INVESTMENT STRATEGY
KEY TO BENEFICIARY SUCCESS

By Richard Krepelka, CEO

Trustees generally rightly focus on governance and administration, but this is often to the detriment of the investment strategy of a fund. This may have something to do with the complexity of investments and the reliance on asset consulting experts, as trustees generally do not have the appropriate level of expertise. Yet just as there are good and bad administrators, so there are also good and bad asset consultants. It is imperative that trustees have a thorough understanding of the investment strategy and its implementation.

The investment strategy is embodied in an Investment Policy Statement, called the IPS. Far too often the IPS is a vanilla document drafted by the asset consultants, approved by the trustees and filed away. This is not enough. The IPS should be specifically tailored to meet the needs of the fund and be formally reviewed at least annually.

For example, two similar funds with different investment strategies may have significantly different performances but while the better performer may be considered the winner, the risk profile may be totally inappropriate. This is the case for beneficiary funds and umbrella trusts. Trustees often compare the performance of these funds to retirement funds, notwithstanding that the objectives and risk profiles are significantly different.

Beneficiary funds have almost entirely replaced umbrella trusts and are defined in terms of the Pension Funds Act as retirement funds. The investment strategy of a beneficiary fund is however distinctly different from that of a retirement fund. Individual members of a beneficiary fund have very different needs and this requires an asset allocation matrix for each category of members. Essentially this is a type of member/investor choice, but determined by the trustees. For example, a one year old member will have very different needs from a 16 year old member in high school and therefore would fit into a separate asset allocation matrix (similar to a life-stage in a retirement fund.)

Members (or beneficiaries) in our industry have two primary needs: subsistence needs which are met through monthly income payments and other needs which are met through capital and/or income to facilitate ad hoc payments in respect of a member’s maintenance, education and general well-being, including medical costs. Fairheads and the trustees have paid a great deal of attention to the investment strategy of The Fairfund Trust and the Fairfund Umbrella Beneficiary Fund over the past 18 months. With the assistance of Riscura Consulting we believe we have significantly enhanced the strategy to better meet the needs of the members. The process commenced with extensive data and statistical analysis. Approximately 90% of ad hoc payments were found to be education related. Statistically we are of course unable to forecast accurately the needs of beneficiaries: however this exercise did assist in establishing sound principles for the asset allocation model.

A beneficiary fund is essentially a “widows and orphans” type fund and thus requires a very conservative investment strategy which incorporates capital preservation. With the average member fund balance being only R80 000, it is difficult to meet all the members’ needs without taking on disproportionate risk and volatility. It is a difficult balancing act to provide sufficient monthly income and educational costs without eroding capital. The monthly income distribution in reality often only supplements a family’s income. The current economic environment has had a significant impact on members’ needs and added to this are a low interest rate cycle and weak equity markets. Trustees could be persuaded to taking on more risk under these conditions and hence the need for a well thought out and strategised IPS. The IPS should be able to withstand both bull and bear markets, as well as low interest rate cycles.

There are many factors affecting the asset allocation model at the member level. These include the age of the member, the amount of the member’s funds, minimum liquidity requirements and the income requirement. The initial asset allocation matrix design takes all of these factors into account, resulting in 14 different categories with each category having a further six sub-categories. In other words, there are 84 different initial asset allocation categories into which a new member account can be placed. Each category has a combination of three investment vehicles in different proportions, namely a cash component, an income fund and a balanced fund. There are also rules that are superimposed on the asset allocation. For example a minimum rand amount is held in cash for liquidity and no investments are made in the income fund if the time horizon is less than two years and less than four years in the balanced fund. This is to factor in market volatility and reduce the risk of capital loss.

One of the most important issues is to ensure that the ongoing asset mix is appropriate as it often distorts over time due to market movement and payments to members. Fairheads has established a rebalancing model which will rebalance each member's investments annually on their birthday. The rebalancing model has 14 categories and seven sub-categories, resulting in 98 different possible allocations. The new model will replace our existing rebalancing model in 2011. This sophisticated asset modelling at member level is only possible if supported by an integrated administration platform and Fairheads has developed extensive administration programmes to manage this process.

Once the appropriate investment strategy has been determined for each category, the investment managers and investment vehicles need to be selected. Unit trusts (for umbrella trusts and beneficiary funds) and pooled portfolios (for beneficiary funds) are most suitable provided they are unitised and priced daily, all of which has to be built into the administration platform. Investment fees are also key and trustees need to ensure that competitive institutional fees are charged by the investment managers.

This article highlights some of the complexities involved in meeting individual members' needs. Trustees of retirement funds should insist on understanding the IPS of their beneficiary fund or umbrella trust service provider. Is it appropriate, are the right investment vehicles and managers being used and are the fee structures appropriate? Once you are satisfied, make sure you receive regular investment reports covering these important areas. That way you will know that members' needs are being met at the all-important investment level.