COLLECTIVE insight

Contents

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Rethinking Retirement

ANNE CABOT-ALLETZHAUSER
Advantage Asset Managers

ONCE AGAIN, we seemed to have identified a particularly pressing topic for South Africa's leading thinkers. We had more than 21 submissions for this edition, which made selection particularly challenging. And, the submissions came from far and wide.

Our old mentor, Prof Anthony Asher (ex-Wits but now residing in Australia) took pains to remind us of the critical role South African's retirement funds play in filling important gaps in a torn social fabric. As he points out: "South Africa's retirement funds are civil society treasures." They straddle economic and social divisions. They offer major opportunities for leadership, recognition and learning to members who may not ever be afforded these opportunities, they provide a place where workers and management collaborate, and, little by little, they are beginning to create the institutional structures required to stand against managerial incompetence. In effect, as Prof Asher points out: "This is affirmative action with which no one can really argue."

But the challenge that faces us – not just in South Africa but globally – is that of both identifying the right models through which savings and retirement funding can most equitably and fruitfully be translated and promoting the appropriate behaviours from members and trustees to ensure success.

We have tried to weave a story in this edition of Collective Insight. First we address the question of determining exactly "how much is enough to retire on?" Alex Pestana and Chris Roelfse of SIM provide some particularly useful guidelines.

Then Pieter Koekemoer of Coronation provides an overview of the current state of savings in South Africa and the Government's proposals to address shortfalls.

For those of our readers who may not be fully appraised of the Government's proposals, Grant Pote, Head of Old Mutual Retirement Fund Reform Project, provides an excellent summary, the full text of which can be found on our website: collectiveinsight.co.za.

As Pote points out, South Africa has unique issues that are not present in many other countries – in particular it has a high number of individuals that are not in formal employment. For that reason, it has contemplated a multi-pillar framework to enhance income security and saving:

1. a non-contributory safety net funded out of Government revenue to provide for old age retirement (SOAP), disability grants, etc. applicable to all citizens (with significant revision or removal of the means test);
2. a compulsory contribution to a national social security system (between 13% and 18% of after tax income suggested) up to an income threshold (R60 000 per annum suggested) applicable to all formally employed citizens;
3. additional compulsory participation in a private occupational or individual retirement fund for all formally employed citizens earning above the income threshold for the social security system; and
4. supplementary voluntary savings by individuals with some tax incentives (still to be defined but capped – see table).

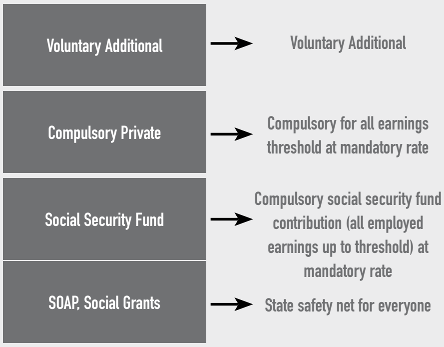
Pote provides examples to illustrate.

As Pote points out, two-thirds of the compulsory contribution rate, will be directed to retirement savings and the rest to death, disability and unemployment benefits. Accumulated savings will be preserved until retirement and there will be restrictions on the lump sums that can be taken at retirement. In addition, there are proposals to reduce costs associated with saving for retirement and to improve the governance of these savings.

But while Government, with its reform proposals, has put in place a framework that will go a long way towards resolving issues of savings and retirement, it will be up to investors and their service providers to ensure that the right investment options and behaviours are also adhered to.

To highlight these points, we've provided an edited version of two particularly useful articles – one by Thomas Fontaine of the US asset manager Alliance Bern- ▶▶ 4

PROPOSED NSSF* STRUCTURE



* NSSF – National Social Security Fund

Source: Old Mutual

3 stein, and the other by OMIGSA's Macro Strategy Investments boutique – that both address the question of whether investors are correctly understanding what asset class exposures would be required to address the myriad of investment goals that members may have.

Next, we asked Rob Rusconi to address the following challenge: what if we were asked to design a system from scratch to provide for the needs of the elderly – what would one have to consider and what would it look like? Rob helps us to understand the complex give and take required of the different stakeholders to get to the most equitable model of providing a savings safety net to the broader population, and gives us some sense of how other countries succeeded (and failed) in their quest for an optimal framework. (We added a brief sidebar comment on where South Africa too may have failed to appreciate that its model could have unintended consequences as well.)

Michael Streatfield then returns us to the dynamics of human behaviour and highlights how, even the best constructed retirement plans can be thwarted with our counter-productline tendencies when it comes to savings. Michael provides pointers as to how we can structure solutions that help mitigate against destructive human tendencies.

Finally, we wrap up our tour of the topic with an article by Jonathan Mort of Edward Nathan Sonnenbergs, who neatly summarises the many conflicts and land mines that can be found in the decision-making committees of pension funds and what we can do about improving the performance of these committees.

Sadly, in spite of such an exhaustive (and exhausting) tour of those issues that reshape our thinking about saving mechanisms for retirement and retirement fund investing, there were many excellent articles that we just couldn't include because of space constraints. As we did last time, we've included these articles, and the full text of articles that we simply provided edited summaries of (such as Thomas Fontaine's excellent article on "Target-Date Retirement Funds" and Urvesh Desai's full text on "Longevity and Growth Assets", on our website: www.collectiveinsight.co.za.

Make sure to also check out on our website the full text of Anthony Asher's article on "Weaving the Social Fabric". Allan Greenblo also offers superb commentary on a vital amendment to the Broad-based BEE Act gazetted earlier this year that allows up to a 40% cap, for black members of pension funds to be recognised as company owners. We also post Rowan Burger's assessment of the Government's proposals for savings along with a number of other extremely interesting points of view from other authors.

But if there's one final word on the topic, Prof Anthony Asher offers it best when he employs TS Eliot to tell us that "the good man is the builder if he builds what is good".

"Retirement funds are civil society treasures, to be encouraged and developed: do not let them be swept away by thoughtless reform – and while on the subject – why not stand for election?" ■

In our next issue

IN OUR NEXT issue of *Collective Insight* we'll address the topic of "Responsible Investing". The topic may have many different connotations for different stakeholders, but we hope to address everything from investing for social and environmental good, to investing for economic sustainability, to the impact of short-termism on our industry. From another perspective, the topic can also address the issue of ensuring that potential investors are responsibly marketed to – and that responsible investment options are available to the broader public.

Authors interested in addressing any topic they feel is related to "Responsible Investing" – should submit articles (approximately 1 200 words, plus illustrations) to Shannon Gunkel at shannong@collectiveinsight.co.za, no later than 5 October 2007.

Please remember this is a research publication and, as such, please no market commentary or marketing material. ■

Getting to Enough

"Annual income twenty pounds, annual expenditure nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds nought and six, result misery." Charles Dickens in **David Copperfield**

ALEX PESTANA
SIM

CHRIS ROELOFSE
SIMLab

TO HAVE ENOUGH is a thing of necessity, comfort and elegance. Unfortunately the word *enough* shares with words such as *beautiful, nice, large, intelligent* and a host of other concepts the quality of being clearly understood, but difficult to quantify. One person's feast is another's famine. Who then has enough, what is enough, and in particular how much is enough on which to retire?

This will always remain a relative question for each individual, and the answer is broadly shaped by three uncertainties: (i) the future of the world (ii) our personal destiny and (iii) our personal psychology.

Of the three, our personal psychology is perhaps most firmly under our control. Unfortunately, human nature rapidly saturates *enough* as soon as it gets it. Demands and aspirations elevate with rising means and can leave us in an unvarying state of satisfaction or frustration.

Our personal destiny can be sunk by the unforeseen. The world can devolve in uncertain ways, and we may lose our jobs despite our diligence. This does not mean savers ought to descend into fatalism. There are a number of principles that underlie getting to *enough* and living off *enough* in retirement.

One way of defining *enough* is to express it as an amount that will provide an income in retirement relative to the income during your working life. People tend to measure wealth relative to the means to which they have become accustomed, a fact the legal profession often takes into consideration when settling maintenance claims.

Assuming that income in employment is well above the subsistence level, it's possible to express *enough* as a percentage of final salary, let's say 70% thereof. This is reasonable since many costs disappear in retirement (mortgages, rearing children etc).

Let's take the example of a saver, Mr Good, as our base case. Mr Good starts saving at age 25 and contributes 15% of his salary to his retirement fund until he retires at 60. During this time he manages to earn a 5% real return on his savings (ie after

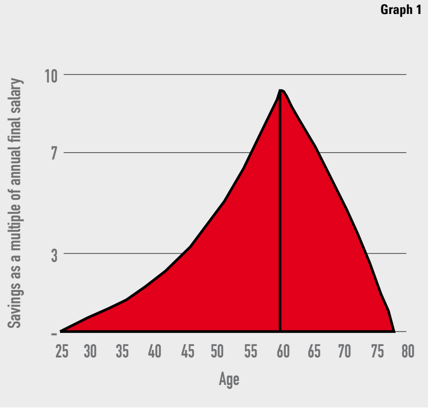
6

▶ 5 inflation).

His salary is assumed to grow at a real rate of 2% in line with general productivity in the economy. In retirement, he manages to live off 70% of his final salary. Mr Good enjoys sound health.

Mr Good's savings record may seem onerous, but is in reality the minimum requirement to keep him solvent to age 78. Graph 1 illustrates the point by tracking

→ MR GOOD'S RETIREMENT SAVINGS



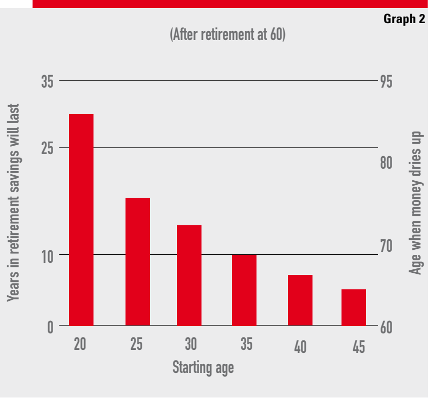
the accumulated savings during Mr Good's working life and its subsequent exhaustion during retirement.

Note that our concept of *enough* is concretised here; given our assumptions, it equates to just over nine times annual salary at retirement. In what follows, we illustrate the sensitivity of Mr Good's financial well-being to changes in various impacting factors.

1. Years of saving

A marginally longer contribution period has a dramatic effect on Mr Good's retirement. If Mr Good does not make contributions before the age of 35, his

→ STARTING AGE'S EFFECT ON HOW LONG MONEY LASTS

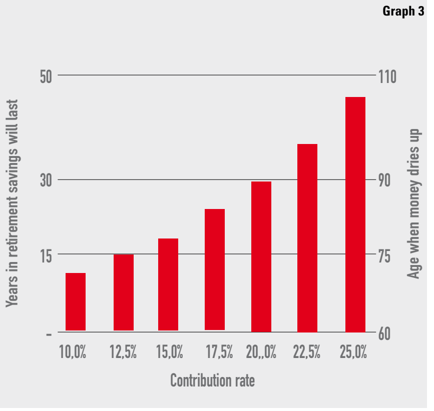


money can dry up 10 years into retirement (graph 2).

2. Contribution rate

Not contributing the required 15% of salary can have a pronounced effect on Mr Good's retirement well-being. A

→ CONTRIBUTION RATE'S EFFECT ON HOW LONG MONEY LASTS



drop in contributions from 15% to 10% results in retirement savings drying up seven years earlier (see graph 3). A recent survey conducted by Sanlam found that South Africans contribute less than 10% of their salary toward retirement savings. This is clearly inadequate, and explains why only a small percentage of South Africans (about 10%) retire financially independent.

3. Real investment return earned

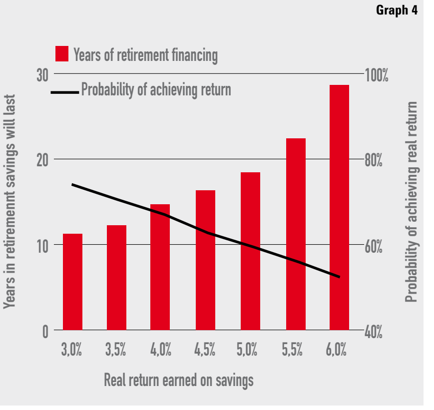
Higher returns translate into extra years of retirement comfort. However, the higher the return, the lower the chances of achieving it. One is 20% less likely to achieve a 6% than a 3% real return.

The benefits of higher returns decrease towards the latter stages of life because returns are earned off a diminishing capital base. Given the low risk tolerance of most pensioners, a more conservative strategy during retirement is sensible.

4. Longevity

People are living longer in retirement

→ REAL RETURN'S EFFECT ON HOW LONG MONEY LASTS



today. Whereas the typical American lived for around 11 years in retirement in 1950, today he must provide for over 18 years in retirement. This demands a larger nest-egg and might mean that many people will have to continue working into early "retirement".

The results of the above analysis indicate that to reach *enough* in retirement, savers need to:

- Start saving as early as possible and put off retirement for as long as possible.
- Maximise retirement contributions.
- Strive for high, yet realistic, real return.
- Prepare for increasing life expectancy – approximately 20 years in retirement.

These principles should prove a sound springboard to financial freedom. Get the balance between financial freedom and a real life right, lest you fall into this trap:

"He neither drank, smoked nor rode a bicycle. Living frugally, saving his money, he died early, surrounded by greedy relatives. It was a great lesson to me."

- John Barrymore, US actor [1882 – 1942].

Notes

1. *Caution: Not financial advice, but an indication of the effect that various factors have on their retirement prospects.*
2. *Sanlam Employee Benefits' 2007 Retirement Survey*
3. *Cadiz Quantitative Research – International Asset Allocation Analysis October 2006.*
4. *Research indicates that an equity allocation of at least 50% is required to optimise the probability of earning a real return in excess of 5%.*

ALEX PESTANA

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CHRIS ROELOFSE

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Restoring confidence in the pension system

It's clear that the retirement landscape will change significantly beyond 2010

PIETER KOEKEMOER
Coronation Fund Managers

SOUTH AFRICA has a well-developed retirement system, with six out of every 10 members of the working population belonging to a pension plan and total pension assets equalling 63% of GDP. However, the system suffers from significant structural deficiencies – primarily relating to poor population coverage – and for those in the system less than ideal post-retirement income replacement rates.

The regulatory framework governing the pension industry hasn't been comprehensively overhauled for more than 50 years, resulting in unnecessary complexity, undesirable inequities and failure to keep pace with new developments, both in financial markets and in global best policy practice.

To address those issues Government will transform SA's pension system over the next three years. The scope of the proposed reforms – contained in a discussion paper released by National Treasury in February 2007 – is ambitious. It includes the introduction of a mandatory social security system (SSS) and significant changes to the structure and role of the existing private sector pension industry.

The key reform objective is to provide basic income protection benefits to as many households as possible. Government also aims to strengthen the social contract between all South Africans through mandatory participation in the SSS. A final aim is a private pension industry that produces better and more cost-effective benefits supported by increased competition and better regulation.

While the strategic imperatives are clear, much of the detail still needs to be resolved in consultation with industry and other stakeholders. Those reforms will fundamentally alter SA's long-term savings industry landscape and should be the key issue on the agenda of any player in the savings industry.

Nine potential implications of the proposed reforms for the existing private sector pensions industry are discussed below.

1. The regulatory environment will become ever tighter

Treasury acknowledges that significant capacity exists in the private sector and that should be built upon. However, they highlight deficiencies in the regulatory and oversight structures that should be addressed. Those include:

- Undisclosed conflicts of interest between funds, trustees and service providers.
- Too much reliance placed by trustees on external service providers.
- Recent governance failures, including the bulking/secret profits, Fidentia and surplus apportionment scandals.
- Excessive costs, especially in existing underwritten individual retirement funding arrangements.

Because the potential of those issues are significant and resolution is relatively clear-cut the process of addressing them has already started, rather than waiting for general consensus on the future shape of SA's retirement system. It's inevitable that the compliance burden placed on funds and fund service providers will increase as a result.

2. The system will become simpler, more consistent and more equitable

All existing retirement vehicles will be unified under one new act, with similar treatment afforded to occupational pension funds, occupational provident funds and individual retirement funds. Current anomalies, such as benefit funds governed by a separate act and umbrella trusts that aren't regulated by the Financial Services Board, will also be removed.

Tax treatment of contributions, regulatory oversight and rules governing payment of benefits will be standardised for all types of funds. That will resolve the current bias against the self-employed and those with irregular employment patterns. It will also lead to administrative savings and a simplified financial planning environment.

3. Forced savings will become a reality

Many fund members retire with inadequate pensions due to starting contributions late, failing to preserve accumulated savings when changing jobs or as a result of crowding out caused by the funding of risk benefits. That will be addressed through the introduction of compulsory contributions and compulsory preservation of built-up benefits to ensure that more people can maintain a reasonable standard of living in retirement.

It's likely that the level of compulsory contributions will be below the current norm of contributing at least 15% of salary to a fund. The importance of freedom of movement within a compulsory system – by requiring portability and regulating excessive exit costs – is also acknowledged.

While compulsion will over time increase the number of savers in SA it's not yet clear whether the private sector industry will benefit meaningfully as a result.

4. Tax policy – fewer loopholes, redirected incentives

While compulsory savings will be introduced, tax incentives for fund contributions will remain in place. It's expected that the full mandatory contribution to a retirement fund will be tax-deductible and that some tax relief will be granted for additional voluntary savings – but only up to a maximum rand amount.

Government argues that there's no ▶▶ 10

8 reason to provide tax benefits to fund more than a "reasonable" standard of living. That will lead to a less progressive deduction formula than currently in place. That will be net negative for higher income earners.

If the maximum contribution deduction levels are set too low there's a real risk that the already depressed household savings rate could deteriorate further as current pension contributions are diverted to immediate consumption.

A portion of the "savings" resulting from the capping of contribution incentives will be redirected to lower income earners through wage subsidies aimed at formalising the income protection benefits for people currently below the tax threshold.

A very positive development was the abolishment of retirement fund tax (RFT), which enables tax-exempt build-up of benefits. It also completely removes tax as a factor to be taken into account when making investment decisions on behalf of retirement funds.

The recent simplification of the formulas governing tax relief on lump sums paid out of retirement funds is a clear sign of things to come: a simple system with no loopholes to be exploited by the wealthy. Hopefully, that will provide a wider tax base that will eventually lead to lower rates of tax.

5. The role of the private sector industry will change

The role of the private sector in the future pension system will be ancillary rather than primary. Basic benefits for all working people will be provided by the SSS, while the private sector will be tasked with providing additional benefits to ensure a reasonable standard of living for middle- and high-income earners.

The potential for existing fund members to opt out of the SSS, partially or completely, will be one of the most contentious debating points in the forthcoming consultation process.

6. A preference for annuity income

Treasury expresses a strong preference for a lifetime inflation-adjusted income in retirement while allowing for a limited tax-free lump sum withdrawal at retirement.

Income drawdown products, such as living annuities, are seen as (at best) suitable to provide additional income after buying a suitably large conventional annuity. That approach is aimed at managing longevity risk but doesn't represent the only viable policy approach.

An alternative solution to the longevity problem may be to make that risk insurable by lengthening the term structure of Government debt. Long-dated bonds will make it easier for insurers to underwrite the payment of an annuity starting 20 or 25 years in the future. Households should be allowed to balance their need to manage longevity risk with the ability to allow future generations to inherit excess capital.

It's also important to avoid creating an unrealistic and unaffordable burden in terms of minimum prescribed pensions for defined benefit funds.

7. Occupational retirement funds: consolidation ahead

Treasury makes the point that more than 80% of the 13 500 registered retirement funds have less than 100 members. In addition, the 88 largest funds have 73% of members. That leads to potential inefficiencies due to a lack of scale economies and increases systemic risk due to the low probability of detecting potential governance failures with the current available enforcement capacity.

The reform proposals therefore support consolidation of the long tail in the industry.

That could be achieved through more competitive personal pensions, industry funds, umbrella funds (with stronger governance structures than at present) and the SSS. Based on current proposals, consolidation will be accelerated by the potential to divert more than R20bn of annual contributions from the existing private sector pension system to the SSS.

8. Individual retirement funds: A more important role?

With tax treatment similar to that of occupational funds and a more competitive landscape through the introduction of simplified "savings-only" personal pensions, individual retirement funds will play a more significant role in the future. That's not dissimilar to trends in other markets, such as Australia, the United States, Germany, South Korea and Chile, where personal pensions make up an increasing share of pension assets.

9. Investment regulation to be modernised

Because members rather than employers carry the investment risk in many funds, it's envisaged that quantitative asset allocation limits (as currently embodied in Regulation 28) will remain a part of the future landscape. In line with an often-repeated industry request there's recognition that the current limits are outdated and should be reviewed to accommodate developments in the financial markets. More clarity on issues such as socially responsible investing and shareholder activism will also be provided. Furthermore, large funds will probably finally be allowed to deviate from the quantitative limits and apply the more appropriate "prudent expert" approach.

CONCLUSION

It's clear that the retirement landscape will change significantly beyond 2010. The principles defined by policymakers have the potential to assist in building a better, fairer SA over the long term, with a better social safety net and private pensions industry worthy of trust.

It's imperative that all stakeholders engage constructively in the public consultation process to ensure that the implementation challenges are adequately met and to minimise the potential for unintended negative consequences. ■

PIETER KOEKEMOER

KOEKEMOER, is a senior executive at Coronation Fund Managers, is responsible for all aspects of its retail business activities since 1999 and is the current chairman of the Association of Collective Investments. He's a CA (SA) a CFA and a CFP. ■

The dangers of equity conservatism

Critical issues for effective portfolio construction for retirement

This is an edited summary of a more detailed paper on target-date funds by THOMAS FONTAINE, of Alliance Bernstein, a US company highly regarded for their investment thinking. It outlines the investment implications of strategies for retirement investors, the need for sufficient equity allocation and where the risk really lies for these investors. The full text can be found on the Collective Insight *website.*

OVER THE PAST few decades we've seen a profound shift in the way that companies provide retirement benefits for workers. The traditional defined benefit plan that our parents relied heavily on has now been largely replaced by defined contribution plans that allow workers to accumulate their own retirement savings.

Employees now assume the responsibility for making investment decisions and the inherent long-term planning risks. Analysis of data available in the United States, makes it clear that most individuals haven't made good decisions. And as people now live longer they should be worried those assets won't last long enough to fund a possible 30- or 40-year retirement.

Drawing from Alliance Bernstein's accumulated research and wisdom concerning investment planning, the following conclusions about sound asset-class selection and effective diversification have emerged.

Research shows that most retirement funds aren't providing the high quality investment planning and asset allocation that trustees – as fiduciaries – should require. The primary flaw is that members invest too conservatively. They hold too little equity and too much fixed income to generate the growth required to fund participants' spending over what may be several decades in retirement.

It takes a lot of equity to generate sufficient growth. Analysis of historical data shows that the conservative and moderate equity allocations were likely to generate enough growth to fund spending for only 15 or 20 years.

Cash is an ineffective and expensive risk-reduction tool, even for retirees. Although cash probably is the safest investment over very short investment periods we demonstrate that only very large cash allocations can significantly reduce the magnitude or frequency of capital losses. Furthermore, the opportunity cost of large cash allocations over long time horizons can be enormous.

To achieve a proper fund design we assess the likely investment circumstances, objectives and risks of plan participants at different life stages.

Young savers enter the workforce with a valuable asset: their future labour income. Their initial plan contributions represent only a small fraction of their ultimate contributions – allowing them the freedom to take more risk – and they should simply seek high returns.

Midlife savers may have already accumulated significant savings, so strong returns can dramatically compound their savings. For a young saver with just R4 000, a 20% return is a gain of R800; for a midlife saver with R200 000, a 20% gain produces R40 000. Midlife savers can also accept significant market risk because they have very long investment horizons and can still replace lost capital through future labour income. They should thus seek high returns, gradually reducing risk as retirement approaches.

New retirees have depleted their labour income and must fund their spending needs through savings. They must deftly balance market risk, longevity risk and inflation risk. A new retiree's greatest risk is longevity; he must seek attractive returns to help fund a possibly protracted spending period.

Senior retirees have less opportunity to compound savings. A senior retiree should seek to limit the chance of a capital loss while generating sufficient returns to preserve purchasing power.

That framework leads us to redefine risk. While a classic measure of risk in investments is volatily measured by the standard deviation of returns, a myopic focus on that measure of risk is inappropriate in addressing retirement savings.

Broadly speaking, risk for these funds is the likelihood of failing to build enough savings to fund spending throughout retirement.

Different asset classes present different types of risk. Consideration of the relative importance of these risks at various life stages should be a central factor in asset allocation for retirement funds. (See table.)

THE RISK TRADE-OFFS IN THE RETIREMENT-SAVINGS PROBLEM

TYPE OF RISK	"SAFER" ASSETS	"RISKIER" ASSETS
Market: The chance that an investment's actual returns will be different from expected due to overall price fluctuations in the market	Cash	Equities
Savings shortfall: The chance an individual will not have enough money set aside to meet spending needs in retirement	Equities	Cash
Longevity: The chance that an individual will live much longer than expected, and will outlive savings	Equities	Cash
Inflation: The chance that inflation will erode the purchasing power of an individual's savings	Equities, Inflation-Protected Securities	Cash, Regular Bonds

The most important type of risk to consider will change over the participant's lifespan. In the working years, the main risk is a savings shortfall caused by not contributing enough or from investing too conservatively (or both). In the retirement years, it's longevity risk (risk of outliving your savings) and inflation risk (risk that your savings will lose buying power).

The risk of capital losses due to adverse market movements is relatively unimportant until well into retirement, when it may deplete savings beyond the point of recovery.

Equities can be effectively diversified to decrease market volatility without sacrificing returns by combining large-cap, small- and mid-cap equities, international equities and property.

The role of bonds is to offset equity ▶▶ 12

11 volatility – but bonds should deliver a real return.

Higher equity allocations can lead to lower savings in bad market scenarios but massively higher savings in good market scenarios. Equity rich combinations can underperform more conservative funds on the downside but the higher median performance and significant upside is compelling. Insufficient equity exposure is risky. Clearly traditional performance benchmarks don't apply more effective employee communications are crucial in helping participants stay the course.

In conclusion, risk indeed needs to be considered more broadly than market risk and varies, dependent on the stage in the retirement cycle of the individual. Wider diversification and active management can be more effective at controlling market risk while benefiting from the growth potential of equities. Retirement fund investors should be wary about adopting low equity weightings to "control risk".

Equity growth is essential, as longevity is putting increasing demands on retirement capital. ■

The case for more growth-orientated investing in SA

How much is enough? The replacement ratio

Urvesh Desai of Old Mutual Investment Group of SA agrees with Thomas Fontaine on the impact of longevity on retirement funds and the need to keep your retirement investment mind open to equity. Below is a summary from his full article, available on the Collective Insight website.

IN THE PAST, understanding the quality of life at retirement was done by calculating the replacement ratio – your income at retirement as a proportion of the average income during your employment. The challenge for retirees in the defined contribution environment is their replacement ratio is unknown until actual retirement. Ultimately individuals' savings determine their replacement ratio and hence the amount of retirement income.

The question that begs asking is: How much capital is necessary to ensure an individual has the necessary replacement ratio (ie income) at retirement?

Table 1 from a study done by Old Mutual Actuarial Consultants, shows that, at worst, the required return for a person saving 10,83% of his salary for 30 years and aiming for a replacement ratio of 80% is 9,3%.

At the other end of the scale, a person saving for 40 years and requiring a 55% replacement ratio would need a return of only 4,5%.

A more likely scenario is an individual saving 10,83% of his salary over 35 years to achieve a 70% replacement ratio. In this instance, he would need to earn a net real return of 6,8%.

For simplicity, we will ignore the effects of fees, the costs of investing and taxes. This allows us to make comparisons with the net real required returns spelt out in the replacement ratio table.

REQUIRED NET REAL RETURN

Table 1

(FOR MEMBERS WITH 10,83% RETIREMENT SAVINGS CONTRIBUTION)

	SERVICE		
	30 YEARS	35 YEARS	40 YEARS
RR:55%	7,1%	5,6%	4,5%
RR:60%	7,6%	6,0%	4,9%
RR:65%	8,0%	6,4%	5,3%
RR:70%	8,5%	6,8%	5,7%
RR:75%	8,9%	7,2%	6,0%
RR:80%	9,3%	7,5%	6,2%

Source: A Groyer and N Holtzhausen, "How Much is Enough?" presented at the 2006 Actuarial Society of South Africa convention.

THE NEED FOR REAL RETURNS

Table 2

TOTAL REAL RETURNS ON THE MAJOR ASSET CLASSES OVER THE LAST 35 YEARS TO 2006:

ASSET CLASS	REAL TOTAL RETURN
SA Inflation	10,4
SA Equities	10,5
SA Bonds	2,9
SA Cash	2,0
Listed Property	7,5
Offshore Equities	7,0
Offshore Bonds	2,4

Source: CSSS

We then construct five simple portfolios with different risk-return preferences, spanning from aggressive portfolios that come close to regulatory limits on equity allocation to income portfolios. Using the returns in table 2, we also calculate the real returns on these portfolios over the 35-year period (table 3).

A retiree would achieve a 70% replacement ratio goal if he had invested in the Balanced portfolio for the entire period until retirement. Investing in the Aggressive portfolio (10% more equities) would have increased the replacement ratio to more than 80%.

Had the investor invested in the Conservative portfolio, the replacement ratio would be less than 55%! Fees and taxes would reduce these returns further and hence reduce the replacement ratio. Active management of the assets, it can be argued, could have compensated for these costs.

We acknowledge historical returns are highly dependent on the period selected. However, these figures do highlight that, in order to create sufficient wealth for retirement, it's essential to have exposure to high growth 14

ASSET CLASSES

Table 3

	SA EQUITY	SA BONDS	SA CASH	SA LISTED PROPERTY	OFFSHORE EQUITY	OFFSHORE BONDS	NOMINAL TOTAL RETURN	REAL TOTAL RETURN
Aggressive	60%	15%	5%	5%	10%	5%	18,3	8,1
Balanced	50%	20%	10%	5%	10%	5%	17,5	7,3
Conservative	30%	30%	20%	5%	5%	10%	15,6	5,4
Defensive	15%	30%	35%	5%	5%	10%	14,3	4,1
Income	0%	40%	45%	15%	0%	0%	13,4	3,2

12 assets like equities for most of the pre-retirement period.

Longevity risks rising

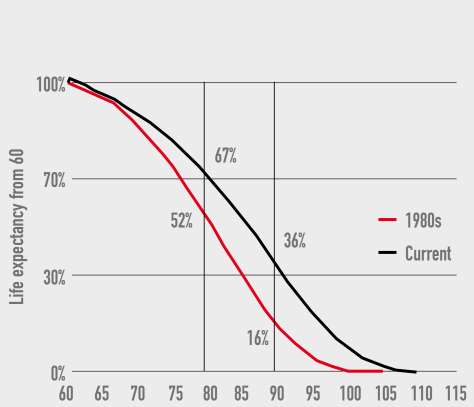
The need for real, inflation-beating returns does not end at retirement. With the present era of relatively low inflation and low bond yields, annuities sold by insurers have become increasingly "expensive". For this reason, more people are choosing to defer buying annuities and instead drawing down their assets through living annuities.

This places the longevity risk squarely on the shoulders of the retiree – at a time that those retiring are living much longer than before, even in societies like SA where Aids is prevalent.

The need for real, inflation-beating returns does not end at retirement.

Evidence from the UK (which is relevant to SA as insurers here adapt these tables) shows that if a person reaches retirement age, there's a high and rising probability that he will live for another 20 or 30 years. The graph above shows the probability of an individual aged 60 surviving to 90 has gone up from 16% to 36%.

SURVIVING TO NINETY?



Source: Old Mutual

Retirement – a point of significant transition?

Given longer living, and with no more contributions to bolster savings during retirement, the case for continuing exposure to high growth real assets should be clear. Retirement has become a crucial point of transition for retirement investments.

The proliferation of Life Staging models attempts to reduce the volatility of investments at retirement. That results in a highly conservative positioning at retirement, which is not appropriate.

Indeed, at retirement, given the length of time those assets will continue to be invested, a retiree should still be concerned with the total return of his portfolio and not merely the income yield.

The possibility of insufficient returns

We live in an age of consumerism, where there's tremendous focus on the cost of investing. Less focus is given to a more significant determinant of ultimate investment value - the opportunity cost of being invested inappropriately.

The ticking time bomb of conservative default options (the refuge of the unknowing and the apathetic) may well prove to be an ugly wake-up call when this generation retires.

For this reason, it's vital that investors focus both on the risk of not having enough at retirement as well as on the risk of not having enough while in retirement. ■

Could you design a better system?

It's well short of 20:20 vision

ROB RUSCONI
Independent Consultant

SO HERE'S TODAY'S assignment: Design the system to provide the needs of the elderly citizens of a country. Do so at minimum cost and maximum effectiveness. If you can benefit key elements of the economy at the same time – for example, the capital and labour markets – that would be a bonus. At least make sure that they aren't damaged.

What do you need to know about this country? Forty-five million people, an emerging economy, some would say middle-income, others not, certainly very sophisticated in services, but with pockets of devastating poverty as well. In fact, South Africa has one of the highest levels of socioeconomic inequality in the world.

It provides well for the very poor through a system of social grants. Private sector provision for the middle- to upper-income isn't too bad but there are a number of problems to sort out... markets sometimes need encouragement to work effectively.

SA's biggest problem is in the middle: above the unemployed, below the comparatively wealthy. Low- to middle-income workers don't save effectively for retirement. Anecdotal evidence suggests that anyone with an interrupted career is unlikely to provide well for those zero-income years of old age.

Roadmap

Examining this assignment you'll recognise two fundamental objectives: saving and redistribution. Identifying them and measuring them are rather different problems and many other goals should receive proper attention alongside those. And you'll identify three design trade-offs in the way in which you set up the system that affects the success with which you meet your goals: the locus of risk, the extent of the funding and the issue of management.

Saving

Why do governments want their citizens to save? Every one of us, unless unfortunate enough to die prematurely, goes through three stages of life: a growing 16

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phase, a working phase and a weakening phase. The increase in the average lifespan doesn't change the reality of those phases. Those who don't make adequate provision during their working life for the time that follows that must find resources elsewhere.

Governments wouldn't like to be the sole source of those resources, so it pays policymakers to encourage citizens to save. That's why the vast majority of governments literally pay their citizens to save – most frequently through tax incentives, occasionally by adding directly to the savings made by their people.

Most economists agree that encouraging household saving is the right thing for the policymaker to do, because strong saving brings economic benefit.

Another advantage of the government incentive is that it draws the savings of citizens into a supposedly safe environment.

As co-sponsor – which is exactly what government is – the policymaker has the right and obligation to safeguard those savings, imposing conditions on private sector entities that enhance the security and investment returns on deposited amounts.

It's in the interest of a government for citizens to save for retirement and most countries back that with finance. The notable exception to that is New Zealand, which provides a flat-rate pension to all citizens and doesn't provide any tax incentives to save. However, on the back of concerns that household savings rates are low it's introducing a saving arrangement with a once-off government subsidy.

Redistribution

For both moral and practical reasons

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State's flawed annuities plan

Is this Robin Hood in reverse?

IN MARCH THIS YEAR, National Treasury commented on annuitisation ahead of the expected second round of its draft retirement reform proposals. In an attempt to foster retirement savings, Treasury is proposing to limit lump sum payments and ensure wider use of annuitisation. While a noble endeavour on the surface, it could have the unintended consequence of resulting in a reverse Robin Hood scenario – of stealing from the poor to benefit the rich.

There are hidden dangers in limiting the choice at retirement only to annuities. International research has shown that compulsory annuitisation has severe drawbacks and can end up being a regressive measure for societies.

How so? It's well known that people with high incomes live longer. Annuities work by sharing mortality risks across the group by paying people in that pool until they die. Those who live longer benefit from a portion of the payments of those who die sooner. In effect, were all South Africans to be in such a pool there would be a shift of wealth from the poor to the richer people, who by living longer benefit from those annuities for longer.

This effect of mandatory annuitisation was documented by Jeffrey Brown, of the Centre for Retirement Research at Boston College, who stated: "These implicit financial transfers are often away from economically disadvantaged groups and towards groups that are better off financially."

Compulsory annuitisation would therefore be a case of Robin Hood reversed. The State would be ensuring the rich would be profiting from the poor – certainly a dire unintended outcome. The goals of the State would be better met by ensuring that a minimum level of income (with inflation increases) is annuitised, with the balance once that's met remaining flexible.

By requiring that investors meet a minimum level of income Government would have the assurance that retired people won't turn to them for social security when their lump sum assets are exhausted. By allowing more flexibility for those with assets over and above that income level wealth transfers from the poor to the wealthy will be minimised.

With compulsory annuitisation, the State would be ensuring the rich could be profiting from the poor.

The flexibility would also allow investors to choose annuities, including more flexible living annuities, or investing in fund investments or even in a post-retirement business.

Another danger is that limiting choices will make investing for retirement unattractive. People may choose to save in other ways – although we know that too often that never happens or those retirement savings are raided.

Compulsory annuitisation also bucks two major international trends: increased freedom of choice in investing and improving longevity trends. We live in a world where people want more choice.

Improving longevity is seeing a massive shift in the number of people living to advanced ages. To put that in context, the number of people in Britain living to 100 and beyond was 6 000 in 2000. However, 60 years from now the number of centenarians is expected to be a staggering 95 000. Those in good health retiring at 55 may want to place a portion of their retirement assets into growth investments to take care of them in much later years. A rigid approach at retirement doesn't address these improving mortality trends and risks offering poor values.

The road to good intention is often littered with the potholes of unintended consequences.

Retirement reform needs to look to improve the lot of all South Africans and should encourage savings. Flexibility for those retiring is needed for them to meet the needs over improving lifetimes. We encourage those in the reform process to keep that in mind and ensure fairness and equality. ■

16 every government looks after the poor. Policymakers do that in a number of ways. All governments play Robin Hood to a greater or lesser extent, taking more in taxes from the wealthy than the poor, systematically redistributing resources across the socioeconomic spectrum in the process.

Redistribution is also a key goal in old age policy. Some can't save for retirement and government has a form of obligation to provide for those people. Some will not.

While most take the view that redistribution is correct, differences on its appropriate extent are sharp, often dividing individuals and groups on ideological grounds. That's unnecessary and unfortunate, particularly in the absence of proper measurement. We must strive for objectivity, recognising the complexity of the issues and working harder to identify and measure the key parameters that demonstrate the extent of redistribution in the system.

Total national system cost, tax revenue foregone, projected individual retirement saving and replacement ratios are all difficult to determine. But in the absence of clear measures how can we formulate clear policy?

So redistribution and saving are the key goals, supported by the respective benchmarks – an objective without a yardstick isn't helpful – of minimum income in retirement and some measure of projected retirement income relative to working income. There are other goals, which should not be omitted in the question for simplicity.

Design must be a means to an end and the end must be framed with the goals in mind, supported by proper benchmarking.

Locus of risk

The DB/DC issue is hardly a debate in SA any longer. That's a little unfortunate, because the denial of a sensible design option is restrictive, particularly on an issue that so profoundly impacts the risk borne by our citizens. Hybrid arrangements that allow risk-sharing between employers and fund members have been effectively ruled out because the surplus legislation classifies them with defined benefit funds.

The reduction of corporate defined benefit funds and Government social security in favour of defined contribution alternatives is ubiquitous. That transformation is evident in widespread restructuring of corporate arrangements. It shows itself in the dramatic modification of national systems throughout Spanish-speaking Latin America – Brazil being a notable exception – and in the former Russia-aligned states of Eastern Europe and central Asia.

Australia has introduced mandatory individual account saving; Sweden has added a small individual account component to the national system; China and India are introducing change; Nigeria has launched compulsory saving to personal accounts; Britain is giving it serious consideration. The list is almost endless.

This process of change has transferred enormous risks from institutions to individuals. While the recipients may benefit from that transfer they may also lose out.

It's puzzling that SA's policymakers appear to have decided that individuals should bear much of the risk of saving for their retirement, despite the fact that Government is a strong risk-taker in the defined benefit arrangement provided to public servants.

Funding

Not all old age plans are funded. Many social security arrangements are completely unfunded, while others have some asset backing and could be described as partially funded. Is the absence of funding a risk? Absolutely, because today's workers are paying the pensions of today's elderly and shifts in the ratio of workers to pensioners present significant financial problems. But that can be managed when the system is set up, through adjusting the retirement age to reflect changes to the balance, for example.

Many European policymakers wish they could turn the clock back to the different world into which those promises were delivered. If they could do it again they'd most certainly design pressure valves into the system, like a formula-driven flexible retirement age.

There are two problems with the illusory solution of funding. It can present a veil of security. If a significant proportion of the assets are invested in gilts then government is borrowing from today's workers and might as well not be pre-funding that portion of the fund anyway.

The second is that funding is expensive. Total expense ratios show private sector retail charges for equity management running at between 2,2% and 2,5%/year of assets. That's a high price for participants to pay for the security of funding, particularly if part of it's illusory.

Still on the issue of funding, dangerous assumptions are common. For example, that a DC arrangement must be funded. At a company level, perhaps, but at national level most definitely not. National DC systems occur in a number of countries, from Sweden to Mongolia via Italy and Russia, and they contain the risks without incurring the expense of pre-funding.

Challenge the misconceptions. An unfunded system is really a massive loan from workers to government, repaid on retirement. That's dangerous. But funding isn't all that it seems to be either.

Management

Most would agree that the public sector provides scale but poor motivation for efficiency, while the competitive dynamics in the private sector incentivise inefficiency but undermine scale. Most would also concede that competition doesn't consistently minimise price: plenty of examples present themselves in SA's financial services industry.

Despite that it's hard to find anybody able to apply their minds objectively to the issue of where pension savings should be managed.

Surely it should be possible to combine the best of both worlds, producing an outcome that's in the best interests of savers?

Fortunately, many lessons are available to us that demonstrate potential solutions to the conundrum. Scale can be obtained by collecting contributions centrally and permitting participants the option to redirect them to private sector entities.

That can be improved further by the introduction of "blind accounts" – under which private managers don't know whose money they're managing, removing much of the marketing incentive. 18

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Further cost efficiency is theoretically obtainable through auctioning the right to provide investment management services to savers.

None of these are pie in the sky: they all exist, in a stable form, in other parts of the world and are being considered by policymakers in a variety of countries.

And that means they're on the desks of SA's public servants, carefully contemplating the way forward best for all South Africans.

Private sector players need to help, but they must get away from false perceptions if they're to do so effectively.

For example, arguing against centralised collection of compulsory contributions purely on the principle that this is private sector domain isn't going to cut it.

Demonstrate that it's not in the interests of SA's citizens or plan for its introduction in some form.

Appeal for objectivity

Back to the assignment: at its core straightforward – identify and prioritise the objectives and resource constraints; for each design option, estimate the extent to which they would be met; and implement the optimal system as efficiently as possible.

SA is deep in the discussion but sadly lacking concerning the fundamentals.

As far as I can tell we haven't properly identified the goals or established objective measurement mechanisms. Is the openness to considering options with objectivity out of reach or do we just need to try harder?

More serious thinking is needed. ■

ROB RUSCONI

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Chocolates or Bananas?

Best be on your best behaviour…

MICHAEL STREATFIELD
Investec Asset Management

EVERYBODY KNOWS that saving for retirement is important. However, 96% of us don't get it right. Yet defined contribution (DC) schemes are increasingly placing the responsibility to get retirement right with the individual – so it may be time to "know thyself," as Socrates put it.

Behavioural finance does just that: by stepping in to understand the retirement problem. Exploring consumers' self-control, how they handle choices and fret about losses, it provides fresh insights to help investors ensure a more comfortable retirement. Such findings are valuable as South Africa embarks on its retirement reform process.

It's your problem

Not only are saving rates in the Western world falling to new lows but people are also living much longer. In addition, the rapidly growing demographic burden on social spending is leading governments to dilute retirement provision. Increasingly, initiatives developed in response are placing more emphasis on the individual to save, such as British personal accounts or US 401(k) plans.

We plan to save but do little when faced with the prospect of consumption.

That leaves investors to make key retirement investment decisions themselves: entry into DC schemes, how much to save and how to save. So what are the barriers to doing what you know you should be doing?

Behavioural finance looks at what prevents us "normal" human beings from being the "Rational Economic Man" expected by economics textbooks. What motivates us to make our financial choices?

Chocolate or bananas? Our self-control

Given the amount of education concerning the need to save, just how well are we doing it? Behavioural finance theorists explain it in terms of poor self-control.

Read and Van Leeuwen (1998) observed inconsistency about good intentions in their chocolate or banana study. When asked for their snack preference a week before the event, people choose much healthier options then, than what they finally selected. (See graph). That could be applied to savings: we plan to save but do little when faced with the prospect of consumption.

Choi et al found exactly that in their studies in the US retirement space. Two-thirds of the participants observed that their savings rate was too low – but just 14% acted to save more. That's a substantial hurdle for personal retirement provision.

Self-control also comes into the poor preservation of retirement benefits in SA. As we're changing jobs with more frequency we need to have more discipline not to cash in our retirement benefits – an issue that retirement reform is likely to address.

Overwhelming choice

While we live in a consumer paradise with hordes of options, the freedom can be overwhelming for investors choosing funds in their DC schemes. Iyengar, Huberman, Jiang (2004) found that extensive fund choice can decrease participation rates in schemes.

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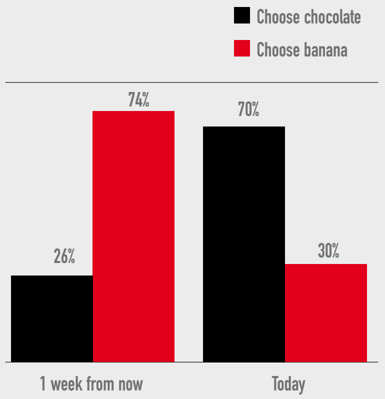
CHOCOLATE OR BANANAS - WILL YOU MAKE THE RIGHT CHOICE LATER?



Source: Read and Van Leeuwen (1990)

18 In addition, large numbers of funds on offer also affected investment strategy.

They saw increased conservatism as the number of fund choices grew, with more allocations to cash and bonds. That suggests when it comes to pension fund choice, less is more.

No regrets

Herding isn't only found amongst investment managers. In Britain, default funds are the prevalent option in most funds and 89% of people stick with that choice.

That's not surprising, given the concept of regret risk. People don't want the pain of going against the grain and then getting it wrong. Especially as we feel the pain of losses twice as much as the thrill of gains.

That's a problem in cases where the default fund isn't appropriately structured (such as in cash) or where a default option is offered on the basis of cost rather than on solid investment grounds.

Loss aversion studies show investors make decisions based on changes in wealth and not necessarily absolutes. The website retirement calculators that show "the scary number" (see www.six-steps.org) needed for retirement can too easily shock investors into ostrich behaviour. Being more educated or forewarned doesn't guarantee wisdom.

Just think about the bananas and chocolates study.

Good, better, best – improving retirement practice

HSBC found when studying global retirement attitudes that individuals want help to save and they favour the option of enforced additional private savings. Retirement reform should take into account human behaviour to maximise the success of the final outcome.

Retirement planners should focus on turning the weaknesses uncovered by behavioural finance into strengths to maximise benefits:

Get me started... and keep me going

Auto-enrolment is the antidote to poor self-control when it comes to retirement savings. It means that savers are automatically added to an available fund and they have to choose to opt out.

That's very successful at getting more people saving and the SA retirement reform process is looking to adopt that valuable technique.

Auto-increases are another technique to help savers and their behaviour. The affordability challenge of residential property is taking precedence for younger savers. A technique used in the US is to start auto-enrol savers at a low savings rate but then have a planned increase in the contribution rate over time.

When you get an annual salary increase, then the contribution rate to retirement is increased. The advantage is that you still see your after-tax earnings increase and you can feel smug that you've put some capital away for later.

Keep the investment choices simple

We now know the dangers of too much choice. Retirement funds should be looking at how they present investment options and consider rationalising the list of available funds for investors.

Some funds use the technique of tiering options – a smaller list of options is initially presented but there are tiers below with more flexibility. That allows the minority who do want more active involvement to dig deeper without negatively overwhelming the majority of investors.

Do the investments for me

Retirement isn't a priority in people's lives, despite the potential of being their second biggest asset after their house. Therefore, retirement products should have embedded advice in them to make it easier. That explains the surge in balanced multi-asset investment funds, like balanced and absolute return funds.

Also rapidly rising in popularity overseas are target date funds. You choose a fund closest to your retirement date – eg, Fund 2030 – and leave the asset manager to dynamically manage the asset allocation over time. The funds move to more protection as you near retirement.

Be bolder if younger

The availability of retirement investment information is breeding inappropriate conservatism. Investors must combat loss aversion fears and think in terms of when they'll retire. Flying in a fighter jet versus a microlight may take you further but it will be a more dramatic flight path.

Expect and appreciate the volatility of equities.

The absolute return fund craze is fine for those near retirement needing capital protection, but those in their forties – 20 years from retirement – may be taking too much risk off the table. The implicit costs to guarantees must be recognised, so retirement designers must guard against playing it too safe.

Conclusion

The actions of the individual are at the heart of future retirement success. Retirement reform needs to consider thoughtfully how to maximise potential and design should combat poor self-control through auto-enrolment and auto-increases.

Funds must have well-considered amounts of choice to balance freedom and avoid consumer vertigo. 21

Retirement planners should focus on turning behavioral weakness into strengths to maximise benefits.

20 Investment funds that take charge with embedded advice need to be part of the solution.

Being on our best behaviour can ensure a brighter future… with enough chocolate to go around.

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Improving your trustees

JONATHAN MORT

Edward Nathan Sonnenberg

THERE CAN BE NO DOUBT that with the greater emphasis today on the proper governance of retirement funds, the spotlight is being increasingly focused on the duties and responsibilities of trustees. This must be good for retirement funds because the ultimate responsibility for the proper governance of retirement funds lies with the trustees.

I wish to raise two fundamental problems with the current thinking around retirement fund trustees. The first problem is the composition of the board of trustees, and the second the accountability of trustees. In raising these problems, I wish also to make some proposals that may be controversial.

In respect of the first issue, the way trustees are appointed could probably not be worse. Trustees are responsible for the management of vast amounts of money in a highly complex and difficult legal, actuarial, investment and regulatory environment. Yet the trustees appointed fulfil their function on a part-time basis, usually for no reward or, if there is reward (even for those independent trustees remunerated mostly on an hourly basis) this bears no relationship to the extent of their responsibilities, expertise and the personal risk they carry in fulfilling that function.

In occupational retirement funds, the trustee boards are usually comprised of half being appointed by the employer and the other half elected by members.

Typically, the employer-appointed trustees are more financially astute than the member-elected trustees; but the employer-appointed trustees are usually caught in a structural conflict of interest where the fiduciary duty borne as trustee may, and often does, conflict with the fiduciary duty borne as an employee.

This is compounded by the fact that usually the employer-appointed trustees are senior employees, often with some degree of decision making within the employer in relation to the fund, such as a financial director or HR director. And when there's a conflict of interests between the employer and the fund, these trustees will find it very difficult to exercise, as they should, an independent discretion as to what's appropriate for the fund and its members. This would typically be found in issues such as the pension increase policy in a defined benefit fund, or where the employer wishes to terminate its participation in the fund.

As for member-elected trustees, the arrangement of employer-appointed trustees and member-elected trustees can make it difficult for those member-elected trustees in the service of the employer to be seen to be exercising their discretion which is correctly in the interests of the fund and the members but to the disadvantage of the employer.

This may limit their career prospects. And such member-elected trustees are also not free of the structural conflict of interest issue since, if the issue to be decided is one that preferred the members over the employer, it may be difficult for such trustees to consider fairly the interests of the employer. This applies especially to pensioner-elected trustees.

The different constituents appointing or electing trustees also gives rise to a common misconception by trustees that they are more accountable, even to the extent of releasing confidential information of the fund to the entity or body of persons that appointed or elected them as trustees. This failing is also found in sponsor-appointed trustees of retail retirement funds (RAs, preservation funds and umbrella funds). The truth is that each trustee owes the same duty to the fund and its members irrespective of how he or she was appointed or elected.

To make matters worse, the highly complex and difficult legal, actuarial and investment issues facing all trustees make them inordinately dependent on the fund's professional advisers. It is, of course, entirely appropriate that trustees seek professional advice on the issues facing a fund; but there are few trustees (with the exception of most independent trustees) who are able to exercise an independent view of the actual advice received from such advisers.

It goes without saying that advice from such advisers may (and the history of administering retirement funds in South Africa is littered with examples) very often be in the interests of that adviser or his/her firm rather than the fund or its members. One has only to look at the advice sometimes given on the transfer of pensioner liabilities to an insurer to see that such a proposal may well be motivated more by the prospect of a lucrative commission than whether it's in the interests of the pensioners.

Is there a solution to this? I believe the only need for an employer to take an interest in a fund is to ensure that the 22

21 governance of that fund is correct. In an occupational fund, I would prefer it if an employer had limited representation on the board of trustees; say no more than a third of the trustees. And such employer-appointed trustees should not be persons who may in their capacity as employees be in a position to take decisions in relation to the fund, so no financial director or HR director.

Also, I would suggest that every fund should have an independent trustee, unless it can satisfy the Registrar that the skills on the board of trustees are sufficient for the board to exercise independent discretion.

This will add to the cost of administering funds, but a good independent trustee would add considerably more value than his/her cost.

The second problem relating to trustees is their accountability. By law retirement funds are not obliged to have an annual general meeting where members can pose questions to the trustees; and many retirement funds, particularly the retail funds, are reticent about the names of the trustees and instead promote the sponsor. The primary relationship should always be between the fund and its members.

The employer may facilitate that relationship and so might the sponsor or administrator, but members should always know that they have a line of communication directly to the trustees via the principal officer. This remoteness of trustees makes it difficult for members to feel that they can hold the trustees accountable. Equally, trustees do not feel accountable in consequence. What also aggravates this situation is confusion about exactly to whom trustees are accountable.

There is a view, to which I do not subscribe, that the trustees' primary obligation is to the fund. However, the primary purpose of the fund is to provide benefits to members.

So I believe the primary duty of trustees should be to protect members' interests.

As part of this, trustees should ensure that the solvency of the fund is preserved, but it is the members first. This confusion that exists about the primary duty of members adds only to the lack of accountability, at least in the minds of trustees, to their members. And it's the sense of accountability that must be promoted, because accountability is at the core of proper governance of any institution.

It's this accountability that'll ensure that the trust that needs to be engendered in retirement fund arrangements can be preserved and enhanced. ■

JONATHAN MORT

MORT is a director of the law firm Edward Nathan Sonnenberg and head of the retirement fund specialised services department. Apart from an extensive practice in all areas of the law affecting retirement funds, he's acted as an independent trustee of 20 funds. ■