thinktank

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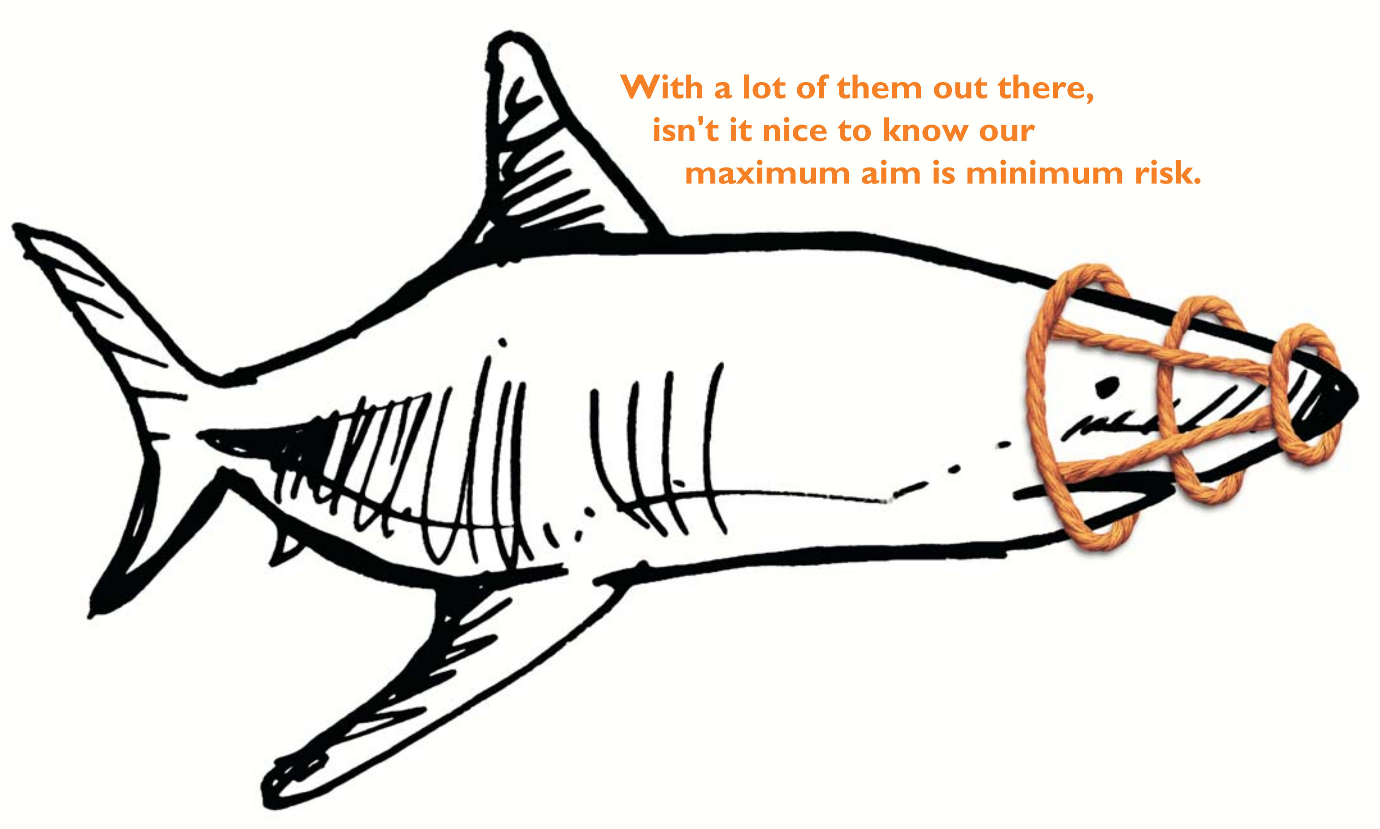

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RisCura

good **thinking**

Sean Crighton, Risk analyst

The INDEPENDENT trustee
Value-add or unnecessary cost?

Trustees carry an enormous responsibility as the guardians of retirement fund members' futures and many don't want to face this important task alone. Trustees are playing an increasingly central role in the management of retirement funds and the fear of making complicated investment decisions without sound advice and support has resulted in a number of Boards of Trustees making use of independent trustees to help guide and support them. An independent trustee can be defined as a person who has no "interests" in the assets of the retirement fund and is not associated with or connected to the employer.

The increased need for decision-making support

Internationally, the Myners Review has highlighted that many trustees are becoming increasingly reluctant to make investment decisions and are uncomfortable with the accountability of their decisions given their knowledge levels. Pension fund legislation is becoming more complex and the potential penalties that could be levied against Boards of Trustees for poor decision-making poses an unpleasant threat. Lay trustees are often not aware of all the key issues when making decisions for the fund and many smaller funds don't have access to or can't afford suitable employee or investment consultants. Despite ongoing efforts in the industry to improve trustee knowledge through training, trustees increasingly want the support and expertise provided by a qualified independent trustee.

The case for value-add

Independent trustees can offer significant value by guiding a Board of Trustees in their decision-making and highlighting the key issues they need to be aware of before making decisions. They can provide an objective viewpoint when trustees have differences of opinion or when conflicts of interest arise between the employer and trustees. In addition, they can provide much needed continuity when there are frequent changes to trustee boards. Their input can also help improve the trustees' knowledge levels, which serves to limit the fund's costs in terms of trustee training. Independent trustees can also be called on to manage other projects such as the appointment of an advisor or investment managers.

Qualified to make a difference?

While retirement fund boards can gain meaningful value-add from independent trustees, problems arise when independent trustees lack suitable qualifications and do not have a strong technical and practical understanding of the industry and complex investment issues. The appointment of an independent trustee does not absolve the Board of Trustees of its responsibility to members and poor decision-making due to an unqualified independent trustee will still have negative implications for the trustees. Retirement fund boards have a responsibility to properly evaluate the independent trustee and ensure he/she has suitable knowledge and experience as well as sound administration and accounting skills. At the same time, trustee boards must continue to improve their knowledge and skills so as to be able to recognise lack of expertise and poor advice.

Understanding the fund

To provide sound advice to the fund, the independent trustee must acquire a strong understanding of fund specific issues relating to the structure of the fund and company, the profile of employees/members and the existing relationships within the fund and with third parties such as investment managers etc. This process will take time and commitment from both the Board of Trustees and the independent trustee.

Costs in line with value-add

There are rising concerns about the high fees that some independent trustees are charging and, as with the employment of any service provider, trustees need to make sure the charges paid to the service provider are properly rewarded by their value-add. Trustees must remember that fees paid to the independent trustee are taken from the assets of the fund and this "loss" must be justified. Apart from the explicit fee paid, the potential implicit costs to the fund of employing an unqualified, inexperienced independent trustee that results in poor decision-making could be huge.

Formal licensing recommended

Currently, there is no barrier to entry in terms of becoming an independent trustee. The industry needs to encourage a formalised registration and licensing process to prevent the entry of unqualified, unsuitable trustees. In addition, setting a standard code of conduct for independent trustees will encourage incumbents to be professionally trained and registered and also alert Boards of Trustees to issues they need to be aware of when appointing an independent trustee.

Albrecht Gantz, Head of hedge fund risk management

Expanding our services - RisCura hedge fund risk management

The South African hedge fund industry's explosive growth over the last couple of years has provided RisCura with an opportunity to become the leading risk consultant to the local and offshore alternative investment industry, and to help create an industry standard for hedge fund transparency and reporting.

Our goal is to help promote the local industry by providing comprehensive fund and risk information that will enable hedge funds and their clients to make informed decisions and ensure that any risks are well understood and properly managed. By doing this, we aim to prevent and limit large errors and "blow-outs" in an arena that is not well understood and where negative events can result in significant destruction to fund values.

Our key advantages are: -

- We are wholly independent - no proprietary trading or selling of investment products;
- A strong understanding of the hedge fund industry;
- A dedicated risk management company and resources;
- Tried and tested risk methodology and techniques;
- Experienced in reporting to investors such as pension funds.

We provide services to both hedge fund managers and fund of hedge fund managers, which include:

- Hedge fund risk management through daily and monthly risk and performance reports. The daily reports contain a snapshot of the portfolio risk and effective holdings, while the monthly report is a more comprehensive overview of risk and performance issues.
- Hedge fund of funds risk management - we provide a risk audit of the underlying funds as well as the fund of funds process. We also supply monthly risk and performance reports, which cover the underlying managers and the composite fund.
- Ad-hoc analysis - we can analyse "what if" scenarios in line with a fund's request.
- We also provide audited performance figures to the hedge fund surveys on behalf of our clients.

All the above reporting can be used for the fund's marketing purposes and as an independent audit check for pension funds or other clients. We provide ongoing pension fund education and consulting around hedge funds via workshops and conferences.

We have a well-qualified, highly experienced team that is passionate about the hedge fund industry and is headed by Albrecht Gantz.

Albrecht obtained his Masters in Commerce from Stellenbosch University where he majored in Fund Management. He started his career in systems development and trade support at HSBC in London and then worked as a forex trader at FX Consulting. He joined RisCura in 2005 as a risk analyst and was quickly promoted to the hedge fund department. He became head of this department in 2006.

If you would like more information on these services, please contact Albrecht on (021) 683 7111 or agantz@riscura.com.

Pam Magcoba, Consultant

Disclose ALL costs - It's the right thing to do

Over the last couple of years, the savings industry has come under considerable pressure to reform with lack of disclosure cited as one of the key areas of concern. Disclosure can be defined as the "submission of all facts and details concerning a situation or business operation". Many retirement funds lose hundreds of millions of rands every year in hidden commissions due to service providers not submitting all the facts regarding these commissions. Recently, it was found that retirement fund administrators did not disclose practices such as the bulking of bank accounts to earn higher interest for clients, and the fees they themselves earned from this. Although much of the blame is being directed at the administrators, trustees also need to shoulder some responsibility as it is part of their fiduciary duty to investigate all fees charged by service providers.

Trustees must demand disclosure

A trustee's key responsibility is to ensure that any service provided to the fund is necessary and that the costs associated with the service are reasonable. Understanding and evaluating expenses associated with investment and other services forms an important part of a trustee's role. Although the retirement fund sector is governed by legislation that compels service providers to disclose all information to trustees, trustees cannot necessarily take legal action against the service provider if they themselves have not sought out this information prior to signing a contract.

Implicit costs are the minefield

The issue of disclosing costs is complex because there are both implicit and explicit costs to be considered. Explicit costs are easier to quantify than implicit costs. They relate to set initial fees or upfront costs, performance-based fees, profit sharing arrangements, consulting and administration fees. All explicit costs should be clearly stated on service level contracts and it's a good idea for the contracts to be reviewed by an independent third party to ensure that the services are spelt out and the fees fully detailed and understood.

Implicit costs are difficult to quantify and can come from many directions. One source of implicit costs is when conflicts of interest around a service provider results in sub-optimal advice for the fund. These conflicts of interest arise when a service provider:-

- pushes the fund towards their other fee paying services or products;
- receives royalties or kickbacks from other fee paying services or products;
- has a shareholding in recommended service providers.

Poor advice that results in the selection of an underperforming manager, the recommendation of an inappropriate and expensive product or the use of a sub-optimal service provider can end up costing the fund far more than all the explicit costs added together. It's difficult for a trustee to know the extent of the implicit costs prior to employing the service provider, but its important for them to demand full disclosure of potential conflicts of interest and assess whether the right checks and balances have been put in place by the service provider to manage these conflicts. Some additional conflict of interest scenarios are detailed in the table below.

Hidden profits mean lower fund returns

Another source of implicit costs are hidden profits, which refer to a situation where profits taken by the service provider should actually accrue to the members. In most cases, funds are unaware of these hidden fees and their potential benefit to a members' retirement payment. Hidden profits can be earned in a number of areas including: -

Avenue	How the profit is made	What should happen
Bank accounts	Retirement funds have to hold large amounts of cash in their bank accounts to meet benefit payments, pay creditors and direct monthly contributions to service providers such as asset managers. An administrator can negotiate a higher interest rate with a bank by bulking the cash of all the funds it administers. Some life assurance companies that are part owners of a bank and offer retirement administration services fail to negotiate better interest rates for the retirement funds so that the associated bank can make more profit.	A preferential rate should always be negotiated and the benefit of this rate should be passed on to each fund.

Avenue	How the profit is made	What should happen
Delayed payments	Large amounts of money flow into and out of a retirement bank account. Hidden profits can be made when administrators or service providers hold money in the account for longer than necessary to earn more interest, for example, payments to asset managers can be delayed, earning extra interest.	Delayed payments should always be disclosed to a fund and where additional interest is earned on the delay, this should be credited to the fund.
Asset management	This is one of the riskiest areas for hidden profits particularly when a multi-manager is involved. Multi-managers may demand a rebate from asset managers wanting to be included on their "offering" or may negotiate lower fees with the asset manager but not pass these onto retirement funds. The rebate structure is problematic as some top performing managers may refuse to pay the rebate knowing that the multi-manager has to include the top performers in their offering. An average or poor performer however has to pay the rebate, potentially resulting in the multi-manager recommending the average or poor performer because of this payment.	Any rebate or lower fee negotiated with the manager should be passed onto a fund. Multi-managers should also disclose whether they are receiving a fee from managers in any way, under any name. This is sometimes hidden under their "administration fees". This will allow trustees to be aware of potential conflicts of interest that may arise.
Scrip lending	This is the lending out of scrip (shares) to investors in derivative markets. A fee is charged by the lender. Asset managers who hold shares on behalf of retirement funds are the main lenders of scrip and in some cases, the profit generated by this lending is not passed onto the fund (the actual owner of the shares).	It is unlawful if the asset manager keeps the fees generated on scrip lending without a fund's consent.
Performance fees	Performance fees are becoming increasingly complicated and in some cases, punishing. Trustees are often not aware of the full effect of the performance fee as returns are only shown after the deduction of fees. Performance fees can also serve to complicate fee structures allowing asset managers to camouflage their actual costs to individual and retirement fund investors.	It's a good idea for performance fee structures to be reviewed by an independent third party to ensure they are reasonable and to the benefit of the fund.
Money market investments	Asset managers can bulk all money going into money market instruments and again negotiate higher interest rates with a bank.	Any gain achieved through bulking should be passed onto the fund.
Life assurance policies	Some retirement funds are managed through a life assurance policy, provided by a life assurer that is associated with a fund administrator. The life assurer then invests the retirement fund money through its own associated or pre-selected asset managers. This may result in the use of underperforming or sub-optimal asset managers, failure to negotiate lower fees with the asset manager, or a payment by the asset manager of some fee or rebate to the life assurer.	Consultants, administrators and asset managers should declare in writing all direct and indirect financial advantage that they, and all associated people/ companies, gain from their work with the retirement funds, in addition to the fees directly paid by the funds.
Group life and disability	In most cases, life assurance companies pay commission to the party that arranges assurance such as the retirement fund administrators or consultants.	Trustees should ensure that these commissions and fees are all fully declared and are for the benefit of fund members.
Switching to umbrella funds	Most umbrella fund trustees are appointed by the umbrella fund sponsor and are therefore connected to or dependent on the sponsor (for example, they could be the sponsoring company's employee). Accordingly, the umbrella fund trustees may not insist that the fund use the best products and services if these are not in the interests of the sponsoring company.	The fund trustees must fully understand the potential conflict of interests associated with an umbrella fund and conduct a proper due diligence before deciding to move to an umbrella fund.

* information in this table was sourced from Personal Finance

The duty of a service provider

When dealing with pension fund money, all service providers are required by law to: -

1. act with the utmost good faith;
2. exercise proper care and diligence;
3. avoid conflicts of interest; and
4. refrain from gaining (directly or indirectly) inappropriate advantage for themselves to the prejudice of the pension funds concerned.

Administrators and investment consultants in particular stand in a relationship of trust when it comes to pension fund monies.

The issue of independence, when it comes to administrators and consultants, plays an important role in this discussion. Many retirement funds continue to use the "one-stop shops" which house a variety of services ranging from benefit consulting, investment management, benefit administration and actuarial services. Although these "one-stop shops" can make the search for various service providers less cumbersome, trustees must examine whether the advice they are being given is for the benefit of the fund or for the broader company/shareholders. Opportunities to make hidden profits by the "one-stop shops" in the form of commissions, lack of fee negotiation and the inappropriate directing of assets are rife.

The Financial Services Board (FSB) shakes its finger

The FSB is looking to gain more power over the retirement fund industry and put tighter regulations in terms of costs and disclosure in place. They are hoping to be able to take immediate action against service providers that commit infringements in these areas instead of having to embark on lengthy court cases. The "naming and shaming" of companies and individuals in breach of regulations has proved a highly effective method of enforcement. Recently the FSB invited administrators to come clean on:

- Any practices and methods whereby administrators and/or associated companies made secret profits to the detriment of pension funds members;
- The pension funds and the amount of money involved; and
- A proposal on how they plan to redress this with the funds.

Trustees: What to do?

In order to facilitate the process of disclosure and ensure maximum benefits for the fund in terms of fees and its members, fund trustees should obtain a declaration from all their service providers disclosing whether they earn any additional profits from providing a service to the fund, other than those agreed to in the fee structure, and whether they have earned such profits in the past. In addition, where possible, all service contracts should be reviewed by an independent body to ensure that the required services are properly laid out and that all costs and fees are fully detailed and understood.

Karlien de Bruin, Quantitative manager

Profile

Qualifications and experience: I have a B.Sc in Actuarial Science and a B.Com (Hons) in Investment Management. I joined RisCura in 2003 after working as a quants analyst at Investment Solutions. At RisCura I have migrated through all the departments: surveys, quants, unitisation and transitions.

Day to day my job involves: supporting all the other departments with any quants related queries. A typical day will involve sorting out a transition settlement or valuation query, doing quants analyses for report backs or new business pitches and assisting the unitisation team with calculations. I'm forever looking to improve things and make life more efficient.

RisCura provides me with: the opportunity to meet extraordinary people. When I spend time with my colleagues, I am always amazed and humbled at what they do and how hard they work. I learn a lot from the people here.

My living hero is: no-one. Nobody is perfect so rather than focusing on one person I try to learn from different people. I like reading biographies of people like Lance Armstrong, Jack Welch, Richard Branson etc, who offer invaluable insight.

I'm passionate about: cycling! I love it. It gives me freedom. When I get on a bike my head clicks out and I'm very competitive. If there is someone in front of me I have to chase them down! I also love music and some of my best work is done when I listen to trance.

My friends know me to be: hyperactive. I have lots of energy and get bored quite quickly so I'm always doing new things - climbing a mountain, learning to fly or studying something.

My life motto is: I will regret more the things I didn't do than the things I did do. At the end of each year I imagine I'm my 16-year old self, looking at where I am today and wonder if I would be impressed or disappointed.

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