remuneration towards his retirement benefit by 27%, based on straight line remuneration. If one were to do the calculation based on remuneration increasing in real terms, the result would be even more pronounced.

From 1900 to 2016 local equity returned 7.6% whereas since January 1987 local equities returned only around 6% (refer to graph 5.4 above). This indicates a decline in long-term return on equity by 1.6% per annum that would exacerbate the situation even further. Adjusting just the domestic equity return from the 7.6% shown in table 1 and 2 above, to 6% as applied in table 3 below, this will reduce investment returns by a further 24%, from 5.1% to 4.6%, before asset manager fees (typically around 0.8%), or 5.5% after asset manager fees thus falling even further short of the implicit return expectation of the traditional pension fund model (refer to table 3 below). The retirement benefit would on that basis decline by another 9.5% or by 39% in total!

Table 3

Asset Class	Historic Real Returns		Typical Balanced Fund Allocation	Proposed Real Return
Domestic Equity - Local	[illegible]	SA equity as proxy	[illegible]	[illegible]
Domestic Equity - Overall	[illegible]	SA equity as proxy	[illegible]	[illegible]
Domestic Bonds	[illegible]	Avg Gov & ILB Bond per Prudential	[illegible]	[illegible]
Domestic Property	[illegible]	SA prop as proxy	[illegible]	[illegible]
Domestic Money Market	[illegible]	Per Prudential	[illegible]	[illegible]
SA Equity	[illegible]	Per Prudential	[illegible]	[illegible]
SA Bonds	[illegible]	Avg Gov, Corp & ILB Bond per Prudential	[illegible]	[illegible]
SA Property	[illegible]	Per Prudential	[illegible]	[illegible]
SA Money Market	[illegible]	Per Prudential	[illegible]	[illegible]
Global Equities	[illegible]	Per Prudential (US Equity)	[illegible]	[illegible]
Global Bonds	[illegible]	Per Prudential	[illegible]	[illegible]
Global Property	0.00%		[illegible]	[illegible]
Global Money Market	[illegible]	SA money market as proxy	[illegible]	[illegible]
Global Other	[illegible]	40% foreign bonds, 60% foreign equity	[illegible]	[illegible]
Total			100.00%	[illegible]

The question is whether the assertion that the investment regulations have indeed constrained asset manager's asset allocation to equities?

Graph 1 reflects that the average allocation to equities (blue line) has declined from about 72% in March 2007, prior to the financial crisis to its current level of around 67%, on the back of a rising JSE Allshare Index. This was just before the 40% Namibian allocation came into effect, although we do believe that most managers had already structured their portfolios with this increased minimum exposure to Namibia in mind, that was initially to be effective 1 January 2018.

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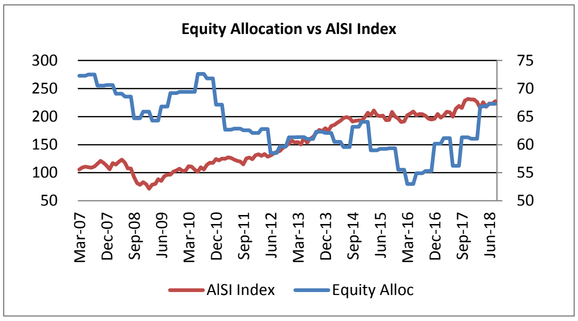
Graph 1



Conclusion

Although there may be many reasons for asset managers having gradually reduced their total equity allocation from72% to 67% over the last 11 years, we believe regulation 13 (previously known as regulation 28) with its dual constraints of what may be invested in dual listed shares and what may be invested outside Namibia, has in all likelihood played the most important role in asset managers reducing their total equity exposure. It is also highly likely that managers will further reduce their total equity exposure by another 5% in line with the increase in the minimum local allocation from 40% to 45% effective 31 March 2019.

As we have shown above, Namibian pension funds face a serious challenge in that it is unlikely their asset managers will be able to generate the gross return of around 6% per annum that is implicit in traditional funding and benefit structures and that pre-supposes a return on equities of 7.6%. We have shown that the impact of this is that member's retirement benefits will be around 27% lower than the implicit assumption to allow fund members to retire in comfort. Currently average 30 year equity returns are furthermore around 20% below the 117 year average returns, exacerbating the challenge pension funds face by prospectively reducing the retirement benefit by close to 40%. To make good this prospective shortfall members would have to contribute 40% more than they do currently, or instead of contributing at a rate of 15% of remuneration, members should contribute at 20% of remuneration.

Clearly pension fund members must bear this in mind when doing their financial planning by either setting aside more for retirement or by using more of their discretionary savings to invest in equities.