

Take Two: Pension Funds Act takes centre stage

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While a number of noteworthy amendments have been made to Regulation 28 of the Pension Funds Act of 1956, the most impactful changes for the investment industry could be the higher allocation limits to alternative investments, due to the diversification potential they offer. With existing interests in Private Equity and a very strong Hedge Fund capability, we at SYm | mENTRY Multi-Manager are already well-equipped to add value for our clients in this specialised area, should the second draft be promulgated.

Numerous economic and investment industry developments over the last few years, particularly with the growth of complex investment options such as hedge funds and derivatives, necessitated the review of Regulation 28 of the Pension Funds Act. Released in December 2010, the second draft of proposed amendments focuses strongly on the requirement of having an Investment Policy Statement, on trustee training and amended asset allocation limits, and for the first time, acknowledges alternative assets as an independent asset class. While, in the longer term, there may be space for further debate around the actual relevance of asset constraints, there is no doubt that the second draft of Regulation 28 will play a key role in bolstering diversification in portfolios and more innovation in the quest to achieve enhanced portfolio returns.

The main amendments

While the second draft, like the current Regulation 28, is rules-based, it differs in that it has overriding principles such as asset-liability matching, improved trustee education, black economic empowerment, sustainable investing and managing foreign exposure risk. The look-through principle has been introduced in the second draft, meaning that for certain assets reporting will be done on underlying assets, not the products through which they are held. The second draft also refers to retirement annuities which were previously exempt, and the concept of investment policy statements is, for the first time, acknowledged and required by law – although the Act could perhaps be more explicit in its purpose, role and requirements.

And finally, derivatives, hedge funds and private equity have been explicitly defined and not merely categorised as “other” – with their investment limit increasing from 2.5% to a maximum allocation of 15%. From an industry perspective, the most impactful of the amendments has been this higher allocation to, and clarity on, these alternative assets.

SYm|mENTRY is well equipped

At SYm|mENTRY, the entire infrastructure for alternative investments, like funds of hedge funds, for example, is already in place, which means we will be well equipped – both structurally and operationally – when Regulation 28 is promulgated in its new form. This also means that cost implications for the actual implementation may not be particularly significant at this stage, although solutions like alternative investments do typically come at a higher cost. Since net returns ultimately drive pension fund members' savings, clients need to weigh up the benefit of diversification of returns to these costs. However, it is important to note that greater flexibility afforded to asset managers will make it easier to help clients fulfil their investment objectives.

While changes to Regulation 28 have meant slight shifts in our distribution, marketing and asset allocation in particular, they certainly haven't required a shift in the investment mindset of the business. We have always believed in alternative assets.

Addressing perceptions

It will be interesting to witness this regulation unfold in the South African investment industry. Regulation 28 changes are likely to give the alternative asset industry a platform from which to readdress the perceptions of this often-misunderstood asset class.

So, the second draft may not only play a key role in addressing the perception of hedge funds and other alternative assets, but also help to bolster these industries in their entirety. Although, we believe there is still some work to be done in terms of the actual classification of funds of hedge funds and single strategy hedge funds in the second draft, the fact that the Financial Services Board (FSB) and pension funds are recognising hedge funds is a testament to their value, and may help investors realise that while it may not currently be an effectively regulated asset class, it is certainly not inherently risky – a myth asset managers, particular those who deal with alternative assets like hedge funds, have been grappling with for years.

Education is key

One of the key factors in maximising the potential of alternative investments, given the proposed higher limits, is educating the industry about their merits, especially among trustees. Trustees are essentially volunteers from non-investment backgrounds who are elected to look after pension funds, yet they are legally held responsible to make decisions on behalf of their members. Professional,

independent trusteeship should be promoted and trustee remuneration should be regulated, but encouraged. Pension funds may do well to hire and pay for experts to become trustees, or existing trustees should continue to empower their members by ensuring they are well informed and educated.

In the near future...

Similarly, as custodians of clients' money, we as managers need to act responsibly and invest prudently. Negative and positive perceptions can pose a systemic risk to the entire industry. Given the proposed changes, asset managers will have to rethink their alternative strategies and determine how to use them more effectively. While in the short term there may not be an overwhelming inflow of funds into hedge funds and private equity funds, over the longer term, as pension funds, retail investors and trustees become more educated on the merits of alternative investing, there is likely to be hardened interest and greater inflows into these funds.

Proper forums, frameworks and dialogues need to be set up to ensure a smooth ride – over the long term striving towards world-class systems and regulatory frameworks.

Local vs Global

Currently, the changes to Regulation 28 differ from trends and practices offshore. Since South African hedge funds, for example, are in their infancy stage, the country has some way to go in terms of size – in relation to the US, for example – as well as regulatory and government interaction. In addition, internationally the trend is not to limit the amount that investors and pension funds can invest, but to put the onus on trustees. Understandably, South Africa may not be ready for this kind of system – primarily due to the education factor.

And finally

While we recognise that there is certainly room for continued improvement of the Act, we are certain the Act will open the playing fields for pension funds – that are entrusted with large amounts of members' funds – to realise the value of multi-manager alternative portfolios. Service providers will have additional opportunities to add value to clients in the alternative space, while providing funds with advice, investment policy statements and strategies.

The move to increase allocations will undoubtedly help to give pension funds and clients greater access to product ranges which can enhance their portfolio returns – and we are well equipped for this new journey.