

Lessons learnt

Biggest challenge for trustees is to change members' behavioural patterns

IT'S BEEN JUST over 12 months since Lehman Brothers failed, proving to be the catalyst in a series of events that came close to destroying the world's financial system. With massive volatility in stock markets, on both South African and global markets the past year has been an especially difficult time for pension funds, many of whose members have the bulk of their life savings invested in them.

With the global economy having stabilised somewhat, the anniversary of the Lehman collapse is an opportune time to highlight the lessons that pension fund trustees and members can learn from those events.

Seelan Gobalsamy of Old Mutual Asset Management, says: "History has shown the prices of assets will eventually revert to their true value. The rampant increases in the equity markets between 2005 and 2007 meant the price of equities in all likelihood outstripped their true value. As such, it can be argued that although the timing may have been difficult to predict, we should have expected a correction.

"The world equity risk premium – the compensation for additional risk you take by investing in equities rather than secure Government bonds – for 2008 was the lowest, at -40%, since the Great Depression. The market fall of 2008 was a correction of the inflated returns up to 2007. In effect, if we look at long-term statistics we were borrowing from the future up to 2007.

"We need to ask ourselves what's supporting and driving underlying growth. For example, the housing bubble of the past few years was similar to the dotcom bubble of 2000, which were both driven by over-inflated prices and expectations," says Gobalsamy.

Given that cycle of destructive investor behaviour, John Anderson, national head of consulting strategy at Alexander Forbes, says the biggest challenge for trustees is to change members' behavioural patterns. "The first lesson is to not over-react, as in practice that serves only to lock in losses. When the correction began and people were questioning what to do many stuck with their long-term plan and simply changed nothing. They've come out of this crisis the best.

"Others got entirely out of equities, typi-

cally at or near the bottom of the cycle and into cash – just as interest rates bottomed and then, in turn, reversed that only when the market had recovered. One reason for that is it's easy to get out of the market and into cash but more difficult to buy back in," Anderson says. "Statistics show people who did that lost out significantly."

Another mistake trustees make is mismatching investment strategies. Gobalsamy explains: "In turbulent times it's important for trustees to review the longer-term investment strategy for their funds and ensure it remains appropriate and suitable to meet their goals. That doesn't mean you should over-react. Cash isn't always the best option. There's a risk that members may end up moving to cash and remain inappropriately invested in this asset class for the medium to long term, reducing their long-term return objectives.

The first lesson is to not over-react, as in practice that serves only to lock in losses

"There's a need to focus on higher risk factors. For example, asset allocation decisions are far more important than trying to select the best manager. Getting your asset allocation decision wrong by as little as 1% may have a much bigger impact on your fund than not choosing the best performing asset manager," says Gobalsamy.

"Funds also need to focus on risk objectives and not just return objectives. Many funds have a CPI+X% return objective, but their members won't accept a negative monthly return. A singular focus on the CPI+X% return objective may result in the fund not adequately meeting members' needs, which was the case over the past 18 months.

"Smoothing of returns is the most common example of addressing both those needs at the same time and, in some cases, allows you to be even more aggressive with your long-term return objective."



Seelan Gobalsamy
Prices of assets will eventually revert to their true value

Anderson adds: "Research shows 90% of fund members opt for the default strategy of a fund yet trustees often set up a one-size-fits-all strategy that doesn't cater for members' different needs. A life stage framework has proven itself more adaptable to such crises: one that adjusts the weighting to various risk profiles, from high through to low equity weightings."

One financial crisis followed by another has dented investors' confidence and many analysts believe we may be headed for a second crisis (the "W" recovery).

"Many fund managers are still conservatively positioned because of concerns about the sustainability of this market correction. The search for quality returns is a symptom of conservatism. That's all the more reason to not deviate from the long-term strategy that's designed to ignore short-term volatility."

Anderson says another lesson trustees

RETIREMENT FUND TRUSTEES

should learn from the collapse of many companies during the financial crisis is to perform due diligence of the quality and strength of their service providers. "We act as brokers for insurers and implement a process and formula that tests providers. We ensure due diligence is built into that – and that should be done not just in the case of insurers but with anyone who provides financial advice."

A final behavioural lesson is that in times of economic recession workers tend to get

retrenched and convert their pensions to cash rather than to a preservation fund – with inherent dangers.

Says Anderson: "In bad times you may need to draw on your preservation fund, so the flip side is that in good times you need to create a buffer for those bad times. People rarely think ahead in that respect."

Gobalsamy says: "There's a large demand and recognition by the industry that member education needs to start at a basic level and not just include retirement funding training;

Many members of retirement funds in SA haven't had the training to understand fully the financial principles necessary to make the correct investment decisions on their pension fund assets. Training therefore needs to start with the basic financial behaviours, such as the need to save.

"Communication is even more critical for funds with member-level investment choice. However, it's just as important to ensure members are educated in order to understand that communication." ■