1 GETTING TO THE BOTTOM OF THE COST PROBLEM

It is time for trustees to rethink what's really worth paying for.

The issue of costs is multi-dimensional:

1. To begin with, **different services** in the value chain of delivery employ **different charging structures**.
2. How these different charging structures **compound over the 40-year period a member is exposed to their retirement fund,** is an important consideration in understanding which **types of charges have the biggest impact** on reducing value to members over that time frame.
3. By decomposing which decisions have the greatest impact on member outcomes, trustees can begin to have more **meaningful debates on where costs could be contained** without compromising those outcomes to members. More importantly, perhaps it's time trustees rethink where they *should* be more actively interested in what they are paying for.

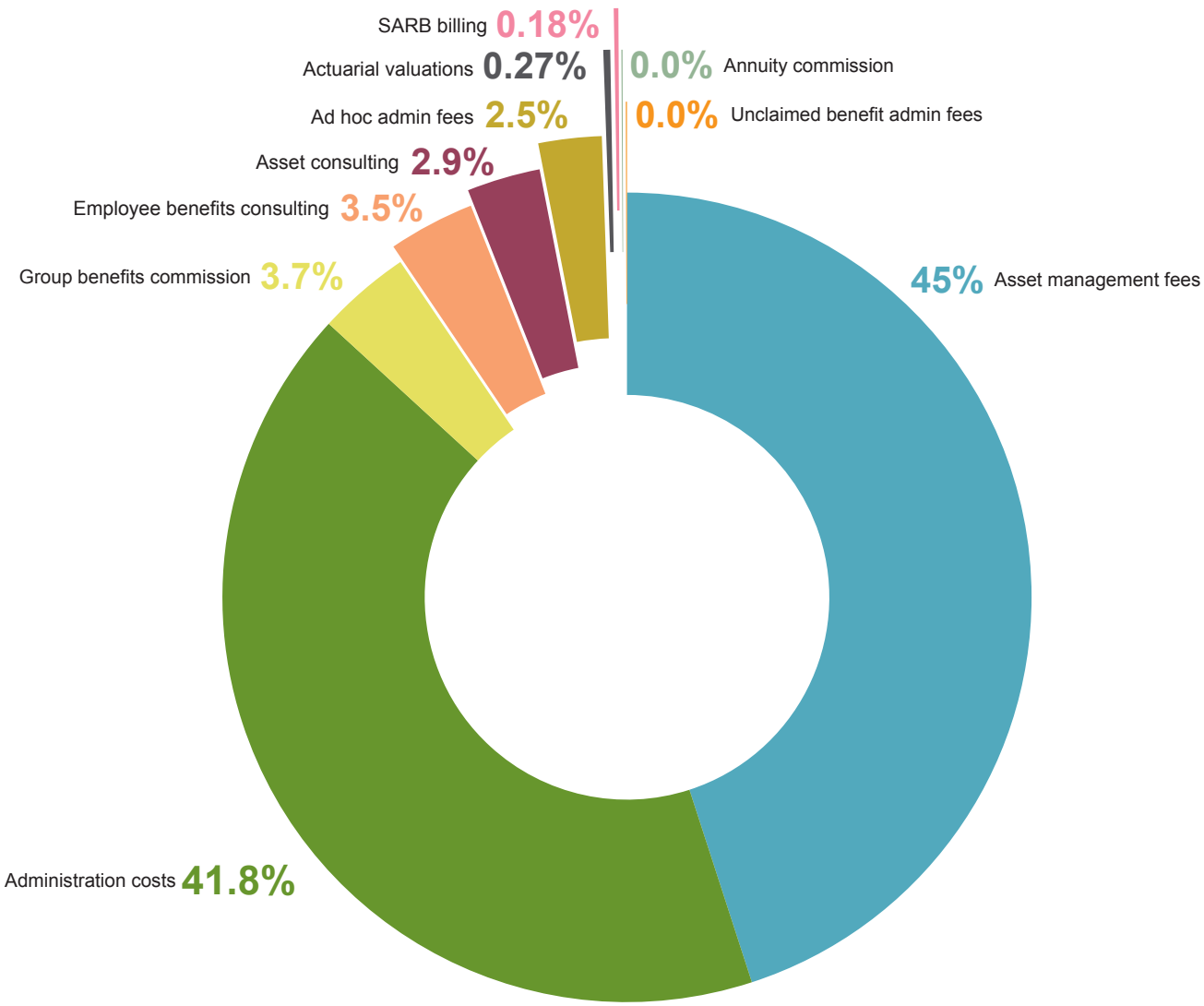
To some extent, National Treasury's paper on costs has already set out many of the issues relating to points 1. and 2. But a brief summary of the key points are important for our discussion here.

If we were to take a snapshot of the charges allocated in a typical, segregated retirement fund at a given point in time, the distribution of charges for an average 35-year-old fund member will be as shown in the graph below.

In the context of this once-off snapshot in time. Most of the fees on the fund go towards asset management and administration costs.

DISTRIBUTION OF CHARGES ALLOCATED TO A SEGREGATED FUND FOR AN AVERAGE 35-YEAR-OLD FUND MEMBER

A crude assessment of how these costs are **distributed** over the **spread of services provided.**

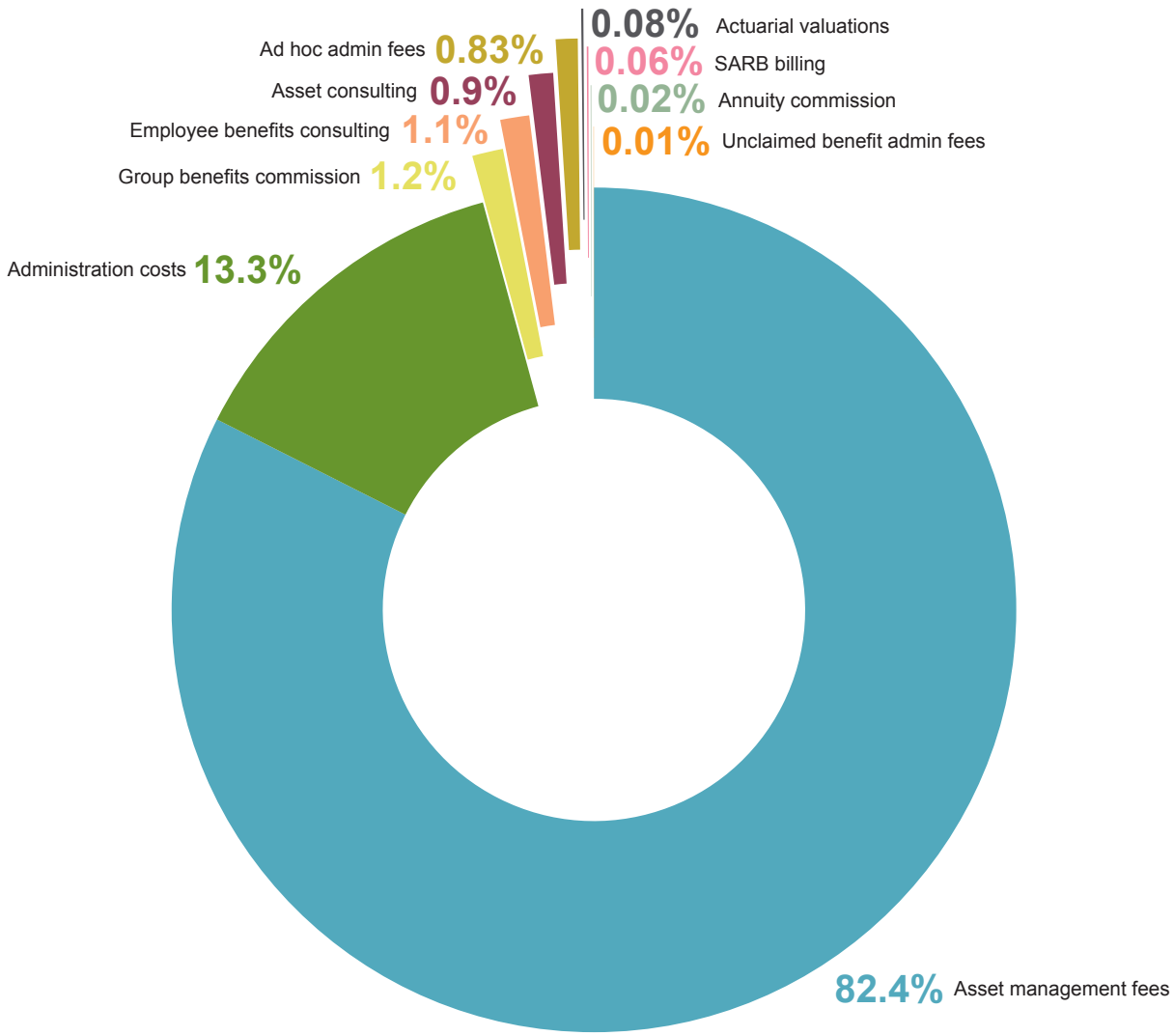


However if we were to assess how the power of compounding would affect those allocations over the 30-year period these members would have until retirement, the allocation to asset management nearly doubles to 82.4% of total costs by the time the member retires.

This translates into a weighted average of 66% for the whole period.

THE EFFECT OF COMPOUNDING ON FEE ALLOCATIONS OVER A 30-YEAR PERIOD

This is primarily a function of the **compounding effect** of each of the **charging types employed across the value chain.**



This outcome is a function of the different ways these services are charged, effectively we have three different charging models:

1. **The asset managers apply an assets under management (AUM) fee model**
   This model represents an annual fee charged as a percentage of *total* assets under management, inclusive of whatever growth occurred each year. Most commonly, asset managers charge these fees. Because *all* the assets are charged year after year, the compounding effect over time has its impact. For example, over a 40-year period, a charge of 0.50% on assets under management would compound to a 7.7% drag on a member's replacement ratio.
2. **Consultants in this example charge a fixed service fee or retainer fee**
   This fee is charged annually but is fixed based on specific services rendered with no reference to size of assets or frequency of cash flows. Of the three, this fee tends to have the lowest long-term impact on the ultimate value to the member. Historically, actuaries and asset consultants have used this charging structure. Occasionally, though, asset consultants and implementation or fiduciary managers apply an AUM based fee.
3. **The administration fee is based on new cash flows to the fund**
   The charge in this case applies *only* to the amount of new cash flows to the fund, when they occur (typically monthly). Some administrators use a fixed rand amount, others base it on a percentage of a member's salary, while others use a percentage of the member's contribution. As such, the impact of these charges is significantly smaller over time. For example, for a new 25-year-old member contributing 15% and being charged a 0.50% of payroll fee on each of those new cash flows, there would typically be a 2.2% drag on the member's replacement ratio after 40 years of contributions.

The outcome of the **fee impact** is a function of the different charging structures and the way they **compound over time.**