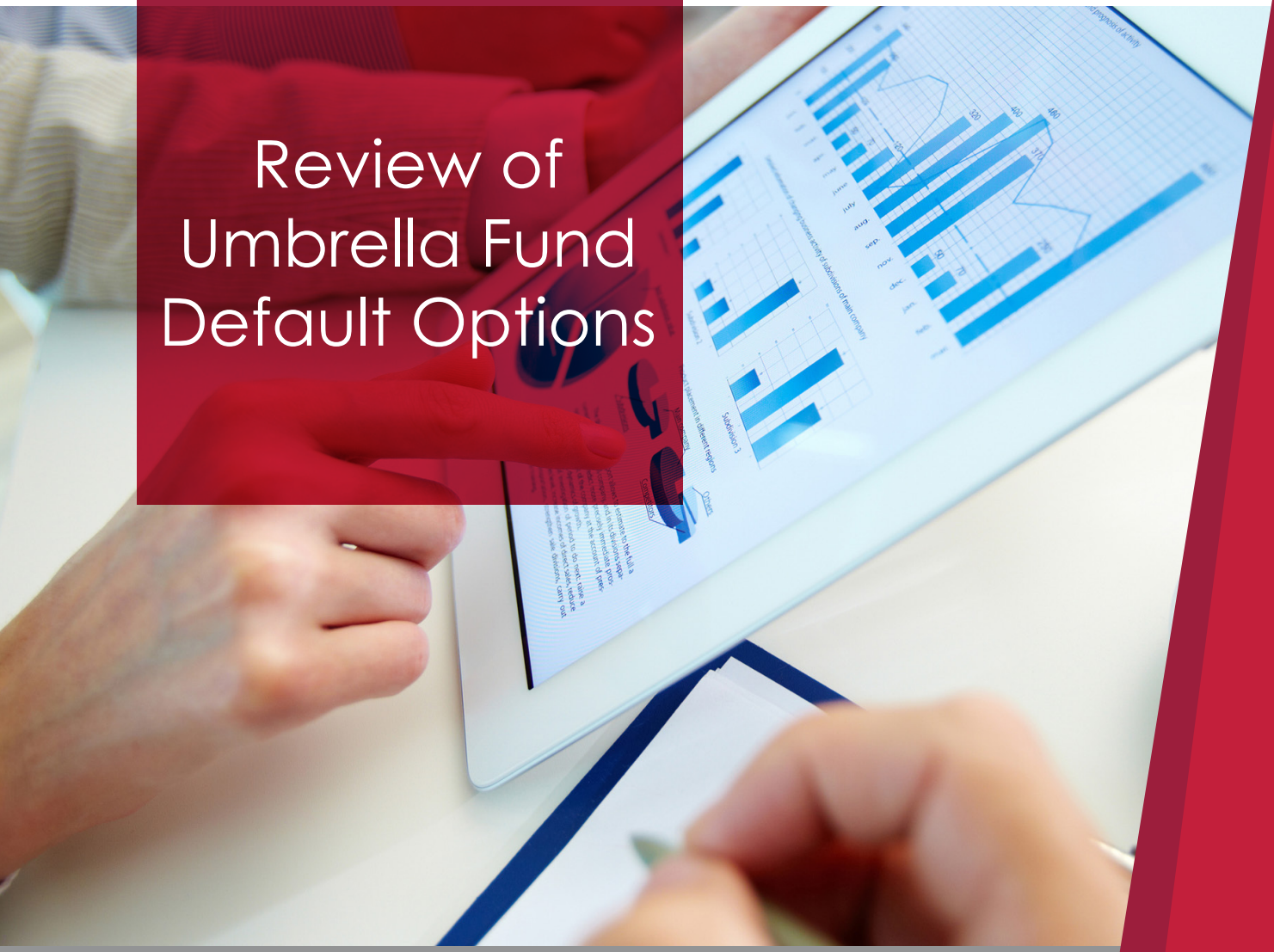
nmg CONSULTING

Review of Umbrella Fund Default Options



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About NMG Consulting

NMG Consulting is a leading multinational consultancy focusing solely on investments, insurance and reinsurance markets. We work with financial institutions (insurers, reinsurers, fund managers and pension funds, banks and brokers) to shape strategy, implement change and manage performance. Our vertically integrated model – high impact consulting backed by the 'information advantage' arising from our proprietary research and analytics programmes – is a unique point of difference in a crowded market. NMG research reports tap into the information flow from our consulting case experience, research and analytics programmes globally to develop a deeper understanding of financial services markets.

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About NMG Benefits

NMG Benefits is the trusted partner of employers, medical schemes, pension funds, employees and retirees. We provide clients with unbiased and professional advice on the provision and management of employee medical, life and disability insurance, and retirement solutions. Our approach is to help clients take a holistic view of their employee benefits programme to ensure the 'common contract' between the employer and the employee encourages greater productivity and loyalty, whilst at the same time protecting the future financial security of the business.

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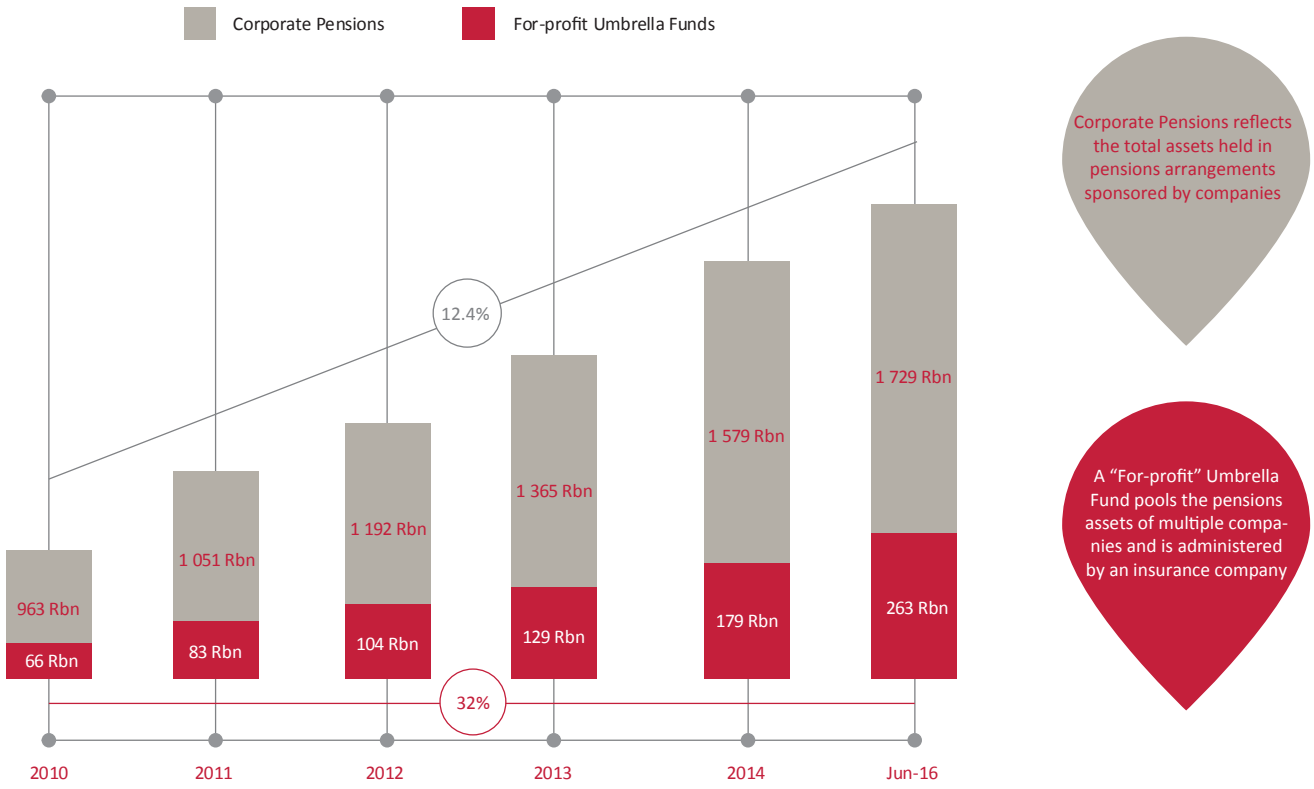
Shining a spotlight on Umbrella Funds' default performance and fees

There has been significant commentary on the benefits of Umbrella Funds for the provision of employee benefits (EB) solutions. With an Umbrella Fund, companies can offer their staff benefits (including insurance and pension savings) from a pooled product administered by an insurance company, as opposed to operating their own standalone schemes. Companies can therefore reduce their administrative burden, governance requirements and fiduciary responsibility all at a cheaper overall cost to company.

Assets managed in "For-profit" Corporate Umbrella Funds have therefore grown significantly and are now responsible for over R260bn in corporate pensions assets in South Africa, making up roughly 15% of the market (see Figure 1). This growth has come in the wider context of a corporate pensions market that has been in net outflow; with pension payments, redemptions and withdrawals exceeding new contributions. With Retirement Reform, the SA Treasury has made an effort to support the corporate pensions market mainly through its initiatives on mandating default options (for investment strategy, preservation and annuitisation).

A study commissioned by Investec Asset Management, and conducted by independent consulting firm NMG Consulting, has found that the growth of Umbrella Funds will ultimately shift the key question for Trustees away from the current "Why Umbrella?" to "Which Umbrella?". NMG proposes that investment propositions offered in an Umbrella Fund's default option, and its associated cost, will become more important when choosing which umbrella fund they select to handle their employee benefits arrangements.

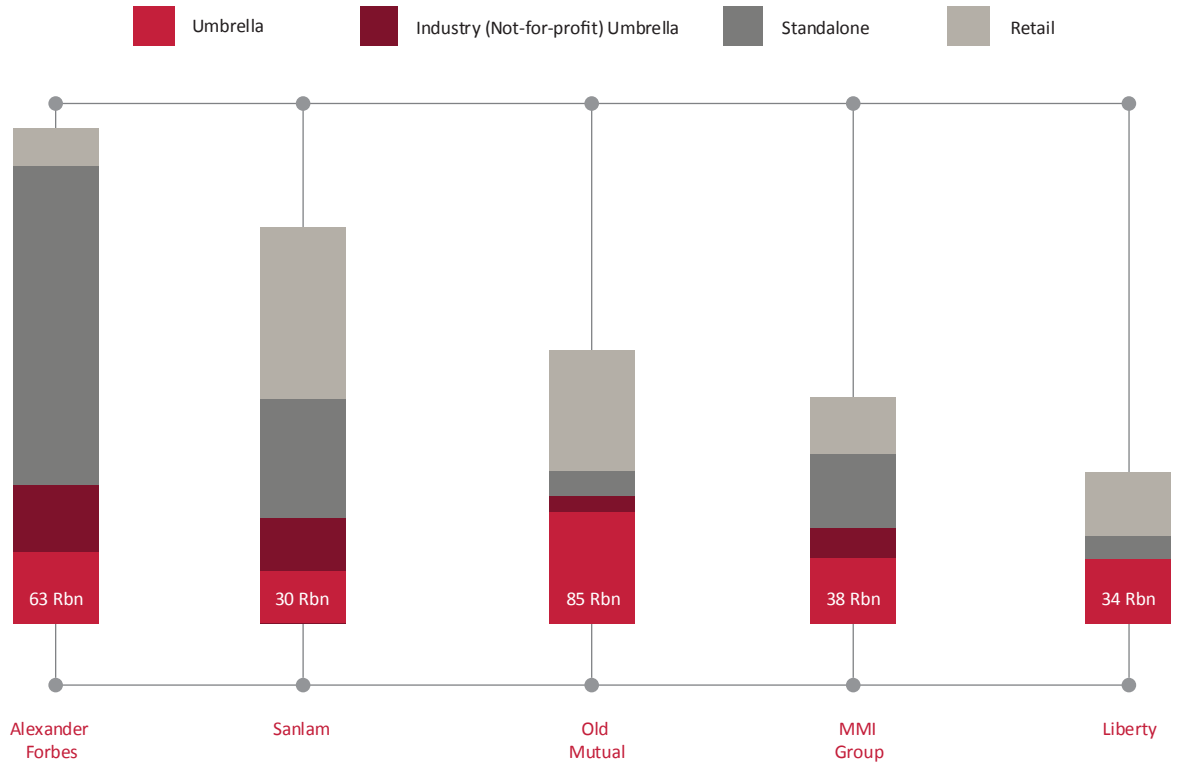
Figure 1: Assets held in Corporate Pensions assets, excluding GEPF (source: FSB Annual Reports)



Shifting the conversation away from "Why Umbrella Funds?"...

The conversation thus far has largely been driven by the Umbrella Fund providers with an explicit aim to convince Trustees to convert from standalone schemes to their own Umbrella Fund. Alexander Forbes has been the dominant market player for corporate pensions provision (with over R400bn in assets under administration predominately in standalone schemes), while Old Mutual has been the most successful in converting its standalone clients into their Umbrella Fund, where they now administer over R85bn in assets within their SuperFund (see Figure 2).

Figure 2: Assets held in top 5 Pension Administrators in South Africa (Source: FSB Employer and Funds Database)



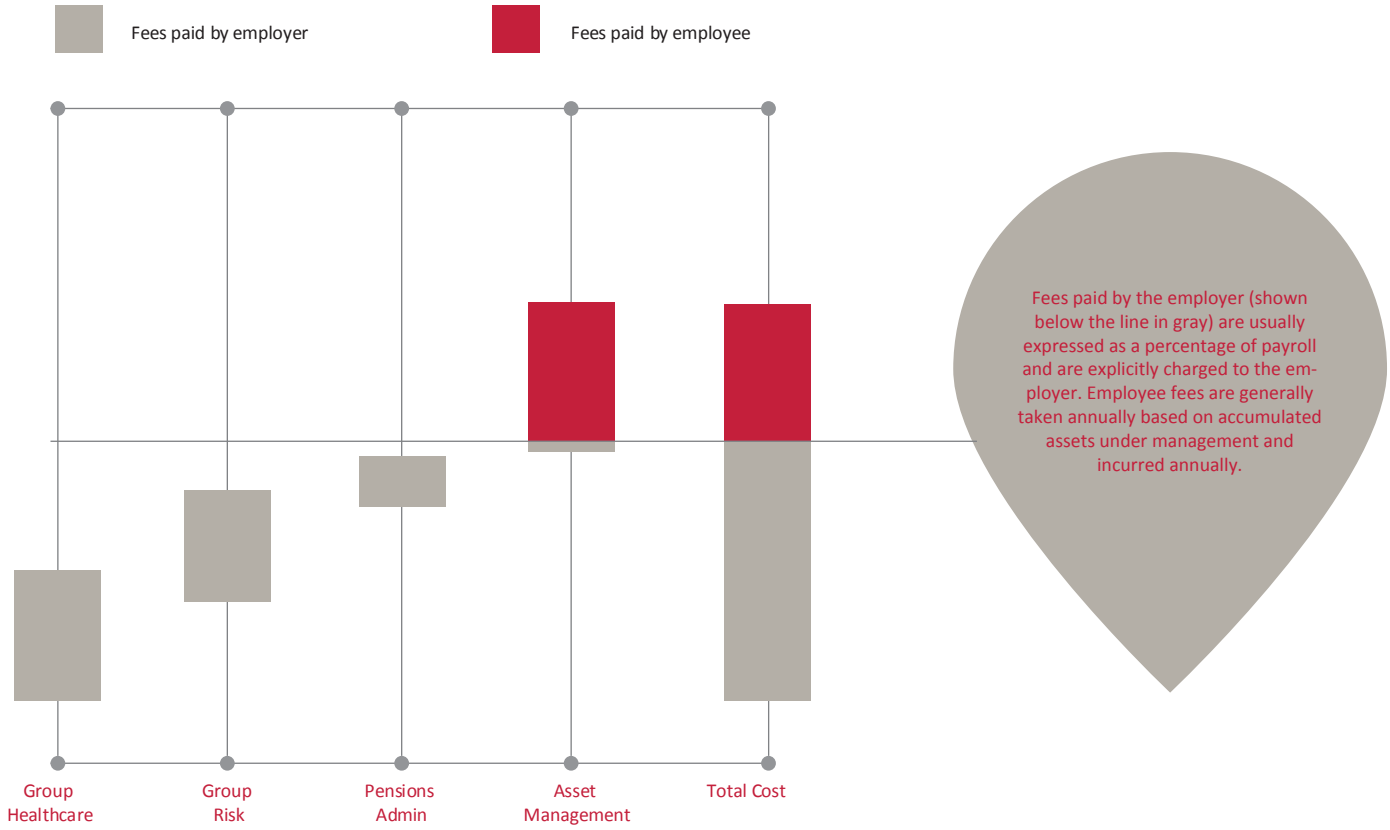
The vast majority of Corporate Trustees make use of either an Employee Benefit Consultant (EBC) or an insurers' own agent to help them select EB providers. These EBCs do provide independent advice for the selection of Group Risk and Healthcare providers. NMG has, however, seen an increasing integration and alignment between these EBC firms and the administration of pensions assets, in an effort to capture the downstream asset management. While this traditional arrangement works well for larger employers operating standalone schemes, it starts to break down with the "bundled" nature of Umbrella fund arrangements.

...to "Which Umbrella Fund is best?"

This brings us to the key dynamic for the providers of these Umbrella Funds. An Umbrella Fund that is able to offer a bundled solution of EB products – across Healthcare, Group Risk, Pension Administration and Asset Management – is able to generate significant economies of scale, thereby reducing overall costs for Trustees. It is therefore critical for the Umbrella Funds to capture a majority share of each corporate's risk, pensions admin and investment and they regularly cross-subsidise between products to achieve this outcome.

From the corporate's point of view, overall cost-to-company is a key factor when selecting an Umbrella provider. One of the main reasons for this is that the final decision usually comes down to the CFO and/or HR manager, as this is a cost borne directly by the company. This can introduce a mis-alignment of interests between the company and the employees based on who is responsible for the costs of these products. This is made clear in Figure 3, which shows an indicative split of costs to the employer and employee for each of the main EB products. Under the most common arrangement, advice and admin costs are paid to providers as a percentage of their monthly payroll. The asset management fees, on the other hand, are paid out of the employee's accumulated pension pot. It is imperative that the decision-makers selecting an Umbrella Fund start to consider the total cost of these services, not just the cost incurred by the company itself.

Figure 3: illustrative split of employee benefits costs between company and employee

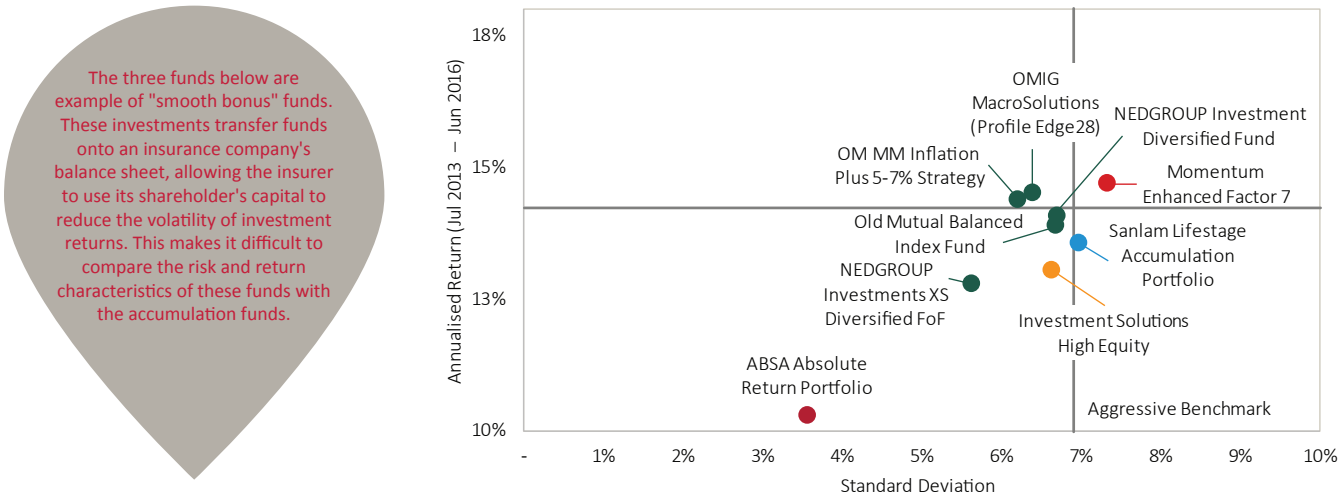


In addition, the majority of members select the default investment option in their Umbrella Fund, which is typically managed by the in-house multi-manager. Hence, Umbrella Funds are incentivised to reduce the "headline" fee for the default option, through a far lower administration fee. But while the default option is often the cheapest option in terms of administration, it is less clear how it compares in terms of investment performance, when compared to the other, single-manager investment options.

How, then, do the Umbrella's Default Portfolios perform?

Most of the Umbrella Funds offer a lifestaging model for these default investment propositions. A lifestage model looks to ensure the greatest asset value at retirement, by managing the risk in an individual's investment portfolio over their career. A younger member will usually be allocated to a high risk portfolio initially – called the Accumulation fund – and then converted to a (series of) lower risk fund(s) over a period of 1-7 years. Figure 4 shows the return of the default Accumulation options for a selection of the top Umbrella Funds in the South African market over the last three years.

Figure 4: gross investment performance (risk / return) for default fund options



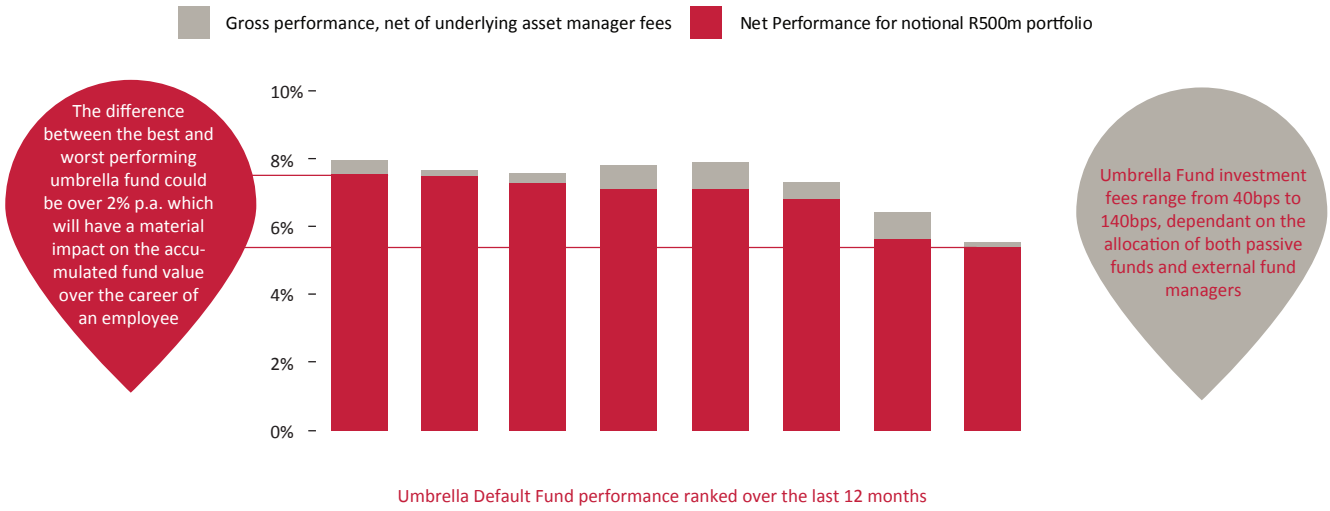
Old Mutual Absolute Smooth Growth	- 16.1%*
Sanlam Monthly Bonus Fund	- 13.6%*
Liberty Stable Growth Fund	- 10.8%*

*Indicative gross of investment management fees and net of capital charges

Fund managers aim to sit in the top left of Figure 4, to demonstrate their ability to generate excess returns at lower risk than their competitors. Risk-defined benefit, or smooth-bonus, funds are designed to do specifically that, through the use of bonus declarations to boost and smooth their returns. There are however additional costs associated with these funds, which usually include a significant penalty fee on early withdrawal. This adds a significant level of complexity and opacity to these products.

Recent regulatory changes (notably proposed Retirement Reform and the Retail Distribution Review) have been focussed on improving the transparency and reporting of investment fees, in an effort to control overall cost across the industry. Figure 5 shows the impact of fees on the performance of the default fund options in the SA Umbrella Funds over the last year. The figure shows that the difference between gross and actual return can be in excess of 0.8%, and may be even more if underlying asset management fees are taken into account. We would encourage Corporate Trustees to consider the total investment fees payable when selecting their default options. This would include the quoted asset management fee to the Umbrella Funds, but also consider any other additional fees payable, whether paid to the underlying investment managers or for capital guarantees and exit penalties.

Figure 5: Impact of quoted fees in Umbrella Fund Default options (based on a notional R500m portfolio)



Umbrella Funds have, to date, used two methods to control the overall fees in their default portfolios. Firstly, increasing allocations to passive investments may bring down the overall cost as they are usually cheaper to administer and do not attract any performance fees. There are, however, some structurual factors in the South African market (notably company and industry concentrations on the JSE and lack of depth in the passive market) which, should they persist, may allow active managers to achieve better risk-adjusted net returns.

The second method that the default funds utilise to reduce costs is to allocate a greater proportion of the default fund to their internal asset management capability. This method may indeed provide a good compromise between the investor and Umbrella Fund as these funds would usually attract a cheaper, institutional price. The underlying internal asset managers should be evaluated, and held accountable, on the same basis as external specialist asset managers operating the same market.

NMG would therefore encourage Trustees to use this framework to consider the investment proposition when selecting an umbrella fund provider. This is especially while default investment options are currently (and likely to remain) the option chosen by their employees. The investment proposition should be considered as a trade-off between the fees paid to the default fund managers and the desired risk-adjusted returns, net of all investment fees.

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