3 HOW DO WE KNOW IF COSTS ARE SUITABLE TO A SPECIFIC MEMBER POPULATION?

We need to consider which pricing structures work best for which member profiles.

Lowest cost is not always the best deal for the member, when we consider value. Likewise, lowest average cost is not always the best deal for the individual member.

In our last solution, we suggested that the long-term reduction in yields outcomes for individual members could vary significantly depending on that member profile, their income levels and their fund credit. To properly round out our assessments about cost structures, we need to understand:

- What are the criteria for payment?
- Where is it getting paid from?
- Who stands to benefit most from the cost structure?

The important point is that services are often priced with the end user in mind. As such, we need to consider which pricing structure works best for which market segment.

Let's use umbrella fund pricing structures as an excellent case in point. Comparing one umbrella fund's cost structure with another can be fairly complicated, but some insight into how providers determine their pricing structure helps in determining which fee structure truly offers value for money for members, given their particular demographic make-up.

1 An umbrella fund's fee structure can be extremely complicated

There are four broad categories of fees which a member in an umbrella fund will face: administration fees, governance fees, consulting fees or broker commission, and investment fees. These fees may be charged in a few different ways (initial or ongoing; fixed rand amount, percentage of salary, percentage of contribution, or percentage of assets). This makes it hard to compare apples with apples. For example, if Fund A charges a lower administration fee (as a percentage of **salary**) than Fund B, but a higher investment fee (as a percentage of **assets**), which fund is cheaper? And over what period?

Increasing the complexity is the fact that many umbrella funds charge multiple layers of fees. For example, instead of charging one administration and governance fee per member, some umbrella funds charge an additional scheme expense or contingency reserve account levy to cover governance-related expenses (such as audit fees, trustee expenses, FSB levies, and fidelity insurance premiums). These funds may also charge additional administration-related fees such as participating employer fees, investment administration fees or asset-based fees, resulting in two or three different administration-related fees being charged.

2 Consider all fees when making comparisons

When comparing umbrella funds, consider the total cost per member across all the different fees (administration, governance, consulting and investments) and not only the administration fee.

National Treasury[3] has commented that "employers may be easily persuaded by low up-front charges (that is, those deductible from contributions) to select a commercial umbrella fund that in fact, because of higher recurring charges [in other words, high investment fees], represents lower 'value-for-money' than other commercial umbrella funds".

This point is best illustrated through an example.

3 National Treasury (2014)

Case study

JOE'S MANUFACTURING

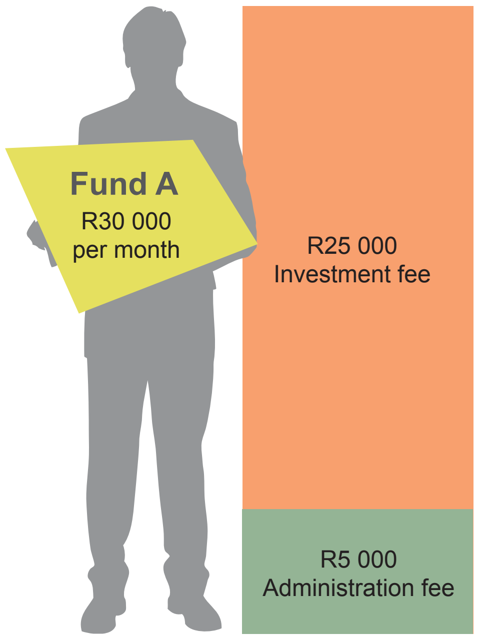
Joe's Manufacturing Ltd is a small manufacturing firm with 100 employees. These employees have a combined monthly pensionable salary of R1 million and total retirement fund savings of R30 million. The company is looking to join an umbrella fund and is comparing various options.

There is a significant difference in the administration fees quoted by two of the options: Fund A will charge a monthly fee of 0.5% of the member's monthly pensionable salary, whereas Fund B will charge only 0.25%. The investment fees of these two funds are fairly similar: 1.0% per annum of assets for Fund A against 1.1% per annum for Fund B. So which option should Joe Manufacturing Ltd select?

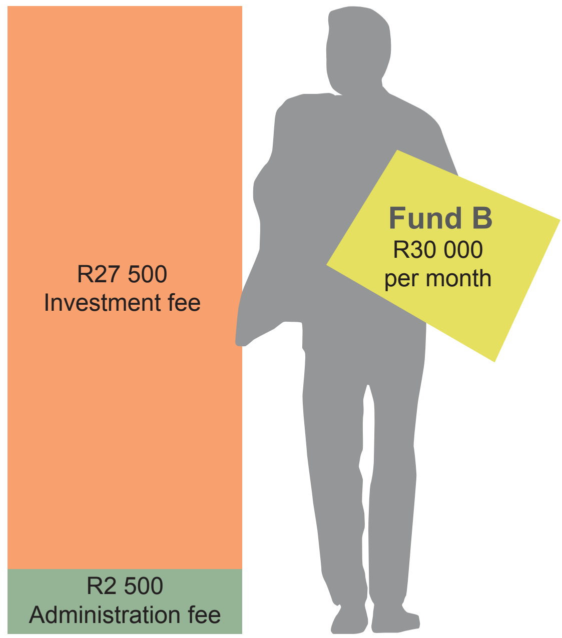
Our initial reaction is that Fund B offers significantly better value thanks to the lower administration fee. We pay little attention to the investment fees as the difference between them is relatively small. However, if we calculate the combined rand administration and investment fee, we find that this fee is the same for both funds (R30 000 per month).

Companies whose employees have managed to accumulate significant retirement fund savings need to be particularly aware of high investment fees. If the member has a choice of investment portfolios with differing investment fees, they should not choose the investment option with the lowest fees, as that option would typically be a money market fund offering a lower expected investment return. Rather the member should assess the potential benefit of such a portfolio against its cost.

TOTAL ADMINISTRATION AND INVESTMENT FEE



If you calculate the **combined rand administration** and **investment fee,** you'll find that this fee is the same for both funds (R30 000 per month).



3 Different charging approaches favour different groups of members

Note that there is not necessarily an optimal cost structure that suits all participants. The employer should balance the various trade-offs and select the cost structure most equitable to the majority of their employees. We can illustrate the point through two examples with Joe Manufacturing Ltd.

EXAMPLE 1

Administration fees are typically charged as a percentage of salary, whereas investment fees are charged as a percentage of assets. These different charging structures affect members with small and large retirement fund savings differently.

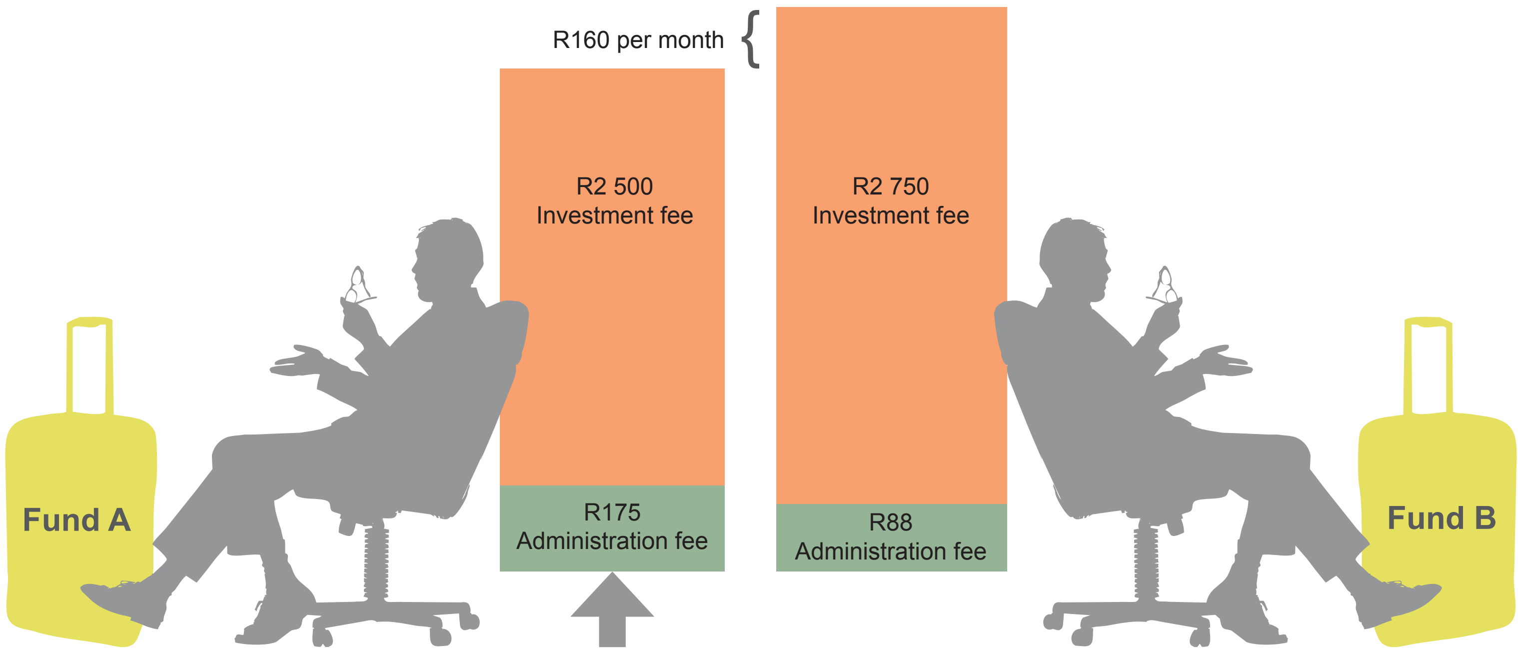
Two employees at Joe Manufacturing Ltd each earn R420 000 per annum. The first employee has worked for 30 years and saved R3 million in his retirement fund. The second employee has worked for 10 years and saved R420 000 in his retirement fund. Although the company is indifferent to the two options at the outset from the previous example (Fund A or Fund B), the two employees should have strong preferences on which fund is selected.

The first employee, who has already saved a significant amount towards retirement, would prefer Fund A. This fund has higher up-front charges (charges that are calculated as a percentage of his monthly salary or contribution) and lower recurring charges (charges that are calculated as a percentage of his total assets). Fund A would result in this employee paying approximately R160 per month less in administration and investment fees combined (at the outset).

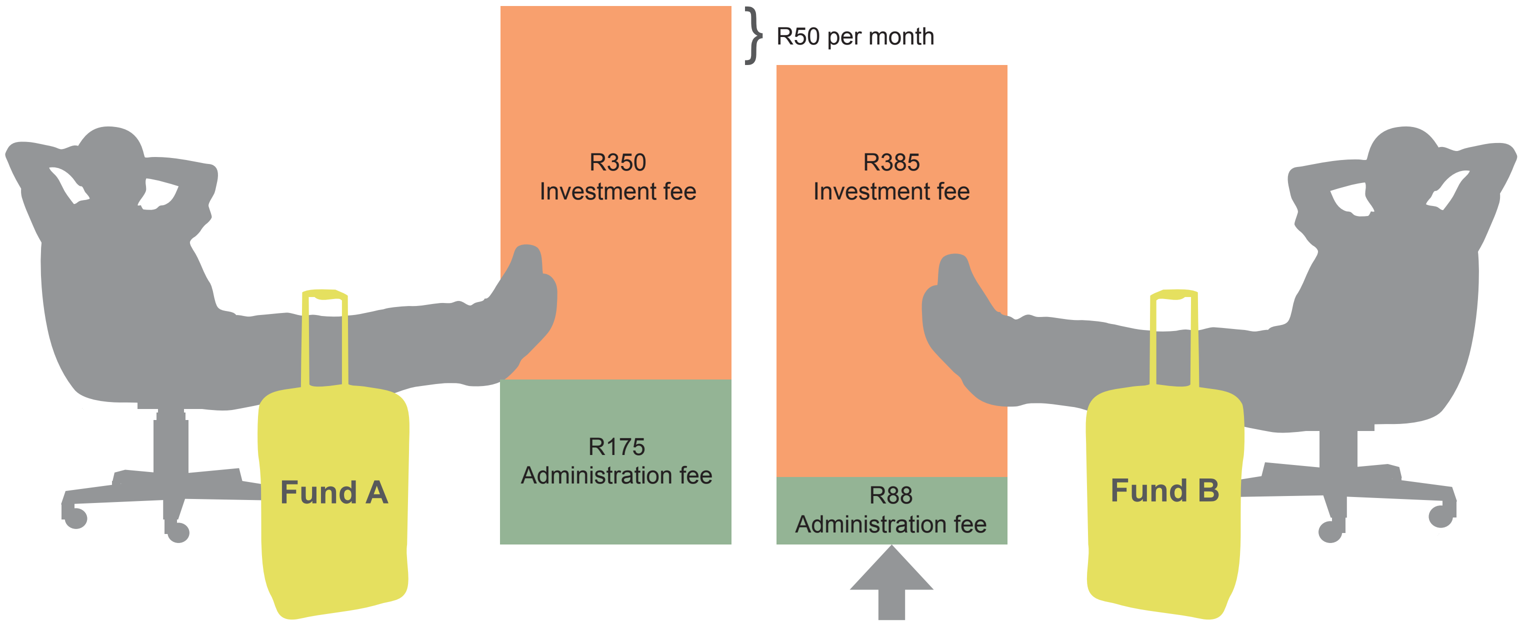
The second employee would prefer higher investment fees as his retirement savings account is relatively small. Fund B would result in this employee paying approximately R50 per month less in administration and investment fees.

Employee 1 has already saved a lot towards his retirement and **should prefer Fund A.** This fund has **higher up-front charges** and **lower recurring charges. Employee 2 would prefer higher investment fees** and lower up-front fees as his retirement savings account is relatively small.

TOTAL ADMINISTRATION AND INVESTMENT FEE
EMPLOYEE 1 (R3 MILLION IN SAVINGS)



TOTAL ADMINISTRATION AND INVESTMENT FEE
EMPLOYEE 2 (R420 000 IN SAVINGS)

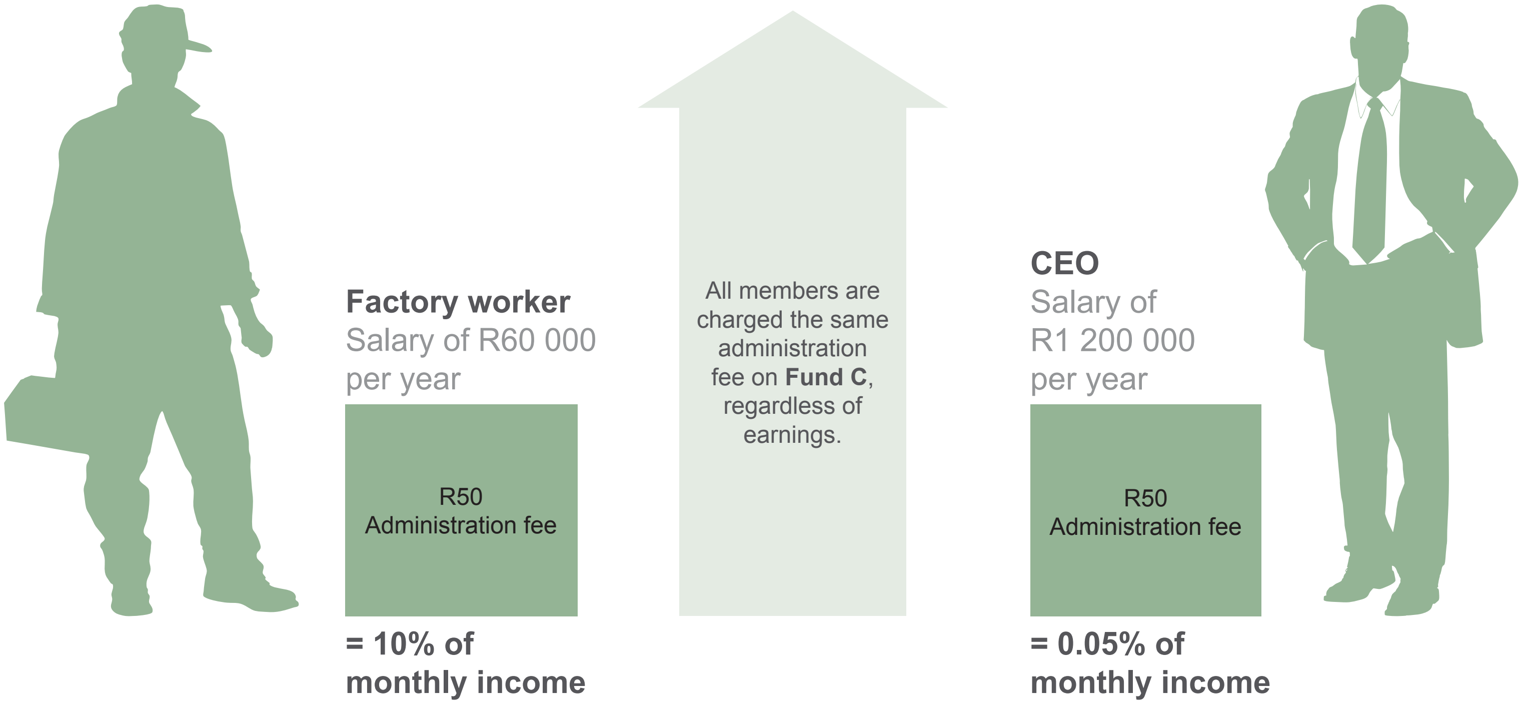


EXAMPLE 2

Different approaches to charging for the administration fee affect high-income and low-income members differently.

Fund A charges each member a monthly administration fee of 0.5% of their monthly pensionable salary. Fund C charges each member a monthly administration fee of R50. The total administration fee is the same for both umbrella funds (R5 000 per month) but the decision on which umbrella fund to select has significant implications to the individual members.

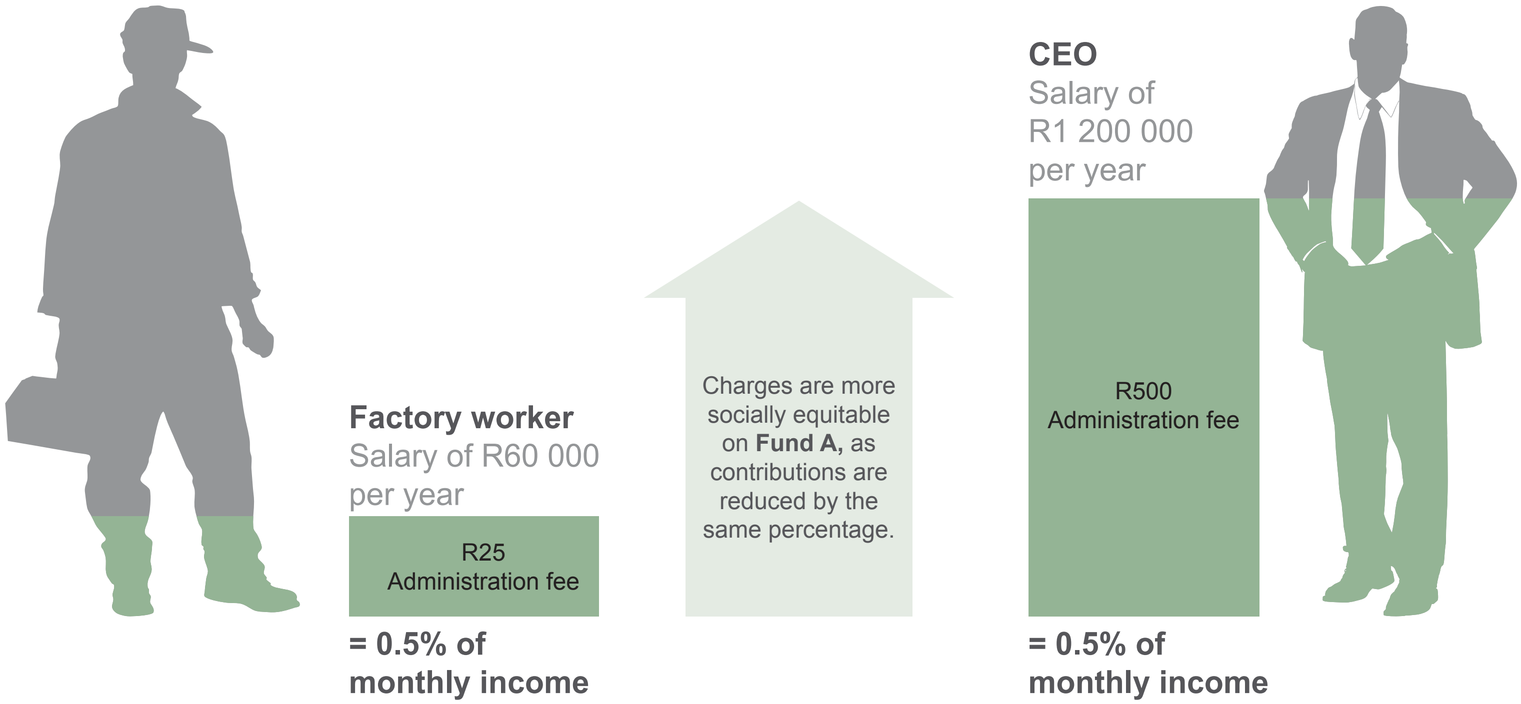
TOTAL ADMINISTRATION FEE FUND C



Fund C charges all members the same administration fee (R50 per month), irrespective of the size of their salaries or their total contribution. Administration fees may be charged for collecting a member's contribution and allocating it to their account, for example. Many of the expenses incurred in providing administration services have a fixed cost per member, irrespective of the size of that member's contribution. Therefore, charging a fixed rand amount is viewed as the most equitable approach from a financial or costing perspective. The issue with this approach is that the administration fee may become prohibitive for low-income members, significantly reducing the amount allocated towards their retirement savings and their expected replacement ratio outcomes. If a factory worker at Joe Manufactoring Ltd earns R60 000 per annum, of which he contributes R500 per month to his retirement fund, he ends up paying 10% of his monthly contribution towards administration fees.

The decision on **which umbrella fund to select** has significant **implications** for the individual members.

TOTAL ADMINISTRATION FEE FUND A



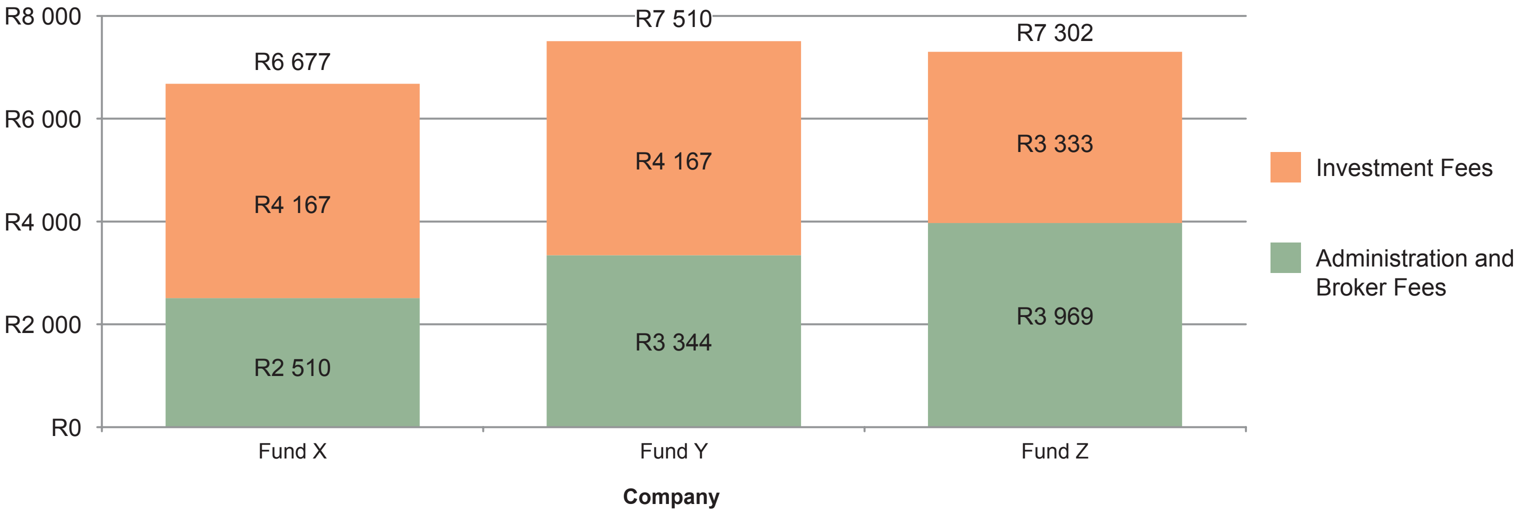
Fund A's charging structure is more equitable from a social perspective, as the administration fee would reduce all members' contributions by the same percentage (assuming the contribution rate is the same). The factory worker at Joe Manufactoring Ltd would pay an administration fee of R25 per month (0.5% of his monthly salary), reducing his retirement fund contributions by 5%. The CEO earning R1.2 million per year and contributing R10 000 per month to his retirement fund would pay a far larger administration fee (R500 per month or 5% of his monthly contributions). Although this approach is more equitable, it introduces cross-subsidies between high-income and low-income members within that employer group. Cross-subsidies need to be understood and managed over time.

4 Make comparisons using prospective measures where possible

All the examples make important points about how differential charging structures can affect members of a fund who may have different fund credits, annual salaries, or years to retirement. While these types of comparisons are easy to calculate and understand, they only represent a snapshot in time. When it comes to the long-term impact on the outcome to member, we need to be able to see how these charges compound over time.

The starting point for most decision-makers is the graph below. This graph provides a composite picture of the total charges for each type of umbrella fund pricing model. In this regard Fund X appears to be the cheapest. Often the decision-maker will stop at this point and simply select the cheapest option.

CURRENT MONTHLY FEES (COMPANY OVERVIEW)



But the real test comes by moving beyond the limits of this snapshot. To add the dimension of time and how compounding impacts the outcomes for various types of members, the chart on the next page provides the really critical information.

This measures the reduction in yield in the member's annual return after the required period of saving. So, for example, although the 'average' employee would appear to get the lowest reduction in fees from Fund X. In truth, though, for those members of the fund who either have a high fund credit or a high annual salary, Fund Y would have turned out to have the lowest impact on member out comes.

The key message here is that employers need to use more comprehensive measures in making their assessments of pricing differentials between umbrella fund fees. A tool that can take one through the debates we have described above can fill that need.

REDUCTION IN YIELD (10 YEARS) – ASSESSING IMPACT ON ALL MEMBERS

Although costs are important, value needs to be the determining factor. Good value in an umbrella fund is all about ensuring that the fund parameters are appropriate, investment options are suitable and appropriately priced, the fund improves member engagement and financial education, and there is firm and fair governance structure to mitigate against catastrophic failures or conflicts of interest.

Conclusion

Costs *do* matter. But paying the right amount for the value on offer also matters. It's a delicate balance. But with the right tools and the right understanding of the retirement fund value chain we should all be able to get to the right decisions about how to appropriately redress the imbalances that still exist in the market today.

The important point, though, is that it is the **aggregate** of all these costs that the member or investor actually bears. That means that this **aggregate** cost has to be held up against the **aggregate** potential value that can be added – and this is where is gets complicated. Until consumers are in a powerful enough position to shake down the value chain and demand fees that are commensurate with the value that the service contributes, the current cost hierarchy will remain.

There is only so much total cost a retirement fund or investment solution can shoulder and still provide investors with reasonable outcome. The travesty is that in a world that believes emphatically in the value of active management, trustees are more likely to try to force down the costs in the other building blocks than take on the price-making top managers. But they do so at the risk of cutting back on the very services that are most important in that final delivery.