In putting together this edition of Collective Insight, an image of a bargain-hunting shopper came to mind. Looking at fees in isolation would be like driving 50km on a hot, busy Saturday morning to take advantage of a 3-for-2 offer for chicken and thinking that you saved 33% off the price, with no regard for fuel, time, hassle and wear-and-tear. Fees are under intense scrutiny at the moment and if global trends are anything to go by, there are more uncomfortable changes afoot for industry players in South Africa as well. One could be forgiven for assuming that lower fees would be just what the investor needs. That would be short sighted, as we believe this edition will highlight. However, fees do warrant inspection. Our first article identifies the value chain. But our next two articles hold the cost debate: should Government or market forces address the issue of appropriate fees?

Next, we zero in on exactly where financial advisers could add value. The relationships, roles and alignment of interests in the South African investment industry are then discussed. Thereafter we take a look at a crucial aspect that’s not captured in any fee calculation, namely the opportunity cost of making the wrong decision and how that affects the outcome in retirement. Administration costs, the impact of the size of a retirement fund and the increasing responsibilities of the trustee are then discussed. Performance fees are seldom viewed with ambivalence and neither is passive versus active investing. Both are fraught with more complexity than most investors realise, and two articles attempt to highlight what you need to consider beyond the obvious matter of the level of fees.

Back to the chicken: What that shopper really needed, was someone who told him that he’d be better off relaxing at home and contemplating his investment strategy than chasing the 3-for-2 deal and giving up his Saturday morning. On that note we end with two critical insights: controlling fees always has to be seen in terms of the benefits provided. More importantly though, perhaps as an industry we need a rethink as to what those benefits should be. We hope you find this issue thought provoking and that you end up looking at fees closely, but with a different mindset.
TIME IS THE DIFFERENCE BETWEEN WHAT IS AND WHAT COULD BE.

RELATIONSHIPS ARE A LOT LIKE INVESTMENTS. THEY BOTH NEED THE TIME IT TAKES TO GROW, DEVELOP AND MATURE. TIME IS VALUABLE, MAKE IT COUNT.

CALL 0860 000 654 OR YOUR FINANCIAL ADVISER, OR VISIT WWW.ALLANGRAY.CO.ZA
Unpacking the Value Chain

BY SANGEETH SEWNATH

Sangeeth is the Deputy Managing Director of Investec Asset Management. His previous roles include Global Head of Product Development at Investec Asset Management where he gained his global experience. Sangeeth is an actuary by profession and an alumnus of Harvard Business School’s leadership development programme.

Here is our challenge as an industry: we seem unable to showcase the value our industry adds to investors, often falling prey to criticism concerning fees rather than demonstrating the very real benefits. Rather than being fixated on fees, we should obsess about meeting the needs of investors. Along with improved transparency, it will ensure that our interests are aligned.

THE PROFESSIONAL FINANCIAL ADVISER

The returns over the last 10 years of the average multi-asset class fund in each sector were as follows:

- Low equity 11.57%/year.
- Medium equity 14.09%/year.
- High equity 16.7%/year.

As the figures above illustrate, the opportunity cost of being in the wrong fund could be a potential sacrifice of 20% over 10 years if the incorrect risk profile is chosen. Without professional advice, investors tend to be too conservative, acting as if they have a short-term horizon. Advisers can help investors overcome their conservative biases and stick with their long-term strategy.

PORTFOLIO ADMINISTRATION

Administrators provide a wide range of services. They provide a system from which to access and transact on a range of funds; access to tools to help you analyse your options; access to experts who can help you navigate through a changing regulatory environment and compliance monitoring. Along with the tools their systems provide, platforms should make advisers more efficient and hopefully more affordable.

What are these services worth? A rough proxy would be what investors are prepared to pay for passive investments. With passive investments, the investor is not paying for outperformance, so the fee should be akin to the administration fee. An investor pays around 45 basis points for a passive investment such as Satrix 40, and interestingly this is in line with what platforms charge for fund administration.

ASSET MANAGEMENT

Active asset management can provide some less obvious benefits over and above out-performance:

- The ability to exploit market inefficiencies index funds may be forced to buy when individual shares go up, and vice versa, regardless of valuations. Active managers can cherry-pick, opportunistically buying an out-of-favour share when prices fall.

- Risk management – passive managers give you the market exposure, warts and all, while the active manager can be more selective in providing diversification and protecting against losing money.

- Efficiencies – I would argue that active management selects against bad businesses. This means that they are removed from an index sooner and hence improve index returns.

UNBUNDLING FOR CLARITY

In the past, opaque product structures and fee bundling made it difficult to understand and compare costs.

The UK is leading the charge with the Retail Distribution Review, which aims to ensure fee transparency. A key principle we expect to see in SA is the banning of rebates (where the client pays the full fee, but a portion goes to the administrator and adviser), which creates a perception that administration and adviser fees are lower with fund management fees shown higher – a confusing picture.

The most popular solution is the launch of a clean fee class, which means that nothing is rebated and all non-fund manager charges are levied separately.

ALWAYS ROOM FOR IMPROVEMENT

Warren Greshes is quoted as saying: “Customers buy on price because they can’t find extraordinary quality, convenience, service and value.” The savings industry has come a long way. We have seen administration fees halved and active asset management fees reduced. It is now up to industry players to demonstrate that our value-add is real and worth the fees we charge.
Markets work, for all participants and on a sustainable basis, if they meet the needs of these participants. To do this, they must align interests. Microeconomic theory rests on the assumption that this is how markets work. This article argues that institutional investment markets are not sufficiently characterised by clean, effective information flows, or by pricing structures that align interests.

“People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices” - Adam Smith.

**EFFECTIVE COMPETITION** is a sign of a healthy market. Unfortunately, sound competition is usually more easily recognised in absence than confirmed in existence. One way to recognise an absence of effective competition is in the distribution of profits: an industry serving employees, are not generally thriving. Asset managers, in contrast, are on average doing much better, attracting a flow of new entrants. This appears also to be supported by some of the industry dynamics of the last few years, within and between firms. This leads to distortions in market behaviour. Loss leadership is encouraged in certain parts of the market, exacerbating the problem because it distorts the price-service trade-off and risks undermining the credibility of entire sectors. The heart of the matter is that a persistently profitable sector can only stay this way if information is not flowing clearly to customers, damping the operation of effective free-market forces.

“To found a great empire for the sole purpose of raising up a people of customers, may at first sight appear a project fit only for a nation of shopkeepers. It is, however, a project altogether unfit for a nation of shopkeepers; but extremely fit for a nation whose government is influenced by shopkeepers” - Adam Smith.

**HOW MIGHT WE ADDRESS A PROBLEM OF INFORMATION ASYMMETRY?** Smith takes care to emphasise the role of government in promoting sound and effective economic interchange. One clearly beneficial intervention is for government to standardise the way prices are expressed. This straightforward intrusion introduces immediate benefits to transparency. It gives customers clearer comparison of available products. Another intervention toward transparency could be restrictions on product bundling. A further useful role for government is publication. It is not in the interest of suppliers to provide their customers with an unbiased comparison of their product pricing, but government could do this to make it easier for customers to find the right price for their needs.

One such service example is asset management fees. Is there any sustainable justification for the current practice of charging fees based on the value of assets under management?

Arguing in favour, we could say that some providers in the cost chain of the asset managers themselves charge asset-based fees, so it would be hard for the asset manager to absorb the mismatch risk. Also, customers understand the method, as it has been around for some time, and they are better able, mentally, to absorb these fees. Finally, asset-based fees do not discriminate against small customers in the same way that flat fees would do.

Considering each of these points, if it is the case that a significant proportion of the cost base of the asset manager is itself based on asset-type fees, should this really be the case? Then, it is not clear at all that customers understand these fees better than the rand-based alternative. Finally, higher asset-based fees are usually applied to smaller customers.

**WHAT ARE THE ARGUMENTS AGAINST ASSET-BASED FEES?**

First, alignment of interests is questionable. How can a pension fund consider the value of a service from an asset manager when the fees are expressed as an annual fraction of the market value of the fund itself? There is no intrinsic link between cost and value. Now, it is true that it may not be easier to ascribe a rand value to the service, but a black-and-white rand cost surely arrests the attention of the trustee more clearly.

Second, it produces the wrong incentive for government, who becomes more interested in gathering assets than in providing superior returns or service, or meeting the specific requirements of each customer. Performance fees require a detailed consideration of the advantages and disadvantages beyond this article. It is sufficient to say here that performance fees do not truly enhance alignment of interests. The asset manager doesn’t really share in the downside risk. In addition, practical implementation almost always introduces behavioural distortions because it changes the way the provider...

**BY ROB RUSCONI**

Rob Rusconi looks after Lombard Life, a member of the Lombard Group, which offers individual risk products under a long-term insurance licence, through partners like FMI and BrightRock. Prior to this he provided independent research and consulting on pension policy and social security to governments and global institutions like the World Bank and OECD.
views risks, particularly with measurement deadlines approaching. Most significant, though, is the reality that performance fees probably do not materially change the behaviour of the asset manager in a way that benefits the customer. Do the decision-makers try harder now that performance benefits the customer? And thus, place, that great object which divides the wives of aldermen, is the end of half the labours of human life; and is the cause of all the tumult and bustle, all the rapine and injustice, which avarice and ambition have introduced into this world. Perhaps things would be different if the providers of these lofty services were to account to the individuals whom, ultimately, they serve. Perhaps if these individuals have the power to choose between providers based on the impacts on their pockets, decisions would be more effectively made. Whose money is it anyway?

Allow the market to do its job

BY PIETER KOEKEMOER

Pieter Koekemoer is head of Personal Investments at Coronation Fund Managers. He is currently Deputy Chair of ASISA’s (Association for Savings & Investment SA) Economics, Savings and Policy Board Committee and convenor of its Standing Committee on Retirement Reform.

Evaluating “value added” in the fund management industry is a daunting task: complicated by the shrill voices of many vested interests all focused on their own objectives:

■ Politicians take positions to increase their popularity.
■ Regulators want a dense lattice work of rules to clean up the inevitable failures in the market.
■ Consultants take positions aimed at enhancing their credibility, helping to win the next client appointment.
■ Passive managers focus on cost at the exclusion of value while active managers require you to take a leap of faith in expectation of uncertain future alpha generation.
■ The first principles easily get lost when all the actors become too self-centred: the objective should be to ensure a fair and open market, allowing free competition between honest actors with their clients’ (and the system’s) best interests at heart.

The investment management market closely meets most of the factors associated with perfect competition:

■ Entry barriers are low, as the business is not capital intensive.
■ Economies of scale are available through outsourcing arrangements, and credibility can be assured through the presence of just one rainmaker.
■ Production factors are mobile, as the key inputs are good people and a robust investment philosophy.
■ Most assets in the industry are housed in open architecture product solutions, where the unbundling of administration and investment services makes it easy (and often free) to switch between managers. Products are reasonably homogeneous, with standardised mandate groupings based on key investor needs aiding in comparison and assisting entry.
■ Active management is subject to a limit on achievable scale benefits, as managers will not be able to meet their clients’ alpha expectations if they allow themselves to become too large relative to the overall opportunity set.
■ Clients evaluate performance outcomes after costs and vote with their feet.

ACTUAL MARKET EXPERIENCE OVER THE PAST TWO DECADES HAS BEEN CONSISTENT WITH THIS VIEW:

■ Many of the large pension fund managers of 1993 have disappeared while other significant players have lost the bulk of their market share.
■ The three biggest unit trust managers today did not exist in their current formats two decades ago.
■ Gaining or losing more than 5% of the market in as short a period as three years regularly happens in the unit-trust industry, and no active manager tends to hang on to more than 15% of an open architecture market for any reasonable length of time. If active managers fail to convince the market of their ability to add value, there’s always the threat of commodification and substitution by passive solutions with least-cost advantage.

This does not sound like a market where regulatory interference in price setting is required.

The key condition for perfect competition that’s absent in the investment management market is information asymmetry. It’s clear that end-clients know a lot less than industry participants, explaining the presence of a large and vibrant advice market as part of the value chain. Often outcomes are poorer than they could have been as a result of this asymmetry between what insiders know and what they are prepared to tell their clients.

This flaw alone justifies the presence of a fairly onerous regulatory environment. However, the focus should always be on finding efficient ways to address the information asymmetries.

Attempts to interfere in areas where the market is working well will not make the grass on the commons any greener. The unintended consequences of over-reach are often worse than the problems the solution was designed to fix.
If you believe much of the media, you hire a financial adviser to try to outperform the stock market. However, this can have very little bearing on whether you can live or retire as you would like.

**DO ADVISERS REALLY ADD VALUE?**

In 2012, two major studies emerged that attempted to quantify the value of financial advice. In September 2012, research from Morningstar came up with a number: 1.82% a year.

That may not sound like much, but the researchers projected that it could mean an extra 30% in income a year for retirees who receive the right kind of financial planning advice. Another research paper put out by the Centre for Interuniversity Research and Analysis on Organisations (CIRANO) called *Econometric Models on the Value of Advice of a Financial Advisor* found that when “identical individuals” were compared, those who had a financial adviser for between four and six years were found to have 58% more financial assets than their unadvised counterparts.

Interestingly, the longer respondents worked with a financial adviser, the bigger the benefit this had on their returns.

But where does this added value actually come from? The surprise answer is that it’s not from choosing investments.

**WHY ADVISERS SHOULDN’T BE YOUR INVESTMENT MANAGER**

Where financial advice has run into obstacles over the years is that most studies find that experts don’t, on average, beat market benchmarks. In a nutshell, that means that most advisers and investment managers don’t choose investments that perform much better than an index fund, which naturally should incur lower fees.

In fact, the *Econometric Models* paper stated that advised savers’ rates of return were only 3% higher than those who received no advice, which hardly accounted for the 173% difference in assets that mounted between the investors who received advice and those who didn’t over a 15-year period. The question then becomes, if financial advisers aren’t helping investors choose better investments, where is that additional value coming from?

**MEASURING THE ADDED VALUE**

What the Morningstar report clearly defines is that return that comes from optimal financial decision-making in financial planning adds the most sustainable value to an individual’s long-term financial success.

The Morningstar report zeroed in on five of these key decisions:

- Adopting an asset allocation decision holistically. This means including an individual’s current and future earning power in addition to their current and future financial savings. By capturing this total picture, the adviser is in a much better position to help individuals identify what their capacity for risk should be rather than simply using risk preference to drive decision-making.
- Developing an optimal withdrawal strategy. Instead of simply electing a static withdrawal strategy based on the initial account balance, strategies that dynamically change the annual withdrawal amount based on market movements and ageing add significant value.
- Determining the optimal annuity purchase at the optimal time.
- Determining the most tax efficient way of withdrawing funds.
- Designing a post-retirement strategy that optimises an individual’s liabilities. By including risks like the ability to fund cash-flow requirements or recognise the impact of inflation on this requirement, investors will typically derive significantly greater value from their investments than from a strategy that simply targets highest return.

**HOW CAN YOU BEST USE YOUR ADVISER?**

Morningstar’s report suggests that the way investors view financial advisers may need to change. It is a question so important that it should be hard to think about anything else.

But what about your investments, are there better ways to use your financial adviser in this context? To begin with, advisers put together financial plans – or should. Few people actually take the time to do this. They identify risks in your portfolio. Ones that you might look right past, like being overweight SA, chasing equity performance, being too conservative for the long term, insufficient manager diversity, being too sector or single stock concentrated.

**THE POINT IS:** advisers add value – but only if they focus on the critical planning and investment issues. The bottom line is, if advisers can add this kind of support and wrap it with the asset management and administration costs into a more sustainable all-in fee of 1.5% then the industry will have a winner.

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**BY GRAYDON MORRIS**

Graydon has a BCom degree, majoring in Economics and Finance, and is a Fellow of the Institute of Life and Pension Advisers (FPI) and a Certified Financial Planner (CFP). He is a founding Director of Sterling Private Wealth.
The primary purpose of a retirement fund is to provide income in retirement to members, says National Treasury. Defined Contribution (DC) funds have created a disconnect between pre- and post-retirement, and the industry has assumed, incorrectly, that members can navigate the retail market in retirement.

Post-economic crisis, we have seen a compression in investment returns and heightened cost awareness in the industry. “Alpha”-fixation and fee “squeezes” have been dominant topics of conversation for trustees of DC funds. But have we missed the bigger picture?

As we look at costs and benefits, we need to ask how far our focus has drifted from the real benchmark of income provision. We need to re-focus on the members’ needs and understand the role that each of us can play in servicing those needs.

Often the largest costs that members face are opportunity costs, where by action or inaction, their benefits are impaired and they fail to meet their ultimate goals.

A prime example is failing to select an appropriate investment strategy to meet members’ income requirements. Consider the traditional life stage model, where members’ investments are “de-risked” over the course of their employment.

The model reduces the expected volatility of members’ investments as their investment horizon decreases towards retirement and immunises them, to an extent, against changes in guaranteed annuity prices.

The problem comes when members decide not to take cash or a guaranteed annuity and instead invest in living annuities.

These annuitants take what is often their largest financial asset, being their retirement benefit, and invest it aggressively in the market, overnight, through their living annuities.

Such a move incurs significant timing risk and means that the annuitant has unnecessarily lost out on market exposure for the years leading up to retirement. (Figure 1)

Figure 2: How Much Does Cash Cost? (Next page) provides an example of four members who retired one month before the market crash in 2008 and invested in living annuities.

Three years prior to the crash, they all chose different investment options. Despite the crash, the members who chose to remain invested in the market throughout their retirement were considerably better off than the member who chose to invest in cash.
HOW CAN WE AVOID SUCH A SITUATION?  The answer is to recognise that members are different and that their needs evolve over time. As they do, so must the strategies that we adopt for them. Trustees must equip members with sufficient knowledge and access to information or advice to be able to decide on what retirement income product(s) they are going to purchase before they reach retirement and introduce default investment strategies, which are designed to cater for these choices (Figure 3).

Guaranteed annuity prices are driven by long-bond yields, which are at some of the lowest levels in history, making guaranteed annuities expensive. As a result, we have seen in excess of 80% of new retirees investing in living annuities. Unfortunately, these too come with their costs and risks: adviser, platform and investment management fees can cost a living annuitant up to 10 years’ worth of income and with increasing longevity, new retirees must be cautious about drawing down too heavily on their living annuities (Figure 4).

CAN TRUSTEES HELP POST-RETIREMENT? Funds possess great leverage over their providers and there’s nothing preventing trustees from negotiating simple, cost-effective annuity options for their members. Trustees should take a holistic view of their members’ needs and ensure that their providers optimise the available options to avoid excessive costs and ill-informed decisions.

Members are equally responsible for educating themselves so that they are able to make informed decisions. Some members tend to change their fund allocations frequently in order to “time the market”. Such speculation incurs considerable costs, and members should instead apply their efforts to ensuring that their investment strategy is aligned with their retirement goals, and that they understand the products that await them in retirement.

As we begin to tackle the issue of costs and value within our industry, we need to consider the roles we have to play in the lives of members. Decision-making is important because it curbs potentially devastating opportunity costs. These are not the costs that are shown on members’ statements but the costs that will destroy their hopes of a comfortable retirement.
In the course of 2012, the Pensions Regulator in the UK published a report and invited comment on quality features that will ensure a retirement fund delivers “good outcomes for the members’ retirement savings”. Since we are in the process of retirement reform in South Africa, we are very keen to see what we can learn from the UK Pensions Regulator and whether we can successfully apply certain aspects in our own retirement fund industry. The regulator identified six principles and 21 quality features relating to the design, governance and other features which, if present in a defined contribution (DC) retirement fund, are more likely to result in a good outcome for its members. The conclusion is that “larger defined contribution pension schemes are significantly more likely to display the features needed to deliver the best retirement outcomes for savers than smaller schemes”.

**FUNDAMENTAL SHIFT IN APPROACH**

In the 2013 retirement reform paper, National Treasury for the first time indicated that trustees’ responsibilities extend beyond pure compliance with the rules of the fund. “Although trustees’ formal responsibilities may end at retirement, the primary purpose of a retirement fund is to provide income in retirement to members. It is therefore part of the responsibility of trustees to guide members through the process of converting their defined contribution lump sum accumulation into an income.”

As a result, they plan to make it compulsory for funds to identify a default preservation option and to select a default life annuity for their members. To cut costs, they plan to reduce the complexity of products thereby reducing the need for financial advice. This is a fundamental shift in approach and one that we fully support. But does this go far enough? We think not. It is very difficult to know how effective a benefit structure and/or a default is unless you can measure it against some standard. We are strong proponents of a targeted benefit strategy. Every retirement fund should have a vision and a mission relating to the level of retirement benefits it aims to provide for its members. This is typically expressed as a net replacement ratio (NRR).

The compulsory implementation of default strategies will achieve more than one objective. Not only can they provide members with appropriate solutions and strategies, they can also be provided at institutional prices that are significantly lower than the retail prices they are presently paying. An NRR capacity report can show how much more money will end up in the pocket of the members by the removal of these and other inefficiencies in the system.

Much progress will be made if trustees are required to prepare and publish a standard report on cost to their members.

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**What the policymakers want and how to get it**

BY KOBUS HANEKOM

Head of General Consulting, Simoka Consultants and Actuaries

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National Treasury has released a number of draft papers on pension fund reform dealing with a range of issues. The only outstanding paper is the one that deals with fees and costs in the industry. One important element of the total costs incurred by investors is the fee paid to the asset manager.

ACTIVE ASSET MANAGERS ARE TYPICALLY Rewarded By TWO Types of Fees:

- **Fixed fees**: Charged annually as a percentage of assets.
- **Performance fees**: Paid over and above a lower fixed base fee, which rewards a manager for performance in excess of a predefined benchmark. Performance fees are designed to reward an active manager’s skill. Performance fees can be an extremely useful way to craft an arrangement between the manager and client that aligns interests to the benefit of both parties.

Alternatively, if poorly conceived, performance fees can also result in the destruction of value to clients. They can often account for more than 75% of the total management fee paid by clients.

REGULATION And Disclosure

The only segment of the industry that requires disclosures on performance fees is unit trusts. This is governed by industry guidelines issued by ASISA. This guideline sets out the minimum information that must be provided to clients in respect of performance fees in a unit trust portfolio. Importantly, the guideline does not limit or prescribe a manager’s flexibility in terms of determining the basis for performance fees. The result is that investors need to make a case-by-case comparison of how performance fees in various funds operate. Clients rarely (if ever) see performance fees in rand terms separately on their statements!

Added to that, performance fees in unit trusts are taken as a direct reduction of performance and are only disclosed as part of the TER, which makes them difficult to determine. Pooled life funds offered through a life licence are widely used by pension schemes and retail investors. Unlike unit trusts, which are required to make certain limited disclosures, life funds are under no obligation to disclose any information relating to performance fees either earned or paid to underlying investment managers.

Segregated portfolios managed specifically for a client afford greater protection as the basis for performance fees needs to be explicitly agreed between client and asset manager usually with the assistance of a professional asset consultant. Clients large enough to operate on a segregated basis are typically advised by an asset consultant. The advantage of segregated mandates is that at a minimum, asset managers will be required to invoice or deduct performance fees directly from the client, thus making it easier for clients to identify the quantum of performance fees being paid.

PERFORMANCE Fee Arrangements have a NUMBER of IMPORTANT Elements to be considered When evaluating them:

- **Performance fee Benchmark**: is the benchmark against which performance is measured. The benchmark should always align with the objectives of the mandate in order to ensure that performance fees are paid for manager skill and not market beta. For example, in an equity mandate, the performance fee benchmark should be a relevant share index and not cash or inflation. A common practice in South Africa is the use of peer benchmarks. In this case, performance fees are payable simply for a manager doing better than another one.

This results in performance fees being paid for underperformance of the market simply because a client chose the “least bad”
manager. Similarly, clients benefit in cases where active management as a strategy is being rewarded by not paying performance fees to managers due to markets being in an inefficient phase.

**HURDLE:** The amount by which a manager needs to beat the performance fee benchmark before earning performance fees. Managers should at minimum outperform the benchmark to cover the cost of the fixed fee paid to them before earning performance fees.

**PARTICIPATION RATE:** The share of the performance that the manager takes. Managers have a free option (the worst managers can do is earn their fixed fee and possibly be fired if they underperform, whereas their actions can permanently erode a client’s capital). Global best practice therefore suggests that participation rates should never be more than 20% of outperformance. Simply put, why get paid excessively for risking other people’s money?

**CAP:** The outperformance level after which no further performance fees are paid. Argument could be made for capped fees which no further performance fees are paid.

**MEASUREMENT PERIOD:** The period of time over which the manager’s performance is measured. Investing and skill should be measured over extended periods. There is no correlation between a manager’s skill and performance against the hurdle over the short term (at least a year). Market cycles and investment time horizons are longer as the riskiness of the asset class increases. Measurement periods should align with the investment time horizon. Ideally, measurement periods should be cumulative from inception of the mandate. Many measurement periods are unfortunately based on so-called “rolling” periods, typically 12 months.

In this scenario, performance fees are measured based on the last 12-months’ performance. The problem with this methodology is that next year’s rolling 12-months’ performance is determined equally by how well a manager does in the next month, versus the same month, 12 months ago which now drops out of the measurement period window. Rolling periods thus forgive a manager for underperformance, whereas the client is never forgiven. Cumulative measurement since inception is thus preferable.

**HIGH WATER MARK:** Performance fee methodologies may include a high water mark. This is the single most important aspect of performance fees to be insisted upon. In simple terms, they ensure that managers do not earn performance fees unless they are generating new outperformance over and above the highest outperformance (watermark) generated previously. This avoids clients paying for performance more than once where managers go through outperformance and underperformance cycles.

**CLAWBACKS:** Clawbacks are a mechanism whereby the performance fees paid to managers are always kept current. If managers outperform, a portion of assets is set aside for them. If they underperform, this pot should be reduced or “clawed back”.

**CROSS SUBSIDISATION:** Occurs where the performance fee methodology is structured in such a way that clients joining a fund pay for performance received by the fund prior to their investment – ie performance they did not participate in. Similarly, clients exiting a pool can often do so without paying for performance they may have received, leaving remaining investors to pick up the tab.

Performance fee determinants come in many subtle derivatives, and in unlimited ranges and combinations, each of which can widely vary the amount and nature of fees paid by clients. Unfortunately, they are complex beyond the grasp of many unadvised clients. At the core of the debate is alignment of interest. In theory, conventional flat investment fees as a percentage of assets does exactly that. More importantly it overcomes many of the above-mentioned short-comings. But asset managers are trying to convince investors that this fee model forces them to become asset gatherers. Investors will have to make the final choice as to what works best for them.

**IN SUMMARY**

Performance fees can play an exceptionally important role in driving and aligning clients’ and managers’ objectives if carefully crafted. Unfortunately, in most cases in South Africa, retail investors and smaller pension fund arrangements have little control, and even less awareness over performance fees and the effect they can have on returns over the longer term.

In the absence of an asset consultant or multi-manager and the further the client is removed from owning the direct manager relationship, the less control the client has on ensuring alignment. TCF may address some of these issues, however some recommendations that could ensure a more harmonious relationship in the future include: a standard for determining TERs and quarterly basis and a standard for performance fee calculations for pooled vehicles.

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**THERE’S A LOT TO BE SAID FOR BEING STUBBORN.**

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Active versus passive investing – Is either one superior?

BY JANINA SLAWSKI

Janina is head of Institutional Distribution at the Old Mutual Investment Group (South Africa). She is a qualified actuary, a CFA charterholder and has an FRM qualification. She has worked in the employee benefit, asset consulting and short-term insurance fields, and is a former president of the Actuarial Society of South Africa.

It is often quoted in the active versus passive investment management debate that active managers underperform their benchmarks. Given the higher cost of active management versus passive, it must surely make sense for investors to invest passively in the benchmark with a correspondingly lower fee, rather than facing the prospect of underperforming the benchmark while paying an active fee? But the real issue around costs is understanding the cost/benefit trade-offs. This article attempts to identify these across the spectrum of investment strategies.

**ACTIVE UNDER-PERFORMANCE?**

The S&P Indices Versus Active Funds (SPIVA®) Scorecard was launched 10 years ago and aims to be a scorecard of the active versus passive debate in US asset management. The SPIVA Scorecard for the year-end 2012 indicates that performance lagged behind the benchmark indices for 63.3% of active large-cap funds, 80.5% of mid-cap funds and 66.5% of small cap funds.

In South Africa, a similar picture emerges – the best performance from active managers in recent years came in 2008 (only 32% of funds underperformed their benchmarks) and the worst in 2005, with nine out of every 10 funds delivering relative underperformance! All of this suggests that passive should provide a better cost/benefit picture. But surveys do not present the whole picture.

**PROBLEMS WITH “INVESTING IN THE BENCHMARK”**

Market-weighted indices have overweight holdings in overvalued securities and are underweight in undervalued securities. Passively managed portfolios, based on market-capitalisation weights, will therefore be positioned to follow market volatility: market bubbles and subsequent corrections.

Intriguingly, active managers experience less volatility due to their persistent underweighting in mega-cap shares. This means they also tend to outperform in down markets. All told, if we look at returns from a risk-adjusted basis, active managers offer the better deal.

**CAN INVESTING EVER BE TRULY PASSIVE?**

In truth, all investing demands active decisions. Investors electing passive because of cost or skill considerations might be alarmed to realise that they still have to make active decisions about the types of indices, index construction, asset allocations and the blend. Each of these decisions can have huge performance implications.

Conversely, the issue around active management is “which managers”? Although active managers can outperform, evidence shows that outperforming active managers are often no longer the top performing managers in future periods. If a fund was in the top quartile of all US domestic funds in September 2008, there was a 99.8% chance that the fund’s performance would be somewhere among the bottom three quartiles by September 2012.

Thus “buying and holding” an outperforming manager could result in subsequent underperformance of benchmarks.

**THE DEBATE HAS MOVED ON**

Effectively, the active/passive debate has moved on. Recently, a number of new passive strategies have entered the market. Known as “smart beta” strategies, they attempt to passively capture the active style component or risk reduction element that makes active strategies so attractive.

These strategies will have higher fees than pure market-weighted index strategies due to the costs paid to the constructor of the smart beta index, but lower fees than those paid for active management.

Due to the “intelligence” that goes into their construction, the return characteristics of these smart beta portfolios are expected to outperform pure market-weighted indices in the longer term, but at a lower cost.

**COMBINATION APPROACH**

Basically, this means that investors now have a much richer toolbox to design lower cost strategies. Instead of investing only passively or actively, investors can follow a combination approach that starts with a passively managed, smart beta core portfolio, together with investment into actively managed satellite portfolios.

This approach will allow for an overall lower-cost offering with the potential for outperformance via the active management and smart beta allocations. It also ensures that the investor has access to a broad range of investments and markets, since options within both active and passive spheres will be considered for inclusion.

Finally, remember that it is not the investment “wrapper” that makes it active or passive (eg unit trust vs ETF), but rather the style of management that determines the investment management fee.
A lifetime in asset management means that one is exposed to a constantly unfolding series of OMG moments. These are nuggets of received wisdom that totally change your understanding of the industry, or the “game”, or perhaps we could better describe it as “the end-game”.

For an industry hell-bent on focusing all its efforts on chasing the ephemeral goal of alpha (let’s define that as outperformance here), and for the clients who may well be responsible for driving asset managers to strive for that end, it may be well-worth everyone’s while to contemplate some of these game-changing insights.

What should we really pay asset managers to do?

André Perold is a South African who has spent most of his adult life out of South Africa. For years he has been a leading light at Harvard Business School, specialising in the asset management industry. I visited him many years back at a time when I had serious questions about viable business models for asset managers and it was this insight that changed my whole take on our industry:

Perold argued that one of the great travesties of our industry was that asset managers ever introduced the notion that they should be assessed on their ability to generate alpha. Academics will tell you that this outperformance is fleeting, rarely persistent. And that lack of persistence often has very little to do with manager skill. Passive managers will argue that on average, managers merely deliver the index’s performance minus the active management fees. (They also tend to neglect mentioning that passive managers also deliver the benchmark – minus their fees.)

What Perold was effectively arguing was that those managers who could keep clients invested simply because they had built up a bond of trust with their clients, warranted compensation for the value of that “steady hand at the tiller” and “calm voice of clarity” around market activity.

What then, is the true cost differential between active and passive?

Perold’s point helps highlight another critical OMG insight that investors often miss: the greatest source of value destruction over the long term is not staying invested. It is the rare investor who bails out of a strategy or fires a manager because of outperformance. More generally the trigger is some serious magnitude of underperformance.

But consider this point carefully: most significant out- or underperformance typically occurs as a result of a manager’s investment strategy. Investors may have to wait through a performance cycle that may well take several years to unfold. And yet, we fail to appreciate that when we sell an underperforming manager we effectively lock in that manager’s underperformance before it can bear fruit (assuming the manager is still holding the same hand). But let’s say that you elect to switch that investment to another manager who has just outperformed the market by 10% (and the manager you would like to fire by 30%). Chances are very good that you will be buying into that new manager just as he starts to take some of those well-earned profits. But, your performance with the manager will only reflect that you came in at the tail end of that manager’s run in the market and you will be lucky to squeeze out but a few additional points from that run (Figure 1).

So, if we are honest about the cost differential between active and passive strategies, we would be remiss in thinking that...
it’s just about the fee differentials. In the institutional market the cost of chopping and changing asset managers/consultants/service providers, when combined with performance short-termism has been estimated to create as much as 3% of value erosion per annum. In the retail market, the results are even more dramatic.

John Bogle compares the returns the US market generated, over the 25 years ended 2005, to the returns earned by the average equity unit trust, to the returns generated by the average investor moving in and out of those unit trusts in the race for performance (Figure 2).

**WHAT REALLY DRIVES PERFORMANCE OUTCOMES IN THE SAVINGS VALUE CHAIN?**

If price were linked to value-add, one could be forgiven for assuming that asset managers must add the greatest value over time. But in truth, if we follow the full course of the flow of funds from what investors save to what ultimately ends up in their pockets at the end of the savings period (think retirement funds as a classic example here), it’s actually the liability manager and not the asset manager who has the greater impact on outcomes.

Liability managers are those consultants/advisers who determine what asset blend has the highest probability of meeting an individual’s funding target given the specified time frame. As Charles Ellis highlighted in his paper *The Winner’s Game* (one of the top OMG papers of the last decade), asset managers may or may not outperform their benchmarks, but if the liability manager hasn’t understood how best to meet the investor’s requirements, its game over.

**Figure 2: Returns the US market generated, over the 25 years ended 2005**

Table 1

<table>
<thead>
<tr>
<th>Fee</th>
<th>Manager skill required for investor to have at least a 50/50 chance of earning positive alpha</th>
<th>Investor’s probability of earning a positive alpha manager skill is 0.80</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.5%</td>
<td>0.62</td>
<td>0.70</td>
</tr>
<tr>
<td>1.5</td>
<td>0.83</td>
<td>0.46</td>
</tr>
<tr>
<td>3.0</td>
<td>0.97</td>
<td>0.15</td>
</tr>
</tbody>
</table>

**TIME TO GET REAL ABOUT COSTS**

If we are going to get a meaningful handle on the cost issue, we need a framework that allows us to assess the trade-off between the cost of a given strategy, the required skill to add value, and the potential value of the strategy. The real question then becomes: what price reflects fair value for that potential value-add?

Richard Ennis developed just such a framework for his paper *Are Active Manager Fees Too High?* In his model, Ennis investigates whether manager skill, calculated as the probability that a manager will produce a positive cumulative alpha (after transaction costs but before management fees), can be translated into investor success (when the investor realises a positive alpha after fees).

The graph above makes no assumptions of skill though. It starts with the assumption that the strategy being assessed has a 50/50 chance of success. But what happens to that probability of success when we add fees to the mix? (Figure 3)

When fees are at a mere 50 basis points, your chance of success deteriorates to 34% (see red numbers). Pump the fees up to 3% (not unheard of in retail space) and now the probability of investor success plummets to 3%. If instead we had asked “how much skill would the manager need to have to add value at the different fee levels?” the results would look like what has been given in the table (1) above.

On average, top quartile stock pickers demonstrate skill at about the 0.6 level. However, finding a manager with a skill level of 0.80 would be remarkable. But let’s look at managers whom we deem exceptional at 0.62 skill levels. With fees at only 0.5% per annum, an investor’s probability of earning a positive alpha is still only 50/50.

**CONCLUSION**

We’re only just starting to mess around with your minds here. But note how a totally different focus – minimising value destruction as opposed to chasing after performance – has the potential to provide far more dependable outcomes over the long term.

Yes – investors need to start paying attention to costs. But what we are suggesting here is that we need to be clear as to what the real “cost” issues are.

Effectively, it’s all about understanding the full value chain and assessing where value is being driven from and where it might be getting destroyed. Get the answers to those questions right and we have the potential to change the whole way that investors assess costs.
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