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COVER STORY

# Fairly fair

There'll always be controversy over pension-fund costs. They're now coming under the microscope for enhanced transparency. National Treasury and the FSB are leading the charge to promote consumer interests, with a thumbs-up from the industry.

Van Zyl . . . profound changes

**Donald Gordon, founder of Liberty Life, once** famously advised his friends to "buy my shares, not my policies". Even these days, National Treasury deputy director-general Ismail Momoniat is fond of challenging the financial industry with a comment that it's better at making money for itself than for its clients.

Put differently, costs and fees chew into pension funds' returns at levels that can smack the inflation-beating value they're supposed to produce. Whether markets are rising or falling, it's the after-costs return that matters most to fund members. The lower the proportion gobbled by fees, the higher the nett return. Ongoing controversy over costs against value is inevitable, but inordinately difficult to analyse and compare.

Remember the seminal paper produced by actuary Rob Rusconi (*TT* March-May '08)? He hardly enhanced his popularity with industry colleagues by showing, for instance, that in a sample year total expenses for self-administered funds could exceed 13% of members' contributions. Do the maths for the compound effect on member payouts after say 20 years of contributions.

What goes in costs feeds a long chain of service providers that does rather nicely for itself, thank you.

But times are rapidly changing, with nudges from friends in Pretoria that daren't be resisted.

While the profit driver necessarily remains as strong as ever, more and more it's counterbalanced by sharpened competition, heightened consumerism and tightened regulation. Determinations by the Pension Funds Adjudicator, circulars from the Financial Services Board (FSB) and incremental improvements to the Pension Funds Act are amongst pressures that have played a part.

Far from being on the defensive, the industry is straining to be seen as a proactive partner in reconciling self interest with public interest. A starting point was the 'statement of intent', signed in 2005 by the Minister of Finance and the life insurers, that rectified a series of consumer-unfriendly practices. More recently, in February, National Treasury issued the policy document, 'A safer financial sector to serve SA better', that sets out wide-ranging reforms for which the industry through its ASISA representative body has indicated support.

Then check also its intended introduction of the low-cost Gap product to extend pensions coverage for lower-income earners (*TT* Oct '10-Jan '11). Witness the cooperation in revising prudential Regulation 28, or in drafting new codes of conduct, or in endorsing the 'Treating Customers Fairly' initiative of the FSB, or in helping produce a revamped Financial Sector Charter.

One could go on. The days of a few dominant players, in comfy relationships that the legislator and regulator let be, are over. These days, with improved oversight making impacts and innovative specialists making inroads, for service providers not to compete on policies' value offerings can undermine the bedrock of their businesses.

At the retail level, as Sanlam chief executive Johan van Zyl noted in his ASISA presidential address earlier this year, electronic share trading and removal of tax benefits for insurance policies against other savings products have opened a level field for new industry entrants. At the institutional level, the mass movement from defined-benefit to defined-contribution pension funds had shifted the balance of power from employers to employees.

"The life insurers with their expensive cost structures and rigid products initially found it increasingly hard to compete with smaller and more nimble, focused competitors," said Van Zyl. "But they did survive, often by embracing exactly those tactics that the new entrants had employed to gain differential advantage. The result is that today we have a savings and investment industry that is much more competitive and client-orientated with good value for money to clients."

And yet, and yet . . .

Overall costs of pension funds' administration remain stubbornly high. Partly, it's because many funds are over-serviced. With each service comes a charge. Such are the requirements of regulation that trustees, often less skilled than they should be, are petrified of offending on their fiduciary obligations. Their nerves are meat for service providers' pickings. Hence the armies of professional advisors.

Partly, it's because there are too many small pension funds. They simply lack economies of scale. Hence their gradual consolidation into umbrella funds, albeit at a compromise to their independence and not necessarily at an immediate saving in costs.

In a national pension study concluded last year, Anton Davies of Compass pointed out that umbrella schemes have an additional layer of cost due to the lack of standardised product offerings across participating employers. In addition, for the schemes' largely fixed costs in infrastructure to be optimally spread, he estimated they'd need to more than double their existing membership from 786 000 to 1,6m.

Neither is the 2011 Budget Review of National Treasury particularly sanguine. It insists that pension funds improve their level of disclosure to clients: "A lack of transparency prevents customers from being able to compare products across funds and often results in excessive charges." National Treasury, it says, "will consult with pension-fund industry bodies to draft a code of ethics and address concerns over high fees".

National Treasury's policy document, on a safer financial sector, is harsh in its observation. It describes the retirement-fund industry as "characterised" by poor disclosure which "can contribute to high charges and harmful inertia". It considers necessary a statutory requirement that specific

information be disclosed to clients.

More generally on cost reductions, the document points to differences in the layers of fees charged by insurers and collective investment scheme (CIS) companies. Pity the man in the street who's supposed to have an inkling of what any of them mean.

For example, an annuity policy sold by an insurer includes a commission charge, an administration charge, a monthly policy fee and an annual service fee. On the other hand, an annuity policy sold by a CIS company includes an annual management fee, a broker commission and a trail fee. "More effort can be made to ensure that investors are aware of the different costs upfront," it states.

Much of this converges in the Treating Customers Fairly campaign. It pulls together the plethora of principles, codes and guidance notes for coordination in a customer-first spirit of market conduct that the FSB wants embedded in the corporate culture of product providers. Its outcomes-based approach is enwrapped in a "roadmap" that includes a structured framework and envisages enhanced supervisory techniques, including FSB "interventions".

The desired outcomes are in the motherhood-and-apple pie category, like selling products whose benefits the companies have led customers to expect. In substance, they're nothing more than good business practice. What elevates this campaign will be FSB

# PENSION FUND COST ANALYSIS: CASE STUDY

**To illustrate the impact of expenses on returns, *TT*** requested Steven Nathan of 10X Investments to perform a line-by-line cost analysis of a randomly-selected standalone mid-sized SA pension fund that's around 20 years old. Below is his analysis of an actual fund whose identity need not be disclosed.

Having recently launched 10X, a retirement-fund administrator and investment manager, Nathan previously held senior positions at Deutsche Bank. Amongst other things, on several occasions he was SA's top-rated analyst of the Banks & Life Insurance sector

This table on the right is his breakdown:

| **Data at 28 February 2009** | | | |
|---|---|---|---|
| Investment assets | R 54,660,209 | | |
| Annual payroll | R 54,439,896 | | |
| Number of members | 346 | | |
| | | | |
| **Fees** | **%** | **Rand per year** | **Fees % assets** |
| **1. Payroll fees** | | | |
| Administration fees | 0.96% | R 522,623 | 0.96% |
| Consulting/commission | 0.28% | R 152,432 | 0.28% |
| Actuarial & investment consulting | 0.12% | R 65,328 | 0.12% |
| Total payroll based fees | 1.36% | R 740,383 | 1.35% |
| | | | |
| **2. Asset based fees** | | | |
| Investment management fees | 1.12% | R 610,841 | 1.12% |
| | | | |
| **3. Fund expenses** | | | |
| Regulatory fees | | R 1,732 | |
| Audit fees | | R 47,766 | |
| Other | | R 810 | |
| **Total Fund expenses** | | **R 50,308** | **0.09%** |
| | | | |
| **Total expenses** | | **R 1,401,532** | **2.56%** |

Source: Fund Annual Financial Statements, Consultants, 10X Investments

## And these are his comments:

At 10X we obtained information on the fees from the fund's annual financial statements and from the consultants. Investment management fees are not disclosed in the financial statements and are not disclosed to the trustees. We relied on the consultants to provide these fees. We do not know whether there are performance-based fees or extra fees for offshore investments. Retirement funds also do not disclose share-trading costs, so members would incur additional costs in the management of their investments.

We divided the fees into three categories:

- Payroll-based fees charged as a percentage of payroll and deducted from the fund members' contributions. These fees are for administration, employee benefit consulting and investment consulting. In aggregate these fees equal 1,36% of payroll and 1,35% of fund assets. Co-incidentally, the fund assets and annual payroll were almost equal at R54m;
- Asset-based fees charged as a percentage of

monitoring. What underlies it is ongoing consumer education, a repeatedly-emphasised objective that's as worthy as its implementation is elusive.

It's all very well to keep hammering away at the need for improved disclosure. Nobody can find fault with that. But disclosure can also be so complex and cluttered that it defies comprehension. Better, surely, to focus on the specifics for relevant disclosures and to insist that they be made in a form intelligible to a relatively knowledgeable consumer.

Such a not-so-utopian scenario requires an industry-standardised checklist of what's to be disclosed, and how. That's doable.

More problematic, having taken consumers to the water, is getting them to drink; for consumers to do the hard miles in upskilling themselves, so that they'll understand what's being disclosed and to make informed choices on competitive offerings. This is the free-market alternative to bureaucratic controls which themselves come at a cost to institutions including pension funds which pay for them in FSB levies.

At the end of the day, having analysed costs and debated fairness, there is a single goal. It's to foster an environment in which people will save because they want to. The more that perceived and promised value are one and the same, and the less there is a suspicion of rip-off in perpetual portrayal of the industry as scoundrels, the more they'll want to. ■

fund assets and deducted directly from the assets. These fees are for investment management. In aggregate these fees equal 1,12% of fund assets. These fees are not disclosed at either the member level or the fund level;

- Fund expenses, for running the standalone fund, are billed directly to the fund. These fees are relatively small, equating just under 0,1% of fund assets.

The aggregate fees incurred equate to 2,56% of fund assets. Such a level of fees is very high for any fund, let alone a fund of this size.

| Fee split | % total fees | Fees per year |
|---|---|---|
| Payroll fees | 53% | R 740,383 |
| Asset based fees | 44% | R 610,841 |
| Fund expenses | 4% | R 50,308 |
| Total fees | 100% | R 1,401,532 |

Only 4% of fees are for operating the standalone fund. The balance is for administration, consulting and investment management. These fees are also likely to be incurred in an umbrella-fund arrangement.

One could argue that the consulting fee would drop slightly in an umbrella fund. But umbrella funds sponsored by life companies pay maximum broker commission that, together with an additional investment consulting fee, could exceed the current consulting fees. This dispels the notion that umbrella funds are automatically cheaper than standalone funds.

## Fees are too high relative to the 5% real return

We conducted research into the long-term real (after-inflation) return from a prudentially managed portfolio invested in local equities (60% of the portfolio), foreign equities (15%) and local bonds (25 percent). This portfolio has provided, on average, an annual real return of about 5% going back to 1900. The past 20 years provided 5,2%, the past 30 years provided 5,3% and the past 40 years provided 5,4%. These returns are before fees.

Each 1% in fees is actually 20% of the investor's 5% real return. A 2,5% fee (the fee for the fund analysed) equals 50% of the real return. Over a member's working life this compounds to erode 68% of the available real return (see table below). The investor only captures one third of the available return.

**Real value of R2 000 a month invested over 40 years at 5% real return (after-inflation)**

| Fees as % investment | Your capital | Your return | Your capital & return | % Return Captured | % Return Lost |
|---|---|---|---|---|---|
| 0.0% | R 1,000,000 | R 1,900,000 | R 2,900,000 | 100% | 0% |
| 0.5% | R 1,000,000 | R 1,600,000 | R 2,600,000 | 84% | 16% |
| 1.0% | R 1,000,000 | R 1,300,000 | R 2,300,000 | 68% | 32% |
| 2.0% | R 1,000,000 | R 800,000 | R 1,800,000 | 42% | 58% |
| 2.5% | R 1,000,000 | R 600,000 | R 1,600,000 | 32% | 68% |
| 3.0% | R 1,000,000 | R 400,000 | R 1,400,000 | 21% | 79% |
| 4.0% | R 1,000,000 | R 200,000 | R 1,200,000 | 11% | 89% |

Source: 10X Investments. Values are rounded.