



Introduction

Clients often regard the prospect of managing their personal finances as a daunting and overwhelming task. Adding to this pressure is the fact that personal financial planning is not a once-off exercise but requires clients to perform ongoing planning and management of their finances, up to and beyond death.

1.1 Overview of the Financial Services Sector in South Africa

The financial services sector provides the necessary infrastructure that allows people to make day-to-day economic transactions, such as paying for goods through a credit card; to save for their future goals and retirement needs; and to insure themselves against risks, such as damage to their property, or loss of income due to a disability.

The financial services sector also plays an extremely important role at the macro-economic level. This is because its infrastructure allows for a smooth and efficient flow of funds from those who have surplus funds, to those who have a shortage of funds, either by direct, market-based financing (for example through the stock exchange); or by indirect, bank-based finance (for example loans through a bank). This, in turn, enables opportunities for economic growth, job creation, infrastructure creation and sustainable development in South Africa.

The South African financial services sector plays a crucial role in facilitating economic transactions, investment, and financial security for individuals and businesses. It provides a well-regulated infrastructure that allows for efficient capital flow, risk management, and economic growth. While historically resilient, the sector has faced significant challenges in recent years, including the economic disruptions caused by the COVID-19 pandemic and evolving regulatory frameworks. The introduction of the Twin Peaks regulatory model has enhanced financial stability by placing equal emphasis on prudential supervision (via the Prudential Authority) and market conduct regulation (via the Financial Sector Conduct Authority). Additionally, the Corporation for Deposit Insurance (CODI) was established in 2023



to safeguard depositors against bank failures, strengthening consumer confidence in the financial system. These developments reflect South Africa's ongoing commitment to financial sector reform, ensuring greater financial inclusion, consumer protection, and systemic stability.

The South African financial services sector continues to evolve with regulatory developments aimed at improving consumer protection and market conduct. The Conduct of Financial Institutions (COFI) Bill, introduced as part of the Twin Peaks regulatory framework, seeks to modernise and consolidate financial sector laws to ensure fair treatment of customers. COFI establishes a uniform regulatory approach for all financial institutions, regardless of their specific industry, by embedding Treating Customers Fairly (TCF) principles into law. This means financial service providers must now actively demonstrate compliance with fair treatment, transparency, and ethical product design to avoid regulatory penalties. These measures aim to enhance financial inclusion while ensuring that consumers are protected from unfair practices, excessive fees, and misleading product offerings.

These documents and numerous other documents on financial sector reform, issued by National Treasury, set out the roadmap for South Africa to move towards a Twin Peaks model of regulation. Twin Peaks places equal focus on prudential and market conduct supervision and removes the existing fragmented (or 'silo') regulatory approach which saw different regulators overseeing different sub-sectors in the industry; to move towards a more streamlined system of licensing, supervision, enforcement, customer complaints, appeal mechanism, and customer advice and education across the financial sector. The 'treating customers fairly' approach, which is already being used in the supervision of market conduct in the sector, is also reforming the industry, to ensure that a culture of 'treating customers fairly' becomes entrenched in the sector. This will ensure that this sector provides accessible and appropriate products and services and thereby remains sustainable into the future.

The South African financial services sector consists of different types of financial institutions, which provide various products and services, and they can be grouped into the following main categories:

- Regulatory authorities (such as the Financial Sector Conduct Authority (previously the Financial Services Board) and the Prudential Authority)
- Banks
- The Johannesburg Stock Exchange
- Insurance companies
- Medical schemes providers
- Asset/ fund managers (such as collective investment schemes managers, employee retirement benefit suppliers)
- Financial services providers (FSPs)



Activity:

Which of the following role-players is NOT part of the South African Financial Services Sector:

- a) South African Gold Coin Exchange
- b) South African Reserve Bank
- c) ABSA Bank
- d) Financial Services Conduct Authority

Answer

a) is the correct answer. The South African Gold Coin Exchange does not form part of the financial services sector in South Africa.

Let us now take a closer look at the roles of each of the main market participants in the financial services sector.

1.2 Main Regulatory Role-Players

1.2.1 Financial Sector Conduct Authority (FSCA)

The Financial Services Board (FSB) was originally established through legislation to oversee the non-banking financial services industry, which included retirement funds, short-term and long-term insurance companies, funeral insurance schemes, collective investment schemes (unit trusts and stock market) and financial advisors and brokers.

In terms of the new Twin Peaks regulatory approach, the Financial Services Board has changed to become the new Financial Services Conduct Authority (FSCA).

The FSCA aims to:

- enhance the efficiency and integrity of financial markets
- promote fair customer treatment by financial institutions
- provide financial education and promote financial literacy
- assist in maintaining financial stability in the sector

In promoting efficiency and integrity of financial markets, the FSCA will focus on ensuring that the market participants act fairly, provide fair access to information about prices, and provide fair access to financial products and services. In promoting fair customer treatment, the FSCA will focus on the conduct of business of financial institutions.



The FSCA will achieve its objectives by setting and enforcing rules governing transparency of market information, rules to avoid market abuse, and requirements to oversee financial markets and market infrastructures.

1.2.2 South African Reserve Bank (SARB)

The South African Reserve Bank is South Africa's central bank. Its primary function is to protect the value of South Africa's currency. In discharging this role, it takes responsibility for:

- Ensuring that the South African money, banking and financial system as a whole, is sound; meets the requirements of the community; and keeps abreast of international developments.
- Assisting the South African government, as well as other members of the economic community of southern Africa, with data relevant to the formulation and implementation of macro-economic policy.
- Informing the South African community and all stakeholders abroad about monetary policy and the South African economic situation.

Under the Twin Peaks approach, the 'Prudential Authority' (PA) – a sub-division of the South African Reserve Bank – now takes on the role of prudential regulator for both banking and non-banking financial institutions.

The main aim of the PA is to promote the safety and soundness of financial institutions and market structures across the financial services sector and to protect customers against the risk that financial institutions may fail.

1.2.3 National Credit Regulator (NCR)

The National Credit Regulator (NCR) was established through the National Credit Act 34 of 2005 and is responsible for the regulation of the South African credit industry. Objectives of the NCR include, amongst others:

- promoting a fair and non-discriminatory marketplace to consumer credit.
- providing for the general regulation of consumer credit and improved standards of consumer information.
- promoting black economic empowerment and ownership within the consumer credit industry.
- prohibiting certain unfair credit and credit-marketing practices.
- promoting responsible credit granting and prohibiting reckless credit granting.
- providing for debt re-organisation in cases of over-indebtedness.
- providing for the registration of credit bureaus, credit providers and debt-counselling services.



Under the new Twin Peaks approach, the NCR will continue to regulate consumer credit but will work cooperatively alongside the new Prudential Authority and Market Conduct Authority.

1.2.4 Council for Medical Schemes (CMS)

The Council for Medical Schemes is a statutory body established by the Medical Schemes Act 131 of 1998, to provide regulatory supervision of private health financing through medical schemes.

Under the new Twin Peaks approach, the CMS will continue to regulate medical schemes.

1.2.5 Financial Services Ombud Schemes (FSOS)

In terms of FAIS and other acts that govern the financial services industry, Ombud and complaints-resolution services had been set up to resolve disputes between clients and the financial services institution involved. Any client can simply contact the relevant office to mediate in their complaint against a service provider if they are not satisfied with the service provider's response to their complaint. These services are provided free of charge to the clients.

The following offices currently exist:

- Long-term Insurance Ombud – www.ombud.co.za
- Short-term Insurance Ombud – www.osti.co.za
- Ombud for Financial Services Providers – www.faisombud.co.za
- Ombudsman for Banking Services – www.obssa.co.za
- Pension Fund Adjudicator – www.pfa.org.za
- Council for Medical Schemes Registrar – complaints@medicalschemes.com

The new Twin Peaks approach has established an Ombud Council, which reduces fragmentation in the Ombud system and promotes and develops best practice standards of conduct across all Ombuds in the financial services sector.



Activity:

Which of the following Regulatory role-players is responsible for regulation and supervision of private health financing through medical schemes?

- a) National Credit Regulator
- b) South African Reserve Bank
- c) Council for Medical Schemes
- d) Financial Services Ombud Schemes

Answer

c) is the correct answer. The Council for Medical Schemes is responsible for regulation and supervision of private health financing through medical schemes.

1.3 Banks

1.3.1 Role and Purpose of Banks

Banks are important to the economy of a country because they act as intermediaries through which the funds of surplus units (savers) can be made available to shortage units (borrowers), in order to finance productive investment activities. This is crucial to the functioning of the economy.

Banks also provide a whole range of financial services and advice to the public, such as payment services that are an everyday fact of life, and without which the economy cannot function smoothly.

1.3.2 Legal Structure of Banks

All banks must, firstly, be registered as public companies, and also be registered by the Registrar of Banks in terms of the Banks Act 94 of 1990, before they can commence business.

To get a banking licence, applicants need to meet. Section 13(2) of the Banks Act stipulates that the Registrar will determine, amongst other things, whether:

- (a) the establishment of the proposed bank will be in the public interest.
- (b) the business the applicant proposes to conduct is that of a bank.
- (c) the applicant will conduct the proposed business of a bank in the capacity of a public company incorporated and registered under the Companies Act.
- (d) the applicant will be able to establish itself successfully as a bank.
- (e) the applicant will have the financial means to comply, in the capacity of a bank, with the requirements of this Act.



- (f) the business of the proposed bank will be conducted in a prudent manner.
- i. (fA) every person who is to be a director or an executive officer of the proposed bank is, as far as can reasonably be ascertained, a fit-and-proper person to hold the office of such director or executive officer.
- (g) every person who is to be an executive officer of the proposed bank has sufficient experience of the management of the kind of business it is intended to conduct; and
- (h) the composition of the board of directors of the proposed bank will be appropriate with regard to the nature and scale of the business it is intended to conduct.”

1.3.3 Typical Product Range of a Bank

Typically, the following products and services are offered to retail as well as to business customers:

- Transactional accounts (such as cheque or transmission accounts).
- Savings accounts.
- Investment accounts (such as call deposits, or money-market accounts, or structured deposits).
- Bank cards (such as debit cards, credit cards, garage or petrol cards).
- Loans (such as overdraft facilities, revolving credit plans, personal or business loans, or mortgage bonds); and
- Asset finance (such as instalment lease).

Savings and investment account products are covered in more detail in the Class of Business modules for Short-term and Long-term Deposits, and Structured Deposits.



Activity:

Indicate whether the following statement is true or false:

The Registrar of Banks will need to check that the applicant for a banking licence will be in a position to establish itself successfully as a bank before a licence will be granted.

Answer

True. The Registrar of Banks will check – amongst other requirements – whether the applicant will be able to establish itself successfully as a bank before a licence will be granted.



1.4 JSE Limited (formerly known as Johannesburg Stock Exchange)

1.4.1 Role and Purpose of the JSE

JSE Limited (JSE) is a multi-asset class securities exchange, which provides a 'marketplace' where equities, bonds, options and futures, and other securities can be traded.

Buyers and sellers come together to trade during specific hours on business days. The Exchange imposes rules and regulations on the firms and brokers that are involved with them. If a particular company is traded on an exchange, it is referred to as "listed."

1.4.2 Legal Structure of the JSE

The JSE is licenced to operate under the Financial Markets Act, 19 of 2012. The JSE is the frontline regulator for the exchange, setting and enforcing listing and membership requirements and trading rules. Currently, the Financial Sector Conduct Authority (FSCA) supervises the JSE in the performance of its regulatory duties. As already mentioned, the regulatory landscape is set to change significantly in the future, as South Africa looks to implement a Twin Peaks model of oversight.



Activity:

Indicate whether the following statement is true or false:

The Johannesburg Stock Exchange provides a marketplace for the trading of equities only.

Answer

False. The Johannesburg Stock Exchange (JSE) is a multi-asset class securities exchange, which provides a 'marketplace' where equities, bonds, options and futures, and other securities (i.e. not only equities) can be traded.

1.5 Long-Term Insurers (called 'Life Insurers' in terms of the new Insurance Act 18 of 2017)

1.5.1 Role and Purpose of Long-Term Insurers

The main purpose of long-term insurers is to provide appropriate products that assist clients in achieving their financial goals in life. Note that long-term insurers could be assisting both individual clients and groups of clients (such as employers wanting to provide for their employees) in achieving certain goals.



Long-term insurers, therefore, also have a major duty to take care of people's money, since millions of clients rely on them to invest and grow their hard-earned cash, so that they will be able to send their children to university, go on that dream holiday one day and, to be able to retire comfortably in their old age.

Clients also rely on long-term insurers to be able to pay out lump sums and/ or monthly benefit payments to the affected families in case of adverse life events, such as unexpected death, disability and severe illnesses. These lump sums and/ or monthly benefit payments are used to ease the financial costs associated with, and to replace income/ earnings lost as a result of these adverse life events.

1.5.2 Legal Structure of Long-Term Insurers

Because of their important role as custodians (or caretakers) of people's money, long-term insurers currently need to be licenced by the Prudential Authority, in terms of the Insurance Act 18 of 2017, before they can commence business.

To obtain the licence, they need to meet the following stringent requirements (amongst others):

- Its primary business activity must be the conducting of insurance business.
- It must meet certain requirements with regard to its key persons and significant owners, business plans, transformation of the insurance sector, operational management capabilities, etcetera. The licensing must not be contrary to the interests of prospective policyholders and or the public interest.
- If it is a State-owned company, an Act of Parliament authorises the company to conduct insurance business.

The licence issued by the Prudential Authority may impose licensing conditions necessary to achieve the objectives of the Insurance Act. Once the licence to operate has been granted by the Prudential Authority, the insurer must ensure that reference to the fact that such a licence is held is contained in its business documentation and marketing material. These businesses must also continue to meet appropriate conditions; for example, having an appropriate governance framework. The Prudential Authority has the right to prescribe governance principles and requirements relating to items listed in the Act, and may, under certain circumstances, revoke or withdraw a licence issued under the Insurance Act.



Take Note

In order to align with the Twin Peaks regulatory approach, the Insurance Act 18 of 2017 – which became effective on 1 July 2018, replaces the prudential framework requirements of the current Long-term and Short-term Insurance Acts, while market conduct will in the future be centralised in the Conduct of Financial Institutions Bill (COFI).

1.5.3 Typical Product Range of Long-Term Insurers

A typical product range for a long-term insurer could consist of the following:

- **Risk cover products**, such as: whole life cover, term cover, accidental cover, funeral cover (assistance policy), disability, temporary disability and functional impairment cover, and severe illness cover. These products are also known as life risk policies.
- **Savings products**, such as: endowment policies (long-term investment policies) or sinking fund policies, and retirement annuities (retail pension benefits).
- **Income provision products**, such as: compulsory guaranteed annuities, living annuities and voluntary annuities.

These products are covered in more detail in the Class of Business module Long-term Insurance.



Activity:

Which of the following forms part of the product range of a long-term insurer?

- a) Life cover
- b) Pension fund
- c) Householder's insurance
- d) Fixed deposit

Answer

a) is the correct answer. Life cover is a type of risk product generally offered by long-term insurers.



1.6 Short-term Insurers (called ‘Non-life Insurers’ in terms of the new Insurance Act 18 of 2017)

1.6.1 Role and Purpose of Short-Term Insurers

The main purpose of short-term insurers is to provide a range of products that assist clients in protecting their physical assets – such as homes, furniture and motor vehicles – from unexpected loss or damage, by providing lump sums to repair or replace these expensive assets when the loss or damage occurs. In addition to this, clients can also protect themselves against unexpected legal claims against them, such as a claim for damages caused to a third party while driving a vehicle and having an accident.

1.6.2 Legal Structure of Short-Term Insurers

As in the case of long-term insurers, short-term insurers currently need to be licenced by the Prudential Authority in terms of the Insurance Act 18 of 2017, before they can commence business.

To obtain the licence, they need to meet similar stringent requirements as in the case of long-term insurers, and similar licensing conditions necessary to achieve the objectives of the Insurance Act may be imposed (see 1.3.2 above).

Once the licence to operate has been granted by the Prudential Authority, the short-term insurer, similar to long-term insurers, must also ensure that reference to the fact that such a licence is held, is contained in its business documentation and marketing material. These businesses must also continue to meet appropriate conditions; for example, having an appropriate governance framework.

The Prudential Authority has the right to prescribe governance principles and requirements relating to items listed in the Act; and may, under certain circumstances, revoke or withdraw a licence issued under the Insurance Act.



Take Note

In practice, many of the bigger insurance companies may offer both life and non-life insurance products, as well as pension fund and retail pension fund products and collective investment scheme products (also known as unit trusts). They can do this, provided they have obtained all of the relevant licences, and provided they continue to meet the on-going requirements in order to offer all of these products.



1.6.3 Typical Product Range of Short-Term (non-life) Insurers

A typical product range for a short-term insurer would include, amongst others:

- **Motor vehicle insurance (known as a motor policy):** provides cover against loss or damage to the client's motor vehicle(s).
- **Homeowner's insurance (known as a property policy):** provides cover against loss or damage to the buildings and immovable or permanent goods and fixtures in the house, e.g. roof, fitted carpets and fitted cabinets.
- **Householder's insurance (known as a property policy):** provides cover against loss or damage to the content/ goods in the house, e.g. television and furniture.
- **All-risk insurance (known as a miscellaneous policy):** provides cover against loss or damage to personal items when they are outside of the home (such as laptops and cell phones).
- **Personal liability insurance (known as a liability policy):** provides cover against costs of any legal liabilities, such as third parties who sue the client for damages.
- **Business Interruption Insurance:** Covers financial losses due to unexpected disruptions in business operations, such as fire, floods, or equipment failure. This insurance ensures that a business can continue to meet its financial obligations during periods of inactivity.
- **Professional Indemnity Insurance:** Protects professionals and businesses against legal costs and claims for damages arising from negligent advice, services, or omissions. This is crucial for industries such as legal, financial, and medical professions.

Short-term Insurance products for both personal lines and commercial lines are covered in more detail in the Class of Business modules Short-term Insurance Personal Lines and Short-term Insurance Commercial Lines.



Activity:

Which of the following forms part of the product range of a short-term insurer?

- a) Life cover
- b) Pension fund
- c) Householder's insurance
- d) Fixed deposit

Answer

c) is the correct answer. Householder's insurance is a type of product generally offered by short-term insurers.



1.7 Medical Schemes

1.7.1 Role and Purpose of Medical Schemes

A medical scheme is established to provide medical financial aid to cover a large group of individuals. These individuals can be from the same employer group, or they could be a large group of private members. Members pay monthly contributions to a medical aid fund and when any of the members have medical expenses, the costs are paid from this fund. All registered medical schemes have to comply with the provisions of the Medical Schemes Act 131 of 1998.

1.7.2 Legal Structure of Medical Schemes

All medical schemes must be registered by the Registrar of Medical Schemes with the concurrence of the Council of Medical Schemes and in terms of the Medical Schemes Act 131 of 1998, before they can commence business. To get the licence they need to meet stringent requirements, including:

- members of the board of trustees and the principal officer of the proposed medical scheme must be fit-and-proper persons to hold the offices concerned.
- the medical scheme is or will be financially sound.
- the medical scheme has a sufficient number of members who contribute or are likely to contribute to the medical scheme.
- the medical scheme does not or will not unfairly discriminate, directly or indirectly, against any person on one or more arbitrary grounds, including race, age, gender, marital status, ethnic or social origin, sexual orientation, pregnancy, disability and state of health; and
- the registration of the medical scheme is not contrary to the public interest.

The Registrar may also demand from the person who manages the business of a medical scheme which is in the process of being established, financial guarantees to ensure the financial stability of the medical scheme.



Take Note

There are currently plans in place by the South African government to implement a National Health Insurance (NHI) scheme, which will most likely lead to extensive restructuring of the public and private healthcare sector, including medical schemes, over the next few years.



1.7.3 Typical Product Range of Medical Scheme

A typical medical scheme offers one or more of the following, to meet various medical needs:

- **Basic care option:** Provides members with cover for basic care (such as GP visits) through a network of providers, such as Medicross.
- **Hospital plan option (major medical expenses):** Provides members with cover for procedures that require hospitalisation but excludes day-to-day medical expenses which may be more regular.
- **Day-to-day care option:** Provides members with cover for day-to-day costs, such as GP or basic dentistry services, at the member's own chosen service provider.
- **Medical savings plan:** Allows members to allocate a portion (up to certain maximum percentages) of their contribution towards an individual savings account, which can be used to pay for medical services not covered under their scheme option.
- **Fully comprehensive plan option:** This option typically covers all the above medical needs.



Take Note

PMB's: Prescribed minimum benefits are the minimum level diagnosis, treatment, and care that a medical scheme must cover – the PMB condition must be paid from the risk pool, in full. There are 270 serious health conditions and 25 chronic diseases that form part of PMBs. The medical scheme will usually have a designated services provider (DSP) who/ which is the medical scheme's first choice in terms of doctor, pharmacy or hospital. If you decide to use a non-DSP, a co-payment will apply.

www.medicalschemes.com/medical_schemes_pmb/index.htm

These products are covered in more detail in the Class of Business module Health Services Benefits.



Activity:

Which medical scheme benefit option offers clients cover for GP visits and other general medical services through a network of providers?

- Fully comprehensive plan option
- Day-to-day care option
- Basic care option
- Medical savings plan



Answer

c) is the correct answer. The basic care option provides members with cover for basic care (such as GP visits) through a network of providers, such as Mediacross.

1.8 Employee Retirement Benefit Suppliers

These are retirement and related benefits for employees of a participating employer. The

1.8.1 Role and Purpose of Employee Retirement Benefit Suppliers

The main purpose of providers of retirement fund benefits is to provide a range of products that assist clients (corporate clients, such as business enterprises) to, in turn, assist their employees in saving money towards their retirement. Retirement products, such as pension funds and provident funds, are intended as vehicles to provide for an income at retirement stage and, as such, have favourable tax benefits to encourage saving.

1.8.2 Legal Structure of Employee Retirement Benefit Suppliers

Employee retirement benefit suppliers consist of suppliers who offer a range of retirement fund structures and retirement solutions to bigger and smaller companies. Bigger companies may opt to have their own registered pension funds, while smaller companies would use the employee retirement benefit suppliers' umbrella fund.

Each pension or provident fund is registered as an individual retirement fund by the Registrar of Pension Funds, and, as such, is governed by the Pension Funds Act 24 of 1956, as amended. The Commissioner for Inland Revenue also approves these funds so that contributions and benefits are taxed in accordance with the Income Tax Act, to enable the special tax concessions that apply to retirement benefit products.

Initial and on-going requirements for actuarial soundness apply to anyone registering a retirement fund before a licence to operate can be issued. In addition, the Pension Funds Act requires each fund to appoint a board of at least four members, who will have the duty to act as trustees on behalf of the registered retirement fund, and to ensure that decisions made by the fund are in the best interests of its members (the employees who belong to the fund).

Another requirement is that each retirement fund must have a set of 'rules' which set out, amongst others, how the fund will be managed and administered, and how decisions about the fund will be made by the trustees.



1.8.3 Typical Product Range of Employee Retirement Benefit Suppliers

A typical product range for an employee retirement benefit supplier could consist of:

- **Group risk insurance benefits**, such as group life cover, group funeral cover, group occupational disability and temporary disability cover.
- **Pension fund benefits** provide registered pension funds for companies.
- **Provident fund benefits** provide registered provident funds for companies.
- **Preservation fund benefits** provide registered preservation pension or preservation provident funds for employees who leave a registered pension or provident fund due to resignation from employment.
- **Umbrella funds** provide access for companies to join an already registered pension or provident fund.

These products are covered in more detail in the Class of Business module Pension Fund Benefits.



Activity:

Who plays a role in registering and approving pension and provident funds?

- Registrar of Financial Services Conduct Authority
- Registrar of Pension Funds
- Commissioner for Inland Revenue
- Commissioner for Retirement Funds

Select the correct combination:

- i) and ii)
- ii) and iii)
- iii) and iv)
- i) and iv)

Answer

b) is the correct answer. Pension and provident funds are registered as individual retirement funds by the Registrar of Pension Funds and approved by the Commissioner for Inland Revenue.



1.9 Collective Investment Schemes Managers

1.9.1 Role and Purpose of Collective Investment Schemes Managers

The cost to purchase a share (equity) in a company may be unaffordable for most people; for example, a share trading at R360.00 may have to be bought in a minimum tranche of 1 000 shares, so the minimum cost of the trade would be R360 000, before trading and brokerage costs. The main purpose of collective investment schemes managers is thus to provide a means for ordinary people to participate in buying shares (also known as equities) and other securities on the Johannesburg Stock Exchange, or on international stock markets, in order to achieve a growth on their investment that beats inflation over the longer term.

1.9.2 Legal Structure of Collective Investment Schemes Managers

Similar to retirement funds, each collective investment scheme is individually registered by the Registrar of Collective Investment Schemes and is governed by the Collective Investment Schemes Control Act (CISCA), 45 of 2002.

Each collective investment scheme is also obliged to appoint a trustee or custodian to ensure that the collective investment scheme manager (the product supplier) operates the scheme according to the rules as set out in the 'deed' that governs it, and that acts as custodian of all cash and securities (such as equities (shares) and bonds) in the investment portfolio (investment fund) of the scheme.

Collective investment schemes also need to meet the requirements and guidelines as set out in the ASISA Standard on Fund Classification for South African Regulated Collective Investment Portfolios ("ASISA Fund Classification Standard"), which establishes and maintains a classification system for CIS portfolios in South Africa.

The ASISA fund classification system classifies collective investment scheme (CIS) funds in three tiers (or levels).

Tier 1 is a geographical classification, in terms of which funds are:

- South African: must invest at least 55% of their assets in South African investment markets.
- Worldwide: can invest in both South African and foreign markets. There are no limits set for either domestic or foreign assets.
- Global: must invest at least 80% of their assets outside South Africa, with no restriction to assets of a specific geographical country (for example the USA) or geographical region (for example Africa).
- Regional: must invest at least 80% of their assets in a specific country (for example the USA) or geographical region (for example Africa) outside of South Africa.



Tier 2 is an asset class classification, in terms of which funds are invested in different asset classes:

- Equity portfolios: invest a minimum of 80% of the market value of the portfolios in equities and generally seek maximum capital appreciation as their primary goal.
- Multi Asset portfolios: invest in a wide spread of investments in the equity, bond, money and property markets, in order to maximise total returns (comprising capital and income growth) over the long term.
- Interest-bearing portfolios: invest exclusively in bond or money-market investments and other interest-earning securities.
- Real Estate portfolios: invest in listed property shares, collective investment schemes in property and property loan stock, and real estate investment trusts. The objective of these portfolios is to provide high levels of income and long-term capital appreciation.

Tier 3 is an investment focus classification, in terms of which funds are classified into 'investment focus' areas, for example:

- Equity – General portfolios: invest in selected shares across all industry groups, as well as across the range of large, mid and smaller market capitalisation shares.
- Equity – Large cap portfolios: invest at least 80% of the market value of the portfolios in large market capitalisation shares, which have a market capitalisation greater than or equal to the company with the lowest market capitalisation in the FTSE/ JSE Large Cap Index, or an appropriate foreign index published by an exchange.

The **objectives** of the ASISA Fund Classification Standard are to –

- promote investor awareness and understanding of CIS portfolio types.
- assist with the comparison of CIS portfolios within and across classification categories; and
- assist with the assessment of potential risks of investing in a particular type of CIS portfolio.

The **purpose** of the ASISA Fund Classification Standard is to:

- ensure that CIS portfolios adhere to the classification category definitions.
- standardise applications for approval of the classification of a CIS portfolio; and
- facilitate the timeous and appropriate classification and reclassification of CIS portfolios.

We discuss the ASISA classification system in more detail in the Economic and Investment Overview module, as well as in the Investments module.



Research Activity:

Visit the following website to obtain more information on ASISA's fund classification standards and asset percentage restrictions:

<https://www.asisa.org.za/standards-guidelines-codes/>



Activity:

What is the main objective of the ASISA Fund Classification system?

Answer

The main objective of the ASISA Fund Classification system is to classify CIS portfolios into logical categories so that they can be compared in terms of the type of investment and the potential investment risk.

1.9.3 Typical Product Range of Collective Investment Schemes Managers

When we talk about the product range of a collective investment schemes manager, we need to differentiate between the investment portfolios (or funds) offered, and the investment vehicle (or type of product) used.

The investment portfolios (or investment funds) are the different combinations of securities and assets that each fund is invested in, so that investors can choose from a range of funds to suit different investment needs.

Examples of investment portfolios (funds) are:

Money-market funds:

These funds invest in interest-bearing investments and are generally used by investors as a safe 'parking place' for their money.

Equity funds:

These funds invest in a range of shares (equities) on the stock market and can be general equity funds (diversified across all the sectors on the stock market) or specialist equity funds (invest in only one sector, such as the resources sector (listed companies that belong to ICB Sectors Oil & Gas Producers and Mining)). These types of funds are used by investors to grow their capital over the long-term.



Income funds:

These funds invest in money market instruments, bonds and rental property, and are generally used by investors to provide them with an income from their lump sum investment.

Prudential funds (also known as Regulation 28 compliant funds):

These funds invest into assets as set out by the Prudent Investment Guidelines contained in Regulation 28 of the Pension Funds Act and are thus suitable for investors who are saving towards their retirement.

On the other hand, the investor can invest into any of the above type of funds via different types of investment vehicles, or products. These products include typical products offered by long-term insurers, such as retirement annuities and endowment policies. However, most collective investment schemes managers also offer clients a simple 'default' collective investment scheme (unit trust) account, where all of the client's transactions of buying and selling participatory interests (units) are recorded.

These products and the underlying asset classes are covered in more detail in the Class of Business module Investments.

1.10 Financial Services Providers (FSPs)

1.10.1 Role and Purpose of Financial Services Providers

In this unit, so far, we have discussed the main role-players in the financial services industry that supply the market with products. Among these are banks, long-term and short-term insurers, employee retirement benefit suppliers and collective investment scheme managers.

We have also discussed some of the typical products provided. Although these products are very important to ensure a person's financial wellbeing (in the present as well as for their future), many people in South Africa are poorly educated about the importance of financial planning or are fearful about financial products due to their intangible nature, and due to the complexity of some of these products. For this reason, the industry also requires competent professionals who can provide clients with the necessary information and advice needed to achieve financial planning objectives, and in order to assist the client to make the right decisions on the most appropriate product for their specific needs.

Financial services providers can be seen as groups of professionals who link up the clients who need financial services, with the product suppliers. Their role includes contacting and reaching clients (done through call centres, or by direct-face-to-face contact, or at branches), educating and guiding clients on financial planning needs, providing clients with information



about financial products and services, and advising clients in terms of appropriate products and services for their specific needs.

The Financial Advisory and Intermediary Services (FAIS) Act regulates this provision of financial services by FSPs. Financial services include providing advice about financial products, distributing products (marketing and selling), dealing in products (trading equities, trading debt instruments), administering and providing supporting services (such as record-keeping, investment platform administration, and valuations).

In terms of this act, people who provide financial services are known as ‘representatives. Representatives are defined in the FAIS Act as ‘any person who renders a financial service for or on behalf of a financial services provider, in terms of conditions of employment or any other mandatory agreement, but excludes a person rendering clerical, technical, administrative, legal or accounting service, which service does not require judgement on the part of that person, or does not lead a client to any specific transaction in respect of a financial product in response to general enquiries.’



Take Note

Historically, there were many terms commonly used to describe the role of ‘representative’ in the industry. You may have heard of the terms ‘agents’, ‘financial advisors’ or ‘advisors,’ ‘brokers’ and ‘intermediaries.’

1.10.2 Legal Structure of Financial Services Providers

Before the Financial Advisory and Intermediary Services Act, 37 of 2002 (FAIS), came into being, anyone could be employed or mandated directly by a product supplier role-player to distribute products, based mainly on their ability to sell the products effectively.

Currently, however, financial services providers are required to apply to the Financial Sector Conduct Authority (FSCA) for a licence in terms of the FAIS Act, before they may operate as a financial services provider.

This licence sets out the different product categories (classes of business) in respect of which the financial services providers may provide financial services.

The FAIS Act also requires all key individuals (managing staff who oversee the provision of financial services to clients in an FSP) to meet certain fit-and-proper requirements. Representatives (the professionals providing the financial services to the clients) are required



to meet similar fit-and-proper requirements as those applicable to key individuals. Financial services providers are required to keep updated registers of all the representatives authorised to act on behalf of the FSP. Any representative who loses his/ her fit-and-proper status needs to be removed from the register and prohibited from acting on behalf of the financial services provider.

1.10.3 Products Distributed by FSPs

Financial Services Providers have to apply for licences in all the different categories and sub-categories (classes) of products that they intend to give advice on (and distribute). Any representative who acts on behalf of an FSP can only provide financial services in those categories and sub-categories (or for those classes of products) for which the FSP he/ she is representing has obtained a licence.

For example, in the case of an FSP that provides financial services in respect of assistance policies, such as funeral policies, that FSP would be licenced as a Category I provider, in Long-term Insurance sub-category A.



Activity:

Indicate whether the following statement is true or false:

A representative of an FSP is responsible for overseeing the provision of financial services to clients in an FSP.

Answer

False. A representative of an FSP is responsible for the provision of financial services to clients in an FSP, while the key individual is responsible for overseeing the provision of financial services.

1.11 The Corporation for Deposit Insurance (CODI)

When we deposit our money into our bank accounts, the banks lend or invest a large percentage of the monies deposited. In South Africa, the minimum reserve requirement¹ is 2.5%. Since a great portion of the deposits do not sit in the bank vaults, in a situation where the majority of borrowers fail to repay their loans when due, or if a bank makes significant losses on the investments it made with depositors' monies, the depositors, are at risk of losing their monies. A recent case in point is the Silicon Valley Bank crisis (see the illustrations below).

¹ This is the amount of cash that banks must hold in reserve in order to be able to meet liabilities in case of sudden withdrawals



The Silicon Valley Bank (SVB) crisis explained



WHAT IS SVB?

The 1983-founded California-based SVB focusses on serving Silicon Valley startups

"IT PROVIDES MULTIPLE SERVICES TO VENTURE CAPITAL, PRIVATE EQUITY FIRMS IN ADDITION TO OFFERING PRIVATE BANKING SERVICES FOR HIGH NET-WORTH INDIVIDUALS"

HOW BIG IS IT?

SVB has business with nearly half of all the US venture-backed startups, and 44% of the US venture-backed tech, healthcare firms that went public last year

As of December 31, SVB had \$212 billion in assets

The bank's clients includes household names like Shopify, Pinterest, etc

WHAT WENT WRONG AT SVB: A TIMELINE



During the funding boom of 2021, SVB amassed large deposits – \$189 billion in 2021, which later peaked to \$198 billion



It later invested heavily in bonds, which were being issued in a low-interest rate scenario. SVB's balance sheet for 2022-end showed \$91.3 billion of securities



In 2022, the US Federal Reserve started raising interest rates, which drove down the value of bond holdings issued at lower rates



Rising interest rates also led to venture capital firms cutting fewer and smaller cheques to startups triggering a funding winter



As funding depleted, deposits made by startups in institutions such as SVB also started declining, forcing the bank to sell securities at a loss to cover up



On Wednesday, SVB announced it had sold \$21 billion worth of bond assets at a loss of \$1.8 billion



It also said it was raising \$2.25 billion via a share sale

Source: [Insights on India](https://edition.cnn.com/2023/03/13/investing/silicon-valley-bank-collapse-explained/index.html)



Activity:

Click on the link below to learn more about the collapse of Silicon Valley Bank:

<https://edition.cnn.com/2023/03/13/investing/silicon-valley-bank-collapse-explained/index.html>

Since customers can withdraw their deposits at any time, banks that find themselves in financial trouble are likely to suffer bank runs, as depositors rush to withdraw their monies quickly before possible bank insolvency. Bank failures can trigger financial crises and economic recessions, and this led to policymakers to implement deposit insurance schemes to protect depositors and to provide the assurance that their deposits are not at risk. Deposit insurance institutions are usually run by governments and may be a part of the central bank. However, some deposit insurance institutions are private entities which have the backing of government while others may be completely private entities.



South Africa is the only G-20 country without explicit deposit insurance. In 2021, the Corporation for Deposit Insurance (CODI) was established as a separate department in the South African Reserve Bank and became a legal entity in 2023. Although CODI was established on 24 March 2023, it will become fully operational by April 2024. CODI is a statutory body and a subsidiary of the SARB, but it has an independent board to manage and oversee its affairs.

CODI is part of the Twin Peaks regulatory reforms and will support the Reserve Bank's mandate of protecting and enhancing financial stability. The aims of the scheme are to protect depositors, promote awareness and to contribute to financial stability.

The FSR Act provides the over-arching framework for the establishment of CODI. CODI will manage the Deposit Insurance Fund (DIF) which allows bank depositors access to their deposits within a reasonable timeframe when a bank fails. It is important to note that CODI will only protect banking products where the capital amount is guaranteed and repayable at par. Examples of such banking products are savings and cheque accounts. CODI will therefore not protect investment products.

When a bank fails, or is liquidated, CODI will use the DIF to pay the failed bank's covered depositors through electronic funds transfers (EFTs) or through an agent bank. Currently, the proposed protection for qualifying depositors is limited to R100 000 per depositor per bank and this protection is automatic. Therefore, depositors do not have to apply for this protection, and this protection is afforded to natural or non-financial persons.

Furthermore, qualifying accounts of sole proprietors will be separately covered from their personal bank accounts. The limit for a sole proprietor will be R100 000 if the bank can identify the accounts the individual uses for the sole proprietorship.

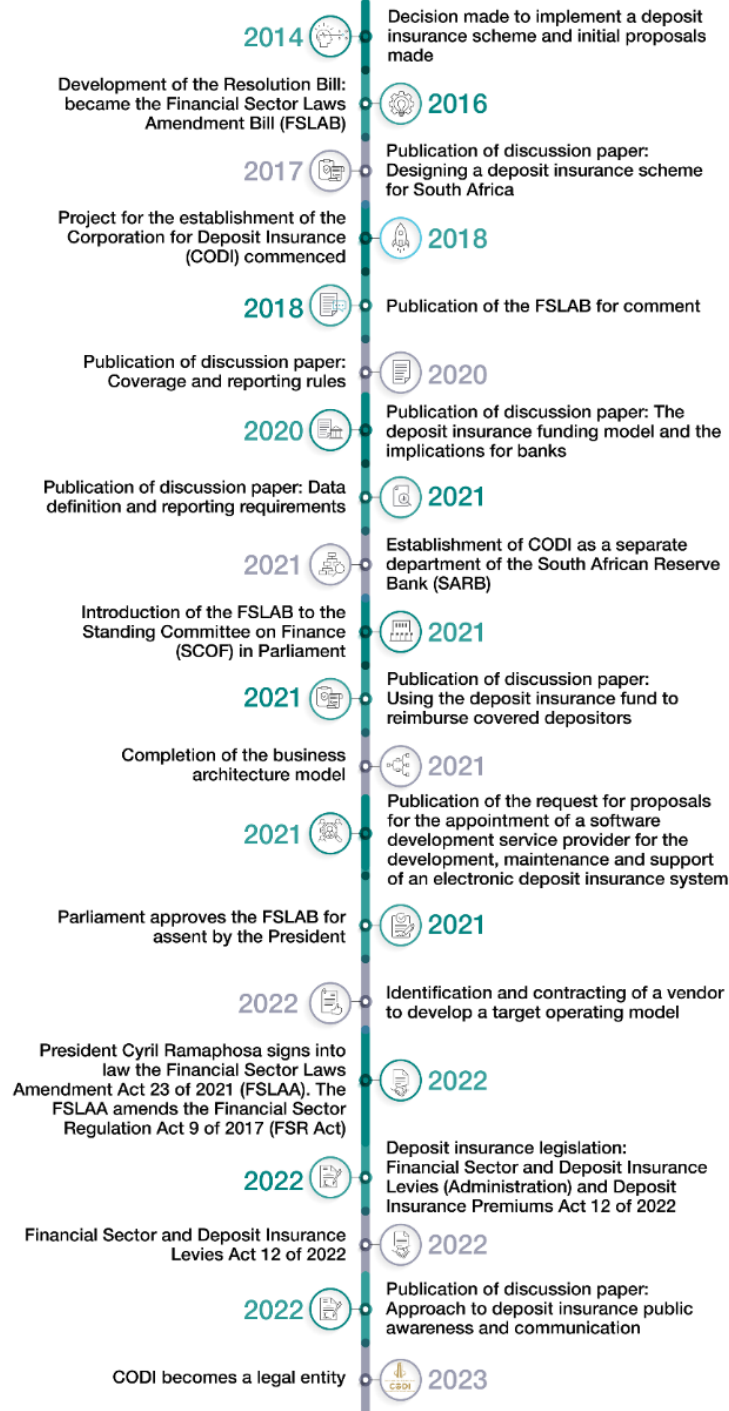
Qualifying deposits in foreign currencies are also covered up to the R100 000 limit and in the event of a bank failure, foreign currency balances will first be converted to South African rand before payments are made to depositors. CODI Membership is compulsory and automatic for all registered banks.

Although the FSR Act provides the over-arching framework for the establishment of CODI, CODI is developing secondary legislation which specifies the cover limit for depositors and will contain detailed rules to explain procedural and/or administrative matters relating to CODI and DIF operations.

CODI is also developing systems to automate the collection of depositors' information from banks which will allow it to calculate the banks' financial contributions to CODI. From 1 April 2024, CODI will be operationally ready to protect depositors if their bank fail.



CODI JOURNEY TO DATE



Source: [SARB](#)



Unit 1 Summary

The financial services sector has moved towards a streamlined twin peaks regulation, enhancing the sector's ability to strengthen South Africa's approach to consumer protection and market conduct in financial services, and creating a more resilient and stable financial system.

The sector consists of various market participants, described below.

Main regulatory role-players include the Financial Services Conduct Authority (FSCA) as market conduct regulator for the financial services sector; the Prudential Authority (a division of the South African Reserve Bank, SARB) as prudential regulator for the financial services sector; the National Credit Regulator (NCR), which regulates the South African credit industry; the Council for Medical Schemes (CMS), which regulates medical schemes; and the Ombud Council, which will oversee the different Ombuds in the financial services industry.

Banks: Provide a range of financial services such as day-to-day payment services and loan services, which also mobilises savings and other short-term funds for long-term investment and growth purposes in the South African economy. Typical products of a bank include transactional accounts, savings accounts, investment accounts, credit cards, loans and asset finance.

The Johannesburg Stock Exchange (JSE Limited): Provides a marketplace for buyers and sellers to trade equities, bonds, options and futures, and other securities.

Long-term insurers: Pay out lump sums and / or regular income payments to the affected life insureds or families in case of adverse life events, such as unexpected death, disability and severe illnesses. These lump sums or income payments are used to ease the financial costs associated with, and to replace income/ earnings lost as a result of the adverse life events. Long-term insurers also provide opportunities for long-term savings, meaning that these savings can, in turn, be used to invest in the economy of the country. Typical products of long-term insurers include risk products, such as life cover, disability cover, and severe illness cover (also known as dread disease cover); savings and investment products, such as endowments and retirement annuities; and income provision products, such as voluntary or compulsory annuities.



Short-term insurers: Provide financial protection for physical assets, such as homes, furniture and motor vehicles, from unexpected loss or damage, by providing lump sums to repair or replace these assets if loss or damage occurs. Short-term insurers also provide protection against unexpected legal claims, such as a claim for damages caused to a third party. Typical products of short-term insurers include motor vehicle insurance, homeowner's insurance, household contents insurance, all-risks insurance and personal liability insurance.

Medical Schemes: Provide medical financial aid to large groups of individuals. Members pay monthly contributions to a medical aid fund, and when any of the members have medical expenses, the costs are paid from this fund.

Employee retirement benefit suppliers: Provide a range of products that assist clients (corporate clients such as business enterprises) to, in turn, assist their employees in saving money towards their retirement, so that they can obtain an income in the form of a monthly annuity (or pension), once they reach retirement.

Typical employee retirement benefit products include retirement benefit products, such as pension and provident funds, preservation funds and umbrella funds; and group risk insurance benefits, such as group life cover, group funeral cover and group disability cover.

Collective investment schemes managers: Provide a means for ordinary people to participate in buying shares (also known as equities) in the Johannesburg Stock Exchange, or on international stock markets, in order to achieve a growth on their investment. Typical investment portfolios include money-market funds, equity funds, income funds and prudential funds; while a simple product to use for accessing these funds is the unit trust account, which is flexible, as funds can be accessed at any point.

Financial Services Providers (FSPs): Provide the service to the consumer where, through a network of representatives, clients are contacted and products are distributed to them on behalf of the role-players, whilst also providing financial planning. Typical products that may be distributed depend on the category and sub-categories for which the FSP has a licence.



Unit 2: Overview of Securities and Instruments Used in the Investment Environment

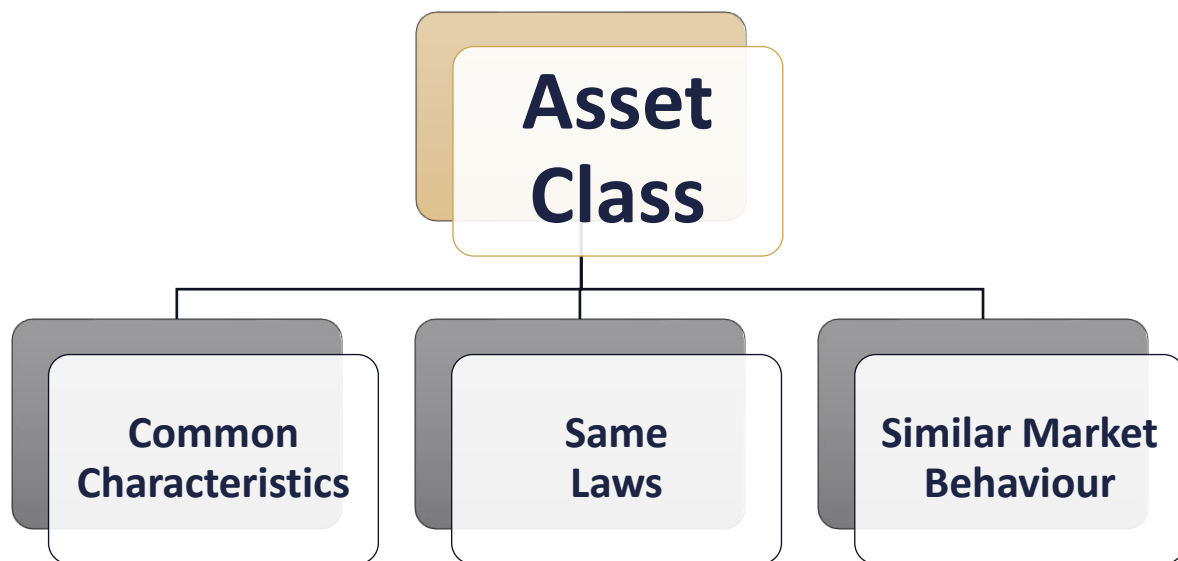
Introduction

Clients often regard the prospect of managing their personal finances as a daunting and overwhelming task. Adding to this pressure is the fact that personal financial planning is not a once-off exercise but requires clients to perform ongoing planning and management of their finances, up to and beyond death.

Asset Classes and Asset Class Categories

Before we find out about asset classes, let us first define assets. An asset can be defined as any possession or investment that has potential value when exchanged. Examples of assets that could be included in this definition are property, stocks, or shares (equities), cash investments at the bank, bonds, etc. Note that this definition focuses on assets in the investment sense (i.e., with the potential of having a growing future value), so we would not include possessions here that we use in everyday life, such as cars or furniture, unless these possessions are, for example, antique collectible furniture, or collector cars that gain in value due to their scarcity.

Asset classes are therefore groupings of assets (or investment instruments) used for investment purposes that share common characteristics, are subject to the same laws (for example tax laws) and behave similarly in the marketplace.



To put it another way, all assets in a particular asset class tend to have somewhat similar levels of performance in given market conditions, whereas assets in different asset classes may perform differently in relation to each other under the same given market conditions (or we can say that different asset classes may have low performance correlation).



Example: Low Performance Correlation between different Asset Classes

When interest rates are high, cash performs well. Equities, on the other hand, tend to perform well when the outlook for growth in corporate profits is good, and this is often when interest rates are low.

These two asset classes thus tend to have a low-performance correlation in a given interest rate market environment.

If invested only in equities, the investment would tend to perform poorly in a market environment where interest rates are too high and restrictive for companies to expand and increase their growth. However, if you invested partly in cash as well, the overall risk profile of the investment would be reduced, since, if interest rates increased, then the cash investment would perform better, and thus be able to offset some of the losses experienced in the equity investment.

Categorising assets into classes assists investors or asset managers to choose an appropriate mix of assets in these different classes, in order to reduce exposure to the risk associated with any one asset class, and to maximise returns in changing market conditions. We will discuss the concept of asset allocation further in Unit 3.



Examples of different asset classes (and the typical assets/ investment instruments associated with the asset class) investors could invest in, are shown in the table below.

Table 1: Examples of asset classes

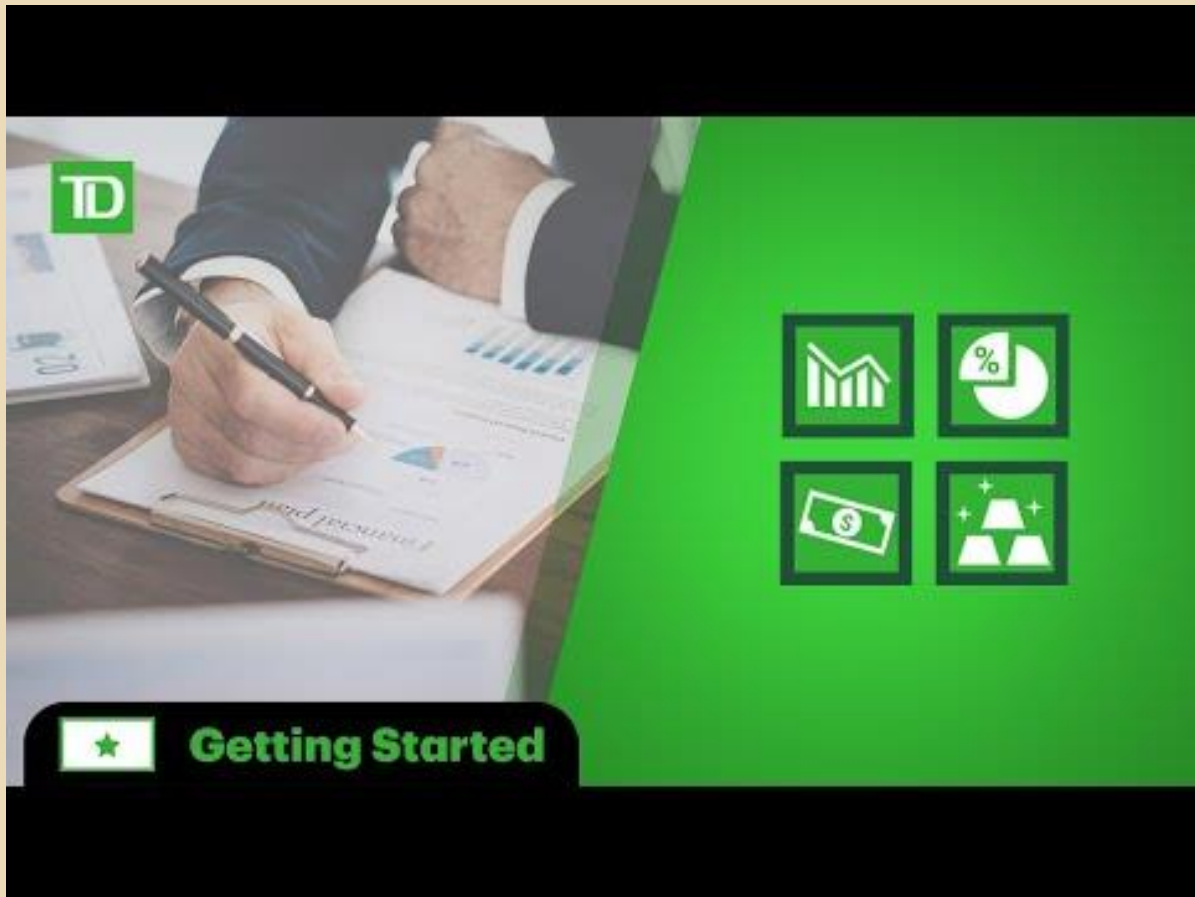
Traditional asset classes	Non-traditional/ Alternative asset classes
Cash , e.g. fixed deposit bank investment, short-term loans between banks and institutions (money market), etc.	Currencies , e.g. US dollars, euros, etc.
	Commodities¹ , e.g. crude oil, gold, silver.
Bonds , e.g. Eskom bonds, RSA government R186 bonds, RSA retail bonds, etc.	Derivatives , e.g. futures contracts in commodities such as crude oil, maize, etc. or in currencies such as the rand/ US dollar.
Property , e.g. houses, shopping malls, office blocks, etc.	Collectibles , e.g. stamp collections, artworks, etc.
Shares/ Equities , e.g. shares/ equity in listed companies such as MTN, BHP Billiton, NASPERS, etc.	Private equity , e.g. shares/ equity in private companies not listed on a stock exchange, such as Moonstone Business School of Excellence.
	Venture capital , e.g. financing to small, early-stage, emerging businesses such as SBubble, The Artery, etc.
	Hedge funds , e.g. Capricorn SCI Market Neutral Fund.

Investors can invest directly into the different asset classes and assets/ instruments by, for example, accessing these through a stockbroker registered with the Johannesburg Securities Exchange. However, financial advisors mainly advise clients on financial products which are structured by the product supplier around a certain collection of asset classes and assets. This collection is what we refer to as the investment portfolio, portfolio, or fund.

¹ Please note that some sources list commodities under 'Traditional Asset Classes;' but most include it under Non-traditional.



Video: Asset Classes Explained



Activity:

How does categorising assets into classes assists investors or asset managers?

Answer:

It assists investors or asset managers to choose an appropriate mix of assets in these different classes, in order to reduce exposure to the risk associated with any one asset class, and to maximise returns in changing market conditions.



2.1 Money-Market Instruments

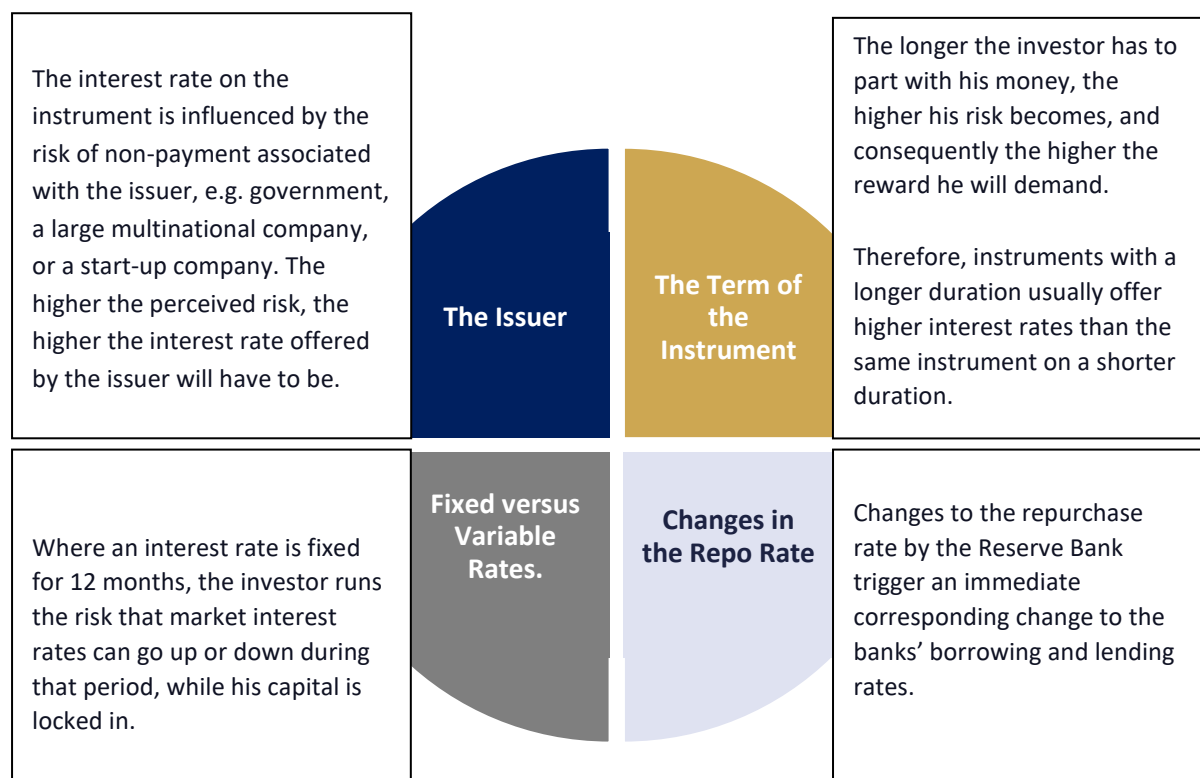
2.1.1 Features of Money-Market Instruments

Typical **Money-Market Instruments** include cash and short-term debt instruments. These are mostly unlisted instruments and are traded directly between investors – this is known as over the counter (OTC) trading, where transactions are not facilitated by a formal organisation, but where dealers usually transact over the phone, in large denominations. Individual investors mostly participate in this market indirectly through bank deposits and collective investment schemes (CISs).

Money-market instruments, or short-term securities, are traded on the money market, which is an OTC market in which banks are the main intermediaries, with the Reserve Bank being a major player. They are called short-term securities because their term to maturity, or duration, ranges from overnight to 365 days. Short duration, high liquidity and low risk go hand-in-hand.

Money-Market Funds are collective investment schemes that use money-market instruments for their underlying asset base, subject to strict rules about the maximum average duration of all the securities in the portfolio, earning them the reputation of being low risk, liquid, and suitable for short-term investments.

Factors that impact the interest rates earned on money-market instruments:





The Repo System

The Reserve Bank lends cash to the banks at an interest rate determined by the Reserve Bank's Monetary Policy Committee. This interest rate is called the Reserve Bank's repurchase rate, or repo rate for short.

Banks are required to hold 2% of their deposits as cash reserves at the Reserve Bank. They use the repo system to finance this cash reserve requirement.

The repo rate serves as a benchmark for the level of short-term interest rates. For example, if the repo rate increases, banks have to pay more for repo funds. In order to maintain their existing profit margins, banks raise the interest rates at which they take deposits from and lend money to their customers.

This causes a general rise in interest rates or the cost of holding money, and this eventually helps to control inflation by reducing the demand for credit to be spent on the purchase of goods and services. The actions of the Bank described here are also known as the formulation and implementation of monetary policy.

Money-market rates move in the same general direction as interest rates.



Activity:

Which entity determines the Repo rate?

Answer:

The SARB (South African Reserve Bank)



2.1.2 Typical Money-Market Instruments

Main types

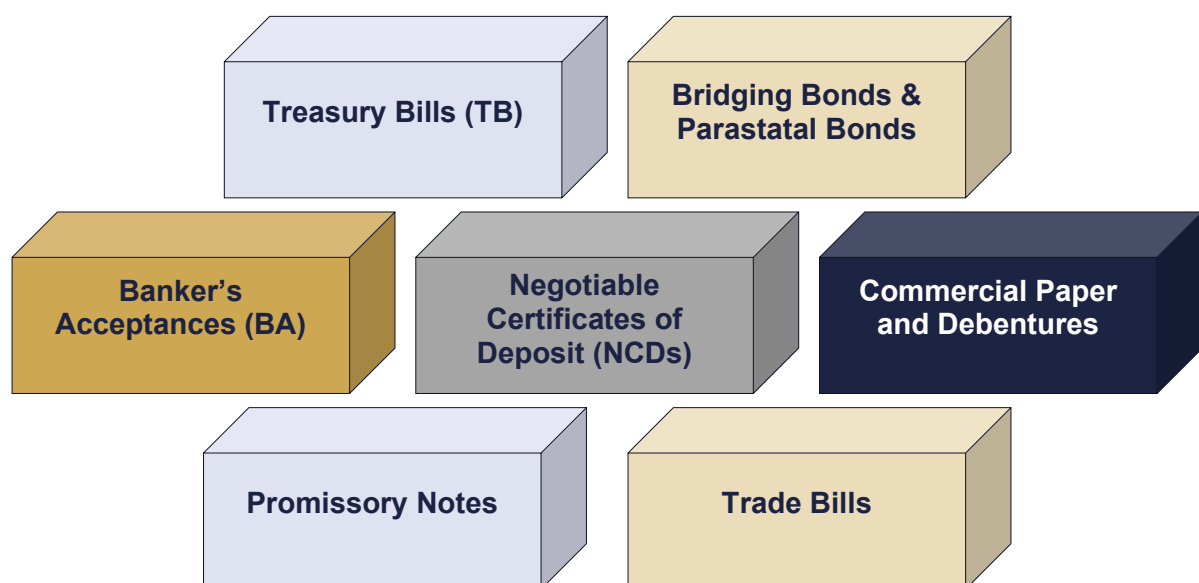
Interest-bearing Instruments	Discount Instruments
e.g. fixed deposits, or negotiable certificates of deposits (NCD's), earn interest at a specified rate, either paid out periodically or reinvested, and at maturity, the investor receives the initial investment plus accumulated interest.	e.g. treasury bills, do not specify an interest rate upfront, but specifies a fixed amount to be paid at the end of the investment period (redemption value), leaving the investor to decide how much he is prepared to pay upfront. Most discount instruments can be traded on the secondary market before the maturity date.

Money-Market Instruments

You will recall that we have looked at money-market instruments in the *Economic and Investment Overview* module. We will now take a closer look at some of the instruments available in this market.

Cash and other bank products are accessed daily by individuals. There are also other short-term debt instruments that are typically traded in large denominations by banks and institutional investors.

Main Types of Money-Market Instruments:



Let's look at each of these in a bit more detail.



i. Treasury Bills (TB)

These are short-term loans to the Reserve Bank used to finance government short-term cash flow requirements. TBs are issued every Friday on a tender basis. They are repaid with interest at the end of the period. They are readily negotiable and offer good investment opportunities. Their duration is usually 90 – 180 days.

ii. Bridging bonds and parastatal bonds

These are very similar to TBs, being short-term loans to parastatals such as Eskom, Landbank, Development Bank, etcetera; to finance short-term cash flow requirements. They are issued weekly on a tender basis. The functioning and trading are identical to that of TBs, but the return is slightly higher. Their duration is usually 90 – 180 days.

iii. Banker's Acceptances (BA)

It starts as an order to a bank by a bank's customer to pay a sum of money at a future date, almost like a post-dated cheque. When the bank endorses the order for payment as "accepted," it assumes responsibility for ultimate payment to the holder of the acceptance.

The fact that the bank guarantees payment of the debt makes this instrument the most tradable in the money market, and it is also an important asset in the portfolio of banks and other financial institutions. The duration is usually between 30 – 180 days.

iv. Negotiable certificates of deposit (NCD)

These certificates are written proof from a bank that a deposit has been made at the bank and that it will become repayable to the holder of the certificate on the redemption date. They are negotiable and can be traded in the secondary market. Whoever is in possession of the certificate is entitled to the interest payments. They are usually issued for a duration of 3, 6 or 12 months.

v. Commercial paper and debentures

These instruments represent loans to companies in the form of negotiable instruments which are tradable in the secondary market. The duration on these instruments is longer than one year, but when used in the money market, they are traded when they are close to maturity. We will have another look at debentures in Unit 1.2 (bonds).

vi. Promissory note

This instrument is a written promise to pay a fixed sum of money to the holder of the promissory note on a fixed date, e.g. a company that buys goods could give the other company a promissory note promising to pay the other company a certain amount on a specific date. The latter can then discount the promissory note at his bank in order to obtain cash immediately. (An ordinary bank note is also a form of promissory note, where the Reserve Bank promises to pay the applicable amount on demand.)



vii. Trade bills

Trade bills are used to finance purchases and sales of goods. The seller draws a bill from the buyer (not a bank), who then accepts it. The seller can discount the bill at his bank and is therefore paid for the sale as soon as the goods are dispatched. The buyer, in turn, does not have to pay until the bill is offered to him for payment. This method of financing, therefore, postpones the buyer's liability, while the seller immediately has cash available.



Activity:

Indicate whether the following statement is true or false:

Treasury Bills are long-term loans issued by the Reserve Bank to finance public cash flow requirements.

Answer:

False. Treasury Bills are short-term loans to the Reserve Bank used to finance government short-term cash flow requirements.

2.1.3 Investment Characteristics of Money-Market Instruments

Returns

Returns from assets in cash/ money-market instruments are received in the form of interest, which is generally paid in line with prevailing interest rates. Interest can be added to an investment such as a bank deposit, enjoying the cumulative effect of interest upon interest, in which case the effective rate of return at the end of the period will be greater than the nominal interest rate. Or interest can be paid out in regular intervals, serving as income for the investor. Where money-market instruments are included in a collective investment scheme, such as a money-market fund, the interest will be paid out to the investor in the form of 'income distributions' which can either be drawn as income or be re-invested in the underlying investment fund.

Taxation

Interest from cash/ fixed-interest investments is taxed as income. As such, it is fully taxable at the investor's marginal rate, subject to the annual interest exemption. When married in a community of property, the local interest received for the tax year is divided between the spouses, allowing both to qualify for the annual exemption. There is no exemption for individuals on interest earned from foreign sources. Note that individuals that invest in tax-free investment products are exempt from paying tax on the interest earned within the fund – terms and limitations apply.



Risk

Cash instruments typically come with a guarantee on the capital and a fixed interest rate, therefore they are seen as 'safe' investments with limited volatility. They are generally considered to be low-risk investments, suitable for conservative investors. Inflation risk is the most notable risk in a money-market investment over the medium to long term.

Volatility

limited volatility. They are generally considered to be low-risk investments. On the risk/return curve, cash features at the bottom of the spectrum, as the potential for growth is virtually zero, and the degree of risk associated with money-market instruments is very low.

Inflation

Cash could possibly keep pace with inflation over the short-term, but not over the medium to long term. There is no real growth on capital invested in cash over the longer term, as the net after-tax returns on fixed-interest investments are historically below inflation.

2.1.4 The role of cash in an Investment Portfolio

Cash, as an asset class, can be used in the short term for providing an income. Other uses for cash could include:

- Cash can be used as a 'parking area,' where funds can be invested with absolute liquidity, until the investor is in a position to make an informed decision on the longer-term investment of the funds.
- For some investors, cash also provides a 'safe haven' during volatile investment market conditions, where funds can be placed until the market has returned to more stable conditions.
- Investors can use a money market fund as a base fund from where they then phase payments into the actual investment portfolio over a period of time. This is done to utilise the benefits of rand-cost averaging (see the definition in the glossary).



Research Activity:

Visit the following websites to view a more detailed explanation of how short-term debt instruments work:

1. Overview of current money-market rates:
<https://www.resbank.co.za/Research/Rates/Pages/CurrentMarketRates.aspx>
2. Promissory notes:
<https://www.documatica-forms.com/south-africa/promissory-note/more-info.php>



3. Bankers' acceptances:

<https://www.youtube.com/watch?v=771p5rxIWPg>

4. Treasury bills:

<http://www.treasury.gov.za/divisions/alm/Treasury%20Bills%20Information%20Memorandum.pdf>

5. Negotiable Certificates of Deposit:

<http://financialmarketsjournal.co.za/oldsite/2ndedition/negotiablecertificates.htm>

2.2 Bonds

Introduction

Bonds are traded on the capital market, which is a debt market for medium- to long-term securities (minimum term: one year).

A bond is a long-term fixed-interest security. It is a contract between the borrower and lender indicating that the issuer has borrowed a certain amount of money from the lender. The issuer promises to make regular payments of interest at a set rate and to repay the face value at maturity. Bonds enable governments and large companies to borrow money on the primary market and enable institutions like retirement funds to invest money in instruments that deliver predictable results and are tradable on the secondary market.

Although the interest (coupon rate) and face value on a bond do not change, the value of a bond can change continually due to interest rate movements, supply and demand and changes in the financial health of the bond issuer.

The South African bond market is regulated under the Johannesburg Stock Exchange (JSE) Interest Rate Market, following the acquisition of the Bond Exchange of South Africa (BESA) in 2009. The JSE facilitates the trading of bonds issued by the South African government, municipalities, state-owned enterprises, and corporates. This market provides a structured platform for investors seeking medium- to long-term fixed-income securities.

You will recall that we looked at bonds during the *Economic and Investment Overview* module. We will now take a closer look at some of the most widely used instruments in the capital market.



2.2.1 Features of Bonds



The following is specified on a bond when issued:

- **Principal:** the amount borrowed and repayable at maturity, also known as the nominal or face value.
- **Coupon:** the regular interest payments over the term.
- **Issuer** – the party that issued the bond and that is responsible for the regular payment of interest as well as the principal amount.
- **Redemption date:** the date when the nominal value will be repaid.
- **Term:** the length of time from issue to maturity.

Depending on the prevailing interest rates and conditions on the bond market, the face value of a bond can differ from the price at which the bond is traded, as they can be sold at less than the face value (discounted rate), or more than the face value (premium rate).

Issuers of Bonds

The main issuers include the South African Reserve Bank (SARB), on behalf of the government; public corporations, like Eskom and Transnet; public utilities, like the Rand Water Board and municipalities; and listed companies. Owing to the low risk and better tradability, the rates of government bonds are the lowest, while small municipalities and private corporations must pay considerably more to raise capital.

It is estimated that the corporate sector accounts for about 29% of the bond market, the government sector about 61% and state-owned entities about 10%.

Lenders of Bonds

These are investors that require a regular income over an extended period of time, without too much risk of capital loss, in an instrument that can be traded before maturity for profit (or loss).

Duration

The minimum term of a bond instrument is generally 12 months. Short-term bonds have durations of 1-3 years; medium-term bonds 3-7 years, and long-term bonds 7+ years.



Factors that impact rates earned on capital market instruments:

i. The issuer

The interest rate on the instrument is influenced by the risk of non-payment associated with the issuer, e.g., government, parastatals, or commercial banks. The higher the default risk, the higher the interest rate offered by the issuer must be.

The government is considered the least risky issuer because it is highly unlikely that government will default on the interest payments or principal repayment. Likewise, a company like Pick 'n Pay is less risky than a start-up IT company.

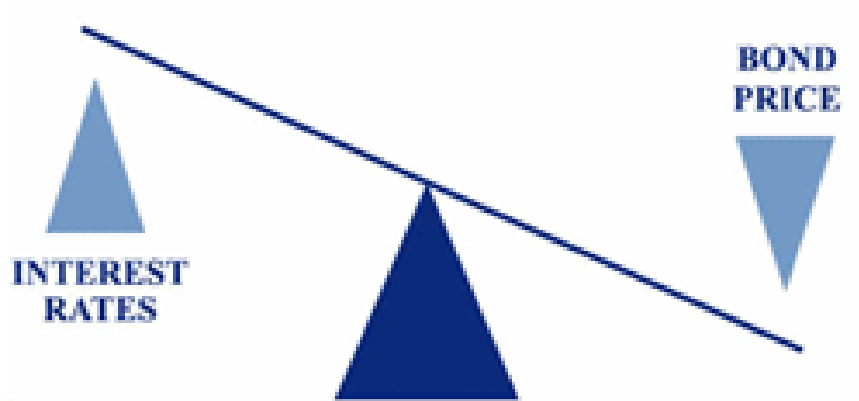
ii. The term

Generally, the longer the term to maturity of the bond, the higher the interest rate, because investors want to be compensated for the fact that they must wait longer to get their capital back.

iii. Interest rate

There is an inverse relationship between bond prices and interest rates. They move in opposite directions, and, like shares, a bond's value can go up or down. When market interest rates rise, investors can get higher returns elsewhere in the market and, therefore, demand higher returns from bonds. For instance, bonds paying 6% interest are obviously worth less if new bonds are offering 9%. Since the coupons are fixed for the term of the bond as well as the principal amount that will be repaid at maturity, the only way a bond can become more attractive to investors is if the price of the bond falls.

Similarly, if market interest rates fall, the current holder of the bond can demand a higher price, as his bond offers a higher return than can be earned on other similar products in the market. For instance, existing bonds paying 9% interest are more attractive than new bonds that yield only 6%. This feature makes it possible for bond traders and portfolio managers to generate profits (or losses) off their bond instruments when traded on the secondary market.





iv. The cash flow profile of a bond

Investors can calculate exactly what cash flow they can expect from a bond. If a bond is traded before maturity, investors will compare the cash flow of this bond to what they can get on a similar instrument at that point in time. Therefore, the most important factor impacting on expected return is the movements in the interest rate market.



Activity:

Which of the following statements is CORRECT?

- a) When interest rates rise, bond prices also increase.
- b) When interest rates drop, bond prices also decline.
- c) When interest rates rise, bond prices decrease.
- d) There is no plausible relationship between interest rates and bond prices.

Answer:

c) is the correct answer. There is an inverse relationship between bond prices and interest rates.

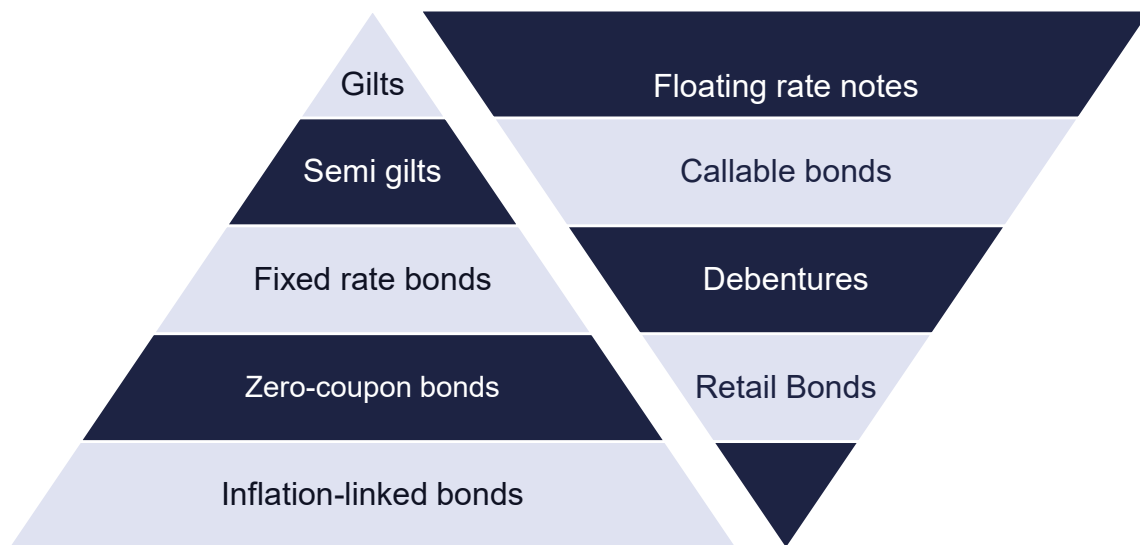
2.2.2 Typical Instruments in the Capital Market

Most bonds are similar in nature – they pay regular coupons, generally every six months, and the principal at maturity. Both the principal and coupon are determined at maturity and never change.

Fixed-rate, floating rate and inflation-linked bonds, zero-coupon bonds, callable bonds, and unsecured bonds (debentures) are amongst the most common types of bonds.

Various types of bonds:

Let's now look at each of these in a bit more detail:



1. Gilts (Government bonds)

A gilt is a long-term loan made by the government to fund capital projects. The government “sells” the bond to investors at a fixed coupon (interest) rate for a fixed term and a fixed repayment (principal) amount on a fixed maturity date.

Investors in bonds that have a longer-dated maturity will typically command a premium for the higher risk, i.e. those investors willing to lend funds to the government for a longer period of time earn a higher rate than on medium-dated bonds.

Trading in government bonds is extensive – the volume of transactions exceeds the trading volume of shares traded on the stock exchange by far.

2. Semi-gilts (semi-government or parastatal bonds)

It is a long-term loan made by semi-government institutions, also known as parastatals, such as Eskom, Transnet, and municipalities. It carries a higher risk than gilts and therefore pays higher interest.

3. Fixed rate bonds

A bond that pays a fixed coupon (interest) rate for the duration of the term, usually bi-annually. They are available over the short, medium, and long term.

4. Zero-coupon bonds

It is a long-term discount bond that does not pay periodic interest. It is issued at a discount (sold at an amount that is less than the principal amount to be paid out at maturity), and the interest is built into the discount. They are usually issued by a government for long-term projects where returns are only expected after an extended period.



5. Inflation-linked bonds (ILB)

It is a long-term loan that pays interest that reflects the movement of the inflation rate. The face value of an inflation-linked bond is adjusted monthly at the CPI rate, which includes the movement of mortgage bonds. The interest rate itself does not change but is fixed at the start.

This means that the same percentage interest rate is paid, but because the amount on which it is based increases with inflation, the interest payments increase, and so does the amount payable at maturity. Initial payments are usually low, compared to fixed-rate bonds. At the date of purchase, although the real interest rate is known, neither the future income nor the maturity is known.

ILBs offer excellent inflation protection, and portfolio managers include them when, in their view, inflation is set to increase, in the expectation of a steadily increasing stream of income over the term that will exceed the currently available rates. The risk faced by the investor is that inflation rates could decrease over the term, resulting in a lower-than-expected interest and maturity.

Not suitable for the short term, ILBs are sold for the medium to long term.

Capital growth on the principal, as a result of inflation adjustments, is not taxed under CGT, but will be spread over the remaining term of the instrument and taxed along with the interest.

6. Floating rate notes

A bond that pays variable interest rates, i.e. the interest payments are not fixed at issue but fluctuate with market interest rates. The variable interest rates are reset regularly against a predetermined benchmark. Interest payments are generally made monthly, quarterly, semi-annually, or annually. They are usually medium-term bonds.

7. Callable bonds

This type of bond includes an option for the issuer to recall the bond prematurely at a specific date (known as the call date). The issuer offers either a higher interest rate or a higher principal than on a normal bond, to offset the additional risk for the investor. The investor's risk lies in the fact that he will have to reinvest his capital at the prevailing interest rates, which may be lower at that stage. These instruments can be sold for short, medium, or long term, but with a call date that precedes the maturity date.



8. Unsecured bonds (debentures)

They are long-term fixed-interest securities, issued by a company that pays a higher interest rate than semi-gilts. They are the most important fixed-interest securities in the private sector. They are not backed by any physical assets or collateral and are thus based only on the company's creditworthiness and reputation.

A debenture contract consists of two parts, the debenture, and the trust deed.

The debenture is a promise by the company to the investor to repay the capital at a specified maturity date in the future and pay fixed amounts of interest at regular intervals over the life of the loan. It is thus a primary contract between the company and the investors.

The trust deed is a secondary contract between the company and the trustees, with details of the rights of the debenture holders. There are many different types of debentures, which are classified according to security, term, and yield. Corporate bonds are often issued as unsecured bonds. The duration of these instruments can be short, medium to long-term term.

9. Retail bonds

The RSA Retail Savings Bond programme, administered by the South African National Treasury, offers both fixed-rate and inflation-linked bond options for individual investors. These bonds provide competitive interest rates and guaranteed capital security, making them an attractive option for conservative investors. Interest rates on these bonds are reviewed regularly based on inflation trends and economic conditions, ensuring that returns remain aligned with market realities. Investors can select payout options, including semi-annual interest payments or reinvestment, to maximize long-term returns. In addition, recent regulatory adjustments allow for periodic changes to payout structures to enhance investment flexibility for long-term savers.

Retail Bonds are available either as fixed rate or inflation linked. The fixed interest rates are considerably higher than the inflation-linked rates. Fixed-rate Retail Bonds can be bought for 2-, 3- or 5-year terms, while terms of 3, 5 and 10 years are available for inflation-linked retail bonds. Interest rates differ for the respective terms and depend on the outlook for future interest rate movements. Investors that expect inflation to increase over the term should consider buying inflation-linked bonds but should keep in mind that the initial income would be substantially lower than on the fixed-rate bond. Retail Bonds cannot be traded. The income can be paid out six-monthly or reinvested. Investors over 60 can elect a monthly interest payment.

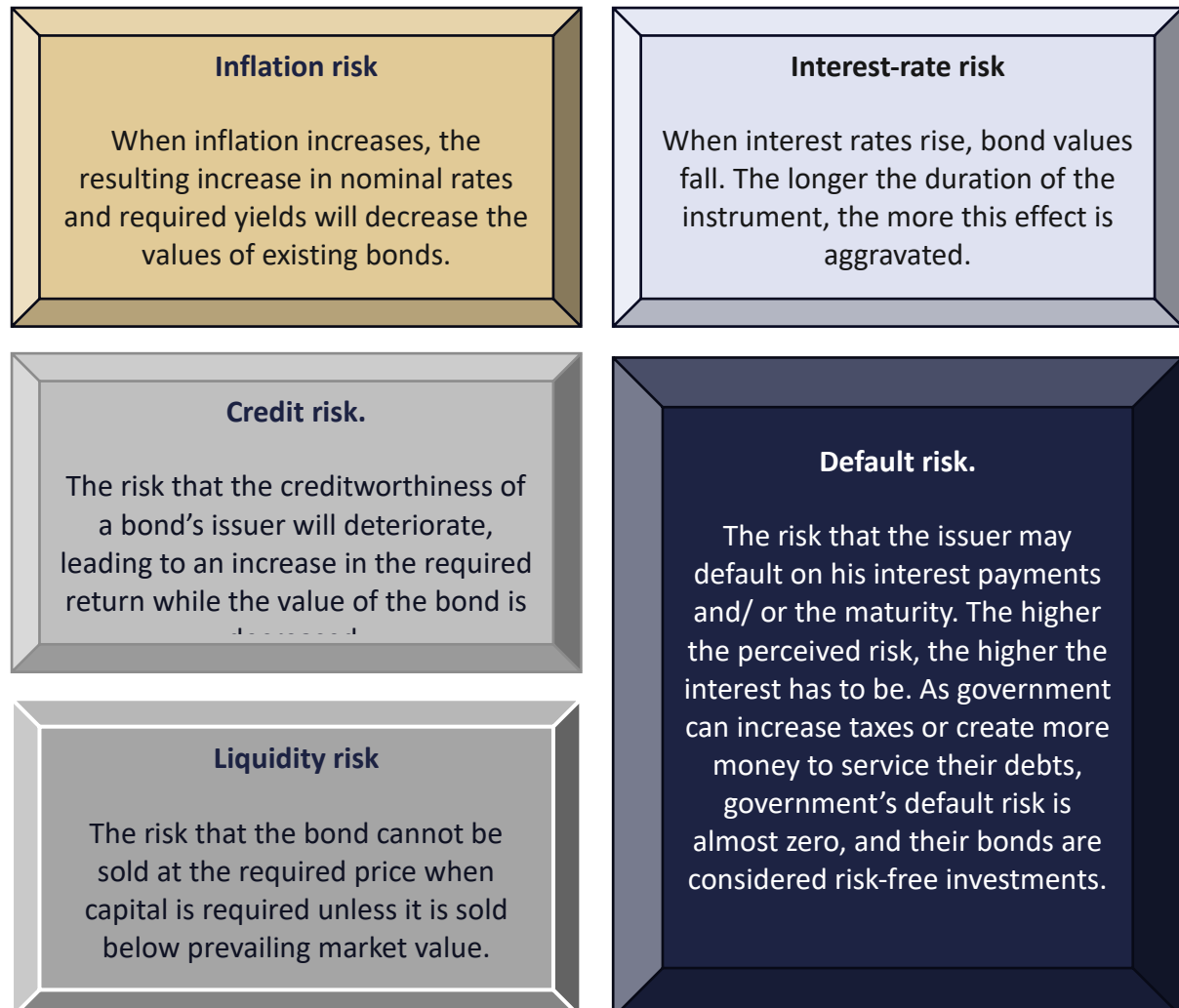
Retail Bonds appeal to conservative investors (such as pensioners), who either want a fixed stream of income or a capital guarantee over a fixed term, or both.



2.2.3 Investment Characteristics of Bonds

RISKS

The risks associated with bonds include the following:



RETURNS

Returns on bonds are either in the form of fixed or variable interest payments. Interest is usually paid bi-annually. Where bonds are included in a collective investment scheme fund, returns are paid in the form of 'income distributions,' which can then either be drawn as income or be reinvested in the underlying investment fund. There is no capital growth on the bond instrument itself, but when traded in the secondary market, bonds can be sold, which can lead to a capital gain or loss.



VOLATILITY

Bonds are generally considered to be medium-risk investments.

On fixed-rate bonds, there is little or no volatility in the instrument as such, as both the interest and maturity is known upfront. However, volatility can occur if bonds are traded on the secondary market before maturity. Interest rate movements will affect the bond value either negatively or positively, causing fluctuations that could lead to possible profits or losses when the bond is traded. On the risk-return spectrum, bonds feature higher than cash, and lower than property.

Bonds can be sold or traded at a rate that is either less than the face value (discounted rate) or more than the face value (premium rate). For this reason, it is possible to incur negative returns on bonds. This often happens during periods when interest rates are rising, and the bond is trading at below face value.

The security of a bond depends on the issuer. Government bonds (previously known as gilts) and bonds issued by semi-government companies (such as Eskom) are generally considered secure, whilst corporate bonds, which are often issued as unsecured bonds (debentures), may be less secure.

LIQUIDITY

Bonds are freely tradable at market prices and can also be used as collateral for a loan.

TAXATION

Income tax is payable on the interest earned (or income distributions received), subject to the general annual interest exemption for individuals. If a capital gain is made on the sale of a bond instrument before maturity (direct investment), or on the sale of units in a collective investment scheme that invests in bonds, capital gains may be payable subject to the annual capital gains tax exclusion.

INFLATION

Bonds usually offer better returns over time than cash/ money-market assets, and in the hands of a skilled trader or portfolio manager, they have the potential to outperform inflation.

2.2.4 Bonds: Role in an investment portfolio

Bonds, as an asset class, are used to provide income and generally offer superior returns over time when compared to cash/ money-market assets, at a risk level that is lower than that for equities. Other uses for bonds could include:

- Bonds are generally perceived as less risky and less volatile than equity investments; they provide a measure of safety to an investment portfolio.



- The future nominal amount to be received at the end of the term of a bond is guaranteed, and this makes bonds a good choice as an underlying investment instrument when investing in a product that offers guarantees.

Portfolio managers include bonds not only for their ability to bring stability as well as a predictable income stream to a portfolio, but also for their potential to deliver returns upwards of inflation. Income portfolios depend on these securities to deliver returns higher than money-market instruments, without exposing the capital to too much risk.



Activity:

Indicate the type of risk being described in each of the instances below:

1. The risk that the creditworthiness of a bond's issuer will deteriorate, leading to an increase in the required return while the value of the bond is decreased: _____.
2. The risk that the issuer may default on his interest payments and/ or the maturity: _____.
3. The risk that the bond cannot be sold at the required price when capital is required unless it is sold below prevailing market value: _____.
4. The risk that interest rates will rise, causing bond values to fall: _____.
5. The risk that inflation will increase, resulting in an increase in nominal rates and a decrease in the values of existing bonds: _____.

Answer:

- 1) The risk that the creditworthiness of a bond's issuer will deteriorate, leading to an increase in the required return while the value of the bond is decreased: Credit Risk.
- 2) The risk that the issuer may default on his interest payments and/ or the maturity: Default Risk.
- 3) The risk that the bond cannot be sold at the required price when capital is required unless it is sold below prevailing market value: Liquidity Risk.
- 4) When interest rates rise, bond values fall: Interest-rate Risk.
- 5) When inflation increases, the resulting increase in nominal rates and required yields will decrease the values of existing bonds: Inflation Risk.

2.2.5 The role of the capital market in our economy

Government raises capital either through taxes or through borrowing. Where the revenue income is not sufficient to support infrastructure or to finance existing deficits, it sells bonds to raise capital.



If there is not sufficient capital in our own markets, the government has to look elsewhere for willing buyers. Foreign investors are attracted to our capital market because of our attractive interest rates relative to other countries. This is one of the most important factors taken into account by the Monetary Policy Committee (MPC) when it debates the future of our interest rate movement.

This factor plays a crucial role in our economy, as these enormous capital injections into our coffers by foreign investors impact heavily on our current account and exchange rate. But this capital can be withdrawn overnight if investors take flight and can, therefore, not be relied upon for the type of investment our country so badly needs for the creation of sustainable long-term projects that can provide employment, growth, and wealth.

The more bonds the government sells to raise money, the faster the national debt increases. Bonds sold to foreign investors mean that the interest payments are paid into foreign coffers and not ploughed back into the local economy where it is needed.



Research Activity:

Visit the website for Government Retail Bonds at:

<https://www.gov.za/about-government/government-programmes/rsa-retail-savings-bonds>

Compare the fixed interest rates offered for two and three years with the following rates:

- The interest rates offered by your bank for a fixed deposit over similar periods.
- The interest rate currently offered by money-market funds.

Find out more:

Investors seeking capital market rates, bond yields, and market trends can refer to data published by the Financial Sector Conduct Authority (FSCA) and the Johannesburg Stock Exchange (JSE) Interest Rate Market. These sources provide insights into fixed-income instruments, guiding investors in understanding interest rate trends and market liquidity. The South African Reserve Bank (SARB) also publishes key interest rate changes, including repo rate adjustments that influence the capital market. Up-to-date market rate reports are accessible via these regulatory bodies' official websites.

Financial Sector Conduct Authority (FSCA) – for bond yields and capital market oversight.
Johannesburg Stock Exchange (JSE) Interest Rate Market – for bond trading and yield curves.

South African Reserve Bank (SARB) – for repo rate changes and monetary policy updates.



2.3 Debentures

2.3.1 What are Debentures?

Debentures are a type of unsecured debt instrument, similar to a bond. They are long-term loans made to a company at a fixed rate of interest and repayable on a fixed date in the future. Companies issue debentures in order to raise capital, also referred to as corporate bonds. Details of debentures are documented in an indenture (a written agreement between the issuer and the holder), and would typically specify the interest rate, maturity date and convertibility.

“Unsecured” means debentures are not secured by physical assets or collateral. Debentures can be traded on the stock exchange.

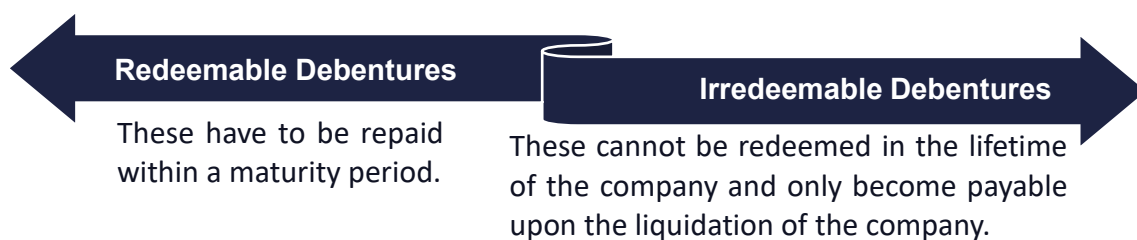
2.3.2 Features of Debentures

- i. Debentures typically provide higher rates of financial return than Government Bonds or bank interest rates.
- ii. The return can either be a fixed or floating interest rate.
- iii. At maturity, the issuer returns the money initially borrowed.
- iv. At the end of the lending period, issuing companies usually offer the choice of converting the debentures into shares. These are called ‘Convertible Debentures’ and usually pay a lower interest rate to the lender (the investor).
- v. Interest must be paid to investors whether or not the issuing company makes a profit.
- vi. Debenture interest must be paid on the dates stipulated on the debenture certificates and arrear interest cannot be carried forward from one year to the next.
- vii. Debentures are transferable (from investor to investor).
- viii. Debentures are unsecured and only backed by the issuing company’s creditworthiness and reputation. The investor is lending money to a business and a debenture carries all the risks that this involves.
- ix. The debenture holder (investor) does not have voting rights and is not a shareholder.

2.3.3 Typical Debenture Instruments

There are two basic types of debentures:





2.3.4 Investment Features of Debentures

Debentures are included in portfolios to add diversity across different asset classes, plus a stream of guaranteed payments with high interest rates. They provide higher rates of financial return and are usually much more rewarding than government bonds or bank investments.

RISK

Interest is paid to investors whether or not the issuing company makes a profit, and the capital has to be repaid at maturity. But debentures are unsecured and only backed by the issuing company's creditworthiness and reputation. In case of bankruptcy, debenture holders are not protected, as they are viewed as general creditors, while bond holders will be given priority over the debenture holders. Compared to securitised debt instruments, debentures represent higher risk but also higher interest rate payment to offset the risk.

VOLATILITY

Debentures can be traded before maturity, which can result in volatility.

LIQUIDITY

Debentures are transferable from investor to investor, and tradable on the JSE.

TAXATION

The investor will be subject to income tax on the interest received. The issuer (i.e. the company) can claim the interest as an expense against its profits for tax purposes.



Activity:

See the activity that follows at the end of equities, looking at the differences between debentures and shares.



2.4 Securitised Debt Instruments

As one of the largest fixed-income security types, securitised debt products (also known as “structured finance”) represent a complicated sector of the fixed-income market. These products are debt instruments that are pooled together to form a new financial instrument that is then sold to investors.

Securitised debt instruments are the products of securitisation, which is the process of turning a large number of loans, such as residential or commercial mortgages, car loans or credit card debt, into tradable securities by pooling them and selling their related cash flows (receivables) on to bond holders. Incoming cash flows from the underlying loans are passed onto the holders of the new instruments.

The value and cash flows of the securitised debt instrument are based on its underlying securities. Compared to government, corporate and municipal bonds, they offer attractive yields, with a corresponding higher risk.

Institutional investors are the main participants in this market, while individuals are indirectly exposed through diversified fixed-income collective investment schemes or exchange-traded funds.’

2.4.1 Different types of Securitised Debt Instruments

Mortgage-backed securities (MBS)

- These are securitised bonds backed by home mortgages or car loans.
- Bonds which are backed by home mortgage payments are the most popular type of securitised debt instruments.
- Car loans are also commonly pooled to create securitised debt instruments, as these bonds are backed by the vehicles themselves.

Asset-backed securities (ABS)

- Bonds backed by non-mortgage-related financial assets, such as credit card debt and student loans, are also popular investment vehicles.
- Although these debts are usually not backed up by a specific collateral, the lender can lay claim to the borrower’s assets.



2.4.2 Investment Characteristics of Securitised Debt Instruments

As one of the largest fixed-income security types, securitised products offer relatively attractive yields, and present fixed-income investors with an alternative to government, corporate or municipal bonds. Institutional investors are the main participants in this market, while individuals are indirectly exposed through diversified fixed-income collective investment schemes or exchange-traded funds.

RISK

In theory, the holder of securitised debt backed by a mortgage or car loan should not suffer a loss if the issuing bank goes bankrupt, as the monthly payments to the investor derive from the home and car owners, and not from the bank itself. This being said holders of securitised bonds lost fortunes during the housing crisis of 2007-2008, as a result of mass defaults and the inability to raise sufficient capital from the seized assets.

One of the primary risks associated with securitised assets is bad debt that arises when borrowers default on their loans, as bad debt can stop these instruments' cash flows. Securitised debt is less risky than debentures, which are not backed by security, and generally offer lower interest rate payments. Both debentures and securitised debt instruments present higher risk than traditional bonds.

Risk can be reduced by breaking them up into **tranches** – securitised debt can present varying degrees of risk and return if sold in tranches, each with different investment characteristics. An investor can choose the tranche with the best combination of yield, cash flow and safety for his/ her purposes.

RETURNS

The investor receives regular income as well as potential capital growth (or loss).

LIQUIDITY

Although these instruments can be traded on the stock exchange before maturity, they are generally seen as long-term investments.

VOLATILITY

Higher than for government or parastatal bonds.

TAXATION

Income deriving from securitised debt instruments is subject to income tax in the hands of the investor. Any capital gain or loss on the disposal of debt securities is subject to capital gains tax.



Research Activity:

Visit:

<http://www.investopedia.com/articles/bonds/08/securitized-assets.asp>

<https://www.investopedia.com/terms/m/mbs.asp>

<https://pocketsense.com/secritized-debt-instruments-6739322.html>

<https://budgeting.thenest.com/secritized-debt-instruments-24975.html>



Activity:

Indicate whether the following statement is true or false:

There are no CGT implications for the investor on the disposal of securitised debt instruments.

Answer:

False. Any capital gain or loss on the disposal of debt securities is subject to capital gains tax.

2.5 Equities

You will recall that we looked at equities (also known as shares) in the *Economic and Investment Overview* module. We will now take a closer look at the general features and characteristics of equities as an asset class.

General

A share, or equity, provides the shareholder with part-ownership of the company whose shares he/ she has bought. Each share represents the same equitable share in the company as any other, i.e. each share is entitled to exactly the same amount of profit and has exactly the same voting rights as any other single share.

As owners, shareholders have the right to share in the profits of the company by way of dividends when they are declared, as well as the right to vote at the annual general meeting.

Shares are generally known as the asset class with the best potential for long-term performance, as well as the greatest potential for risk among the traditional asset classes.



Companies' shares are issued and traded in the equity market, on the Johannesburg Stock Exchange (JSE). Large established companies are listed on the Main Board; while small, newly established companies are listed on the Alternative Exchange (AltX). Companies such as multinational companies can be listed on more than one exchange. The JSE is governed externally by the Stock Exchange Control Act of 1985, and the Stock Exchange Control Amendment Act of 1996. Extensive rules and regulations are applied internally as a measure of control, and to ensure that buyers will be treated fairly and that they receive exactly that for which they have paid.

The main reason why companies list on the stock exchange is to raise money, for example, to expand their business. Investors get the opportunity to share in the growth and profits of the company, by buying the shares on the stock exchange. The JSE offers investors the opportunity to share in the prosperity of the country by participating in job creation, through aiding the growth of companies in various industries.

Unlisted shares, or private equity, fall into an alternative asset class and will be discussed below under Alternative Investments.

Sectors

The shares on the JSE are grouped together into sectors, based on their economic characteristics. The broad sectors, e.g. resources and financials, are then broken down into smaller sub-sectors. Each sub-sector combines companies operating in similar markets, e.g. banks, life insurance, gold mining, platinum, etc. This facilitates comparison between similar companies and makes it easier for the investor to find information.

Index – Indices give one an idea of how a group of shares is performing. The actual level of an index is not important, but the change from period to period is what counts. Examples of indices are the All-Share Index (ALSI), Top 40 Index, Financial Index and Mining Index.

2.5.1 Features of Equities

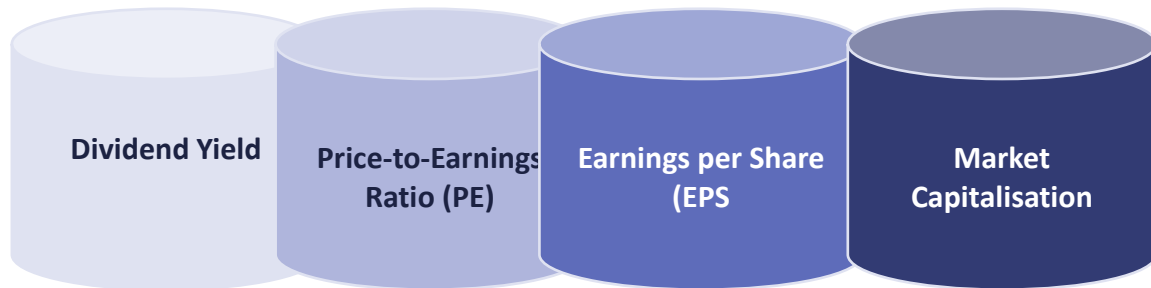
Price mechanism

Prices of shares traded on the stock exchange are governed by supply and demand. If a company is more profitable (relative to other companies in the same sector), there is a greater demand for its shares resulting in its price rising. The opposite applies when a company shows weak results or experiences financial problems. Prices are also influenced by the attractiveness of expected returns in the equity market relative to other asset classes. The share price reflects the expected future returns of the share, including dividend income and capital growth.



Share Evaluation

When trying to compare listed companies, investors have to analyse the share data. Various ratios and other information are published along with the share price to help investors evaluate a share. Let us look at a few of the more common ones.



- **Dividend yield** is calculated as the dividends paid to an ordinary shareholder over the past 12 months, divided by the current share price. In other words, it tells one what percentage return was received as a dividend the previous year, relative to what one pays for the share today. The higher the dividend yield the more cash was paid out to shareholders, relative to its share price. Mature, well-established companies tend to have higher dividend yields; while young, growth-oriented companies tend to have lower ones; and most small growing companies don't have a dividend yield at all, because they don't pay out dividends.
- **Price-earnings ratio (PE)** is calculated as the current share price divided by the earnings per share for the past 12 months. This tells an investor how long it will take him to recoup the current share price in terms of the profits of the company; or, put differently, how many cents he pays when he buys that share, for each 1 cent of profits. A PE of 10 therefore tells him that he will be paying 10c for each 1 cent of profits, or that it will take 10 years to recoup the share price in terms of the current profits of the business.

A high P/E ratio indicates that investors expect the company to do well in future, as it is a reflection of the market confidence in the future prospects of the company. It could be said that the higher the ratio, the less risky the investment could potentially be. The PE ratio is only a relative indication and best applied to shares in the same peer group.

- **Earnings per share (EPS)** is the most common measure of how expensive a share is. EPS is the total earnings divided by the number of shares outstanding. Earnings per share is arguably the most important variable when a share's price is determined. It is also a major component of the PE valuation ratio. EPS is the profit attributable to ordinary shareholders, divided by the weighted average number of shares, i.e. the profit attributable to the holder of one ordinary share.



- **Market Capitalisation:** This tells us what value investors are placing on a particular company's share capital. This is the total rand value of all issued shares at the current share price. Market capitalisation (cap) is calculated as a number of shares in the issue multiplied by the current share price.

There are many more angles from which a share can be evaluated. Professional analysts spend their working hours poring over data, utilising highly specialised software in their effort to gain an edge in the market. But there are no guarantees that the market or a particular sector or a particular share will perform as expected. The equity market has a life of its own and can change at the drop of a hat, moving in different cycles from the economy in general, often anticipating changes in the business cycle.

The growth trajectory of equities during a bull run can be spectacular, just as much as the free fall during a bear market can be devastating. For this reason, the equity market is best suited to investors with a long-term vision, who can ride out the bumps in the market knowing that the criteria they applied when selecting their equities are fundamentally sound.



Activity:

1. Which ratio indicates the percentage return that was received as a dividend the previous year, relative to what one pays for the share today?
2. Which ratio tells an investor how long it will take him to recoup the current share price in terms of the profits of the company?

Answers:

- 1) Dividend yield
- 2) PE ratio

2.5.2 Different Types of Equities

Ordinary shares

Also sometimes called “equity” shares; they share in the profits and risks of the company. Ordinary shares rank after debt holders and preference shares when a company is liquidated. Unlike the fixed dividend paid to preference shareholders, the ordinary dividend is decided by the directors and is dependent on the company's profits. If the company is liquidated, the ordinary shareholders share in the proceeds after the creditors and preferential shareholders have been paid out. For these reasons, ordinary share prices tend to be far more volatile than preference shares, giving opportunities for capital gains. Most of the shares published in the newspaper are ordinary shares.



Preference shares

These shares rank higher than ordinary shares in terms of dividends and capital if the company goes into liquidation. They do not have voting rights. Dividends on preference shares are normally a pre-determined percentage of the nominal value of the share. This percentage can be fixed (e.g. 5%) or index linked (e.g. 75% of prime interest rate). Unless the shares are specifically defined as non-cumulative, the company is liable for any arrears of preference dividends.

Investors that are more interested in (dividend) income than capital growth will usually consider preference shares.

There are many different types of preference shares, which include:

- Cumulative preference shares – if a company is unable to pay dividends, the dividends accrue until they are fully paid.
- Participating preference shares – receive a pre-determined dividend and also share in the remaining profits on a formula basis.
- Convertible preference shares – may be converted into ordinary shares under certain conditions.
- Non-cumulative participating preference shares – entitle the holder to vote and to fixed dividends. There is no right to a share of the company's profits or any claim to arrear dividends.
- Profit-sharing preference shares – entitle the holder to preference dividends as well as a share in the remaining distributable reserves.
- Redeemable preference shares – may be redeemed at the company's discretion at a pre-determined price on a specific date(s).
- Non-redeemable preference shares – issued by banks, the yield on these shares is linked to the prime rate.
- Deferred shares specify that dividends should be paid only after a certain period.

2.5.3 Investment Features of Equities

RETURN

Investors buy shares for two main reasons – they expect to see the capital value of their investment grow, and they expect to earn an income that also keeps growing.



- **Income in the form of dividends**

Dividends are paid to a company's shareholders from its net profits. The dividend policy of a company will depend on its profitability and its need to retain funds to reinvest in the company in order to grow. A fast-growing company, which needs to buy a new plant and equipment to keep growing, is likely to pay fewer dividends than a mature company with lower reinvestment needs. The declaration of dividends by companies is discretionary (the board of directors decides on the level of dividends), and a shareholder only has a right to dividends once they are declared.

- **Capital growth.**

Share prices are influenced by many different factors, but, over the long term, the primary driver of a share price is the future earnings prospects of that company.

RISK

As an asset class, shares are classified as aggressive because of the high levels of volatility associated with them. Because shares never mature and their market value can go up or down at any given time, there is far more risk involved in buying shares than bonds or money-market instruments, but the potential reward is much greater too.

The level of risk can be reduced in a portfolio by diversifying across sectors and sub-sectors, and by minimising correlation between underlying shares.

VOLATILITY

This asset class is known for its volatility. Share prices can undergo dramatic fluctuations several times a day, being sensitive to supply and demand, market reaction to local and global events, market sentiment, and a multitude of other factors. Volatility has a much stronger effect over the short time, as shares tend to keep moving upward over the long term, regardless of the volatility. Volatility can be reduced in a client's portfolio by following investment strategies to minimise the effects.

LIQUIDITY

Shares can always be traded on the JSE, as long as there is a willing buyer prepared to pay your asking price. Thus, although it may be relatively easy to convert the shares into capital, it may take long before the investor is able to get his required price.



INFLATION

Over the long term, shares have the capacity to outperform inflation by far, as well as all other traditional asset classes. Over shorter terms, the property has often outperformed shares.

TAXATION

Although the investor is taxed on income and growth, shares can still be regarded as tax-friendly investment instruments. They are subject to two types of taxation in the investor's hands:



- **Dividends Withholding Tax (DWT)** is payable on all dividends at a fixed rate. DWT is withheld by withholding agencies and paid over to SARS on behalf of the investor, who receives the after-taxed dividend.
- **Capital Gains Tax (CGT)** is payable on the gain made when the share is realised. Acquisition costs as well as the annual exemption can be deducted, and only a percentage of the net gain is taxable. The taxable capital gain is added to the shareholder's taxable income and taxed at his marginal rate.

2.5.4 Equities: Role in an Investment Portfolio

Equities offer the investor capital growth and are therefore essential to any medium- to long-term (5 – 10 years) as well as long-term (10 years and longer) investment plan, as it has, over time, been the investment instrument that has offered the best returns with the best chance of beating inflation.

Equity investments often deliver really good exponential growth during the upturn cycles in the market, making them vital to the realisation (or even surpassing) of investment goals.



Activity:

Open a newspaper where the share prices are published (or visit an online site like <http://www.sharennet.co.za>)

Pick two stocks from the same sector, for example, Sanlam & Old Mutual, or Standard Bank & FirstRand.



Compare the shares in terms of:

- Price Earnings (PE)
- Dividend yield (DY)
- Market capitalisation

Visit the following site for an interesting article about what drives share prices:

<https://www.investopedia.com/articles/basics/04/100804.asp>

To see the differences between shares and debentures, go to:

<http://keydifferences.com/difference-between-shares-and-debentures.html>

Make a list of the key differences between debentures and shares with regard to the following:

- Status of instrument holders
- Type of return
- Payment of return
- Voting rights
- Repayment in the event of the issuing company winding up.

Answer:

Basis for comparison	Shares	Debentures
Status of holders	Owners	Creditors
Type of return	Shareholders get the dividend.	Debenture holders get the interest.
Payment of return	Dividends can be paid to shareholders only out of profits.	Interest must be paid to debenture holders even if there is no profit.
Voting rights	Shareholders have voting rights.	Debenture holders have no voting rights.
Repayment in the event of the issuing company winding up	Shares are repaid after the payment of all the liabilities.	Debentures get priority over shares, and so they are repaid before shares.



2.6 Derivative Instruments, Warrants, Certificates, and other Instruments

Derivatives are financial instruments whose values are derived from the value of some other financial asset or an underlying factor (such as a share, a commodity like oil or gold, interest rates, currencies, or some abstract conditions such as the weather). They are not an asset class as such but are increasingly being used within collective investment schemes.

The idea originated in the sixteenth century in the commodity markets where prices for products such as cocoa, coffee and sugar moved up and down at the slightest rumour of e.g. frost or an export embargo. Growers of agricultural products use futures and options to determine prices that they will receive for their produce, long before such products are delivered, while food producers use them to project the future prices of the raw material.

The main purpose of these instruments is to provide hedging for the risks associated with direct investment in shares or commodities, for example, by increasing or reducing the exposure to a particular market segment without physically trading the shares.

These instruments are also known for their large potential profits and losses arising from speculation. Unit trust managers (hedge funds excluded) are restricted to using derivatives for hedging purposes only.

Hedging means taking action to protect against the risk of an adverse outcome. This is the case when you have the underlying asset and are trying to protect its future value.

Speculating means taking a risk position in a market purely for-profit purposes, i.e. you are not trying to protect yourself or your investment; you are doing it hoping you will make a profit from taking this position. Speculating is dangerous, as your losses grow when the market moves in the opposite direction to your position. Derivatives are contracts between two parties where one wins at the other's expense.

Derivatives may be listed or unlisted. In South Africa, the most important exchange for trading listed derivatives is the SA Futures Exchange or SAFEX, which falls under the JSE.



Activity:

When you take action to provide protection against a risky result, it means you are _____ against the adverse outcome.

In contrast, taking up a risk position, without any form of protection, generally refers to the act of _____ in the market.

Answers:

hedging; speculating.

2.6.1 Features of Derivatives

The value of most derivatives is based on what one expects the price of an asset to be at some point in the future.

The underlying cash or physical market refers to the market where the underlying item, e.g. gold, oil, property, shares, potatoes, etc. can be bought and sold. An investor can either buy a property directly or can buy an option on that particular property – the option being derivative.

The main reason why a hedger would need recourse to a derivative rather than trading in the underlying market is because of timing differences. He is trying to control a risk in the future but doesn't have the physical product to sell now.

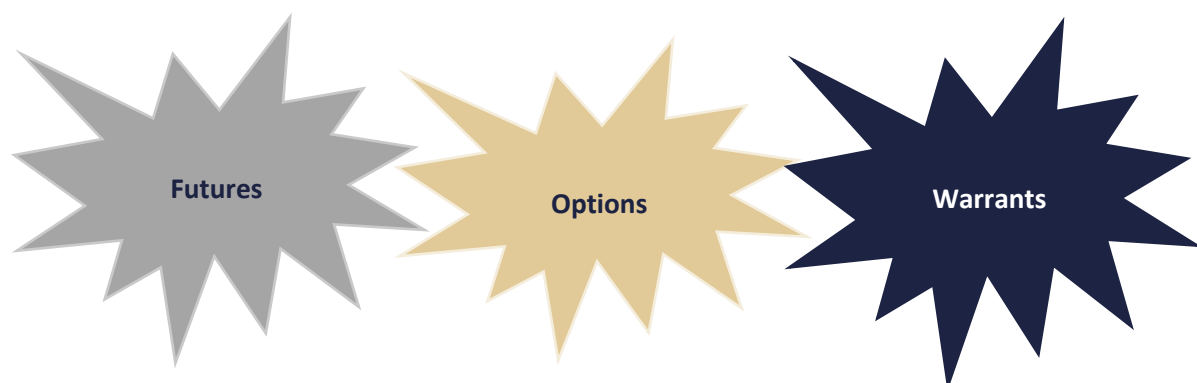
The benefits of hedging by utilising derivatives include:

- They allow traders and fund managers to make profits even when markets are falling.
- They enable asset managers to hedge their positions.
- Linked shares are not sold and thus dividend income is not lost.
- Transaction costs, expressed as a percentage of the value of the transaction, are low.
- The market in derivatives is very liquid. Large transactions can thus be closed much quicker than those in the underlying market.



2.6.2 Different Types of Derivatives

The three most common types of derivatives are:



Future/ futures contract refers to an exchange-traded contract to buy or sell a precise quantity of a specific underlying asset at a specific price, place, and time in the future. If you buy a March future for maize, you are contracting to buy a specific quantity of maize in March at a price you fix now. Usually, a fair price is determined by what the current price (spot price) is plus a carry cost (which is really the interest cost you forgo by paying today rather than in March).

In the equities market, it is possible to get a future on a single stock or on an index.

Futures contracts are amongst the most heavily traded markets in the world. Prices in the secondary market change continually depending on the market conditions. The unlisted version of a futures contract is called a **forward** contract.

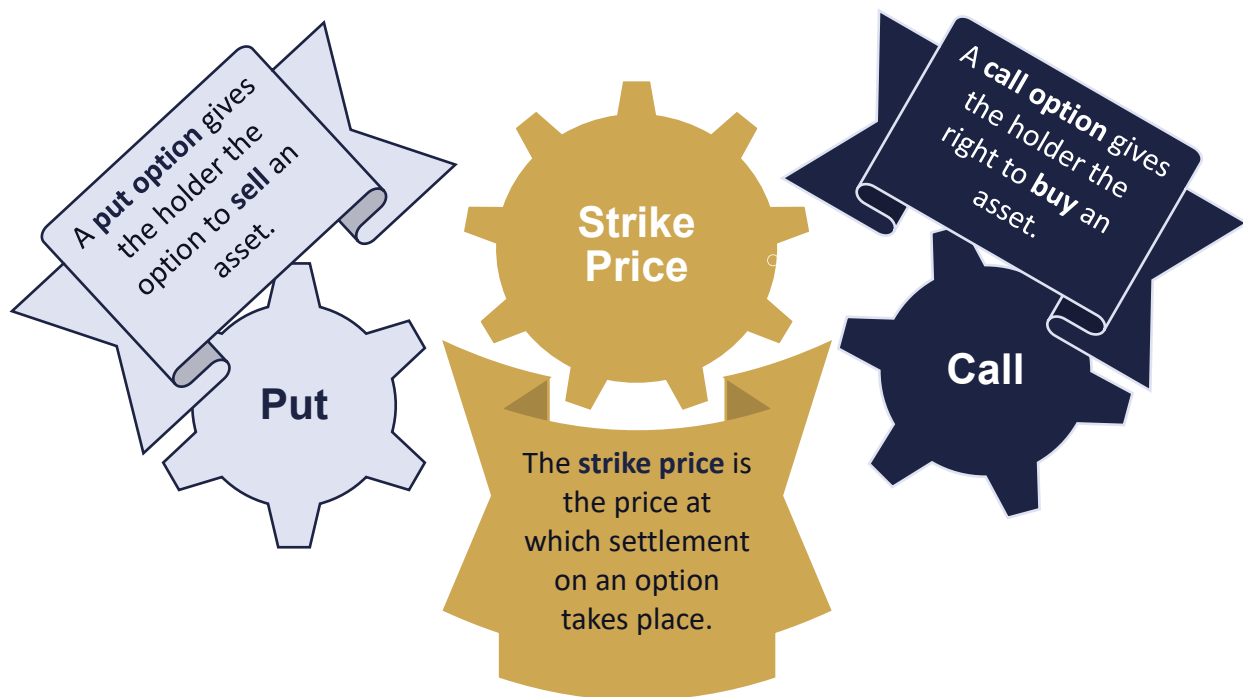
Futures contracts are standardised to facilitate trading on a Futures Exchange and include details of the quality and quantity of the underlying asset. Some futures contracts may call for physical delivery of the asset, while others are settled in cash. It is common practice in the futures market to use very high leverage relative to stock markets.

A futures contract is binding on both parties, in contrast to an **option**.

Option: a contract that gives the holder the **right**, but **not the obligation**, to buy or sell a specified quantity of an asset at an agreed price at some future date. The easiest way to understand an option is to think of buying an option on a home. It allows you, for a small sum, to keep your options open. You have some time to decide whether you really want that house, without any obligation to buy it. The holder is the party that has **bought** the option, sometimes said to be “long the option.” The party who has sold the option and collected the premium is known as the seller, or the **writer** of the option and is “short the option.”



When a party buys an option, they pay a premium to the seller for this right. The premium is a small fraction of the cost of the actual underlying asset. The holder of the option now gets exposure to that underlying asset, e.g. a property. If the property's value increases significantly before the option expires, the holder can exercise the option at the price agreed when the option was bought, sell the property, and pocket the profit. However, if the price of the property falls significantly before the option expires, the holder doesn't exercise the option and all he loses is the premium. For a fraction of the cost of holding the physical asset, the option holder can reduce his risk and achieve a similar upside.



If the option contract is exercised, the writer is responsible for fulfilling the terms of the contract by delivering the shares to the appropriate party. In the case of a security that cannot be delivered, such as an index, the contract is settled in cash. For the holder, the potential loss is limited to the price paid to acquire the option. When an option is not exercised, it expires. No shares change hands and the money spent to purchase the option is lost. For the buyer, the upside is unlimited.

Options are used by investors as a hedging tool (to protect the value of their investments) or for speculative purposes.

Today, options are quoted on most leading exchanges and in the OTC market on a wide range of underlying assets.



Warrants: a particular type of exchange-listed option, aimed at the small investor. It is usually created with ordinary shares as the underlying assets.

Equity warrants grant the holder thereof the right to purchase ordinary shares in a specific company at a fixed price, in the future. The price of a security warrant is lower than the ordinary share price of a specific company, and for this reason investors can achieve the same amount of exposure to a certain company with equity warrants than they would have had with ordinary shares, at a lower cost.

The price movement of equity warrants is “geared,” which means that a certain price movement of an ordinary share would normally result in a far greater price movement of the warrant in the same direction. This is because the base price from where it rises or falls is lower than that of the ordinary share. The closer it gets to the maturity date for the exercising of the share purchase option, the more expensive the warrants would become, provided the ordinary share price has increased over the time period.

Equity warrants are more readily tradable than share options and are listed under their own sector on the JSE. The period allowed to exercise the option is considerably longer than that of ordinary options.

The main difference between warrants and call options is that warrants are issued and guaranteed by the company, whereas options are exchange-traded instruments and are not issued by the company. Also, the lifetime of a warrant is often measured in years, while the lifetime of a typical option is measured in months.



Activity:

Which of the following statements are CORRECT?

- a) A put option gives the holder the option to sell an asset.
- b) A call option gives the holder the option to buy an asset.
- c) A put option gives the holder the option to buy an asset.
- d) A call option gives the holder the option to sell an asset.

Answer:

a) and b) are the correct answers.



2.6.3 Investment Features of Derivatives

RISK

When derivatives are used for speculative purposes, they are extremely risky and volatile, with considerable profit and loss potential. However, when employed for their hedging abilities, derivatives help to reduce the risk for traders and asset managers. When traded successfully, traders can make profits regardless of whether markets rise or fall.

VOLATILITY

Derivatives are known for their volatility.

INFLATION

Derivatives are, by their nature, short-term instruments. Depending on whether they are used for speculation or for hedging, their purpose is to protect against losses or to make profits. In both cases there is potential for beating inflation.

TAX

Taxation of derivatives is a complicated subject. In simplified terms, suffice it to say that proceeds from derivatives are subject to either income tax or CGT, depending on whether the receipt or accrual from the instruments is regarded as income or as a capital gain.

Mostly the receipts and accruals arising from speculation in derivatives would be taxed as income, whereas receipts and accruals arising from hedging would be taxed as a capital gain. CGT will normally have a lesser impact on proceeds than income tax.



Activity:

Which of the following statements regarding derivatives is CORRECT? Derivatives are:

- a) not very volatile.
- b) subject to dividend withholding tax.
- c) extremely risky when used for speculative purposes.
- d) unable to beat inflation under any circumstances.

Answer:

c) is the correct answer.



Research Activity:

Options Basics: What Are Options?

Link: <http://www.investopedia.com/university/options/option.asp#ixzz4s6ASoMhm>

Tax on derivatives:

Link: <http://www.investopedia.com/articles/active-trading/061015/how-are-futures-options-taxed.asp?ad=dirN&qo=investopediaSiteSearch&qsrc=0&o=40186>

2.7 Property

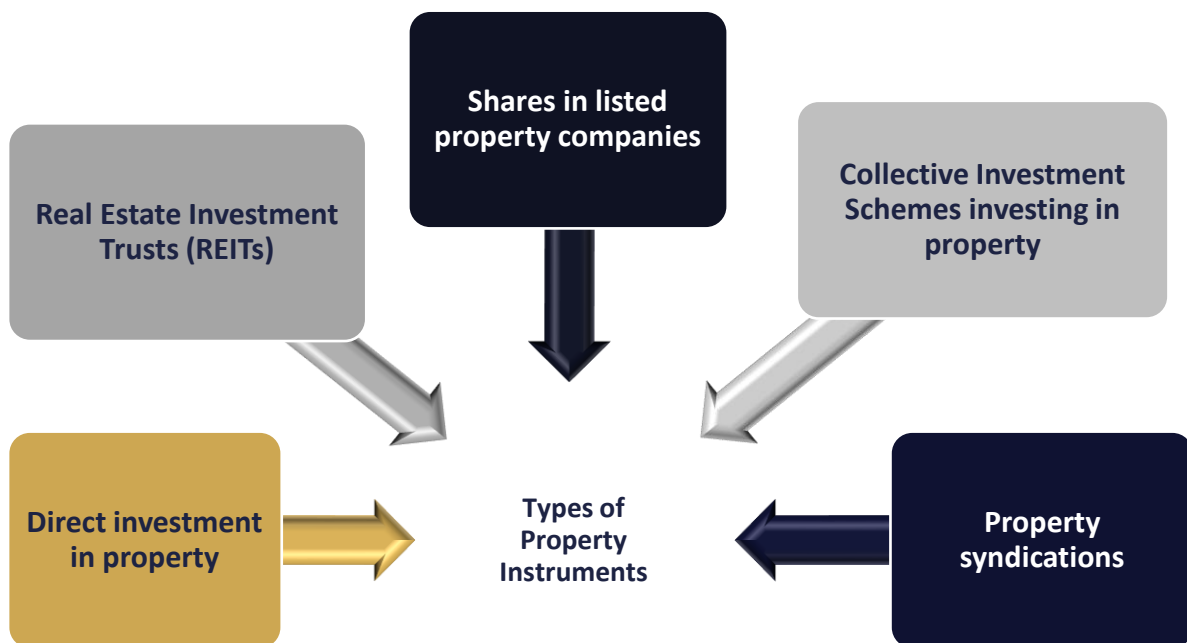
Property investments have features of both bonds and equities. Like bonds, property investments provide a reasonably steady flow of income from rentals; and, like equity, they can realise considerable capital gain.

Investments in property can be either direct (purchasing residential, commercial, or industrial property) or indirect (through property-related instruments like real estate investment trusts (REITs), CISs that invest in property, or shares in a listed property company). For the purposes of this module, our focus is on property-related instruments, and not on direct property investment.

Listed property has created significant wealth for South African investors over the recent decade, but, just as with other asset classes, real estate is a difficult environment to operate in when the economy is not growing, be it direct or indirectly.



2.7.1 Different Types of Property Instruments



Direct investment in property

You or your client may be directly invested in property through a residential home or a second property for recreational, income or speculation purposes.

TAX

CGT is payable on profits above R2 million on a primary residence. All non-residential property is subject to normal CGT rules. Income tax is payable on rental income, after expenses are deducted.

LIQUIDITY

Property is known for its low liquidity. It should not be regarded as a short-term investment.

RISK

Direct investments in property are exposed to various risks, such as market movements, interest rate movements, rental defaults, new legislation, changes in taxation, location risk, even political risk, but the greatest risk is probably the risk of not being able to sell it when necessary.

RETURNS

For many homeowners, their residential property is the most important investment made during their lifetimes and can play a crucial role in their financial position at retirement. The major return for a prime residence is in the form of capital growth and usage. Rental income, where applicable, can be expected to increase steadily if it is a good property investment.



Indirect investment in a property through property-related instruments

The risks and advantages listed above are still prevalent in each of the property-related instruments, as, at their core, the underlying asset base is still actual property, although packaged differently. Let us now take a closer look at the property-related instruments individually.

REITs (Real Estate Investment Trusts)

Companies that manage, operate, and own a real estate portfolio. They allow investors to reap the benefits of owning property as an asset class without directly owning and managing property.

Investors enjoy exposure to a wide variety of expertly managed properties that provide a regular income stream that increases annually, as well as a capital profit.

TAX REIT shareholders (investors) pay CGT when they sell their REIT shares, and income tax on all interest distributions (e.g. dividends, rental income, and income from derivatives). Dividend withholding tax does not apply. The REIT itself is exempt from CGT.

LIQUIDITY REITs are considered more liquid than physical property and are tradable on the JSE. The share prices of REITs are determined by demand and supply, which means it has the potential for capital profits.

RISK

Investors are exposed to market risk as well as other risks associated with property investments.

REGULATION

REITs are listed on the JSE under the *Real Estate* sector. They are well regulated, being subject to the REIT legislation, the Companies Act, as well as their own Articles of Association or the Collective Investment Schemes Control Act.

Shares in listed Property Companies – A listed company whose assets mostly consist of fixed property. Shares are traded on the stock exchange like any other shares.

TAX

Shareholders are subject to Dividend Withholding Tax (DWT) by way of a final withholding tax on dividends received and will pay CGT on profits made when they sell their shares. The property company is subject to 28% company tax on its net earnings, like other companies.



REGULATION

Property companies are listed on the JSE, and trading in its shares takes place in the normal way.

Collective Investment Schemes that invest in property

TAX

Investors pay CGT when they sell their participatory interest (units) in the fund and income tax on all interest distributions.

LIQUIDITY

In contrast to direct investments in property, a CIS that invests in property is 100% liquid. Investors in collective investment schemes will always be able to sell their participatory interests immediately, as the CIS management companies are obliged to repurchase the units. The repurchase price, however, is not guaranteed and can turn into either profit or loss for the investor.

RISK

Less risky than shares in a listed property company and REITs, where willing buyers have to be found first before shares can be liquidated. Riskier than bonds, and sensitive to cyclical movements, these CIS have the potential to outperform even equity unit trusts.

REGULATION

Like other CISs, property CISs fall under the Collective Investment Schemes Act (CISCA).

Property syndications – These are unlisted companies that invest in property.

RISK

Property syndications have a notoriously bad reputation and are often associated with Ponzi schemes. Examples of unscrupulous property syndicates which caused investors to lose all or most of their capital are 'Masterbond' and 'Sharemax.' They use complex unlisted company structures and debenture instruments to channel investors' money into their schemes. When a scheme collapses and is placed in liquidation, investors (the actual shareholders) are last in the queue of creditors, after the taxman, the banks that issued mortgage bonds on the properties and the liquidators themselves. So, investors often receive only a few cents of every rand they invested.

RETURNS

Investors are promised exceptionally high-income returns and so-called capital back on demand, but this seldom transpires, as directors tend to abscond with the investors' money at the first sign of detection.



LIQUIDITY

Extremely low or non-existent, for the reasons mentioned above.

REGULATION

As property syndicates are not listed on the JSE, they are not subject to the same strict regulation as listed property instruments. Investors can complain to the Ombud for Financial Services Providers against the advisor that advised them to put their money in a failed scheme unless there is sufficient evidence that the client was fully informed of the risks before he entered into the transaction.



Activity:

Indicate whether the following statements are true or false:

1. REITs are a form of direct property investment.
2. Property syndications are strictly regulated.
3. A property CIS is highly liquid.
4. You will pay Capital Gains Tax on the sale of your primary residence if it is sold for more than R2 million.

Answers:

1. False. Real Estate Investment Trusts are an indirect investment in property.
2. False. As property syndicates are not listed on the JSE, they are not subject to the same strict regulation as listed property instruments.
3. True. A CIS that invests in property is 100% liquid. Investors in collective investment schemes will always be able to sell their participatory interests immediately, as the CIS management companies are obliged to repurchase the units.
4. False. When selling your primary residence, you first need to subtract the base cost (the price at which you initially acquired it), to determine the capital gain. Then, you are allowed to subtract the R2 million primary residence exclusion from the gain. Only if you are left with a positive value (i.e. the capital gain on the sale was more than R2 million), would you have to pay CGT.

2.7.2 Investment Features of Property Instruments

Reasons for investing in property include the expectation to obtain portfolio diversification (especially from equities), to obtain a stable real return on the investment (rental income), to make an investment that could serve as a hedge against inflation, and to enjoy considerable capital appreciation.



Investment in the property sector of the financial markets is particularly suitable for persons for whom income is important, and who have a relatively low personal risk profile, such as pensioners.

Although the immovable property is not immediately liquid, it is an excellent form of security to borrow money against. Thus, whilst the investor in property may not be able to realise the property as and when he chooses the price he wants, he can use the property as security for raising a loan should he require capital urgently.

RETURNS

Returns from property investment come in the form of rental income (which tends to increase annually), and capital growth. Property is regarded internationally as an investment that should be included in a portfolio for its ability to beat inflation and create wealth over the longer term. Historically it has often outperformed equity in the medium term.

TAXATION

- **Income tax** – Rental income earned from (direct) investment in fixed property is taxable. Expenses incurred, e.g. maintenance, insurance of the property and bond interest, are deductible for income tax purposes.
- In investment-related instruments like REITs and CISs, the after-cost income is distributed to the investor via income distributions that are taxed as income in the investors' hands.
- **DWT** – Income distributions from a listed property company is subject to Dividend Withholding Tax, and not income tax.
- **CGT** – The capital profit made on the (direct) sale of property is subject to capital gains tax. If the property remains in the investor's possession for a considerable time, the profit will normally be deemed to be of a capital nature, and only the portion of the profit that must be included (inclusion rate) will be subject to capital gains tax. Profit on the sale of shares in a REIT or a listed property company, or participatory interest in a property Collective Investment Scheme, is also subject to CGT. This is passed on to the investor, who will pay CGT on any profits when he realises his investment.

RISK

Investment in listed property is riskier than investment in bonds. For this reason, property investments should trade at a higher yield than bonds. On the risk spectrum, property lies somewhere between bonds and equities. Property is not quite as volatile as equities.

The risk of property investment depends on a number of factors, such as interest rates, location, price range, supply and demand, whether the property is to be used for residential or commercial purposes, and the method of investment. Property is generally considered to be a medium- to high-risk investment.



Interest rate movements have a direct impact on performance. In general, the price of listed property companies will fall when interest rates rise (similar to bonds). Property prices are cyclical and move up and down, but over the long term, the general direction is up. Over the short term, the volatility in property investments is lower than in equities; therefore, property investments are considered less volatile than equities over the short term.

Property investments tend to be illiquid; therefore an investor's timeframe should be long-term. Proceeds are not readily available from the sale of the property. There is no formal exchange for trading property, therefore there is little price transparency.

COST

The relatively low cost of investing in property indirectly via REITs, listed property companies or CIs, makes this asset class affordable to small investors. Compared to indirect investment, direct investment in property comes with high initial costs such as capital outlay, valuation cost, transfer, and registration costs. There are also ongoing costs related to the maintenance of the property. Selling a property (directly) also has other costs, such as the agent's commission and advertising costs, depending on who is selling the property on behalf of the client.

2.7.3 Property: Role in an Investment Portfolio

Property can provide both income (in the form of rental income) and potential capital growth over the longer term and is, therefore, a popular investment.

Property returns also tend to have weaker correlations with equity returns, especially in times of poor market returns, making this an ideal asset for diversification purposes.

Indirect property investments, such as listed property shares or collective investments investing in the property sector, are becoming more popular with investors, as they provide a greater degree of flexibility, are easier to trade than actual properties, and provide an effective and convenient means to diversify property exposure.



Research Activity:

For insightful commentary on listed property as an investment, visit:

<https://www.fin24.com/Finweek/Investment/the-investment-case-for-listed-property-20170518>



Activity:

Returns from property investment come in two forms. What are they?

Answer:

Rental income and capital growth.

2.8 Alternative Investments

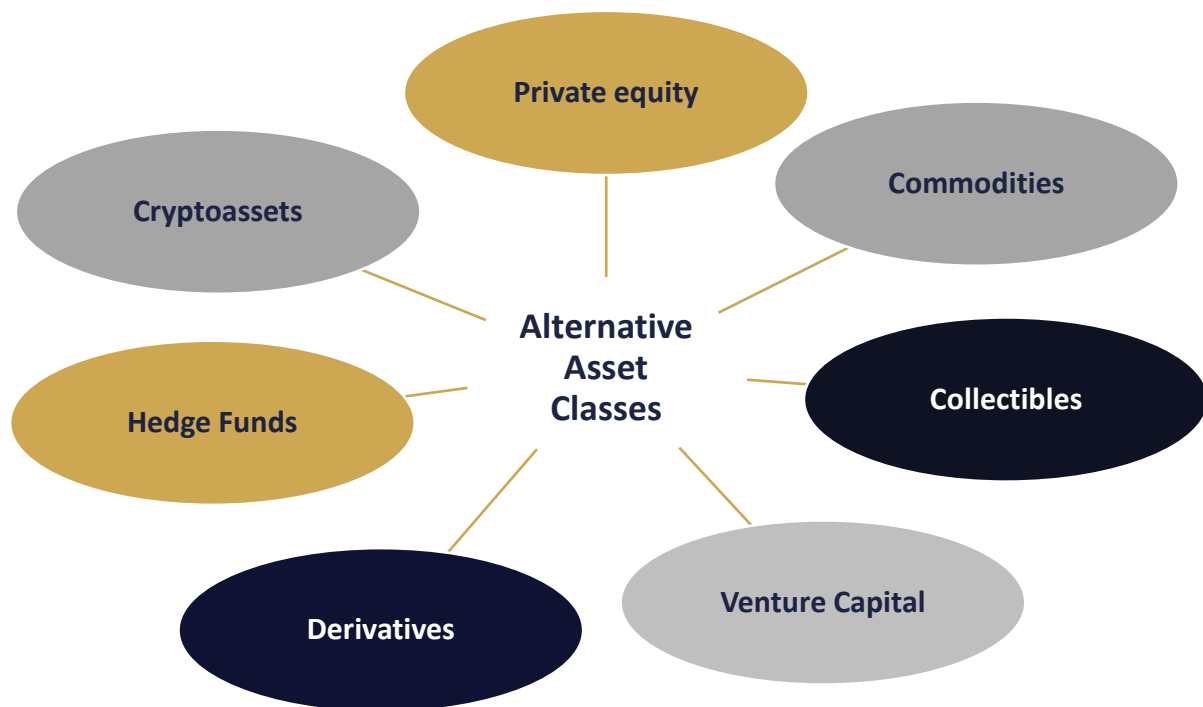
Alternative assets are a newer type of asset that, traditionally, have not been considered part of an investment portfolio. An investor should spread his investments between different asset classes to reduce the risk and/ or improve return. By investing in non-traditional alternative investments in addition to the traditional asset classes, an investor can add new and exciting risk and return characteristics to his portfolio. Recognised as a fifth asset class, alternative investments, including commodities (such as gold), private equity (shares in unlisted companies), and collectibles (such as rare stamps and oriental rugs), perform differently from other asset classes.

2.8.1 Features of Alternative Investment Instruments

Dealing in alternative investments requires specialised knowledge and skills. It is not always easy to evaluate their performance because prices are not readily available, as they are not traded on the regular stock exchange. In addition to this they tend to be quite illiquid and should be seen as long-term investments.

2.8.2 Types of Alternative Asset Classes

Alternative assets could range from first editions to racehorses to gold coins to trading cards – there is not really a limit. The main types of alternative investments include:



i. **Private Equity** (shares in unlisted companies).

Investment in private equity is different from investing in listed companies. The deal is negotiated between the investor and the company, as opposed to listed shares where the price is determined by the market through a standardised dealing structure. Information on private equity is not made available to the public; unlike listed companies whose information is available to the public. Investors in private equity are quite often involved in the company and represented on the board, whereas holders of listed shares generally have limited dealings with the company. Private equity carries a higher risk and, therefore, a potentially higher return. The number of private equity companies listed on the JSE has shown a marked increase recently.

ii. **Commodities** include any natural resource that can be processed and traded, such as gold, crude oil, and silver (hard commodities that are mined or extracted), and wheat, potatoes, livestock, and coffee beans (soft commodities that are grown or raised). Most commodities are essential components in the manufacturing of other goods, for example, platinum, iron, and oil. Commodity prices are very sensitive to market forces and supply and demand and can fluctuate greatly.

Instead of direct trading in the commodities themselves, traders often trade them in the form of derivatives, especially futures, which is an agreement to buy or sell a certain asset (commodity) for a certain price by a certain future date. The price is determined at the time of trading the contract.



As an asset class, commodities offer high risk and with-it high returns. As they tend to have a low or negative correlation to equities in general, their inclusion in a portfolio with equities and bonds will add substantial diversification.

- iii. **Collectibles** refer to scarce and valuable articles such as numismatic coins, rare stamps, works of art and oriental rugs, which are invested in as much for their rarity and beauty as for their financial value. Because there is not really an open or organised market for these items, they can be difficult to trade. This market can fluctuate widely as fashions, laws, and taxes change.
- iv. **Venture capital** is a type of private equity. It involves investing money in small emerging companies deemed to have high growth potential, in exchange for equity (ownership in the company). The risks are high and the expectations long term. Government has also made it very appealing to invest in Section 12J Venture Capital Funds by offering attractive tax benefits. Under Section 12J, investment into these funds is now fully tax deductible and that deduction will be permanent if they are held for five years.
- v. **Derivatives**, such as futures contracts in commodities or in currencies, are a relatively new addition to investment instruments. We have already discussed them in Unit 1.5.
- vi. **Hedge funds** fall under the alternative investment asset class. They represent an alternative to traditional unit trusts. We will discuss hedge funds in Unit 2.7.

Direct investment in alternative asset classes requires specialised knowledge, skills, and capital; and, as such, is not advisable for the smaller investor. Investors enjoy indirect exposure by way of collective investment schemes and retirement funds, which are allowed to allocate up to 15% to alternative assets in terms of Regulation 28 of the Pension Funds Act.

- vii. **Crypto assets** are defined by the South African Revenue Service (SARS) as digital representations of value that are not issued by a central bank and use cryptography techniques to trade, transfer, and store electronically as a means of payment, investment, and other forms of utility.

The word “crypto asset” was replaced “cryptocurrency” in order to adopt a uniform definition within the South African regulatory framework². On 19 October 2022, the FSCA published General Notice 1350 of 2022 in Government Gazette 47334 (Notice) to declare crypto assets as ‘financial products’ under section 1 of the FAIS Act.

² See: Explanatory Memorandum on the Taxation Laws Amendment Bill as issued on 20 January 2021



The FSCA has also set out the effect, scope, licensing, and transitional provisions of the Notice and requires crypto service providers in South Africa to apply for a license between 1 June 2023 and 20 November 2023 to operate legally within South Africa or risk criminal conviction and an R10 million fine. In a press conference on 20 October 2022, the FSCA stated that the regulation and licensing of crypto assets are aimed at protecting consumers from crypto scams and empowering the authorities to take action against scammers.

In terms of the tax implications, SARS states that normal income tax rules are applicable to crypto assets and crypto asset gains, or losses must be declared as part of taxable income. Taxpayers must declare all crypto assets-related taxable income in the related tax year. Failing to declare can lead to interest and penalties being charged in addition to whatever tax liabilities arise as a result of crypto-related tax liabilities³.



Research Activity:

Visit the following website for some additional reading:

<http://www.ashburtoninvestments.com/za/individual-investor/news/insights/article/2017/10/24/a-place-for-private-debt-in-alternative-asset-allocations>

³ See: <https://www.sars.gov.za/individuals/crypto-assets-tax/#:~:text=A%20crypto%20asset%20is%20a%20digital%20representation%20of,and%20applies%20cryptogr,aphy%20techniques%20in%20the%20underlying%20technology>.



Unit 2 Summary

In this unit, we looked at the traditional asset classes, namely money-market instruments, bonds, property, and equity, including derivatives.

We studied the typical terms, features, and benefits of each asset class, as well as the typical instruments used in each asset class and their investment characteristics.

Money-market instruments include cash, call accounts, debit cards, savings and fixed deposits, bankers' acceptances (BAs), Treasury Bills (TBs), Land Bank bills, trade bills, promissory notes, and negotiable certificates of deposit (NCDs). They are best known for their short duration (1 year and less), low volatility and low risk, and high taxability (income tax).

The capital market includes gilts and semi-gilts, fixed-rate bonds, floating-rate and inflation-linked bonds, zero-coupon bonds, callable bonds, unsecured bonds (debentures) and government retail bonds. This asset class is best known for its income-generating features, relative stability, inverse relationship with interest rates and high taxability (income tax).

Debentures (corporate bonds) are unsecured long-term debt instruments and include convertible and non-convertible debentures. They are best known for their high-risk relative to government bonds and are taxed in the same way as other bonds.

Securitised debt instruments (structured finance) include mortgage-backed securities (e.g. home and car loans) and asset-backed securities (e.g. student loans and credit card debt). These debts are pooled together and then sold to investors. They are best known for their high fixed income relative to the more traditional bonds, and relative riskiness, and are taxed on their income and capital gains.

The main equity types are ordinary shares and preference shares. We looked at ways to evaluate shares, namely dividend yield, price-earnings ratio, earnings per share and market capitalisation. They are best known for their capacity for real growth over the longer term, coupled with their volatility over the shorter term, and income in the form of dividends. Dividend Withholding Tax and CGT are the main forms of taxation.

Derivative instruments' values are derived from the value of an underlying financial asset or an underlying factor and form part of the alternative asset class. We looked at futures, options and warrants. Derivatives are best known for their capacity for hedging on the one hand, and speculation on the other hand. In their former capacity, they can reduce risk in a



portfolio through hedging strategies, while in the latter capacity, they can generate extreme profits and losses. They are subject to income tax, DWT and CGT, depending on the nature of the receipt or accrual.

Property as an asset class has been known to outperform equities but are generally seen as less volatile. Indirect investment in property is most commonly obtained through listed property companies, REITs (Real Estate Investment Trusts), and Collective Investment Schemes that invest in property. Property is best known for its capacity to generate a steady income stream as well as real capital growth and is subject to income tax and CGT. Income from listed property companies is subject to DWT.

We also looked at alternative asset classes, the so-called fifth asset class, including commodities, private equity, collectables, venture capital, derivatives, and hedge funds. These instruments differ from the traditional asset classes in their risk and return characteristics. They are best known for their peculiarities compared to traditional asset classes, including the fact that they are not traded on a formal exchange, their limitless variety, and their low liquidity. Depending on the nature of the instrument and return generated, they are subject to income tax, DWT and CGT.



Unit 3: Risk in the Investment Environment

Introduction

Different asset classes tend to be associated with different levels of risk. But what is risk? In the investment sense, risk can basically be understood as the uncertainty associated with future returns. The higher the uncertainty about the future return (positive or negative), the riskier the investment can be said to be.



Example of Risk:

John uses R1 000 to purchase lotto tickets. His chances are about 1 in 100 000 000 that he may be a winner. This could be said to be a very risky investment.

On the other hand, Elizabeth puts her R1 000 into a fixed deposit at the bank that pays her a guaranteed 6% interest per annum. This is a low-risk investment as the bank will, in all probability, be able to repay Elizabeth's capital with interest. However, there is, of course, a small chance that the bank could go bankrupt, in which case Elizabeth could lose a part or all of her capital – but this chance is likely to be much lower than that of John losing his capital.

3.1 Risk-Return Relationship.

If we look at the example of John and Elizabeth discussed above, we can say that John has made a high-risk investment with potential for a high return, but there is also a very high probability that he could lose everything; whilst Elizabeth has made a low-risk investment with a potential of a low return, but the possibility of losing her capital is also very small. Why would John take on this level of risk in his investment? The answer to this is that although John probably knows his chances of winning are low, he also knows that if he *did* happen to win, he would get an absolutely huge reward in return for the risk taken on.



This is also how the risk-return relationship operates, i.e. there is a direct relationship between the amount of risk an investor takes on and the potential return he or she may expect to get. Generally, the higher the risk taken on, the higher the potential return should be.



Take Note

That we talk about a *potential* return not a *guaranteed* return, since there is also a greater risk that the investor could lose his/ her money.

Taking this a step further, each of the asset classes that we discussed above has its own level of risk and return, based on the amount of certainty/ uncertainty regarding the return. There is thus a direct relationship between the type of assets held, and the risk and potential return (investment earnings).

Risk-Return Relationship of different Asset Classes.

	REAL RETURNS	NOMINAL RETURNS		
	SINCE 1930 (p.a.)	SINCE 1930 (p.a.)	ALL-TIME HIGH (year)	ALL-TIME LOW (year)
SA EQUITY	7.2%	13.6%	+94% (1979)	-26% (1970)
SA PROPERTY (since 1980)	2.9%	11.4%	+53% (1999)	-26% (1998)
SA BONDS	1.7%	7.8%	+36% (1986)	-9% (1994)
SA CASH	0.8%	6.8%	+22% (1985)	0% (1934)
GOLD ZAR (since 1967)	3.8%	10.0%	+122% (1979)	-19% (1997)
GLOBAL EQUITY*	5.1%	8.4%	+73% (1933)	-40% (2008)
GLOBAL EQUITY ZAR	7.3%	13.7%	+155% (1961)	-42% (2002)
GLOBAL BONDS*	1.0%	4.2%	+36% (1933)	-25% (1945)
GLOBAL BONDS ZAR	3.1%	9.3%	+110% (1961)	-25% (1945)

* In US dollars and using US inflation

Source: Old Mutual (2023 Long Term Perspectives)

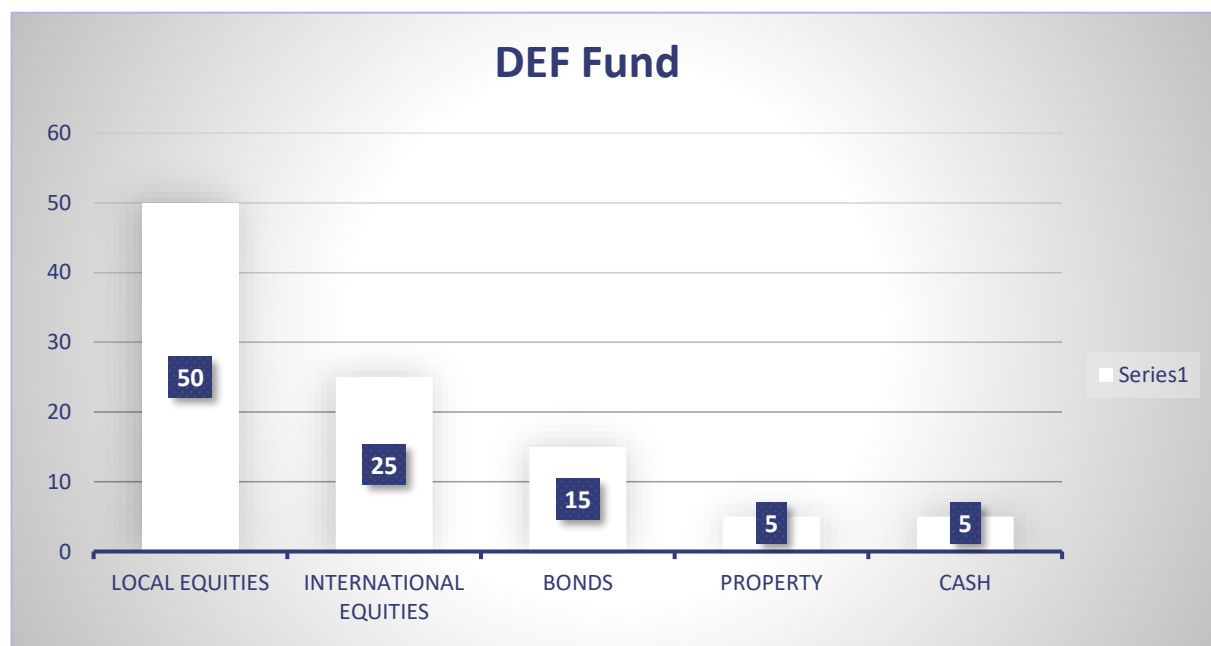


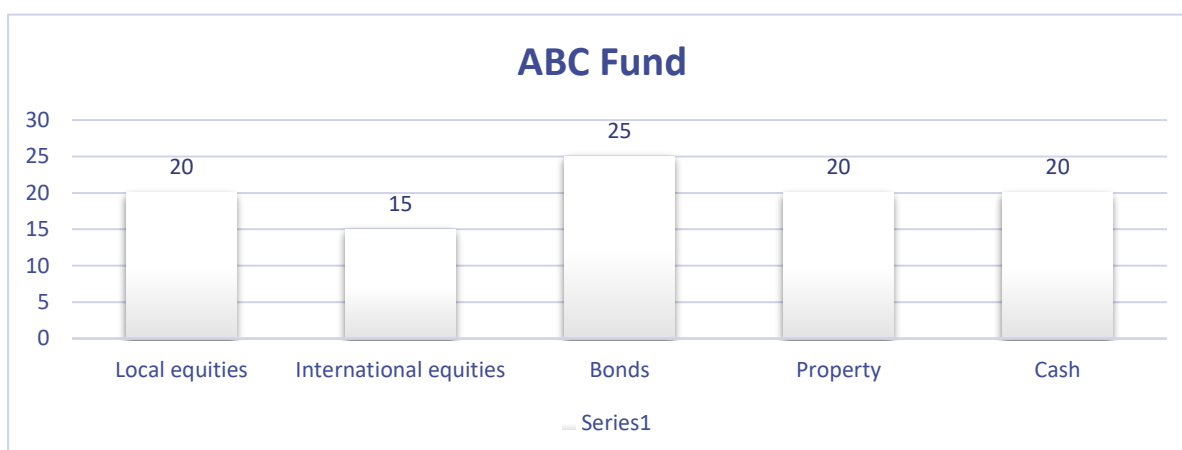
The table above shows the performance of the various asset classes. Nominal return is the stated or the actual percentage increase in the value of an investment while real return is the nominal return minus inflation. Since 1930 to 2022, while equity has delivered the highest average return, it also experienced the highest volatility. Volatility is a term used to describe the degree of fluctuation in an asset's price over time, and this is another term used to describe investment risk. From the table, we can see that equity (both SA and global) also experienced some of the highest decline in value with SA equity experiencing a decline of 26% while global equity experienced a decline of 42%. While SA cash has a 0% all-time low, i.e., no decline or loss of capital, it also has a corresponding low return.



Activity:

The percentage asset allocations of DEF Fund and ABC Fund are shown below. Study these asset allocations and then answer the questions that follow. Try to answer the questions on your own first before checking your answers.





Activity:

1. How much total equity exposure does ABC Fund have (including local and international)?
35%
2. How much total equity exposure does DEF Fund have (including local and international)?
75%
3. How much cash exposure does ABC Fund have (including local and international)?
20%
4. How much cash exposure does DEF Fund have (including local and international)?
5%
5. How much property exposure does ABC Fund have (including local and international)?
20%
6. How much property exposure does DEF Fund have (including local and international)?
5%
7. How much bond exposure does ABC Fund have (including local and international)?
25%



8. How much bond exposure does DEF Fund have (including local and international)?
15%

9. Which fund in your opinion is riskier, ABC Fund or DEF Fund? Motivate your answer by referring to the risk-return relationship diagram.

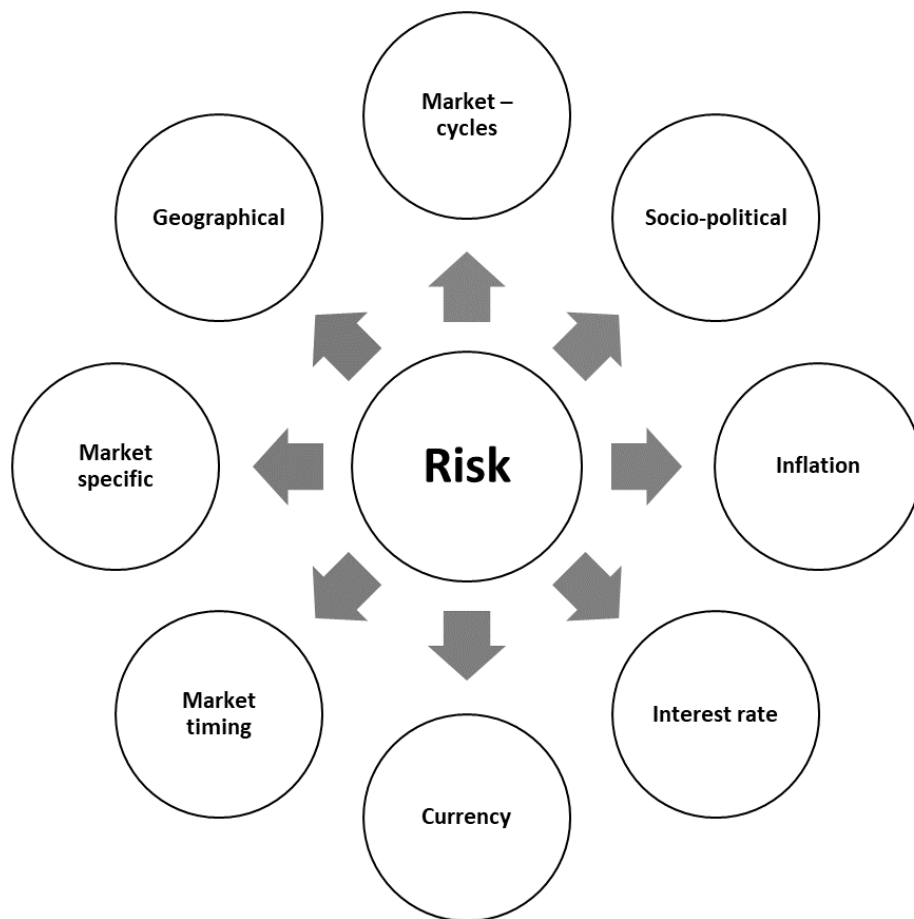
Looking at the asset class composition of the two funds and the risk-return diagram, DEF fund appears to be riskier. This is because it has a larger percentage of equities (75%), which are on the extreme right-hand side of the risk-return diagram, meaning that they are the riskiest asset class; and, in addition, it also has a lower percentage of cash exposure (5%), which is the least risky asset class.

10. Which fund, in your opinion, has a higher return potential, ABC Fund or DEF Fund? Motivate your answer by referring to the risk-return relationship diagram.

Again, looking at the asset class composition of the two funds and the risk-return diagram, DEF fund appears to have a higher growth potential. This is because it has a larger percentage of equities (75%), which are on the extreme right-hand side of the risk-return diagram, meaning that they have the highest potential to achieve good returns over the long term; and, in addition, it also has a lower percentage of cash exposure (5%), meaning that exposure to this low-return asset class is limited in the fund.

We've now looked at a basic picture of the risk-return relationship, showing the different levels of risk attached to different asset classes, and, in the activity above, we've seen that the particular 'mix' of assets used in an investment portfolio will impact on the risk level of the fund.

We will now consider the following **risks present in the investment environment** and how they impact on the different asset classes. This may assist you in getting a better understanding of *why* certain asset classes are much more volatile (and therefore considered to be riskier) than others.



3.2 Market Risk

Market risk refers to the potential for an investor's portfolio to decline due to fluctuations in market prices. Historical examples include the 2008 global financial crisis, the European debt crisis, and more recently, the COVID-19 pandemic, which triggered market volatility as global economies slowed. The 2022 inflation surge and subsequent interest rate hikes by central banks worldwide further impacted financial markets, causing sharp corrections in equity and bond prices. Understanding these risks allows investors to implement diversification and hedging strategies to mitigate losses.

Asset managers often use hedging (i.e. taking out an investment to limit the risk of another investment) in order to protect their investment portfolios from systematic risk.



Research Activity:

Visit the following website to find out more about hedging:

[What is hedging & how it helps you trade \(rediff.com\)](https://www.rediff.com)



Let us now look at a few concepts related to market risk and their impact on asset prices.

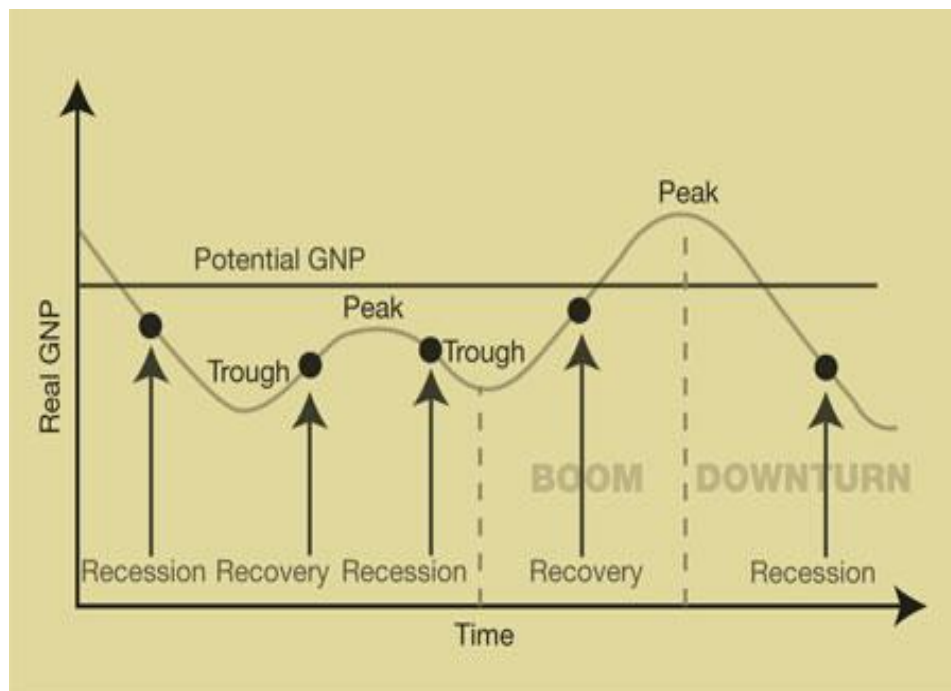
3.2.1 Economic and Business Cycles

An economic cycle (also called a business cycle) can broadly be defined as the periodic and recurring upward and downward changes in the economic activity in a country.

Traditional economic or business cycles typically have four main phases or stages:

- recession (downturn)
- trough
- recovery (upturn)
- peak

These phases continuously repeat themselves over time, with varying durations, as seen in the diagram below.



Recession (downturn) Phase:

In a recession (downturn), which generally follows the peak of the upswing phase, prices become too high, and consumers start spending less money. Investor sentiments become negative, which causes the number of new investments to fall and causes the market to drop. This, in turn, causes the return on equity investments to fall.

Factors that could aggravate a recession phase include sharp falls in the prices of goods, droughts and floods, socio-political unrest and instability, a slowdown in international economic growth or international financial and economic crises.



The main economic indicators of the recession phase are:

- Investor confidence is low
- Growth in spending slows down
- Investment and production growth falls
- Unemployment rises

Sometimes a recession becomes so severe that it turns into a depression. This may occur where investor sentiment remains negative due to uncertainty in socio-political conditions (domestic or global). People are generally afraid to invest in times when they are uncertain or not confident in what the future of their investment holds. They perceive the investment market as risky and avoid making new investments. During a recession, central banks reduce interest rates to stimulate borrowing and spending (investing) by households (firms).

In a depression, unemployment rises dramatically and consumers' demand for goods plummets. Prices level off and may even fall. Business profits drop and, in many cases, businesses make losses. There is an overwhelming air of pessimism about the future of the economy, and, as a result, people are unwilling to risk making new investments. Interest rates fall sharply.

The trough signals the point of lowest growth in the cycle. Economic factors, such as production, profit, sales, and employment, are at their lowest level but do not decrease further.

Recovery (upturn) Phase:

In a recovery phase (upturn) we generally see a stabilised socio-political environment, a promising global economy, and an increase in production.

In the very early phases of the upturn, investors may not be aware of the trend and may still be invested in interest-bearing assets, such as cash. As the upturn gains momentum, people become more optimistic about the future and start investing again. This optimism causes a demand for goods and businesses start building up their stock of goods in reaction to rising sales (due to an increase in demand).

At the same time, investment in capital goods (such as machinery and equipment) rises so as to produce more goods to satisfy the increasing demand. Factories and businesses also need to employ more workers to help produce these additional goods. This causes employment to increase.



Consumers who, during the recession were forced to cut back on their purchase of durable goods such as motor cars, furniture, and electrical appliances, come back into the market during the recovery phase. As a result, employment, gross domestic product (GDP), and consumer spending gradually begin to rise; and this, in turn, results in increases in production, sales and profits. This will have a positive impact on equity prices and may also positively impact property prices.

Main economic indicators of the recovery phase are:

- International economic growth rises.
- South Africa exports more goods, which brings more money into the country.
- Current account of balance of payments improves.
- Gold and foreign exchange reserves improve.
- There is greater liquidity because people are spending more, and more money is flowing into the country due to exports of our goods.
- Consumer spending rises (particularly on durable and semi-durable goods such as motor cars, furniture, and electrical appliances)
- Production of goods and services rises to meet the increasing demand.
- Employment increases to meet the demand for the production of goods/ services.
- Investment spending rises because people have a more positive outlook on the future of the economy.

At the start of the recovery phase, interest rates may be very low, and the central bank may periodically readjust interest rates upwards in the course of the recovery phase to avoid 'overheating' – a situation where productivity capacity is unable to keep up with aggregate demand. At the peak phase, the increase in growth has achieved its limit. Economic factors, such as production, profit, sales, and employment, are high but do not increase further. There is now a gradual decrease in the demand of various products due to the increase in prices of products, while the income of individuals remains constant, leading to a decrease in demand for products.

Interest rates at the peak of the upturn phase tend to be high, which has a positive impact on cash. However, dividend yields on equities may decline at this point. Bond values decrease at this point due to the high-interest rates.



Activity:

Is the following statement true or false?

During a recessionary period, central banks tend to increase interest rates.



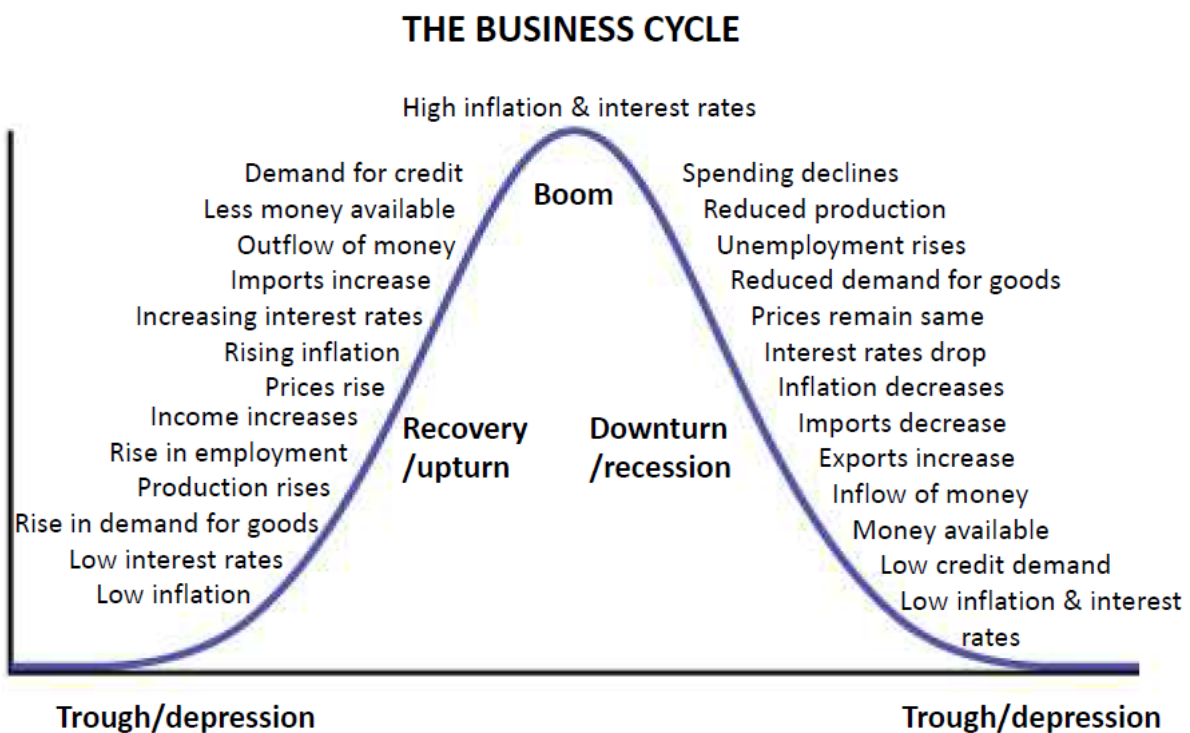
Answer:

False. Central banks tend to *decrease* interest rates during a recessionary period.

The effect of the business cycle on the economy

The diagram below outlines some of the changes that occur within an economy as a result of changes in the phases of the business cycle.

Fluctuations in the Economy Resulting from Changes in the Business Cycle



3.2.2 Fiscal and Monetary Policies (Social and Political Risk)

In general terms, a country's macro-economic policy aims to achieve sustainable and balanced economic growth, create increased access to employment, and curb inflation. Economic policymakers use two methods to achieve these goals, namely fiscal policy, and monetary policy.

Fiscal policy is set by the government to influence the economy by changing the level of government expenditure and/ or taxes.

In the event of reduced economic activity and large-scale unemployment, an expansionary fiscal policy may be adopted. This entails increasing government spending and/ or providing some degree of tax relief. Higher government spending boils down to the state pumping more money into the economy in areas such as infrastructure or education, for example, which



would have the effect of creating more jobs and increasing the gross domestic product. Tax relief would mean that the government takes less money from households and businesses so that they will have more money to spend on products and services.

In theory, both of these expansionary actions create increased growth in the economy, leading to an increase in equity prices. However, expansionary fiscal policy can also create problems in the economy, such as an increase in the government's budget deficit, which could lead to increased inflation (inflation risk is discussed in 2.2.3 below). It could also lead to an increase in interest rates (interest-rate risk is discussed in 2.2.4 below), in order to entice investors to buy the securities issued by the government to fund the increased spending.

Monetary policy aims to put measures in place to regulate the economy and target a certain level of inflation to achieve stability in the interest of sustainable and balanced economic development and growth. This reduces uncertainty in the economy and, therefore, provides a favourable environment for growth and employment creation.

In South Africa, the Reserve Bank plays an integral role in this regard, as they control the supply of money (by trading or purchasing government debt securities for cash in attempts to expand or contract the total money supply); and the extent of credit available by controlling the Repo rate (the rate at which the Reserve Bank lends money to other banks). Changes in the Repo rate, in turn, determine the level of the prime lending rate, which is the Repo rate + 3.5%. The prime lending rate is the base rate that banks use to determine the interest rate that they will charge customers for credit or pay on deposits. Therefore, changes in the Repo rate impact directly on customers.

Depending on economic circumstances, the Reserve Bank may implement a restrictive monetary policy (namely, reduce the rate of increase in the money supply and raise the cost of credit) or a more expansionary policy (allow the money supply to grow at a faster rate and lower interest rates).

If the Reserve Bank implements a restrictive policy, inflation will decrease because there will be less money (demand) chasing goods (supply). Sellers will, therefore, bring their prices down in order to get the goods sold. If the Reserve Bank implements an expansionary policy, inflation will increase, because there will be more money (demand) chasing goods (supply), which will cause sellers to increase the price of goods as there is a great demand for the goods.

Overall, fiscal, and monetary policies serve to provide stability and certainty in the market, which creates the right environment for long-term growth in the economy, leading to a situation where equity prices will achieve growth levels in excess of inflation over the longer term.



Activity:

Give an example of a macro-economic objective.

Answer:

Macro-economic objectives include sustainable and balanced economic growth, creating increased access to employment, and curbing inflation.

3.2.3 Inflation Risk

Inflation can be defined as a “sustained and significant increase in the general prices of goods and services.”¹ Inflation, therefore, has the effect of decreasing the buying power of your money, which means that, in total, fewer goods can be bought for your money.



Example of Inflation:

Imagine that you want to buy a new 4x4 motor vehicle – which, today, costs R750 000. If you wait another five years, you will have to pay more for the same car. The extra amount you pay is the ***inflation*** on the price. If the average yearly inflation over the next five years is, say, 6%, the price of the 4x4 will increase to R1 003 700 in five years. This means that you will have to pay R253 700 more for the same car in five years' time.

Alternatively, you could buy a cheaper car; one that will only cost R750 000 in five years' time. This means the R750 000 can only buy you a lower range car in five years' time. This is why we say that inflation decreases the buying power of your money.

¹ Wikipedia

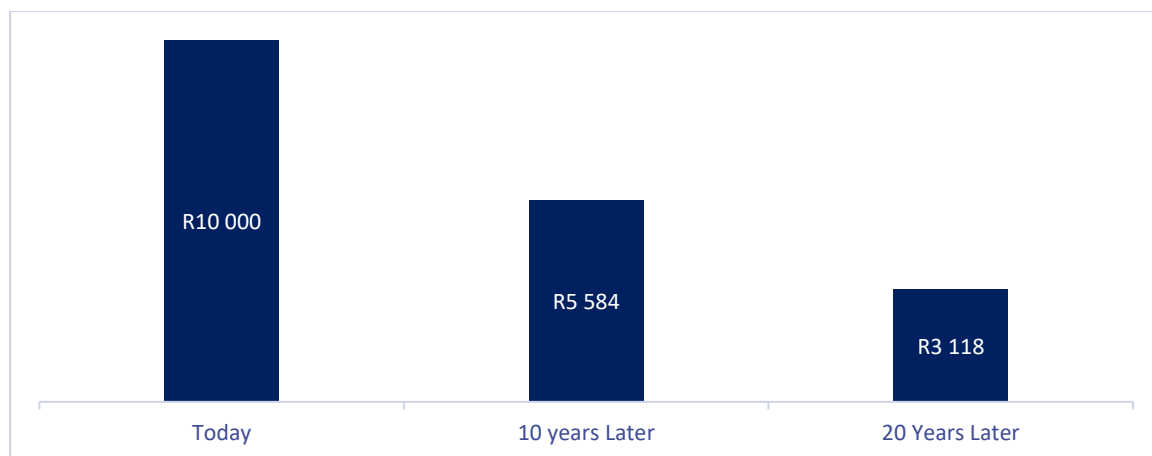


Product	Description	2017	2018	2019	2020	2021	5-year %
Apples	1,5kg	R21,49	R24,74	R28,74	R27,74	R28,49	33%
Bread	Brown, one loaf	R9,67	R9,99	R10,37	R11,24	R12,37	28%
Cabbage	One head	R14,99	R13,74	R16,49	R17,49	R14,74	-2%
Coca Cola	2 litres	R16,11	R16,69	R21,99	R22,12	R22,62	40%
Eggs	6 extra-large	R17,99	R20,61	R20,24	R20,49	R20,12	12%
Flour	Self-raising, 2,5kg	R36,59	R38,95	R41,24	R45,74	R42,74	17%
Maize	2,5kg	R25,48	R22,24	R25,49	R25,49	R26,49	4%
Margarine	500g	R23,99	R26,61	R32,24	R24,99	R26,49	10%
Milk	Full cream, 2 litres	R25,23	R26,68	R26,23	R29,49	R32,24	28%
Rice	2kg	R25,73	R23,53	R22,97	R32,24	R30,49	18%
Sugar	White, 2,5kg	R37,73	R36,64	R38,49	R45,74	R45,74	21%
Tea	100 bags	R20,60	R30,64	R28,74	R33,24	R32,49	58%
Total		R275,59	R291,05	R313,22	R336,01	R335,01	22%

Source: <https://businesstech.co.za/news/lifestyle/523844/how-food-prices-have-changed-in-south-africa-over-the-last-5-years/>

The example above from BusinessTech shows how inflation impacts on the buying power of your money over time.

The chart below shows how inflation erodes purchasing power. If you have R10 000 today and decide to keep it in your safety box, at a 6% inflation rate, your money will be worth R5 584 in 10 years' time, and only worth R3 118 in 20 years' time.



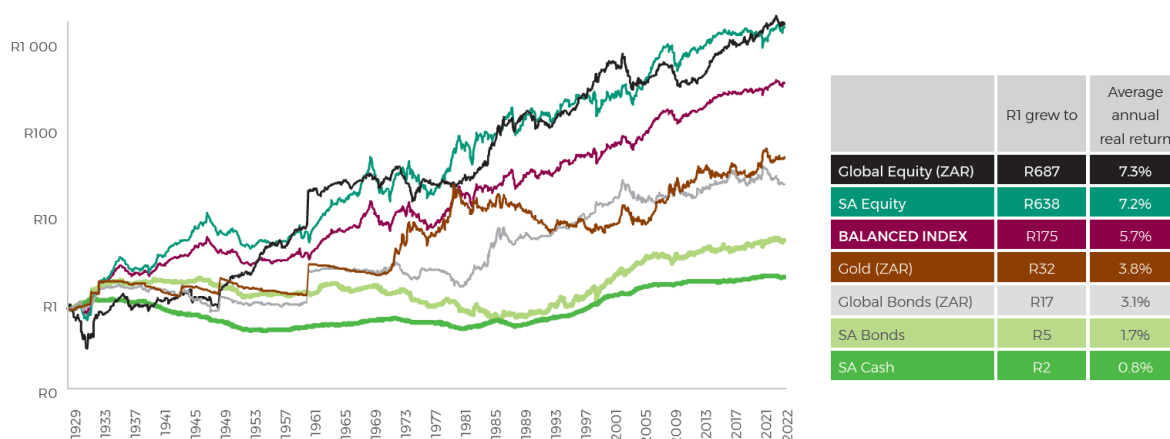
If we consider the risk-return diagram and the different asset classes in 2.1 above, we see that although the asset classes on the left of the diagram may have low levels of risk over the short term, the inflationary risk increases over time. For example, in the case of the money-market investment, over time the risk inherent in this asset class increases as the low returns mean a higher risk that the value of the capital is eroded by inflation.



Equity investment, on the other hand, is very volatile in the short term and thus risky over the shorter term. However, over time the growth in equities tends to outpace inflation, and equities have in the past been proven to yield real growth in excess of inflation, over terms of 10 years or more.

The chart shows the growth of R1 in real terms from December 1929 to December 2021. The values have been adjusted for inflation over the periods measured. In other words, the amount under each asset class is the value of R1 invested plus investment growth in the particular market, less inflation.

Growth of R1 over 93 years in real terms (December 1929 – 2022)



Source: Old Mutual Long-Term Perspectives 2023

As is shown in the chart above, inflation risk affects different asset classes differently; therefore, this risk can be mitigated over time (but not totally eliminated) by diversifying one's investment to include asset classes such as property and equities that have the potential to yield returns exceeding inflation over time.

3.2.4 Interest-Rate Risk

Cash or money-market investments will be directly impacted by interest rate changes (both up and down), as the interest rate earned is dependent on the prevailing Repo rate and prime lending rate. Thus, when interest rates go up, this asset class will experience greater returns, and vice versa.

Bonds, on the other hand, especially longer-term bonds which are often traded in the secondary market, are negatively impacted by a rise in interest rates. This is because when interest rates rise, newly issued bonds will reflect the higher interest rate and make the older bonds less attractive in comparison. If interest rates drop, the value of an older bond will increase, as its higher interest rate will make it relatively more attractive in comparison to newly issued bonds that reflect the lower interest rate.



Equities are less directly impacted by changes in interest rates but are impacted indirectly. For example, if interest rates increase, consumers will need to pay more money to service their loans and will have less disposable income to spend on products and services, which will lead to a decreased demand and thus lower growth in businesses, which would have the effect of decreasing the share prices. Businesses too, will tend to 'spend less,' and may delay capital purchases due to the higher costs of servicing the loans they would need to take out to make the purchases – this could lead to less expansion, less production or slower growth, and ultimately a reduction in returns of the share price.

Property is also impacted indirectly. For example, if interest rates go up, consumers may decide to target a lower-priced property, as the higher-priced property may be too expensive (taking into account the higher interest costs), or they may decide against taking out a mortgage and buying property – leading to lower demand. Both these factors will cause property prices to decrease. Property companies who make use of loans to buy properties for rent may also have to pay a higher percentage of their rental income to service debt, thereby decreasing their profits. Their customers, in turn, may also target lower-priced rental properties leading to decreased rental income.

3.2.5 Currency Risk

The strength of a currency tends to have different effects on different parts of the economy. For example, exporters gain from a weaker currency, as the weaker rand makes prices seem attractive to global investors (when compared to relatively stronger currencies), and this will increase jobs and profits. On the other hand, consumers gain from a stronger currency, as the prices of imports (like oil) are lower, and this, in turn, keeps inflation down.

In addition to the above impacts on the economy as a whole, there is also an added specific risk (unsystematic risk) when investing in a different currency, namely the risk that gains or growth in the investment will be eroded by a depreciating currency.



Example of Currency Risk:

Let's say a foreign investor invested US\$1 000, at a time when the rand to dollar exchange rate being R18 to the dollar. This investment is worth R18 000. Four years later, his investment has grown to R24 000. However, over the same period, the rand has depreciated to R24 to the dollar. Although the investor achieved a good growth in rand terms, in dollar terms he has made nothing as the R24 000 worth \$1 000 when converted, due to the rand's depreciation in value against the dollar over the same period.

Of course, if the rand had strengthened to, say R10 to the dollar, over the same period, the investor would benefit from the positive investment return, plus the appreciation in the



rand's value. His US\$1 000 investment which grew to R24 000 after four years would, in this case, would be worth \$2 400 when converted ($R24\ 000 \div 10 = 2\ 400$ US dollars).

For South African investors, currency risk can be reduced by diversification into offshore investments, or by investing in shares of companies that hold currencies other than rands.

3.3 Market-Timing Risk

Market timing risk is “the risk that an investor takes when trying to buy or sell a stock based on future price predictions.”²

In other words, the risk is that an investor or asset manager buying or selling assets to speculate on predictions of future market movements or ‘hot’ market sectors, may get their predictions wrong and lose money in the process.

Market-timing risk is the risk that can be reduced by investing smaller amounts, systematically over a period of time, to avoid getting the market-timing wrong. For example, most collective investment schemes allow for regular monthly contributions to provide a systematic option for investing, also known as rand-cost averaging (see definition in the glossary).



Activity:

How can an investor reduce market-timing risk?

Answer:

Market-timing risk can be reduced by investing smaller amounts over a period of time.

3.4 Market-Specific / Sector-Specific Risk

Market-specific risk (and sector-specific risk) relates to risk that is specific to a business or small group of businesses, or to a specific business sector. This type of risk is another example of an unsystematic risk that will impact the share prices of the business or group of businesses, or market sectors involved only. Depending on the event, the impact could be positive or negative.

² Timing risk/ Investopedia



Example of Market-Specific (Unsystematic) Risk:

SA's chicken industry is 'in a crisis' – RCL Foods chief³

The diversified food producer is feeling the pinch from cheap chicken imports.

Ray Mahlaka (31 August 2016 00:53)

The widespread dumping of chicken into South Africa remains a pressure point for diversified food producer RCL Foods, with the pronounced trend continuing to weigh on its earnings.

RCL Foods, formerly known as Rainbow Chicken, reported an 11.9% decrease in headline earnings from continuing operations for the year to June 2016 to R849.7 million, while its headline earnings per share declined by 12.2% to 98.5 cents.

It grew its group revenue by 6.8% to R25 billion during the period under review.

The impact of chicken imports is felt by the company on its Ebitda which declined by 12.8% to R1.8 billion. Excluding the chicken and sugar businesses, its Ebitda would have increased by 12.4% to R1.5 billion.

RCL Food's CEO Miles Dally says the company is in a difficult space due to the losses it's making due to South Africa's open door to cheap chicken imports largely from Brazil. "We really need to have a hard look at the chicken industry which is in crisis. We can't continue making little money like we have in the past five years," Dally tells Moneyweb. He adds that South Africa has recorded chicken imports of about 30 000 tonnes in the past month, which is bigger than what Rainbow Chicken sells in the retail market.

"Irrespective of the rand having halved in the last year, the chicken is coming in and we can't continue with the status quo even though we have been talking about this with the government for five years now."

The renewal of the African Growth and Opportunity Act (Agoa) between the United States and South Africa, which will see the import of 65 000 tonnes of chicken without anti-dumping duty, was largely supported given the continued trade relations between both countries. But chicken producers have warned that Agoa might have a detrimental impact on the poultry industry and job preservation.

³ Mahlaka



Despite the headwinds in the domestic poultry industry, the company is now embarking on a review of its chicken business model, which Dally says cannot yet be unveiled.

In the interim, the company is focusing on growing higher-margin added-value categories. Among the added-value categories that RCL Foods is looking to grow is the supply of chicken to quick-service restaurants such as KFC and Nandos.

“Five or six years ago we got roughly six birds out of 100 that are in their [restaurants’] weight range. The remaining chickens had to be put somewhere else. We now get 46 out of 100 in their weight range. And we can make a decent margin here,” Dally explains.



This type of risk will thus have a direct impact on the business or group of businesses, or the sector being impacted by specific events. In the case of RCL foods in the example above, one can see the impact of the alleged dumping of chicken on the decrease in the RCL share price during the second half of 2016. As the title of the newspaper article suggests, we can also see that the entire ‘SA chicken industry’ was impacted by this event.

Diversifying into assets in different industries or different sectors will reduce market-specific or sector-specific risk.

⁴ Google Finance



3.5 Geographic Location Risk

Geographic location risk is the risk to an investment as a result of being located in a particular geographic area. Being invested in a particular geographic location means that your investment will be sensitive to aspects that are specific to that geographic location, for example, a drought that reduces production of crops, or floods and other natural disasters that may impact negatively on the entire market in that geographic location.

Geographic location risk is an unsystematic risk that can be reduced by diversifying into assets in different geographic locations.

3.6 Risk Associated with Active and Passive Investment Portfolio Management.

Active and passive fund management are two different investment strategies used in the investment arena, and after decades, there is still ongoing debate about which approach is better.

We discuss each style, its advantages, disadvantages and uses below.

3.6.1 Active vs Passive Fund Management Style

Active fund management means that a professional asset manager/ fund manager makes tactical decisions to buy or sell certain assets in the fund, based on his/ her view of opportunities in the market, in order to try and achieve superior growth in the fund (better growth than the average growth in the market); or to protect investors' capital by losing less value when markets fall, by opting out of certain assets and exposure to certain market sectors.

According to Investopedia (2022), "Active investing refers to an investment strategy that involves ongoing buying and selling activity by the investor. Active investors purchase investments and continuously monitor their activity to exploit profitable conditions."⁵

Passive fund management, on the other hand, means that your fund will simply track the market, which is often represented by a specific index, for example the FTSE/ JSE Top 40 index, which tracks the 40 biggest companies on the Johannesburg Securities Exchange. Passive funds are essentially run by computer and will replicate all of the assets in a particular market, or represented in a particular index, to give you a return that mirrors the return in the market.

This approach is based on the 'efficient market hypothesis,' which proposes that markets are efficient, since investors have free access to information on share prices, companies, social

⁵ Investopedia (a)



and political environment, etcetera; and 'price' these factors in already when deciding to buy/sell shares at certain prices. Therefore, over time, it is virtually impossible to beat the market.

In contrast to actively managed funds, passive funds use a buy-and-hold strategy to profit from long-term trends in the market, rather than trying to beat short-term trends.

3.6.2 Advantages and Disadvantages of Active vs Passive Fund Management

Some **advantages of active fund management** include the following:

- It can provide 'peace of mind' to the investor, knowing that a knowledgeable person is managing their investments.
- Active fund managers who get their investment decisions right, can beat average market growth, especially in times of good market performance.
- Active fund managers can also shield investors from the full extent of a market downswing by switching assets to create less exposure to equities, for example.

Some **disadvantages of active fund management** include the following:

- Actively managed funds have high fees attached to them. Typically, the fees on an actively managed fund are at least twice as much as what you would pay for a passively managed fund. The risk is that, over time, the higher fees may have a significant negative impact on investment growth.
- Active fund managers may make bad investment choices or follow unsound theories in managing the fund, which will lead to poor investment returns (in addition to the higher costs).
- There have been numerous studies done covering different time periods to determine how successful active fund managers are at beating the market, and the majority of these studies have concluded that, although there are some funds that do tend to consistently beat the market, on the whole there seems to be more funds that underperform than outperform their benchmark index, especially over longer periods of time.

Some **advantages of passive fund management** include the following:

- It reduces costs due to the 'passive buy-and-hold' strategy, and this can have a significant impact on real returns (after the deduction of costs), over time.
- Passive fund management can be said to provide simplicity, in the sense that the investor knows what they are getting – a replica of all the shares in the market or index being tracked.
- Passive funds offer a low-cost method of diversification since shares representing the entire index are bought.
- In a passive fund, the investor is not at risk of being exposed to bad management decisions.



- Since passive funds are invested in an entire market, investors automatically benefit from upswings in that market.

Some **disadvantages of passive fund management** include the following:

- With passively managed funds, investors cannot ever outperform the market and, when costs are included, a passive fund will effectively always underperform the market.
- When the market experiences a downswing, investors automatically experience the full extent of the downswing in their investment, since there is no active fund manager that could shield them from full exposure to the market.

3.6.3 When is Active and Passive Management an Appropriate Style for Investors?

Active management is appropriate for investors who want to invest in specialised equity markets that require specialised knowledge and expertise, to take advantage of inefficient pricing. For example, emerging markets, small-cap stocks, and companies involved in resources and metals mining. Active management may also be appropriate for investors who want an experienced professional to make tactical investment decisions to outperform the market, and to shield them from negative market volatility.

Passive management is appropriate for investors who want a well-diversified holding of well-known popular shares (such as large cap shares, for example, as tracked by the FTSE/ JSE Top 40 index), and who are comfortable to ride out the short-term market fluctuations.

Increasingly, fund managers are also trying to make the best of both worlds using a blended approach, where parts of a portfolio may be passively managed, whilst other parts may be actively managed.



Activity:

Below are extracts from the objectives/ focus of two different collective investment portfolios. Read both extracts and then state, for each of the funds (XYZ and UVW), whether it is actively or passively managed. Motivate your answers. Once you've answered the questions, check your answers at the end of this topic.

Extract from **XYZ Fund** focus statement:

The XYZ Fund is a specialist equity fund which is designed to replicate the performance of the top 40 shares of the FTSE/ JSE Africa Top 40 Index over time.



The fund manager aims to track the movements and replicate the performance of the FTSE/ JSE Africa Top 40 Index by investing in the correct ratios, weightings, and proportions of the top 40 shares.

Extract from **UVW Fund** focus statement:

The UVW fund aims to deliver a stable and growing capital and income base, via a balanced and diversified portfolio.

In order to achieve its objectives, the fund invests in a flexible combination of asset classes ranging from equities, bonds, property, money-market instruments and other assets in liquid form.

Answers:

The XYZ fund is passively managed. We can see this from the statement that the fund manager is 'tracking' the movements and 'replicating' the performance of the FTSE/ JSE Africa Top 40 Index by investing in the correct ratios, weightings, and proportions of the top 40 shares.

The UVW fund is actively managed. We can see this from the statement that the fund invests in a flexible combination of asset classes to achieve its objectives, meaning a fund manager actively decides which asset classes to invest in.



Unit 3 Summary

In this module, we discussed the risk-return relationship between different asset classes, and how different types of risk impact on different asset classes.

We considered a systematic risk (also called market risk), which is the risk of losing investment value due to broad macro-economic factors – for example uncertainty about economic conditions, inflation, interest rates, wars, or recessions – which affect the performance of an entire market or even the entire global market. Systematic risk can be only partially mitigated through diversification into different asset classes, as it tends to impact the entire economy and will affect all asset classes to a larger or lesser degree.

Systematic risk factors we discussed included:

- Economic and business cycles that have an upside or downside impact (at different phases of the cycle), mainly on equity prices, interest rates and bond values, but also on commodity prices (such as gold) and property prices.
- Fiscal and monetary policies which, when applied sensibly, provide stability and certainty in the market, to create the right environment for long-term growth in the economy, leading to a situation where equity prices will achieve growth levels in excess of inflation over the longer term.
- Inflation risk, which is the risk that the value (or buying power) of an investment in real terms will decrease over time, due to the returns on the investment being less than inflation. This risk has an especially negative impact on lower-risk, lower-growth assets such as cash, and can be mitigated by diversifying one's investment to include asset classes such as property and equities, which have the potential to yield returns exceeding inflation over time.
- Interest-rate risk, which will have a direct impact on cash (money market) asset returns, i.e. the returns increase directly as a result of increases in interest rates, and vice versa. It will also have an inverse impact on the tradeable asset value of bonds, i.e. when interest rates increase, bond values decrease, due to the fact that a new bond instrument would yield a higher interest rate, and vice versa. Equities and property asset values are impacted indirectly due to the higher costs of servicing debt when interest rates increase.
- Currency risk, which impacts macro-economic factors such as exports/ imports.

Unsystematic risk factors we discussed included:

- Currency risk, which is the risk that investment returns (in a specific currency), will be eroded due to a weakening in value of that currency. This risk can be reduced by diversifying one's investment to include other currencies.



- Market-timing risk, which is the risk that an investor or asset manager buying or selling assets to speculate on predictions of future market movements or 'hot' market sectors may get their predictions wrong and lose money in the process. Rand-cost averaging is one method that can be used to reduce this risk.
- Market-specific risk (and sector-specific risk) relates to risk that is specific to a business or small group of businesses, or to a specific business sector. This type of risk impacts the share prices of the business or group of businesses, or market sectors involved, only. Depending on the event, the impact could be positive or negative. Market-specific risks can be reduced through diversifying investments in different markets and sectors.
- Geographic location risk is the risk to an investment as a result of being located in a particular geographic area. Being invested in a particular geographic location means that your investment will be sensitive to aspects that are specific to that geographic location, such as a drought or floods and other natural disasters. Diversifying into assets in different geographic locations will reduce geographic location risk.

We also looked at the risks, as well as advantages and disadvantages of active and passive investing:

- Active investing can produce superior returns, especially in times of good market performance, and can also shield investors from the full effects of a market downswing.
- However, active funds are associated with higher fee levels, and, over time, research has shown that few active fund managers are able to consistently outperform the market.
- Active fund management may be more appropriate when investing in a specialist fund in a specific market sector where the expertise of a specialist can make a big difference to the fund growth. In addition, the fund manager may have access to additional little-known assets for diversification (such as private equity) that are not available to the ordinary investor, and which would thus not be represented in an index-tracked fund.
- Active fund management may also be appropriate when investors want a risk-managed fund with the ability to get out of certain shareholdings or sectors when the risks get too large.
- Passive fund management reduces costs, which can have a positive impact on overall returns over time.
- Passive fund management also offers the investor a low-cost method of diversification, as one is practically buying the index.

A disadvantage of passive fund management is that the investor is exposed to the full impact of market downswings. For this reason, passive funds should only be recommended to investors who are willing and able to ride out the short-term market fluctuations, and who are investing for the longer term.



Unit 4: Participatory Interests in one or more Collective Investment Schemes and Hedge Funds

You will recall that we have looked at collective investment schemes (CISs) in the *Economic and Investment Overview* module. In this unit, we will take a closer look at CISs as an investment instrument.

A Collective Investment Scheme (CIS) is an investment vehicle that pools contributions from multiple investors to buy a diversified range of assets such as shares, bonds, property, and money market instruments. Under the Collective Investment Schemes Control Act (CISCA) of 2002, these schemes operate under strict regulatory oversight. Participatory interests in a CIS represent an investor's proportional share of the total assets in the fund. It is a product in which the contributions from different investors are pooled together and then used to buy shares, bonds, property, money-market instruments, and other securities. The total value of this pool of invested money is divided into identical units, called participatory interests, each unit containing the same proportion of all assets in the portfolio. Each investor's participatory interest is determined by the number of units he/ she owns, which, in turn, depends on how much he/ she has contributed and at what price. Investors share in the fund's gains, losses, income, and expenses in proportion to their participatory holding in the CIS.

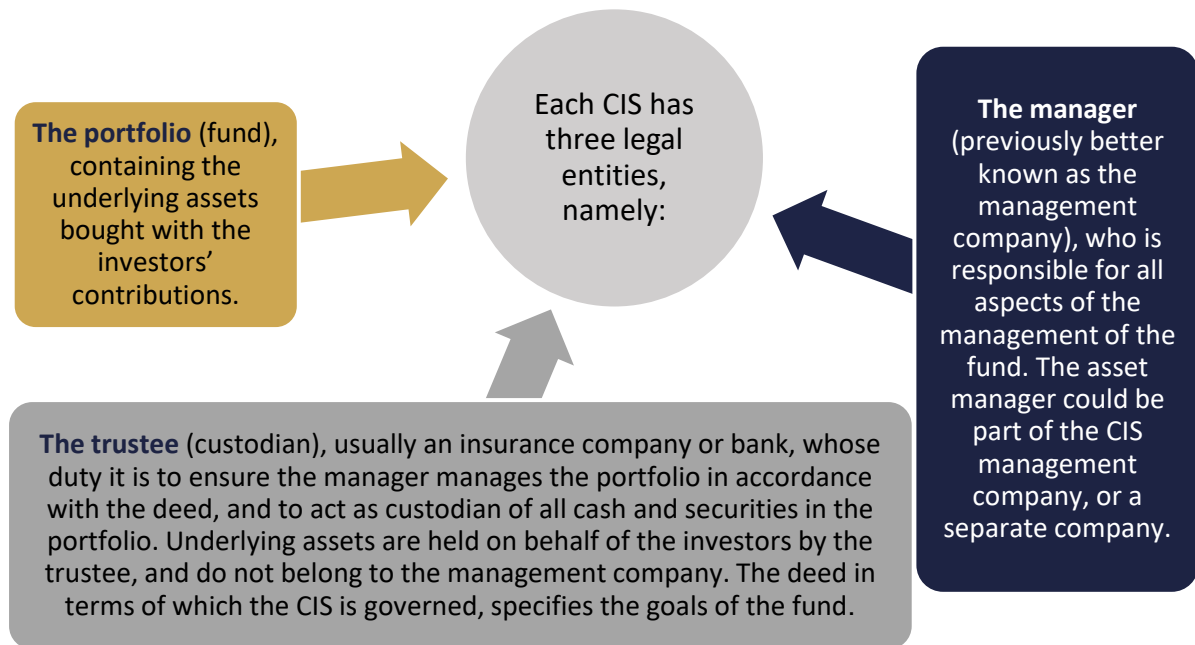
We use the terms **“fund,” “unit trust,” “portfolio”** and **“collective investment scheme”** interchangeably. Under the Collective Investment Scheme Control Act (CISCA) of 2002, “Collective Investment Schemes” include a variety of instruments, including unit trusts, hedge funds, open-ended investment schemes, participatory bonds, declared collective investment schemes and collective investment schemes in property. The predominant type of CIS known to South African investors is the unit trust (a portfolio held in trust for investors by the trustee). Under the same act, “participatory interest” means “any interest, undivided share or share, whether called participatory interest, unit or by any other name...”¹

¹ Source: Profile's Unit Trusts & Collective Investments (March 2017), p53



4.1 Terms, Features, and Benefits of Participatory Interests in one or more Collective Investment Schemes

4.1.1 Structure of Collective Investment Schemes



The other important role player is **the investor** (unit holder), who gains ownership of units in the fund through his/ her contributions. The investor does not own the unit trust – he/ she owns a few units in the fund, i.e. the investor holds a participatory interest in a fund. He/ she may sell these units back to the management company, or keep them, or buy new units; but cannot trade them.

CIS managers are required to operate within the **mandates** laid down by ASISA and the Financial Services Conduct Authority (FSCA) (formerly the FSB). The primary purpose of these mandates is to protect the investments of unit trust holders.



Activity:

What is the correct term to use when referring to the 'units' an investor holds in a CIS?

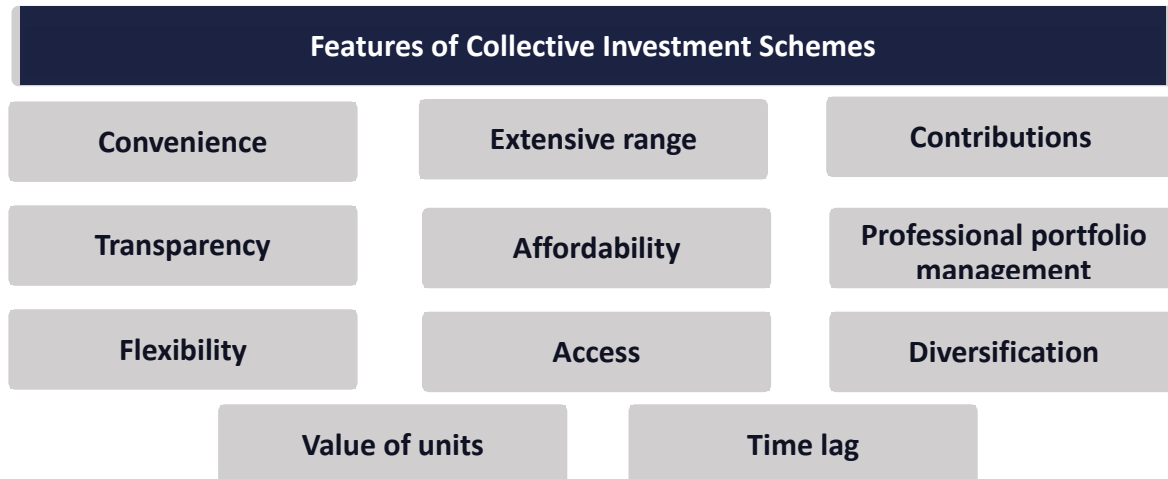
Answer:

Participatory interest



4.1.2 Features and Benefits

The popularity of unit trusts as an investment instrument can be ascribed to features such as simplicity, convenience, affordability, transparency, liquidity, and flexibility. The extensive range of unit trusts cater for all types of investors and can accommodate any risk preference.



Let's have a look at each of these features a bit more extensively:

i. Convenience

From the investor's perspective, a CIS is a convenient and relatively simple investment. All the investor has to do is select a fund or compose a portfolio of unit trusts to suit his objectives and risk preferences, sign a debit order, and forget about it until it is time for a review. The portfolio manager looks after the investment, making all the investment decisions and doing the buying and selling of assets on his/ her behalf.

Most CIS companies offer clients the convenience to buy or sell directly from the company via the internet, toll-free numbers, or customer help desk, instead of through an intermediary.

ii. Transparency

Ever since the implementation of CISC, CISs have a high degree of transparency. There are strict requirements for the disclosure of fees, costs, and charges. Investors know exactly how much of their contribution is invested, and what charges will be applied to an investment portfolio. Since the implementation of Effective Annual Cost in 2016, the effect of these costs must be displayed as well, in a prescribed manner.

iii. Flexibility

Extremely flexible in respect of terms, contributions, and withdrawals, compared to endowment or sinking fund policies, retirement annuities and structured investments.



iv. Extensive range

The range of CISs is so extensive that virtually all types of investors with all degrees of risk preferences can be accommodated.

v. Affordability

The minimum monthly contribution varies by fund, but most unit trusts now require at least R500 per month, with minimum lump sum contributions ranging between R5 000 and R10 000. These figures may vary depending on the fund provider and the investment mandate. Regular contributions can be set to escalate at fixed or inflation-linked rates.

vi. Access

Investors can invest directly into a CIS of their choice, but they can also invest indirectly via other product wrappers. Most product wrappers, including endowment and sinking funds, retirement annuities, preservation funds, pension and provident funds, and investment-linked life annuities, have CISs as their underlying investments. Investors can select an underlying portfolio consisting of various funds to support their investment objectives.

vii. Contributions

Contributions are flexible and can be made on a regular or ad hoc basis. Regular contributions are not contractual and can be ceased, reduced, or increased at any time, without incurring additional transaction costs or penalties. The minimum monthly contribution per CIS can be as low as R100 p.m., while the minimum lump sum contribution can be as low as R1 000. These low entry levels enable small-time investors to enter and share in the benefits of this lucrative market. Regular contributions can also be set to escalate annually at fixed or inflation-linked rates.

viii. Professional portfolio management

Investors enjoy the benefit of expert portfolio management by a team of professionals, with access to research data and state-of-the-art tools to manage the investment on their behalf.

ix. Diversification

The most basic method of reducing risk. By spreading capital among different asset classes and sectors within an asset class, diversification within a CIS can protect the investor against unfavourable developments in the market. Due to the effects of diversification, CISs are less volatile than individual shares and are more likely to move in the direction of the general market.

x. Value of units

The price of a unit is directly related to the underlying value of the assets in the trust and will reflect the fluctuation on the corresponding equity, bond, and property markets.



xi. Time lag

CISs cannot be traded in real-time, like listed shares or OTCs, where the price is known almost instantaneously. Repurchasing transactions can only be concluded a day or two after the instructions were received, meaning that the investor does not know at what price he will be buying or selling his units.



Activity:

Indicate whether the following statement is true or false:
It is difficult for small-time investors to enter the CIS market.

Answer:

False. The minimum monthly contribution per CIS can be as low as R100 p.m., while the minimum lump sum contribution can be as low as R1 000. These low entry levels enable small-time investors to enter and share in the benefits of this lucrative market.

4.1.3 Other Important Investment Aspects to Consider.

RETURNS are received in the form of interest and dividends. A capital gain can be realised on the sale of the units. Returns are not guaranteed.

RISK

As investors own units in a pool that is spread over various assets and securities, managed by experts, their risk is reduced (compared to investments in direct shares). There are more than 900 portfolios to choose from, varying from low-risk money-market funds to high-risk equity specialist funds.

VOLATILITY

CIS depends on the choice of the underlying portfolios. The movement may, for example, be in line with the movement in the equity market if the CIS portfolio includes equities.

LIQUIDITY

The management company is obliged to repurchase all units offered to it at any given time; unlike listed shares, where the investor has to find a willing buyer first. This feature means that all collective investment schemes are liquid – they can be turned into cash within 48 hours.

A CIS investment is open-ended. As more investors join, more units are created. Collective investment schemes are not subject to any legislative or regulatory liquidity restrictions and are 100% liquid.



While the unit trust investment has no fixed term, a medium to long term is recommended, especially as so many CIS portfolios include equities. Even though they are liquid, they are influenced by changes in the market, which might make the liquidation of the investment at a particular time inappropriate, e.g. it may not be in the best interests of the investor to liquidate his investment at a time when the market is experiencing a downturn.

TAXATION

Depending on the nature of the underlying securities, CIS investments could be subject to income tax, dividend tax and capital gains tax. More about this in Unit 2.6.

INFLATION

CIS investments can outperform inflation over the longer term.

COST

Depending on the type of unit trust fund that the investor chooses, fees will differ. All unit trusts are allowed to deduct initial fees and annual fees (more about this in Unit 2.2).



Activity:

Which of the following statements regarding Collective Investments Schemes is CORRECT?

- a) Returns on CIS investments are guaranteed.
- b) CIS investments are exempt from CGT.
- c) CIS investments can outperform inflation over an extended investment period.
- d) A drawback of a CIS is that it is illiquid.

Answer:

c) is the correct answer.



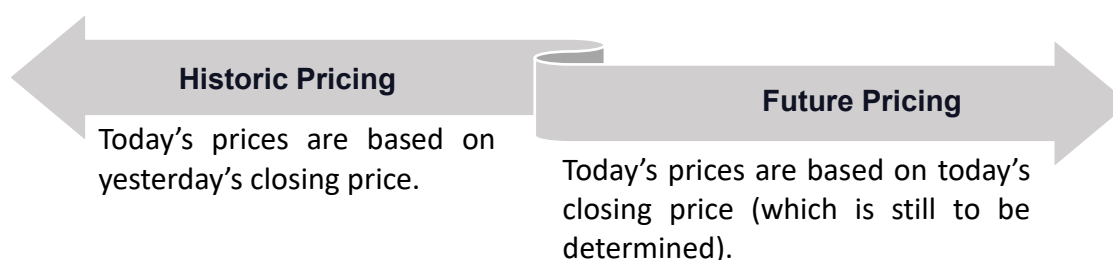
4.2 Typical fee Structures, Charges and other Costs Associated with Participatory Interests in one or more Collective Investment Schemes.

Unit Price

To calculate the price of each unit, the net asset value (NAV) of the fund is divided by the number of units in the fund. This is the price that is published and used for buying and selling units. The price of units in a collective investment scheme is determined and published on a daily basis. To determine the net asset value, permissible deductions are deducted from the gross investment value, and these include any costs relating to the running of the portfolio, such as trustee fees, audit fees, annual manager service fees, levies, brokerage fees and securities transfer tax. What is left after costs, is then divided equally between the number of units.

The investor's fund value is calculated by multiplying his/ her number of units with the NAV. As the price fluctuates on a daily basis, the investor's fund value will also fluctuate.

Prices are calculated using either historic or future (forward) pricing.



Fees and Charges

In terms of CISCA, managers of collective investment schemes are allowed to charge both initial (upfront) and annual fees.

Initial Fees cover the costs of administration, marketing, and agent's commission. Most management companies no longer charge an initial fee. Initial charges are deducted from the initial investment amount before participatory units are bought.

Annual Fees include the fees charged by the management company for asset management and related services and are expressed as a percentage of the funds under management. Some fund managers include performance fees. Although fund management fees are quoted as an annual percentage, in practice, the annual fees are calculated and recovered daily or monthly. These funds may only be recovered from the accrued income of the fund, and not from the capital invested. Annual fund management fees now typically range between 0.15% and 3.50%, with index-tracking funds charging lower fees (0.15% - 1.00%) and actively



managed funds charging higher fees (1.00% - 3.50%). The latest Total Expense Ratio (TER) calculations must reflect performance fees where applicable. Money-market funds usually do not charge initial fees. Annual service fees typically range from 0.11% to 0.57% p.a. on the money invested.

Bond funds typically charge zero initial fees and annual fees of between 0.11% and 1.71%.

Equity-based schemes vary considerably in their costs. Actively managed funds, of which the specialist funds are the most expensive, charge higher fees than index-based funds, which are less expensive to manage. Annual fees will be higher than for money-market and bond funds.

Performance fees typically reward fund managers for outperforming a specified benchmark and can be levied in addition to the quoted annual management fee. Different fund managers have different ways of calculating and applying performance fees.

Broker fees or **commissions** are negotiable between broker and client, must be fully disclosed, and must be explicitly approved by the client. Commission can be paid upfront or annually; and is deducted from the contribution before the balance is used to purchase units. In the case of a lump sum investment, annual advice fees or trailer fees are funded by selling units every month to the value of the fee payable. In the case of recurring contributions, the trailer fees will be deducted from each new contribution before the balance is used to purchase new units.

Total Expense Ratio (TER) is a measurement of costs that applies specifically to collective investment schemes. It refers to the total expenditure incurred by a fund manager in relation to the management and administration of a fund expressed as an annual percentage. TER has to be recalculated every quarter. It does not take any costs that are not directly related to the fund into account, such as advisory fees, transaction, and platform fees. Most fund managers include fund performance fees are included in TER calculations.



Activity:

Which of the following statements regarding CIS costs is CORRECT?

- a) The Total Expense Ratio takes into account all costs directly and indirectly related to the fund.
- b) Commissions are paid on an annual basis only.
- c) Initial charges are deducted from the initial investment amount after participatory units have been bought.
- d) Although quoted as an annual percentage, in practice, the annual fees are calculated and recovered daily or monthly.



Answer:

d) is the correct answer.

4.2.1 Effective Annual Cost (EAC)

The Effective Annual Cost (EAC) Standard, implemented by ASISA, ensures full transparency on investment costs. The four cost components—Investment Management Charges, Advice Charges, Administration Charges, and Other Charges—must be disclosed for investment periods of 1, 3, 5 years, and full-term maturity. As of 2023, all financial product providers must present EAC in a standardised format to facilitate comparison.

The four components that have to be disclosed under EAC are:

- Investment management charges – costs and charges for the management of the underlying investment portfolios
- Advice charges – initial and annual fees on lump sum and recurring contributions
- Administration charges – all admin charges
- Other charges – this includes termination charges, penalties, bonuses, costs of guarantees, etc.

Below is an extract from a typical Minimum Disclosure Document (MDD), also known as a fund fact sheet. Costs, fees, and charges must be disclosed, and must include details of the fund management fees, TER and how it was calculated, and information on where to find more details pertaining to the EAC of an individual's investment.



Fees (Incl. VAT)

Retail Class (%)

Advice initial fee (max.)	3.42
Manager initial fee	N/A
Advice annual fee (max.)	1.14
Manager annual fee	1.25
Total Expense Ratio (TER)	1.60

Advice fee | Any advice fee is negotiable between the client and their financial advisor. An annual advice fee negotiated is paid via a repurchase of units from the investor.

Obtain a personalised cost estimate before investing by visiting www.sanlamunitrustsmdd.co.za and using our **Effective Annual Cost (EAC)** calculator. Alternatively, contact us at 0860 100 266.

The portfolio manager may borrow up to 10% of the market value of the portfolio to bridge insufficient liquidity. This fund is also available via certain LISPS (Linked Investment Service Providers), which levy their own fees. Fluctuations or movements in exchange rates may cause the value of underlying international investments to go up or down.

Total Expense Ratio (TER) | PERIOD: 1 April 2014 to 31 March 2017

Total Expense Ratio (TER) | 1.60% of the value of the Financial Product was incurred as expenses relating to the administration of the Financial Product. A higher TER does not necessarily imply a poor return, nor does a low TER imply a good return. The current TER may not necessarily be an accurate indication of future TER's. Inclusive of the TER of 1.60%, a performance fee of 0.31% of the net asset value of the class of participatory interest of the portfolio was recovered.

Transaction Cost (TC) | 0.28% of the value of the Financial Product was incurred as costs relating to the buying and selling of the assets underlying the Financial Product. Transaction Costs are a necessary cost in administering the Financial Product and impacts Financial Product returns. It should not be considered in isolation as returns may be impacted by many other factors over time

including market returns, the type of Financial Product, the investment decisions of the investment manager and the TER.

Total Investment Charges (TER + TC) | 1.88% of the value of the Financial Product was incurred as costs relating to the investment of the Financial Product.

Manager Performance Fee (incl. VAT) | Performance Fee Benchmark: FTSE/JSE All Share Index
Base Fee: 1.25%, Fee at benchmark: 1.25%, Fee hurdle: FTSE/JSE All Share Index
Sharing ratio: 20%, Minimum fee: 1.25%, Maximum fee: 3.42%, Fee example: 1.25% p.a. if the fund performs in line with its Performance Fee benchmark being FTSE/JSE All Share Index.

The performance fee is accrued daily, based on performance over a rolling one year period with payment to the manager being made monthly. Performance fees will only be charged once the performance fee benchmark is outperformed and only if the fund performance is positive. A copy of the performance fee FAQ is available on www.sanlamunitrusts.co.za.



Activity:

Indicate whether the following statement is true or false:

The components that have to be disclosed under EAC are investment management charges, advice charges, administration charges, and other charges.

Answer:

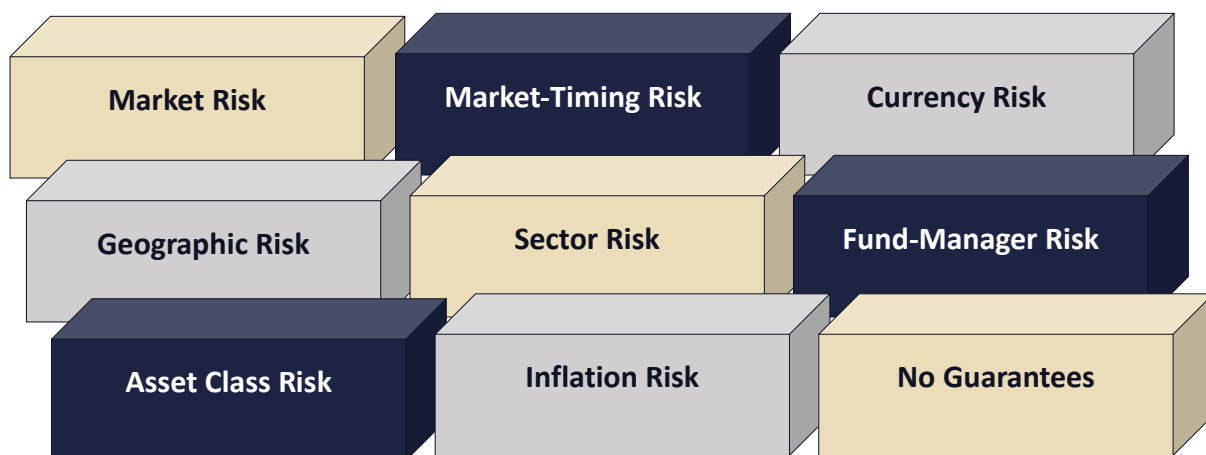
True

4.3 Risks Associated with Investing, Purchasing, and Transacting in Participatory Interests in one or more Collective Investment Schemes.

Some of the information in this unit will be familiar to you from the *Economic and Investment Overview* module. Risk is such an important factor that it will always feature in any investment-related study content. In this unit we will take another look at the types of risk that are typically associated with investment in collective investment schemes. We will then have a closer look at some risk measurement techniques that are commonly used by fund managers in their Minimum Disclosure Documents (MDDs).

Depending on the underlying asset classes, investment mandates and fund management approach, the risks associated with collective investment schemes can range from ultra-conservative to hyper-aggressive.

There are many different types of risks associated with investment in collective investment schemes. These include:





Let's have a look at each of these risks in a bit more detail:

Market risk is the risk that the value of a portfolio is impacted negatively as a result of fluctuations in the market.

Market-timing risk is the danger of judging market movements wrong when trying to exploit market cycles for optimum profit. Fund managers of multi-asset funds, especially flexible and high equity funds, take full advantage of market timing by shifting market exposure according to their view of expected market movements, as their mandates allow them to invest in different assets and sectors. Managers of theme or sector funds do not have the same freedom to invest outside of their mandated sector. Investors trying to buy or sell a gold fund or a bond fund at just the right moment need the expertise to time it right.

Currency risk is the risk of having investment returns eroded by a weak currency. South Africans can protect themselves against the risk of the rand depreciating by investing in funds that hold offshore assets and rand hedge stocks, whose value appreciates when the rand depreciates. During times of rand appreciation, currency risk can be reduced by being exposed to importing companies. The returns on an offshore investment will be impacted negatively by a stronger rand when the investment is converted into rands.

Geographic risk is the risk caused by different markets performing differently in different countries. South Africans should be careful not to amplify the risks of the local market by selecting regions that are also emerging markets and commodity heavy.

Sector risk – Different sectors of the market perform well under different circumstances and at different times. Having all of the assets in a portfolio invested in one sector, like in a theme fund, is high risk. A specialist fund, such as a gold fund, carries a much higher risk than a general equity fund, as the latter is invested across several sectors within the equity market. Spreading the assets between different sectors will reduce the sector risk but also means that the portfolio will always be exposed to the underperforming sectors.

Fund-manager risk is the risk that the fund manager in charge of the active investment decisions fails to perform according to expectations. Investors should mitigate this risk by including funds with different management styles or from different investment houses in their portfolios.

Interest-rate risk – Interest rate fluctuations impact different asset classes in the following ways:

- **Cash & Money Market Funds:** Higher interest rates increase returns on money market instruments.



- **Bonds:** Long-term bonds decline in value when rates rise, as newly issued bonds offer better yields.
- **Equities:** Rising rates reduce corporate borrowing and spending, potentially affecting stock market returns.
- **Property:** Higher interest rates lower demand for mortgages, negatively impacting property valuations and REITs.

Recent Developments (2023-2024): In South Africa, the Repo Rate remains elevated, impacting bond yields and equity markets. Investors should consider laddering bond portfolios to manage risk.

Bonds, on the other hand, especially longer-term bonds which are often traded in the secondary market, are negatively impacted by a rise in interest rates. This is because when interest rates rise, newly issued bonds will reflect the higher interest rate and make the older bonds less attractive in comparison. If interest rates drop, the value of an older bond will increase, as its higher interest rate will make it relatively more attractive in comparison to newly issued bonds that reflect the lower interest rate.

Equities are less directly impacted by changes in interest rates but are impacted indirectly. For example, if interest rates increase, consumers will need to pay more money to service their loans and will have less disposable income to spend on products and services, which will lead to a decreased demand and thus lower growth in businesses, which would have the effect of decreasing the share prices. Businesses too, will tend to 'spend less,' and may delay capital purchases due to the higher costs of servicing the loans they would need to take out to make the purchases – this could lead to less expansion, less production or slower growth, and ultimately a reduction in returns of the share price.

Property is also impacted indirectly. For example, if interest rates go up, consumers may decide to target a lower-priced property, as the higher-priced property may be too expensive (taking into account the higher interest costs), or they may decide against taking out a mortgage and buying property – leading to lower demand. Both these factors will cause property prices to decrease. Property companies who make use of loans to buy properties for rent may also have to pay a higher percentage of their rental income to service debt, thereby decreasing their profits. Their customers, in turn, may also target lower-priced rental properties leading to decreased rental income.

Asset class risk – each asset class presents its own risks.

- **Money-market instruments**, although in themselves not risky instruments, with a very low or no risk of absolute loss, nevertheless carry the risk of low real returns (after tax), as well as interest-rate risk. The longer the term, the bigger the inflation risk. Money-market funds have high liquidity, allowing investors to make withdrawals and additional contributions on an ad hoc basis.



- Bonds and gilts present an even bigger interest-rate risk than money-market instruments. Bond prices go down when interest rates go up, which could potentially result in significant losses.
- Equities carry a risk of negative returns, as they are subject to volatile price changes.
- Derivatives amplify the risks inherent in the underlying assets but can also reduce the risk in a portfolio were used appropriately as hedging instruments.

By following diversification strategies within the scope of the fund's mandate, fund managers can reduce the effects of risks posed by any one asset class or sector. By including assets with a low or negative correlation to one another, the fund manager can reduce the downside risk in the portfolio.

In terms of CISCA, no more than 10% of a fund's value may be invested in unlisted shares. Specialist funds may not invest more than 35% in any single share, and multi-asset funds are limited to 20% per single share.

Inflation risk – Inflation has the effect of decreasing the buying power of your money. Inflation risk in an investment point to the risk that the returns could underperform the rate of inflation over the term, meaning that your investment will be worth less, in real terms, when realised. This risk is more prevalent in conservative and cautious funds, and primarily associated with money-market instruments and, to a lesser extent, bonds.

Guarantees – There are no guarantees in collective investment schemes, regardless of the underlying assets or instruments. Not even money-market funds or bond funds, or funds that are primarily invested in money-market instruments and bonds, carry any guarantee, despite the fact that their underlying instruments carry guarantees.



Activity:

Indicate the type of risk being described in each of the instances below:

1. The risk that the fund manager in charge of the active investment decisions fails to perform according to expectations: _____.
2. The risk of having investment returns eroded by a weak currency: _____.
3. The risk that the value of a portfolio is impacted negatively as a result of fluctuations in the market: _____.
4. The risk caused by different markets performing differently in different countries: _____.
5. The risk that the returns underperform the rate of inflation over the term: _____.



Answer:

1. The risk that the fund manager in charge of the active investment decisions fails to perform according to expectations: Fund-manager risk.
2. The risk of having investment returns eroded by a weak currency: Currency risk.
3. The risk that the value of a portfolio is impacted negatively as a result of fluctuations in the market: Market risk.
4. The risk caused by different markets performing differently in different countries: Geographic risk.
5. The risk that the returns underperform the rate of inflation over the term: Inflation Risk.

4.3.1 Risk Measurements Disclosed in a Minimum Disclosure Document (MDD)

You will recall that we looked at fund fact sheets (minimum disclosure documents), and some of the information disclosed in them, in the *Economic and Investments Overview* module. Investors and their advisors should be familiar with the type of information on MDDs, and how to use it to their best advantage, when considering investment in collective investment schemes.

Minimum Disclosure Documents (MDDs)

MDDs, commonly known as fund fact sheets, must be updated every quarter and must include the essential characteristics of a portfolio, which will enable an investor to understand the nature and the risks of the portfolio and make informed investment decisions. This includes, amongst others, the:

- investment objective and a summary of the investment policy
- risk-reward profile of the investment.
- portfolio benchmark
- date and amounts of income distributions.
- fees and charges (total expense ratio, management fees, initial fees, performance fees, advisory fees, and any other applicable fees)
- portfolio category or classification
- performance of the portfolio
- asset allocation

Below are extracts from a typical fund fact sheet, displaying the required disclosures that speak to the risk profile of the fund, its objective, and its strategy. This is the type of information that the investor should scrutinise before deciding to invest in a fund, to ensure that he is comfortable with the level of risk.



Fund Information

ASISA Fund Classification	SA - Equity - General
Risk profile	Aggressive
Benchmark	FTSE/JSE All Share Index

Risk statistics: 3 years to 31 Jul 2017

Std Deviation (Ann)	9.96
Sharpe Ratio (Ann)	(0.30)

Actual highest and lowest annual returns*

Highest Annual %	29.33
Lowest Annual %	(10.25)

Fund Objective

This is a pure equity fund diversified across all sectors of the JSE. This fund is suitable for investors who can withstand potential capital volatility in the shorter term.

Fund Strategy

This fund aims to outperform the FTSE/JSE All Share Index through active stock selection across all sectors and market capitalisation on the JSE. The fund may at any time hold a maximum of 25% in offshore assets. This fund may also invest in derivatives for efficient portfolio management.

Why choose this fund?

- *The fund offers a carefully selected, well diversified basket of shares from any sector on the JSE.
- *All shares are subject to rigorous, in-depth research and must adhere to SIM's pragmatic value investment philosophy.
- *This is a risky fund and is not for the short-term investor.
- *The fund aims to achieve maximum capital growth over the medium to long-term by investing in companies that are undervalued relative to realistic growth prospects.

In this example the reader's attention is drawn repeatedly to the fact that the fund is an actively managed, high-risk fund, which is only suitable for long-term aggressive investors who can tolerate volatility.

You will recall that we looked at the risk profiles of funds in the *Economic and Investment Overview* module, and how to match an individual's risk profile to a fund's risk characteristics. We will now take a closer look at some of the risk measurement techniques used for disclosing purposes, namely Standard Deviation, Annualised Volatility, Maximum Drawdown, and the Sharpe Ratio.



Standard Deviation

Standard Deviation is a method to measure volatility. It measures the possible range of outcomes around the expected return (the mean, or norm). The bigger the range, the higher is the deviation; or, put differently, the further the lowest and highest points of return move from the average expected return, the greater is the volatility of the fund. This means that the price of the fund can change dramatically over a short time period in either direction.

In our example that follows below, the annual standard deviation is 12.4%, which indicates a relatively high degree of volatility. A fund with a standard deviation of 8% has experienced less volatility over the period of measurement and can therefore be expected to show less volatility in future than a fund with a standard deviation of 12.4%.

Annualised volatility

Risk is also often referred to as volatility. Volatility has been discussed in several of the modules you have completed, as well as in Unit 2.3 of the current module. Volatility measures the extent to which an asset's (or portfolio's) price fluctuates around an average. For example, an investment in a fixed deposit has zero volatility, since, at any point in time, the average return, the expected return, and the actual return are exactly the same, at say 6%. However, for an investment in an equity fund, the average return, the expected return, and the actual return will be different, indicating a level of volatility.

There are various measures that can be used to measure exactly how much volatility (or risk) is inherent in an investment. We will now consider the 'annualised volatility' (derived from the standard deviation) that is provided as a measure of risk in most fund fact sheets, as well as the 'maximum drawdown' as risk evaluation technique.

Annualised volatility is a measure of how variable the returns for a fund have been around their historical average (also known as their standard deviation). The calculation that is used to determine annualised volatility is the standard deviation of 36 monthly returns presented as an annualised number.

But what exactly is the significance of this measure of risk? There are two important aspects to know about standard deviation (or annualised volatility):

1. Firstly, two funds may produce the same return over a period and may even be rated at a similar level of risk by the fund manager. The fund whose monthly returns have varied less will have a lower annualised volatility and can be considered to have achieved its returns with less risk. This should be borne in mind and discussed with the client when considering suitable funds.
2. Secondly, standard deviation also allows us to make certain predictions on the expected future return variations, based on the assumption that, over the long term, investment returns do tend to follow the normal bell-shaped distribution. This allows



us to make a generalisation that, when the standard deviation (or annualised volatility) is calculated for a particular portfolio, 68% of returns fall within one standard deviation of the mean (average) return, 95% of values fall within 2 standard deviations of the mean return and 99.7% of values fall within 3 standard deviations of the mean return for that portfolio.



Example of using annualised volatility to predict future returns:

Let's say we have two investment funds, the A Fund and the B Fund. Fund A's annualised return over the last three years was 17.5%, and its annualised volatility was 3.2. Fund B's annualised return over the last three years was 15.1%, and its annualised volatility was 1.0.

We can predict Fund A's expected future returns to be as follows:

1. 68% of the time, the growth on Fund A can be expected to come in anywhere between 14.3% ($17.5 - 3.2$) and 20.7% ($17.5 + 3.2$) (i.e. within 1 standard deviation of the average return).
2. 95% of the time, the growth on Fund A can be expected to come in anywhere between 11.1% ($17.5 - 2(3.2)$) and 23.9% ($17.5 + 2(3.2)$). (i.e. within 2 standard deviations of the average return).
3. 99.7% of the time, the growth on Fund A can be expected to come in anywhere between 7.9% ($17.5 - 3(3.2)$) and 27.1% ($17.5 + 3(3.2)$). (i.e. within 3 standard deviations of the average return).

We can predict Fund B's expected future returns to be as follows:

1. 68% of the time, the growth on B fund can be expected to come in anywhere between 14.1% and 16.1%.
2. 95% of the time, the growth on B fund can be expected to come in anywhere between 13.1% and 17.1%.
3. 99.7% of the time, the growth on B fund can be expected to come in anywhere between 12.1% and 18.1%.

If we compare the expected returns from these funds, we can see that Fund A's worst-case scenario growth could be as bad as 7.9%, while its best-case scenario growth could be as high as 27.1%. Two-thirds of the time, we could be lucky and have the growth of Fund A fall between 14.3% and 20.7%.

Fund B's worst-case scenario growth could be as bad as 12.1% (much higher than for Fund A), while its best-case scenario growth could be as high as 18.1% (much lower than Fund A). Two-thirds of the time, we could be lucky and have the growth of Fund B fall between 14.1% and



16.1%. Clients should be made aware of the significance of this easily available risk measurement, as they are then in a better position to understand the impact of volatility on their potential returns.



Research Activity:

How to calculate variance and standard deviation:

<http://www.macroption.com/calculate-variance-standard-deviation-4-steps/>

Why standard deviation is a useful measurement of investment risk and return:

<http://www.investinganswers.com/financial-dictionary/technical-analysis/standard-deviation-4948>

<https://www.mathsisfun.com/data/standard-normal-distribution.html>

Calculating the annualised volatility of a fund:

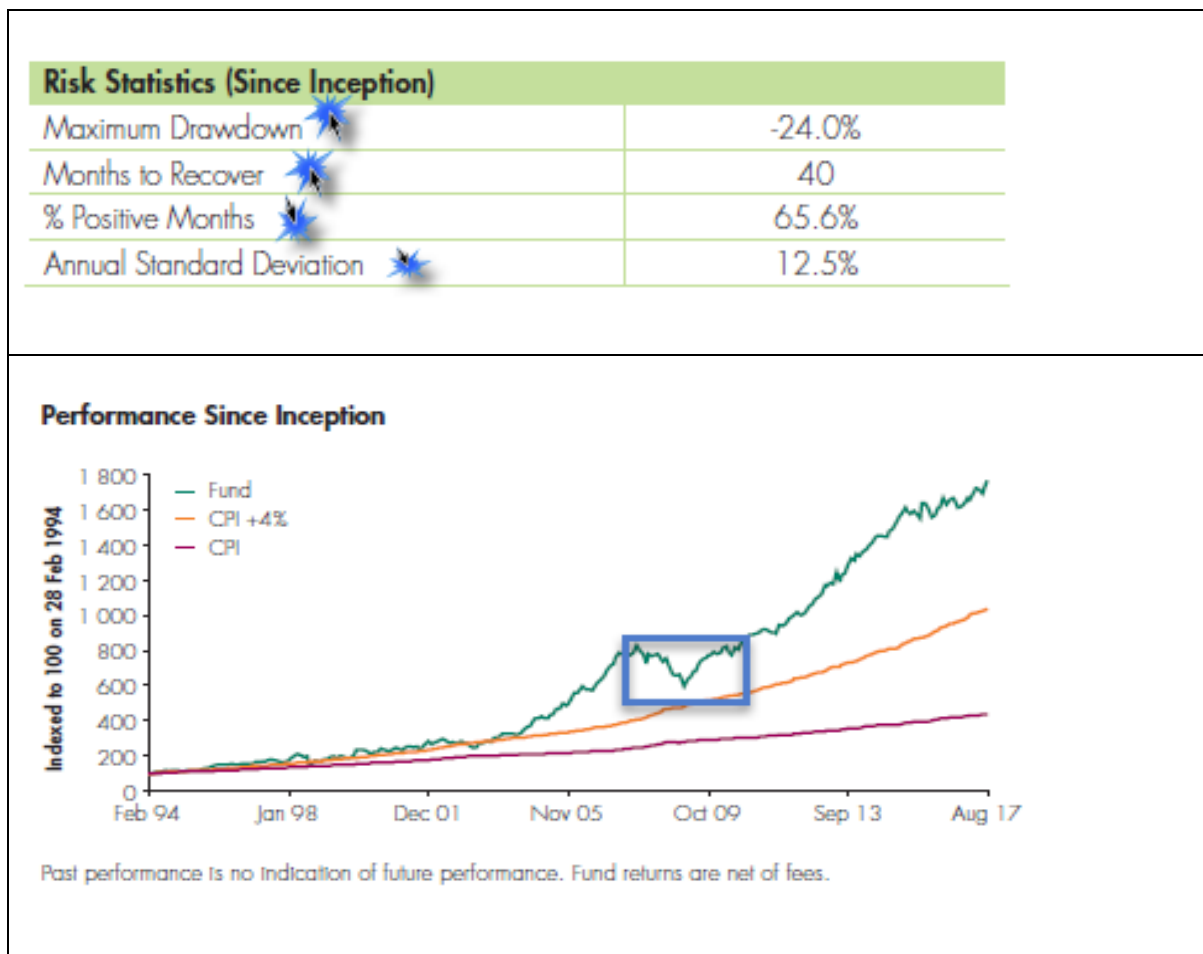
<https://www.fool.com/knowledge-center/how-to-calculate-annualized-volatility.aspx>

Maximum drawdown

Maximum drawdown is a risk measure that is used to illustrate the worst-case scenario, based on historical performance. It is always measured from the highest point (peak) to the next lowest point (trough). The specific time period used for calculating the maximum drawdown will make a huge difference to the result, e.g. the maximum drawdown of the JSE ALSI over the past 5 years could be about 15%, and over the past 10 years it could be about 46% and over the past 48 years it could be about 60%.

This presents a dilemma for the investor – what period should he used to determine the maximum drawdown for the fund he is considering? In the absence of a definitive answer, the best practice would be to use a term similar to the investment term he is considering, although the results could be misleading.

In the example below, the maximum drawdown for this particular fund is -24.0% over the time period (inception in March 1994 up to August 2017). This indicates the maximum monthly capital loss experienced between the highest point to the next lowest point. It took 40 months to recover to the same level as the previous peak.



In this example, the fund experienced 65,6% positive months since inception, which indicates there was a high percentage of months where the growth in the fund was not positive.

Sharpe Ratio

The Sharpe ratio is also sometimes displayed on a Minimum Disclosure Document to indicate a fund's riskiness, or volatility relative to its returns or the fund's risk-adjusted returns. It is a measurement that indicates the excess return generated per unit of risk. A fund's Sharpe ratio should be compared to that of its peers – a higher ratio means the fund generated higher risk-adjusted returns. This could be due to either higher returns or lower volatility, or a combination of the two. The higher the Sharpe ratio, the better the fund's returns are relative to the risks taken on to achieve those returns.



Activity:

Compare the risk statistics of the following two funds. Indicate which of the two funds indicate greater volatility.

Fund A (inception date: June 2013)

Risk Statistics (Since Inception)	
Maximum Drawdown	-5.6%
Months to Recover	N/A
% Positive Months	68.0%
Annual Standard Deviation	7.6%

Fund B (inception date: June 1992)

Risk Statistics (Since Inception)	
Maximum Drawdown	-26.9%
Months to Recover	35
% Positive Months	63.6%
Annual Standard Deviation	15.7%

Answer:

Fund B shows a higher standard deviation, indicating greater volatility over the last year.



Activity:

Compare the risk measurements of the two funds below. Which of the two funds displays a higher volatility, and why?

Fund A:

Risk statistics: 3 years to 31 Jul 2017

Std Deviation (Ann)	9.96
Sharpe Ratio (Ann)	0.30

Actual highest and lowest annual returns*

Highest Annual %	29.33
Lowest Annual %	(10.25)

Fund B:

Risk statistics: 3 years to 31 Jul 2017

Std Deviation (Ann)	3.82
Sharpe Ratio (Ann)	0.18

Actual highest and lowest annual returns*

Highest Annual %	13.70
Lowest Annual %	3.40

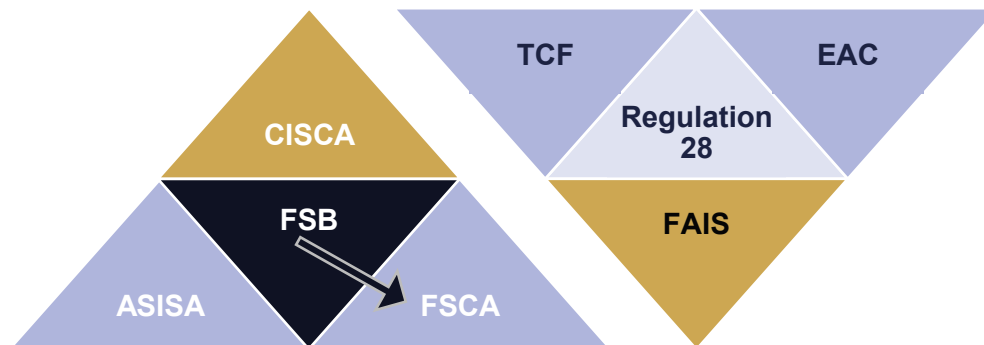
Answer:

Fund A, with a standard deviation of 9.96 has a higher volatility than Fund B, with a standard deviation of 3.82. Fund A however has a higher Sharpe ratio than Fund B. Remember, the higher the Sharpe ratio, the better the fund's returns are relative to the risks taken on to achieve those returns. Overall, Fund A has a higher risk-adjusted return than Fund A.



4.4 Legislation applicable to Participatory Interests in a Collective Investment Scheme

We have already looked at an overview of the financial services industry, as well as general legislation and codes of conduct in Unit 1 of this module. In this unit, we will again take a quick look at the main legislation that is currently applicable to Collective Investment Schemes.



Collective investment scheme management companies fall under the jurisdiction of the Collective Investment Schemes Control Act 45 of 2002 (**CISCA**).

The CIS industry is regulated by the Financial Services Conduct Authority (**FSCA**), previously known as the Financial Services Board (**FSB**), which has to ensure that the management companies adhere to their mandates. All collective investment schemes are required to register with the FSCA and to submit updated details every three months.

One example of the role played by the FSCA to regulate the conduct in the industry, is the strict regulation of advertising. In order to prevent unethical advertising that could lead to unrealistic investor expectations, all CIS companies must obtain prior approval from the FSCA for any advertising.

The CIS industry is represented by the Association for Savings and Investments South Africa (**ASISA**), an association that negotiates with the government and legal bodies, including the FSCA, on behalf of management companies. One example of the definitive role played by ASISA in this industry is the ASISA standard for fund classification (more information on this in Unit 2.5).

Any person giving financial advice to clients in a professional capacity is subject to the Financial Advisory and Intermediary Services Act (**FAIS**). Financial service providers (**FSPs**) have to be licensed and must meet the fit-and-proper requirements, namely personal characteristics of honesty and integrity, knowledge and skills, and financial soundness. Representatives of the FSP must also meet the fit-and-proper requirements and comply with the FAIS Code of Conduct. The Code tries to ensure the highest possible levels of professional conduct, integrity, and transparency.



The Treating Customers Fairly (**TCF**) principles aim to ensure that customers enjoy good service, simple communication, informed advice, and appropriate products from financial service providers.

Regulation 28 of the Pension Funds Act (PFA) limits asset allocation for retirement portfolios as follows:

- Equities: Maximum 75%
- Property: Maximum 25%
- Offshore investments: Maximum 45%
- Hedge funds and private equity: Maximum 15%

Recent Amendments (2023): Regulation 28 now allows private equity allocations to increase from 10% to 15%, enabling pension funds to diversify risk and access alternative investment opportunities.

CIS companies are required to adhere to the ASISA standard on Effective Annual Cost (**EAC**), which was implemented in October 2016.



Activity:

What do the following abbreviations/ acronyms stand for?

1. CISCA
2. FSCA
3. TCF
4. EAC
5. ASISA

Answers:

1. Collective Investment Schemes Control Act
2. Financial Services Conduct Authority
3. Treating Customers Fairly
4. Effective Annual Cost
5. Association for Savings and Investments South Africa



4.5 Investment Portfolio options for Different Clients

4.5.1 ASISA Classification of Collective Investment Schemes

Before we can understand the investment portfolio options, it is important to understand the fund classification system first.

ASISA's Three-Tier Classification System (2023 Update):

- **Geographical Focus:**
 - South African Funds: At least 55% in SA.
 - Worldwide Funds: Flexible allocation between SA and offshore assets.
 - Global Funds: Minimum 80% offshore exposure.
 - Regional Funds: At least 80% in a specific region (e.g., Africa, Asia, Europe).
- **Asset Allocation Focus:**
 - Equity Funds: Minimum 80% in shares.
 - Multi-Asset Funds: Mixed asset class investments.
 - Interest-Bearing Funds: Bonds, cash, and fixed-income instruments.
 - Real Estate Funds: Listed property investments.
- **Investment Focus:** Includes general, large-cap, small-cap, flexible, high-equity, low-equity, and fixed-income funds.

New Addition (2023): A Sustainable/ ESG Fund Category has been introduced for funds prioritising environmental, social, and governance (ESG) factors.

Tier 1 is a geographical classification, in terms of which funds are:

- **South African:** must invest at least 55% of their assets in South African investment markets.
- **Worldwide:** can invest in both South African and foreign markets. There are no limits set for either domestic or foreign assets.
- **Global:** must invest at least 80% of their assets outside South Africa, with no restriction to assets of a specific geographical country (for example the USA) or geographical region (for example Africa).
- **Regional:** must invest at least 80% of their assets in a specific country (for example the USA) or geographical region (for example Africa) outside of South Africa.

Tier 2 is an asset class classification, in terms of which funds are invested in different asset classes:

- **Equity portfolios:** invest a minimum of 80% of the market value of the portfolios in equities and generally seek maximum capital appreciation as their primary goal.
- **Multi-asset portfolios:** invest in a wide spread of investments in the equity, bond, money, and property markets, in order to maximise total returns (comprising capital and income growth) over the long term.



- Interest-bearing portfolios: invest exclusively in bond or money-market investments and other interest-earning securities.
- Real Estate portfolios: invest in listed property shares, collective investment schemes in property and property loan stock, and real estate investment trusts. The objective of these portfolios is to provide high levels of income and long-term capital appreciation.

Tier 3 is an investment focus classification, in terms of which funds are classified into 'investment focus' areas, for example:

- Equity – General portfolios: invest in selected shares across all industry groups, as well as across the range of large, mid, and smaller market capitalisation shares.
- Equity – Large cap portfolios: invest at least 80% of the market value of the portfolios in large market capitalisation shares, which have a market capitalisation greater than or equal to the company with the lowest market capitalisation in the FTSE/ JSE Large Cap Index, or an appropriate foreign index published by an exchange.

Fund classification diagram²

1 st Tier Domicile of Assets	SOUTH AFRICAN	WORLDWIDE	GLOBAL	REGIONAL
	Invest at least *55% of assets in SA investments. Max 35% outside SA, plus an additional 10% in Africa outside of SA.	Invest in SA and/ or foreign markets (complete flexibility, up to 100% either way).	Invest at least 80% of their assets outside of SA.	Invest at least 80% of their assets outside of SA, in a specific geographical region (incl. Africa), other than SA.
2 nd Tier Asset Allocation	EQUITY	MULTI-ASSET	INTEREST BEARING	REAL ESTATE
	Listed shares on various stock exchanges, depending on 1 st tier classification.	Invest in a combination of equity, interest bearing and listed real estate assets.	Bonds, money-market instruments, and other interest-bearing securities.	Listed property shares on local and overseas stock exchanges.

² Source: Profile's Unit Trust & Collective Investments (2017), p 139)



	FUNDS	FUNDS	FUNDS	FUNDS
3 rd Tier Focus	General Large Cap Mid & Small Cap Resource Financial Industrial Unclassified General – Africa	Income Low Equity Medium Equity High Equity Flexible Target Date	Money Market Short Term Variable Term	General
Many permutations are possible across first and second tiers, e.g. SA – Equity; Global – Equity; Worldwide – Multi-Asset; Regional – Equity etc. Third tier classifications are specific to asset allocation – Equity, Multi-Asset, Interest Bearing and Real Estate.				

Investors can compare similar funds offered by different investment houses with ease, knowing that all funds containing the words, for example, “South African – Equity – General” or “South African – Multi-Asset – Flexible” in the fund name, have to adhere to the same basic mandate. Likewise, all funds that are registered as “fund of funds,” “money-market funds,” “index” or “tracker” funds and “feeder funds,” must contain these same words in their fund names, to indicate the specific type of fund.

4.5.2 Investment Portfolio Options in Terms of Fund Classification

The options available to investors in terms of the fund classification for South African portfolios are explained below.³

A. Equity Portfolios (South African)

These portfolios invest a minimum of 80% of the market value of the portfolios in equities and generally seek maximum capital appreciation as their primary goal.

Equity – General portfolios:

These portfolios invest in selected shares across all industry groups, as well as across the range of large-, mid- and smaller-cap shares. While the managers of these portfolios may subscribe to different investment styles or approaches, their intent is to produce a risk/ return profile that is comparable with the risk/ return profile of the overall JSE equities market. The portfolios in this category offer medium to long-term capital growth as their primary investment objective.

SA Benchmark: FTSE/ JSE All Share index (J203T).

³ Source: ASISA Standard on Fund Classification for South African regulated collective investment scheme options (March 2017), p. 3-6, available at: ASISA Standard on Fund Classification for South African regulated collective investment scheme options (accessed 131 March 2023)



Equity – Large cap portfolios:

These portfolios invest at least 80% of the market value of the portfolios in large market capitalisation shares which have a market capitalisation greater than or equal to the company with the lowest market capitalisation in the FTSE/ JSE Large Cap Index, or an appropriate foreign index published by an exchange. 100% of share purchases must be in this investable universe at the time of purchase.

SA Benchmark: FTSE/ JSE Large Cap index (J205T).

Equity – Mid- & small-cap portfolios:

These portfolios invest at least 80% of the market value of the portfolios in shares that are in the FTSE/JSE Small Cap Index or FTSE/JSE Mid Cap Index, or in shares that have a market capitalisation smaller than the company with the lowest market capitalisation in the FTSE/JSE Large Cap Index, or an appropriate foreign index published by an exchange. 100% of share purchases must be in this investable universe at time of purchase. Due to both the nature and focus of these portfolios, they may be more volatile than portfolios that are diversified across the broader market. SA Benchmark: FTSE/ JSE Mid Cap index (J201T).

Equity – Resources portfolios:

These portfolios invest at least 80% of the market value of the portfolios in shares listed in the FTSE/JSE Oil & Gas and Basic Materials industry groups or in a similar sector of an international stock exchange. Up to 10% of a portfolio may be invested in shares outside the defined sectors in companies that conduct similar business activities as those in the defined sectors. Due to both the nature and focus of these portfolios, they may be more volatile than portfolios that are diversified across a wider range of FTSE / JSE industry groups.

SA Benchmark: FTSE/ JSE Resources Index (J258T).

Equity – Financial portfolios:

These portfolios invest at least 80% of the market value of the portfolios in shares listed in the FTSE/ JSE Financials industry group, or in a similar sector of an international stock exchange. Up to 10% of a portfolio may be invested in shares outside the defined sectors in companies that conduct similar business activities as those in the defined sectors. Due to both the nature and focus of these portfolios, they may be more volatile than portfolios that are diversified across a wider range of FTSE/ JSE industry groups.

SA Benchmark: FTSE/ JSE Financials index (J580T).

Equity – Industrial portfolios:

These portfolios invest at least 80% of the market value of the portfolios in industrial shares listed on the JSE Limited or in a similar sector of an international stock exchange. Industrial



shares include all companies listed on the JSE other than those shares listed in the FTSE / JSE Oil & Gas, Basic Materials, and Financials industry groups.
SA Benchmark: FTSE/ JSE All Share Industrials index (J257T).

Equity – Unclassified portfolios:

These portfolios invest in a single industry or sector or in companies that share a common theme or activity as defined in their respective mandates. Due to both the nature and focus of these portfolios, they may be more volatile than portfolios that are diversified across the broader market. The performance of these portfolios cannot be compared to others in this category. Should it be considered appropriate, where five or more portfolios focus on a particular theme a new category will be created and the funds transferred.

B. Multi-Asset Portfolios (South African)

Multi-asset portfolios are portfolios that invest in a wide spread of investments in the equity, bond, money, and property markets, to maximise total returns (comprising capital and income growth) over the long term.

Multi-Asset – Flexible portfolios:

These portfolios invest in a flexible combination of investments in the equity, bond, money, and property markets. The underlying risk and return objectives of individual portfolios may vary as dictated by each portfolio's mandate and stated investment objective and strategy. These portfolios may be aggressively managed with assets being shifted between the various markets and asset classes to reflect changing economic and market conditions, and the manager is accorded a significant degree of discretion over asset allocation to maximise total returns over the long term.

Multi-Asset – High equity portfolios:

These portfolios invest in a spectrum of investments in the equity, bond, money, or property markets. These portfolios tend to have an increased probability of short-term volatility, aim to maximise long-term capital growth, and can have a maximum effective equity exposure (including international equity) of up to 75%, and a maximum effective property exposure (including international property) of up to 25% of the market value of the portfolio. The underlying risk and return objectives of individual portfolios may vary as dictated by each portfolio's mandate and stated investment objective and strategy.

Multi-Asset – Medium equity portfolios:

These portfolios invest in a spectrum of investments in the equity, bond, money, or property markets. These portfolios tend to display average volatility, aim for medium- to long-term capital growth, and can have a maximum effective equity exposure (including international equity) of up to 60%, and a maximum effective property exposure (including international property) of up to 25% of the market value of the portfolio. The underlying risk and return



objectives of individual portfolios may vary as dictated by each portfolio's mandate and stated investment objective and strategy.

Multi-Asset – Low equity portfolios:

These portfolios invest in a spectrum of investments in the equity, bond, money, or property markets. These portfolios tend to display reduced short-term volatility, aim for long-term capital growth, and can have a maximum effective equity exposure (including international equity) of up to 40%, and a maximum effective property exposure (including international property) of up to 25% of the market value of the portfolio. The underlying risk and return objectives of individual portfolios may vary as dictated by each portfolio's mandate and stated investment objective and strategy.

Multi-Asset – Income portfolios:

These portfolios invest in a spectrum of equity, bond, money market, or real estate markets, with the primary objective of maximising income. The underlying risk and return objectives of individual portfolios may vary as dictated by each portfolio's mandate and stated investment objective and strategy. These portfolios can have a maximum effective equity exposure (including international equity) of up to 10%, and a maximum effective property exposure (including international property) of up to 25% of the market value of the portfolio.

Multi Asset – Unclassified portfolios:

These portfolios invest in a spectrum of equity, bond, money market, or real-estate markets, where the asset mix may vary over time in order to achieve a predetermined investment outcome that is not linked to an economic or market-related variable such as an index or an inflation rate. Examples may include portfolios that target a specific retirement date or a specific targeted level of income. Due to the unique investment objectives, portfolios in this category cannot be compared and consequently cannot be ranked.

C. Interest-Bearing Portfolios (South African)

Interest-bearing portfolios are collective investment portfolios that invest exclusively in bond or money-market investments, and other interest-earning securities. These portfolios may not include equity securities, real estate securities or cumulative preference shares.

Interest Bearing – Variable-term portfolios:

These portfolios invest in bonds, fixed deposits, and other interest-bearing securities. These portfolios may invest in short-, intermediate- and long-dated securities. The composition of the underlying investments is actively managed and will change over time to reflect the manager's assessment of interest rate trends. These portfolios offer the potential for capital growth, together with a regular and high level of income. These portfolios may not include equity securities, real estate securities or cumulative preference shares.

SA Benchmark: JSE/ ASSA All Bond index (ALBI).



Interest Bearing – Short-term portfolios:

These portfolios invest in bonds, fixed deposits and other interest-earning securities which have a fixed maturity date, and either have a predetermined cash flow profile or are linked to benchmark yields, but exclude any equity securities, real estate securities or cumulative preference shares. To provide relative capital stability, the weighted average modified duration of the underlying assets is limited to a maximum of two. These portfolios are less volatile and are characterised by a regular and high level of income.

SA Benchmark: STeFI Composite index.

Interest Bearing – Money-market portfolios:

These portfolios seek to maximise interest income, preserve the portfolio's capital, and provide immediate liquidity. This is achieved by investing in money-market instruments with a maturity of less than thirteen months, while the average duration of the underlying assets may not exceed 90 days, and a weighted average legal maturity of 120 days. The portfolios are typically characterised as short-term, highly liquid vehicles.

SA Benchmark: STeFI 3-month index.

Due to the nature of the underlying money-market instruments, money-market funds are low-risk in nature and suitable for conservative investors.

D. Real Estate Portfolios (South African)

The real estate has only one general sector.

Real Estate – General portfolios:

These portfolios invest in listed property shares, real estate investment trusts (REITs), and other collective investment schemes in property. The objective of these portfolios is to provide high levels of income and long-term capital appreciation. These portfolios invest at least 80% of the market value of the portfolio in shares listed in the FTSE/ JSE Real Estate industry group or similar sector of an international stock exchange and may include other high-yielding securities from time to time. Up to 10% of a portfolio may be invested in shares outside the defined sectors in companies that conduct similar business activities as those in the defined sectors.

SA Benchmark: FTSE/ JSE SA Listed Property index (J253T).



Research Activity:

Use the internet to obtain a couple of fund fact sheets of various Collective Investment Schemes. Based on the information contained therein, see if you can correctly classify each fund based on the ASISA system.

Note: The answer will appear on each fund fact sheet, in order for you to confirm if you are right.

4.5.3 Portfolio Management Options

i. Managed options

You will recall that we have looked at the process of assessing a client's risk profile and matching it with appropriate investment funds in the *Economic and Investment Overview* module. If intermediaries do not have expert knowledge of the markets, they can invest their clients' money in managed portfolios. A managed portfolio is a portfolio of investment funds that matches clients' financial goals and risk tolerance. The portfolio managers make investment decisions on behalf of the client according to the client's selected risk profile.

A managed portfolio puts professionals in charge of clients' assets. When clients invest in managed portfolios, all decisions – including investment research and selection – are made on their behalf by the portfolio managers. (Also see section 4.5.6 below for “active and passive portfolio management”).

ii. Wrap Funds

A wrap fund is a portfolio comprising underlying investment products, wrapped into a single product. The underlying investments need not be collective investment portfolios. A wrap fund is not a registered collective investment portfolio, but most wrap funds hold a portfolio of separate collective investment portfolios and money-market accounts/ instruments. It is an individually designed portfolio with guidelines specified by the investment management company. The underlying combination of investment tools or instruments is selected to target the risk/ return requirements of the individual investor. This portfolio or “wrap” is then managed by a portfolio manager, who is responsible for the selection and combination of these specialist unit trusts on an ongoing basis, providing investors with access to the appropriate blend of unit trusts available.

Wrap funds are not controlled by the same legislation as Collective Investment Schemes and can be managed by anyone who has registered with the Financial Sector Conduct Authority as a portfolio manager. They are not considered suitable investments for the small investor.



See Unit 4.6.3 for the **Capital Gains Tax** treatment of wrap funds.

iii. Fund of Funds

This is a CIS that invests in a range of other collective investment schemes. The CIS chosen may originate from the same manager (in which case they would be called an internal fund of funds), or they may include those of a different manager. Every fund of funds has to invest in three or more underlying collective investment schemes. This type of product offers an alternative to wrap funds and allows the investor to diversify between different investment houses.

A fund of funds is subject to the same legislation as other unit trust funds, which provides more security for investors. A fund of funds seeks to add performance by combining the asset allocations, sector strengths, and different fund manager skills in one fund.

iv. Multi-manager funds

A multi-manager CIS invests in a combination of specialist equity and fixed-interest portfolios, by bringing together a number of different fund managers into one investment product.

Each of the managers is responsible for his/ her portion of the entire portfolio, each with a specific management style and approach to the markets, to provide diversified multi-managed portfolios. The portfolio managers are chosen for their expertise in a particular area, and the combination of the managers will be tailored to suit the client's needs.

The primary asset allocation in the portfolio will, therefore, determine allocation of assets to a particular portfolio manager regarded as an expert in that particular area. In an international portfolio, the primary asset allocation will be to different regions of the world, and investment managers will be selected for their expertise in these regions. The European portion of the portfolio will therefore have a different investment manager than the North American portion.



Activity:

Indicate whether the following statements are true or false:

1. A fund of funds is a collective investment scheme that invests in various other CISs.
2. In a managed portfolio, clients have absolute control in implementing investment decisions themselves.
3. A wrap fund consists of a single product (which must be a CIS), which is broken up into smaller investments, 'wrapped' together in one portfolio.



Answer:

1. True.
2. False. A managed portfolio puts professionals in charge of clients' assets. When clients invest in managed portfolios, all decisions – including investment research and selection – are made on their behalf by the portfolio managers.
3. False. A wrap fund is a portfolio comprising underlying investment products, wrapped into a single product. The underlying investments need not be collective investment portfolios.

4.5.4 Shari'ah Compliant Funds⁴

The term Shari'ah refers to the fundamental code that governs Islam. There are two main sources of Shari'ah law – firstly the Qur'an (Islamic holy book) and the example set by the Prophet Muhammad (PBUH), i.e. the Sunna. Shari'ah investing, therefore, means investing in accordance with Islamic law and adhering to the principles that govern it.

The five main principles that govern Shari'ah investing:

1. **Ban on interest:** According to Shari'ah law, both parties need to take a risk when profit is earned and therefore cannot invest in conventional fixed-interest instruments.
2. **Ban on uncertainty:** In terms of Islamic principles, the future outcome of investment needs to be free of major uncertainty. Speculative financial instruments, like options and other derivatives, may, therefore, not be used.
3. **Ban on financing certain economic sectors that are deemed to be non-permissible,** such as non-halaal meat products, gambling companies, weapon production, etc.
4. **Profit- and loss-sharing principle:** Both parties to the financial transaction must share in the risks and the rewards attached to it.
5. **Asset-backing principle:** Each transaction needs to be backed by or linked to a tangible underlying asset.

Certain companies or sectors are prohibited, therefore Shari'ah managers must screen all companies before investing in their shares.

As Shari'ah funds are not allowed to invest in conventional fixed-interest and money-market instruments, the fixed-interest type portion of Multi-asset Shari'ah funds is invested in instruments known as “sukuk” (certificate of ownership).

⁴ Source: Glacier Research: Shari'ah Fund Guide (2016): Available at: http://www.syncbs.co.za/wp-content/uploads/2017/02/ShariahBooklet_Q32016-002.pdf



Activity:

Indicate whether the following statement is true or false:

Shari'ah compliant funds must invest in accordance with Islamic law and adhere to the principles that govern it.

Answer:

True.



Research Activity:

Use Google to Identify a Shari'ah-compliant fund. Compare the information on its fund fact sheet to the information of a similar non-Shari'ah fund. Pay attention to the mandate, the underlying securities, and the returns.

4.5.5 Exchange Traded Funds (ETFs) and Index Funds

Both ETFs and index funds are tracker funds that are established under registered collective investment schemes, regulated by the FSCA.

Index Funds	Exchange Traded Funds (ETFs)
- These are collective investment schemes designed to replicate the performance of a specific benchmark. - Index funds are passively managed. - These funds do not have their own category but instead are classified into a category based on the index/benchmark that the fund is tracking. - The best index fund will be the one that tracks its chosen index the closest. The portfolio manager will, therefore, not aim to outperform the index, but rather invest in a basket of investments that simulate the underlying investments of the relevant index.	- ETFs, or tracker funds, differ from index funds in that they are listed on the JSE, and can be traded like a share. - Apart from this, they are almost identical to their index fund counterparts. - An ETF replicates the composition of an index of a pre-selected basket of shares. But where a unit trust only trades once a day, an ETF trades real time at the market price determined by supply and demand. - They can be bought and sold as ordinary shares on the JSE. And like ordinary shares, the price is available in a daily newspaper.



- | | |
|--|---|
| <ul style="list-style-type: none">• Index funds differ from exchange-traded funds (ETFs) in that they are classified as unit trusts, and units are bought from and repurchased by a CIS management company like any other unit trust.• Index fund prices are only known the next day. | <ul style="list-style-type: none">• Both ETFs and index funds are required to publish NAV prices on a daily basis – these prices are usually quite close. |
|--|---|

Range of ETFs and Index Funds

The range is broad, as they can track anything with an index, and include stock markets, property markets, bond markets, money markets, currencies, commodities, indexes (such as the ALSI), subsets of an index (such as the Top 40 or FTSE/ JSE Industrial Index), and benchmarks adjusted and weighted by things such as dividend yields (e.g. the Satrix Divi).

Costs of ETFs and Index Funds

Costs are generally lower than on other collective investment schemes because they are not actively managed; the underlying share portfolios are not traded regularly; they have lower marketing, distribution, and administration expenses; and they do not involve expensive analysts.

Investing in ETFs or Index Funds

Index funds are available via LISPs (Linked Investment Service Providers), but not ETFs. ETFs can be bought directly from the company, or through a stockbroker, or via an administration platform.

Taxation

ETFs that are registered as CIS are subject to the same taxation as CISs. No tax is payable on any trades that are made to keep the ETF in line with an index. Investors will pay the dividend withholding tax on dividends earned. Capital gains tax may also be payable in the event of disposal, subject to the annual exemption.

Risk

Buying a basket of shares (an ETF) is less risky than buying shares in a single listed company, as the diversification and spread of investments reduce the risk exposure. ETFs typically track an index of the most liquid shares on the stock market. Indices are regularly rebalanced by JSE Limited to ensure that they reflect the most successful securities on the exchange.

Return

Returns are received in the form of dividends, and capital gain on the sale of shares in an ETF fund. Returns are not guaranteed.



Volatility

The volatility of an investment in an ETF depends on the underlying assets in the index. The movement will be in line with the movement on the equity market if the ETF fund is invested in equities.

Liquidity

ETFs can be sold at any stage during a trading day at the market ruling price. Even though they are liquid, they are influenced by changes in the market, which might make the liquidation of the investment at a particular time inappropriate, e.g. it may not be in the best interests of the investor to liquidate his investment at a time when the market has experienced a downturn. ETFs are generally not suitable for short-term investments.

Inflation

Over the longer term, exchange-traded funds (if linked to equity indices) have outperformed inflation.

Cost

Brokerage fees (stockbrokers have varying brokerage charges, depending on the size of the transaction), custodian and administration fees, as well as management fees will be payable.



Activity:

Which of the following statements regarding Exchange Traded Funds (ETFs) is CORRECT?

- a) Investment returns on an ETF is guaranteed.
- b) The volatility of an investment in an ETF depends on the underlying assets in the index.
- c) Dividends earned in an ETF investment is not subject to DWT.
- d) ETFs generally outperform inflation in the short term.

Answer:

b) is the correct answer.

4.5.6 Risk Associated with Active and Passive Investment Portfolio Management

Active fund management means that a professional asset manager/ fund manager makes tactical decisions to buy or sell certain assets in the fund, based on his/ her view of opportunities in the market, in order to try and achieve superior growth in the fund (better growth than the average growth in the market); or to protect investors' capital when markets fall, by opting out of certain assets and exposure to certain market sectors.



According to Investopedia (2016), “Active investing refers to an investment strategy that involves ongoing buying and selling activity by the investor. Active investors purchase investments and continuously monitor their activity to exploit profitable conditions.”

Passive fund management, on the other hand, means that your fund will simply track the market, which is often represented by a specific index, for example the FTSE/ JSE Top 40 index, which tracks the 40 biggest companies on the Johannesburg Securities Exchange. Passive funds are essentially run by computer and will replicate all of the assets in a particular market, or represented in a particular index, to give you a return that mirrors the return in the market.

This approach is based on the ‘efficient market hypothesis,’ which proposes that markets are efficient, since investors have free access to information on share prices, companies, social and political environment, etcetera; and ‘price’ these factors in already when deciding to buy/sell shares at certain prices. Therefore, over time, it is virtually impossible to beat the market.

In contrast to actively managed funds, passive funds use a buy-and-hold strategy to profit from long-term trends in the market, rather than trying to beat short-term trends.

4.5.6.1 Advantages and disadvantages of active vs passive fund management

Some **advantages of active fund management** include the following:

- It can provide ‘peace of mind’ to the investor, knowing that a knowledgeable person is managing their investments.
- Active fund managers who get their investment decisions right, can beat average market growth, especially in times of good market performance.
- Active fund managers can also shield investors from the full extent of a market downswing by switching assets to create less exposure to equities, for example.

Some **disadvantages of active fund management** include the following:

- Actively managed funds have high fees attached to them. Typically, the fees on an actively managed fund are at least twice as much as what you would pay for a passively managed fund. The risk is that, over time, the higher fees may have a significant negative impact on investment growth.
- Active fund managers may make bad investment choices or follow unsound theories in managing the fund, which will lead to poor investment returns (in addition to the higher costs).
- There have been numerous studies done covering different time periods to determine how successful active fund managers are at beating the market, and the majority of these studies have concluded that, although there are some funds that do tend to consistently beat the market, on the whole, there seems to be more funds that underperform than outperform their benchmark index, especially over longer periods of time.



Some **advantages of passive fund management** include the following:

- It reduces costs due to the 'passive buy-and-hold' strategy, and this can have a significant impact on real returns (after the deduction of costs), over time.
- Passive fund management can be said to provide simplicity, in the sense that the investor knows what they are getting – a replica of all the shares in the market or index being tracked.
- Passive funds offer a low-cost method of diversification, since shares representing the entire index are bought.
- In a passive fund, the investor is not at risk of being exposed to bad management decisions.
- Since passive funds are invested in an entire market, investors automatically benefit from upswings in that market.

Some **disadvantages of passive fund management** include the following:

- With passively managed funds, investors cannot ever outperform the market and, when costs are included, a passive fund will effectively always underperform the market.
- When the market experiences a downswing, investors automatically experience the full extent of the downswing in their investment, since there is no active fund manager that could shield them from full exposure to the market.

4.5.6.2 When is active and passive management an appropriate style for investors?

Active management is appropriate for investors who want to invest in specialised equity markets that require specialised knowledge and expertise, to take advantage of inefficient pricing. For example, emerging markets, small-cap stocks, and companies involved in resources and metals mining. Active management may also be appropriate for investors who want an experienced professional to make tactical investment decisions to outperform the market, and to shield them from negative market volatility.

Passive management is appropriate for investors who want a well-diversified holding of well-known popular shares (such as large cap shares, for example, as tracked by the FTSE/ JSE Top 40 index), and who are comfortable riding out the short-term market fluctuations.

Increasingly, fund managers are also trying to make the best of both worlds using a blended approach, where parts of a portfolio may be passively managed, whilst other parts may be actively managed.



Activity:

Below are extracts from the objectives/ focus of two different collective investment portfolios. Read both extracts and then state, for each of the funds (XYZ and UVW), whether it is actively or passively managed. Motivate your answers. Once you've answered the questions, check your answers at the end of this topic.

Extract from **XYZ Fund** focus statement:

The XYZ Fund is a specialist equity fund that is designed to replicate the performance of the top 40 shares of the FTSE/ JSE Africa Top 40 Index over time.

The fund manager aims to track the movements and replicate the performance of the FTSE/ JSE Africa Top 40 Index by investing in the correct ratios, weightings, and proportions of the top 40 shares.

Extract from **UVW Fund** focus statement:

The UVW fund aims to deliver a stable and growing capital and income base, via a balanced and diversified portfolio.

In order to achieve its objectives, the fund invests in a flexible combination of asset classes ranging from equities, bonds, property, money-market instruments and other assets in liquid form.

Answer:

The XYZ fund is passively managed. We can see this from the statement that the fund manager is 'tracking' the movements and 'replicating' the performance of the FTSE/ JSE Africa Top 40 Index by investing in the correct ratios, weightings, and proportions of the top 40 shares.

The UVW fund is actively managed. We can see this from the statement that the fund invests in a flexible combination of asset classes to achieve its objectives, meaning a fund manager actively decides which asset classes to invest in.



4.6 Tax Implications applicable to Participatory Interests in a Collective Investment Scheme

Investors are taxed on income received (annually) and on capital gains made when realised. Income distributions in collective investment schemes are made regularly, either quarterly or bi-annually, and include interest, rental income, and dividends, from local and foreign sources.

Interest and dividends are taxed and treated differently. Depending on the nature of the underlying assets, certain types of funds will generate more interest (if the predominant allocation is to fixed-interest instruments like money-market instruments and bonds, as well as property-related instruments), or more dividends (if the predominant allocation is to shares).

Funds with a predominant allocation to shares and property-related instruments are most likely to generate capital gains tax. Capital gains is measured in the growth of the underlying unit, or participatory interest, and not on the actual fund value. For instance, if an investor has allowed the interest received from his money-market fund to be reinvested automatically instead of paid out to him, he would experience a growth in his fund value, but not in the price value of the underlying units, as the unit price has not changed from 100c per unit. The interest was used to buy new units on his behalf. Therefore, money-market funds are not subject to CGT, but only income tax.

4.6.1 Income Tax

Income distributions are taxed in the hands of the investors, regardless of whether the investor has elected to have the income paid out to him or reinvested. Investors pay tax at their marginal rate on the full interest amount, subject to the annual exemption on interest for individuals. The exemption for individuals of 65 years and older is currently set at R34 500, while it is R23 800 for individuals younger than 65. These limits are not likely to be increased again, as annual increases on interest exemption ceased when tax-free investment plans were introduced in 2014. If married in a community of property, interest received for the tax year is divided by two, and taxed in the hands of both spouses, allowing each spouse to qualify for the full annual exemption.



Activity:

Jack (66) and Jill (63) are married in community of property. Jack earned R70 000 interest from his investments. What amounts may the couple deduct as their respective allowable interest exemptions?

- a) Jack = R34 500; and Jill = R23 800.
- b) Jack = R35 000; and Jill = R35 000.
- c) Jack = R34 500; and Jill = R0.
- d) Jack = R70 000; and Jill = R0.

Answer:

a) is the correct answer. As they are married in community of property, their collective interest earnings for the year (Jack's R70 000) are divided by 2 = R35 000 each, to be included in their respective Gross Incomes.

As Jack is over 65, he qualifies for an exemption of R34 500, whilst Jill can only exempt R23 800 from her taxable income, as she is younger than 65.

Foreign Earnings

Investors that earn foreign interest, dividends or make a capital gain through their investment in collective investment schemes, are taxed on their worldwide income. In cases where taxes were deducted by the foreign authorities, investors can claim the foreign tax paid as a tax credit if there is a double tax agreement with that country.

At the end of the tax year, the unit trust management company will send the investor a tax certificate that would typically contain the following information:

Table 4.6.1 Typical information on a tax certificate issued by a CIS management company for interest received during the tax year.

Nature of investments	Amount received
Interest income	
Local	R
Foreign	R
Tax paid – foreign	R



4.6.2 Dividend Withholding Tax (DWT)

Dividends are distributed to the unit trust investor by the fund manager as part of the bi-annual or quarterly distributions. Dividend Withholding Tax (DWT) remains at 20%. However, certain double taxation agreements (DTAs) between South Africa and foreign countries may reduce the effective tax rate for non-residents. Investors should check their tax residency status to determine whether reduced DWT rates apply. The fund manager, through his withholding agent, withholds the tax and remits it to SARS on behalf of the investor. DWT is levied at a flat rate of 20%.

Given that tax is withheld before the dividends are distributed to the investors, they are not added to the individual's taxable income and will therefore not increase his effective income tax rate, as opposed to interest and capital gain. In the case of the affluent, this has a benign effect, but not so for individuals that would otherwise be below the tax threshold, as they end up paying tax on their dividends regardless of their tax status or marginal rate.

Table 4.6.2 Typical information on a tax certificate issued by a CIS management company for dividends received during the tax year.

Nature of investments	Amount received
Dividend income	
Local	R
Local – taxed	R
Foreign	R
Foreign – taxed	R
Foreign – tax paid	R
Foreign – taxed (dual listed)	R
Foreign – dual listed – tax paid	R



Activity:

At what rate is Dividend Withholding Tax levied?

Answer:

20%



4.6.3 Capital Gains Tax

The capital gains on unit trusts are taxable in the hands of the investor when he/ she sells the investment. Profits made by the fund manager while buying and selling shares within the portfolio are not taxed within the fund. Instead, the individual is taxed on the value of his/ her units (participatory interest) increasing or decreasing as a result of the fund manager's activities.

The exception is "wrap funds," where CGT is passed on directly to the investor as a result of the underlying portfolios being bought or sold by the fund manager.

Capital Gains Tax (CGT) for Individuals (2024):

- Annual Exemption: R40 000
- Inclusion Rate: 40%
- Effective Tax Rate: Between 7.2% and 18%, depending on marginal tax brackets.
- For Trusts: 80% inclusion rate, with an effective rate of up to 36%.

CGT Planning Tip: Investors can stagger disposals, if possible, over multiple tax years to maximise the R40 000 exemption.

CGT can have a ruinous effect on the profits made on a CIS investment if it is not managed carefully.

Table 46.3 Typical information on a tax certificate issued by a CIS management company for capital gains received during the tax year.

Name of CIS fund	Number of units sold	Total gross return	Basis cost of unit	Net Profit/ Loss
				R
				R
				R

Comparative impact of different forms of taxation on collective investment schemes

Tax-free savings accounts do not play an important role in the lives of current pensioners, being limited to contributions of R36 000 per annum (this is the current limit applicable in 2024/2025 but is subject to change as per the budget speech each year). Significant levels of tax-free income will not be generated any time soon – given the current contribution limit, it will take almost 14 years to reach the maximum lifetime limit of R500 000 (this is the current lifetime limit (2024/2025) but may change in the future).



Until such time, the annual **interest exemption** will still have significant value in the lives of ordinary (as opposed to affluent) investors, as it makes a difference to the amount of capital that can be invested in the fixed-income environment without increasing the individual's taxable income. Those dependent on income from their investments, such as pensioners, will increase their taxable income through any investment in money-market funds, income-type funds (normally including cash, money-market instruments, bonds, and property), government retail bonds and bank investments.

Investment Strategy: Investors should prioritise high-growth assets (e.g., equity funds) in TFSAs to maximise the tax-free compounding effect over time.

Assuming an effective rate of 8% p.a., senior citizens can have up to R435 000 (or R870 000 if married in a community of property) invested, tax-free, across these instruments.

The effect of **dividends withholding tax** is less cruel than income tax (ignoring the annual interest exemption), given the flat rate of DWT compared to marginal income tax rates. Investment portfolios with a high allocation to shares will generally have a smaller impact on an individual's taxability than fixed-interest portfolios.

Capital gains tax can be managed to a large extent, given the annual exemption. The prevailing inclusion rates also help to limit the effects of CGT on an investor's portfolio. It is always wise to consider the effects of CGT before making decisions regarding the amounts of capital to be realised in any particular tax year, as any taxable capital gain is added to the individual's taxable income, thereby increasing his effective tax rate.

Compared to investment in endowment policies, CISs are more tax-efficient if the investor's marginal income tax rate is less than 30% (being the tax rate for individual policyholder funds). If the investor has not fully utilised his/ her annual interest exemption, CISs can be more tax-effective even if his/ her marginal income tax rate is above 30%.



Activity:

What are the missing values in the sentences below?

- 1) Tax-free savings account contributions are limited to _____ per annum.
- 2) Tax-free savings account contributions are limited to a lifetime limit of _____.
- 3) The maximum annual deduction allowed on capital gains realised within a year of assessment is _____.
- 4) The CGT inclusion rate for natural persons is _____.

**Answers:**

- 1) R36 000
- 2) R500 000
- 3) R40 000
- 4) 40%

**Research Activity:**

Visit the website of any well-known collective investment scheme provider. Locate a fund fact sheet for each of the different types of collective investment schemes listed below and compare the information in respect of income distributions' frequency. Indicate which of the funds is the most likely to indicate the highest taxable income (ignoring the annual interest exemption), with 1 being the lowest, and 4 the highest.

Type of CIS:

- Money-market fund
- Income fund
- Balanced fund
- Equity fund

Company websites:

<http://www.coronation.com/za/personal/#>

<https://www.oldmutual.co.za/personal/investments-and-savings/unit-trusts/products>

<http://www.allangray.co.za>

<http://www.prudential.co.za/>

<https://www.sanlam.co.za/personal/investments/unit-trusts/Pages/default.aspx>



4.7 Participatory Interests in a Hedge Fund

Hedge funds are alternative investment instruments that are classified as collective investment schemes. In hedge funds, the strategies are more important than the asset class.

A key feature of these funds is that they can generate positive returns when markets are falling.

Asset managers often use hedging (i.e. taking out an investment to limit the risk of another investment) in order to protect their investment portfolios from systematic risk.

The main strategies include various methods of exploiting market conditions through leveraging and hedging techniques. In theory, a hedge fund should be less risky than an equity fund, because of its hedging properties.

The typical investors are wealthy individuals and institutions, who have a great deal of money to invest, and who can weather significant downturns in their portfolios in order to obtain higher returns.



Research Activity:

Visit the following website to find out more about hedging:

<http://www.rediff.com/money/2007/jun/23hedge.htm>

There are two classified types of Hedge Funds:

1. CIS QIHF

The Qualified Investor Hedge Fund restricts access to qualified investors, who are knowledgeable and wealthy, with an investment track record, and who can afford to invest at least R1 million into the restricted hedge fund. This includes institutional investors like pension funds, insurance companies and asset managers.

2. CIS RHF

The Retail Investor Hedge Fund is open to any investor and is more closely regulated. They are restricted to gearing at 100% (which means they may not borrow for more than 100% of their asset base) and may not invest in property or in QIHF funds.



Both types of hedge funds are subject to prudential requirements meant to ensure that the manager has and maintains sufficient capital reserves to meet redemption and other operational needs.

4.7.1 Terms, Features and Benefits of Participatory Interests in a Hedge Fund

4.7.1.1 Key Characteristics of Hedge Funds

These funds utilise a variety of financial instruments to reduce risk, enhance returns and minimise the correlation with equity and bond markets. Alternative market strategies enable hedge funds to make profits in both a bull and bear market. This means they can deliver non-market correlated returns.

Historically, hedge funds give better returns than more conventional investments, but they are generally regarded as a higher risk form of investment. Most hedge fund strategies tend to hedge against downturns in the markets being traded.

Most hedge funds are managed by experienced investment professionals, who are generally disciplined and diligent. They are usually highly specialised, and trade only within their area of expertise. They attract the best brains in the investment business through high performance incentives. The fund managers usually have their own money invested in their fund as well.

Pension funds, endowments, insurance companies, private banks and high net-worth individuals invest in hedge funds to minimise overall portfolio volatility and enhance returns.

4.7.1.2 Hedging Strategies

Hedging strategies available to hedge fund managers include:

Selling short, meaning shares are sold without owning them, hoping to buy them back at a future date at a lower price, in the expectation that their price will drop.

Using arbitrage, seeking to exploit pricing inefficiencies between related securities, for example going long on convertible bonds and short the underlying issuers' equity.

Trading options or derivatives, which are contracts whose values are based on the performance of any underlying financial asset, index or other investment.

Investing in anticipation of a specific event, such as merger transaction and hostile takeover, and investing in deeply discounted securities of companies about to enter or exit financial distress or bankruptcy, often below liquidation value.



Many of the strategies used by hedge funds have low or negative correlation with the general direction of equity markets.

4.7.2 Differences and Similarities Between Hedge Funds and Unit Trusts

Table 4.7.2 Similarities and differences between hedge funds and unit trusts.

	Hedge funds	Unit trusts
Legislation	Both are collective investment schemes and fall under CISCA.	
Governance	Both are governed by the FSCA.	
TER	Both are required to publish TERs (total expense ratios) and portfolio details.	
Taxation	Hedge funds and equity funds are treated the same for tax purposes.	
Income distributions	Hedge funds and equity funds make taxable income distributions to investors that consist partly of interest and partly of dividends.	
Capital risk	Investors will only risk the capital they invest (although investors in qualified hedge funds may lose more than the capital they invested).	
Risk profiles	Often very different to those of other CISs. Vary significantly across strategies.	Risk profile derives more from underlying assets than from investment strategies.
Performance fees	Most hedge funds charge high performance fees, usually 20% of outperformance.	Performance fees are usually much lower.
Withdrawals	Withdrawals usually require a month's notice.	Repurchases are paid out within 2 or 3 days.



Activity:

Select the correct answer. When compared to a unit trust, a hedge fund:

- a) charges lower performance fees.
- b) issues only dividends (i.e. no interest can be earned).
- c) does not need to publish total expense ratio details.
- d) is also a collective investment scheme and governed under CISCA.

Answer:

d) is the correct answer.



4.7.3 Risks Associated with Investing, Purchasing and Transacting in Participatory Interests in a Hedge Fund

Hedge funds tend to be risky alternative investments, for various reasons. They are complex products, making use of complex strategies. Compared to unit trusts, they are less transparent and much less liquid and associated with higher fees.

Hedge funds are not designed to outperform all market conditions, but to protect portfolios on the downside and preserve capital. They tend to outperform the market during bear markets but can disappoint during strong bull markets.

Hedge funds can be used by investors to enhance diversification, reduce volatility, improve returns, and reduce correlation to other assets. They can be structured to be risk neutral by simultaneously taking long and short positions in a market to offset risk.

Pension fund investors are protected from undue exposure to hedge funds through the limitations of 10% imposed by Regulation 28.

4.7.4 Legislation Applicable to Participatory Interests in a Hedge Fund

Hedge funds were officially classified as Collective Investment Schemes from 1 April 2015. Since then, they resort under the Collective Investment Schemes Control Act (**CISCA**). Although hedge funds are classified as a new category of Collective Investment Schemes, they are not always subject to the same rules governing the unit trusts.

The ASISA Standard on Fund Classification for South African Regulated Collective Investment Hedge Fund Portfolios

Also known as “ASISA Hedge Fund Classification Standard,” it establishes and maintains a classification system for CIS RHF and QIHF portfolios in South Africa. It provides a framework within which hedge fund portfolios with comparable investment objectives and investment universes are grouped together. It is a key tool for investors and their advisers in that it provides useful information during the consideration of investment choices.

The **objectives** of the ASISA hedge fund Classification Standard are to –

- Promote investor awareness and understanding of portfolio types.
- Assist with the comparison of portfolios within and across classification categories.
- Assist with the assessment of exposures and the subsequent potential risks of investing in a particular type of CIS hedge portfolio.



The **purpose** of the ASISA Hedge Fund Classification Standard is to –

- Ensure that CIS hedge fund portfolios (including hedge fund of funds' portfolios) specifically adhere to the classification category definitions.
- Standardise applications for approval of the classification of a CIS hedge fund or hedge fund of funds portfolio.
- Facilitate the timeous and appropriate classification and reclassification of CIS hedge fund and hedge fund of funds' portfolios.

FIRST TIER OF CLASSIFICATION

- **Retail Hedge Funds (RHF):**

These are collective investment hedge funds that are available for retail investors as per the classification set out in BN 52.

- **Qualified Investor Hedge Funds (QIHF):**

These are collective investment hedge funds that are available for qualified investors only as per the definitions set out in BN 52.

SECOND TIER OF CLASSIFICATION

- **South African Portfolios:**

These are collective investment hedge fund portfolios that invest at least 60% of their total exposure in South African investment markets. These collective investment portfolios may invest a maximum of 30% of their assets outside of South Africa plus an additional 10% of their assets in Africa excluding South Africa.

- **Worldwide Portfolios:**

These are collective investment hedge fund portfolios that invest in both South African and foreign markets. There are no limits set for either domestic or foreign assets.

- **Global Portfolios:**

These are collective investment hedge fund portfolios that invest at least 80% of their total exposure outside South Africa, with no restriction to assets of a specific geographical country (for example the USA) or geographical region (for example Africa).

- **Regional Portfolios:**

These are collective investment hedge fund portfolios that invest at least 80% of the total exposure in assets in a specific country (for example the USA) or geographical region (for example Africa) outside South Africa.



Take Note

For the purposes of this second tier of classification, inward-listed equities are deemed to be South African assets.

THIRD TIER OF CLASSIFICATION

This tier of classification is based on the manager's self-classification according to the objectives of the investment strategy. Where a CIS RHF portfolio or CIS QIHF portfolio has a prior track record and has been classified in a published survey, the category in which they have been published will be considered and any deviation from this will need to be justified by the manager.

- **Long Short Equity Hedge Funds:**

These are portfolios that predominantly generate their returns from positions in the equity market. Regardless of the specific strategy employed, these funds will all over time look to the equity market for investment opportunities.

- **Fixed Income Hedge Funds:**

These are portfolios that look to interest rate sensitives to generate their investment returns. They will over time predominantly invest in instruments and derivatives whose characteristics are determined by the interest rate market.

- **Multi-Strategy Hedge Funds:**

These are portfolio that over time do not rely on a single asset class to generate investment opportunities but rather blend a variety of different strategies and asset classes with no single asset class dominating over time.

- **Other Hedge Funds:**

These are portfolios that have a very specific strategy that does not fit into any of the other classification groupings,

FOURTH TIER OF CLASSIFICATION

Applicable to those funds classified as Long Short Equity Hedge funds only.

- **Long Bias Equity Hedge Funds:**

These portfolios are those that over time will have had or aim to have a net equity exposure in excess of 25%.



- **Market Neutral Hedge Funds:**

These are portfolios that have had over time or expect to have over time very little directional exposure to the equity market. On average over time net equity exposure should be less than 25% but greater than -25%.

- **Other Equity Hedge Funds:**

This category is for portfolios that follow a very specific strategy within the equity market such as listed property or sector-specific strategies.

CREATION OF NEW CLASSIFICATION CATEGORIES

New categories of classification will be considered where there are five or more CIS RHF or QIHF portfolios with an identical or substantially similar portfolio objective, investment policy or restrictions applied by a CIS management company (CIS Manco). In such instances, the past performance history of the portfolio will be included in the newly created category.



Activity:

Locate and download the ASISA Hedge Fund Classification Standard.

Regulation 28 of the Pension Funds Act allows funds used in retirement funds to invest up to 10% of their asset base in hedge funds.



Activity:

Indicate whether the following statement is true or false:

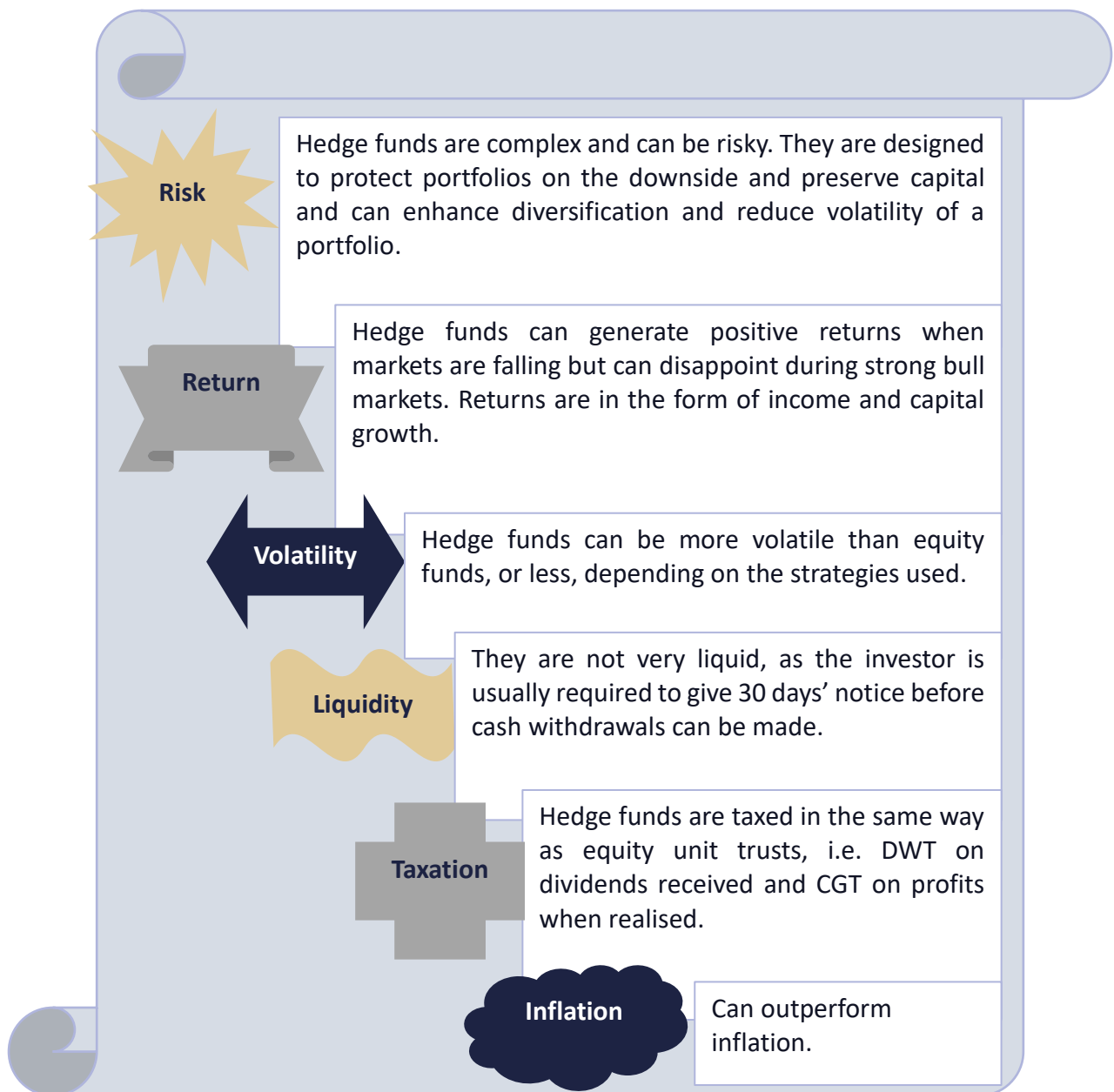
In terms of Regulation 28, up to 15% of funds used in a retirement fund can be invested in hedge funds.

Answer:

False. A maximum investment of 10% in hedge funds is allowed for retirement-funding investments, in terms of Regulation 28.



4.7.5 Investment Characteristics of Hedge Fund Investments



Activity:

Indicate whether the following statement is true or false:

Hedge funds are fairly illiquid and are subject to DWT and CGT; but can outperform inflation and generate positive returns when markets are falling.

Answer:

True



Unit 4 Summary

In this unit, we looked at participatory interests in collective investment schemes, as well as hedge funds. We studied the terms, features and benefits, the structure and the fees, charges and other costs associated with investment in CISs.

The reasons for the popularity of unit trusts as an investment instrument include features such as simplicity, convenience, affordability, transparency, liquidity and flexibility, easy access, low minimum contributions, professional portfolio management and the advantages of diversification. The extensive range of unit trusts cater for all types of investors and can accommodate any risk preference.

Taxation depends on the underlying securities, but will involve income tax, DWT and CGT. Investors are taxed on their worldwide earnings, which means they are taxed on interest, dividends and capital gains derived from offshore investments.

The Net Asset Value (NAV) is the price used for selling and buying units in a CIS. Fund managers may charge both initial and annual management fees, but nowadays most funds no longer charge an initial fee. Commission or advice fees can be negotiated with the client and must be specifically approved by the client. The ASISA standard on Effective Annual Costs (EAC) makes it easier for investors to determine the relative effect of costs on their investments.

Various types of risk are associated with investment in collective investment schemes, including market risk, market-timing risk, currency risk, geographic risk, sector risk, fund-manager risk, and asset-class risk. Fund managers manage risk by various means; for instance, by following diversification strategies within the scope of the fund's mandate, fund managers can reduce the effects of risks posed by any one asset class or sector. By including assets with a low or negative correlation to one another, the fund manager can reduce the downside risk in the portfolio. CISCA limits the exposure within a fund to unlisted shares and any one single share.

We also looked at risk measurements used in a minimum disclosure document (fund fact sheet), namely annualised volatility, maximum drawdown, standard deviation, and the Sharpe ratio. These are all measures to indicate the relative volatility or riskiness of a fund when compared to its peers.

Collective Investment Schemes fall under the jurisdiction of CISCA, are regulated by the FSCA, and are represented by ASISA. FAIS requires any person giving financial advice to



clients in a professional capacity to meet the FAIS fit-and-proper requirements. The TCF principles aim to ensure that customers enjoy good service, simple communication, informed advice, and appropriate products from financial service providers. Portfolios managed for inclusion by retirement funds have to comply with Regulation 28 of the Pension Funds Act, which limits the fund's exposure to equities, property, offshore and other assets. All CIS companies must adhere to the ASISA standard on Effective Annual Cost (EAC).

In order to get a better understanding of available portfolio options, we looked at the ASISA fund classification structure. We saw that the first tier classifies CISs in terms of where they invest geographically; the second tier in terms of the asset class distribution within the CIS; whilst the third tier classifies them in terms of their focus. There are explicit mandates for each of the CIS classes in terms of their exposure and allocation, that all FSCA registered funds have to comply with.

We also looked at different management styles, such as multi-manager, fund of funds and wrap funds. A wrap fund differs from other types in that CGT is triggered in the hands of the investor every time the fund manager makes profits or losses when selling the underlying portfolios.

Shari'ah-compliant funds have to comply with Islamic law and are, therefore, prohibited from investing in certain companies or sectors. Exchange-traded funds (ETFs) and index funds are designed to replicate an underlying index or benchmark. ETFs are listed on the JSE where they can be traded, whilst index funds are CISs. Costs are generally lower than in ordinary CISs.

In Unit 2.7 we looked at Hedge Funds, their features, and benefits, hedging strategies, differences between hedge funds and unit trusts, and risks associated with investments in hedge funds. We also looked at legislation applicable to hedge funds and investment characteristics.

Hedge funds are alternative investment instruments classified as collective investment schemes that employ hedging strategies involving derivatives, to protect against downside risk, and profit from positive market movements at the same time.

Hedging strategies available to hedge fund managers include selling short to gain from future price drops, using arbitrage to exploit inefficiencies between related securities, and trading options or derivatives. Fund managers also invest in anticipation of a specific event like mergers and bankruptcy and in distressed securities below liquidation value.



Hedge funds, being complex products using complex strategies, are riskier than unit trusts. They are less transparent and less liquid and charge higher fees, including much higher performance fees. They tend to outperform the market during bear markets but can disappoint during strong bull markets. Hedge funds can also be used by investors to enhance diversification, reduce volatility, improve returns, and reduce correlation to other assets. Regulation 28 limits the exposure to hedge funds in retirement funds to 10%.

Hedge funds are classified as Collective Investment Schemes and resorts under the Collective Investment Schemes Control Act (CISCA). There are two types of hedge funds, namely the funds for retail investors (RIHF) and the funds for qualified investors (QIHF). The latter is only available to qualified investors. We saw that according to the ASISA Hedge Fund Classification Standard; there are four tiers of classification applicable to CIS in Hedge Funds.

Hedge funds are riskier and more volatile than unit trusts. Their long withdrawal notice period makes them illiquid. Earnings in a hedge fund are subject to DWT and CGT, when applicable.



Unit 5: Retirement Products – General Aspects

5.1 General Legislation Governing Retirement Funds

The two laws that have the greatest direct impact on retirement funds are the Pension Funds Act and the Income Tax Act. Where a retirement fund offers additional risk benefits to members, these benefits are typically insured through a long-term insurer. In addition, certain retirement fund structures fall under the Long-term Insurance Act 52 of 1998. Therefore, aspects of the Long-term Insurance Act also impact retirement fund arrangements. In the event of divorce, a former spouse may lay claim to a portion of a retirement fund member's retirement savings, subject to terms and conditions. For this reason, the possible implications of divorce are important.

The main laws and regulations impacting retirement funds are as follows:



We will now look at these laws as they have the most direct impact on retirement savings products.



i. The Pension Funds Act, 24 of 1956

The Pension Funds Act regulates non-government retirement funds, which include pension and former provident funds, preservation funds, benefit funds and individual retirement annuities.

A pension fund organisation or a retirement fund is inclusive of preservation, pension, provident, benefit and retirement annuity funds, as defined in the Income Tax Act, **and** means:¹

- (a) any association of persons established with the object of providing annuities or lump sum payments for members or former members of such association upon their reaching their retirement dates, or for the dependants of such members or former members upon the death of such members or former members; or
- (b) any business carried on under a scheme or arrangement established with the object of providing annuities or lump sum payments for persons who belong or belonged to the class of persons for whose benefit that scheme or arrangement has been established when they reach their retirement dates or for dependants of such persons upon the death of those persons,
- (c) any association of persons or business carried on under a scheme or arrangement established with the object of receiving, administering, investing and paying benefits that became payable in terms of the employment of a member on behalf of beneficiaries, payable on the death of more than one member of one or more pension funds,
- and includes any such association or business which in addition to carrying on business in connection with any of the objects specified in paragraphs (a), (b) or (c) also carries on business in connection with any of the objects for which a friendly society may be established, as specified in Section 2 of the Friendly Societies Act, 1956, or which is or may become liable for the payment of any benefits provided for in its rules, whether or not it continues to admit or to collect contributions from or on behalf of, members.

According to the Pension Funds Act, no fund is allowed to conduct the business of a retirement fund unless it has been registered and complies with the various requirements of the Pension Funds Act and Regulations.

The registration process of a retirement fund includes registering its rules. The **rules of a retirement fund** are the formal documents by which a fund is constituted and includes information on the conduct of the business of the fund and provisions relating to any rights, obligations or benefits which may be granted to members, former members or family of a former member. In other words, the rules govern how a fund will be managed and how it is structured.

¹ http://www2.saflii.org/za/legis/consol_act.DEL/pfa1956165/5



In terms of the provisions in the Pension Funds Act and Regulations and the Income Tax Act, a range of requirements must be included in the rules of all retirement funds. The Registrar of Pension Funds registers and approves the rules of a retirement fund, if satisfied that the rules comply with all the legal requirements. Registration formalises a retirement fund as a legal Pension Fund Organisation; while approval formalises its tax status, meaning that the various provisions in the Income Tax Act may be applied – for example, tax deductions on contributions.

A member of a retirement fund must receive a benefit statement at least once a year. The benefit statement provides critical information on benefits provided, as per the fund's rules; as well as the member's level of retirement savings; investment information; and other general information, such as normal retirement date. When conducting retirement planning, the most recent benefit statement for the client who belongs to a retirement fund must be sourced. If any additional information is needed, the rules of the fund should be sourced and examined.

If advising the Board of Management (trustees) of a retirement fund, the rules of the fund must be sourced and examined to determine the details of its structure, benefits provided, etcetera.

Once a retirement fund has been registered and approved, activities in relation to the fund must comply with the provisions of the Pension Funds Act and Regulations. Sections of the Pension Funds Act that impact on the day-to-day activities of a retirement fund have been summarised in Table 1 below.

Table 1

Section	Focus Area
Definitions	Description of important concepts that arise in the Act.
Section 7	Matters relating to the Board of Management of a fund, including the object and duties of the Board (trustees, Chairperson and Principal Officer).
Section 8	Application requirements to register a fund and appointment of a Principal Officer (person responsible for the legal documentation of the fund, amongst other duties).
Section 9	Appointment of an auditor (person responsible for checking and approving the financial statements of a fund).
Section 9A	Appointment of a valuator (person responsible for determining whether a fund is able to meet its current and future obligations).



Section	Focus Area
Section 13A	Payment deadlines for contributions, and controls for ensuring timeous payment.
Section 13B	Registration of a retirement fund administrator (business responsible for the day-to-day administration of a fund).
Section 14 and Conduct Standard 1 of 2019	Minimum benefits accruing to members, deferred pensioners and pensioners; and control of amalgamations of retirement funds and transfers of groups of members between funds.
Section 15	Accounting requirements.
Section 15A – 15K	Control, use and regulation of surplus money.
Section 16	Fund valuations (conducted by the valuator).
Section 19	Limits on investments and housing loans.
Section 28	Voluntary dissolution of a fund.
Section 30	Complaints and the office of the Pension Funds Adjudicator.
Section 37A	Limits on transferability, reducibility or cession of retirement benefits.
Section 37B	Protection of retirement benefits.
Section 37C	Disposition of death benefits.
Section 37D	Deductions from benefits, including divorce benefits.

The Board of Management (trustees, including the Chairperson and the fund's Principal Officer) is responsible and accountable for a retirement fund. They need to know and understand their duties, as well as the legal and technical requirements laid out in the Pension Funds Act (amongst other legal requirements) – for example, when considering how to dispose of retirement benefits in the event of death of a member, the process must be done according to the provisions of Section 37C.

The Board has a responsibility to ensure that there are processes in place to comply with each of the legal provisions, that they measure and report on compliance, and take appropriate action to address any non-compliance issues.

Pension Fund Regulations

The Act includes various Regulations, which are an extension of certain sections of the Act:

- **Regulation 28** is of particular importance, as it deals with retirement fund investments, i.e. limits of assets that may be held as retirement fund investments, and reporting requirements on investments.



- **Regulation 30** lays out the minimum details that must be included in the rules of the fund to become registered and approved.
- **Regulation 37** requires funds to accommodate a default investment portfolio for their members.
- **Regulation 38** requires retirement funds to implement a default preservation strategy to allow members exiting before retirement to automatically become paid-up members in the fund.
- **Regulation 39** requires funds to make provision to accept any amount paid or transferred to the fund from another fund for the benefit of a member or member, provided that the transfer comprises a defined contribution benefit component.

PF Circulars

The Registrar for Pension Funds (the Commissioner) issued directives and circulars called Pension Fund (PF) circulars in the past, which expanded on or added to the provisions of the Pension Funds Act. These will be updated or replaced in due course by Conduct Standards (discussed further below).

PF circulars are essentially guidance notes and are more detailed than the provisions in Act. The most noteworthy PF circulars are summarised below.

Table 2

Circular	Focus Area
PF 86	Minimum disclosures to fund members (content and issue of annual benefit statements to normal fund members, and when changes are planned).
PF 90	Minimum disclosures to pensioners (content and issue of annual benefit statements to pensioners, and when changes are planned).
PF 96	Minimum requirements relating to Board members that must be included in the rules.
PF 98	Guidelines to Board members on exercising their duties.
PF 130	Good governance.



Pension Fund Circular/ PF 130

PF 130 is one of the most significant circulars issued. It outlines the specific duties of the Board of Management in relation to good governance principles:

- To act in the best interests of the members.
- To recognise all stakeholders, including the employer (where a group retirement fund is involved).
- That the Board of Management is fully responsible and accountable for the fund; and
- Minimum actions and processes that must be in place to ensure good governance.

This circular makes it clear that minimum compliance with the law is not sufficient; governance measures must include ethical principles and standards of behaviour.

The principles of governance outlined in PF 130 cover three main areas:

- The governance of the Board itself, i.e. the governance structure.
- Governance by the Board of the operations of the fund, i.e. the governance mechanism that the Board will use; and
- The management of relationships in the governance of the fund.

Conduct Standards

The Financial Sector Conduct Authority (FSCA) is responsible for industry conduct, including conduct within the retirement fund industry, as per the Financial Sector Regulation Act, 9 of 2017. In line with requirements as the conduct regulator, the FSCA is bound to formulate and implement Conduct Standards to enhance compliance and safeguard the interests of financial services clients and members of funds. From 2019, various conduct standards impacting on retirement funds have been issued, some of which replaced existing circulars or Board Notices.

These include:

- Conduct Standard 1 of 2019 regarding amalgamations and transfers under Section 14 of the Pension Funds Act (bulk transfers), which replaced Board Notice 120 and previous PF Circulars.
- Conduct Standard 4 of 2020 on minimum skills and training required of Board members (trustees).
- Conduct Standard 1 of 2022 regarding contributions and actions that must be taken if contributions are not paid, which replaced Regulation 33 to the Pension Funds Act:
 - This is important as it outlines the reporting requirements in the event of non-payment, late payment or short payment of contributions. These provisions are in place to protect members' interests where the employer has failed to pay contributions, as per the rules of a retirement fund, and within the prescribed time period (which is seven days after month-end).



Various draft conduct standards have been issued in relation to different matters, which will in due course become standards with which the industry must comply, e.g. standards regarding benefits administrators, smooth bonus investments and investments in hedge funds, derivatives and securities lending, and treating customers fairly and complaints handling.

In summary, the Pension Funds Act, together with the Regulations to the Act and PF Circulars, form the main legal framework within which a retirement fund operates. In addition, Conduct Standards, Directives and Board Notices (now called RF Notices) are issued by the regulators from time to time, detailing requirements to be met in certain circumstances, e.g. when a group of members transfers from one fund to another.

ii. **Income Tax Act, 58 of 1962**

Provisions in the Income Tax Act impact on retirement funds in the following ways:

- Retirement funds must be approved by the Pension Funds Registrar/Commissioner on behalf of the Commissioner for Inland Revenue, for tax purposes.
- Rules must comply with certain minimum provisions.
- Benefits payable when a member leaves, dies or retires from a retirement fund are subject to tax, and may not be paid out until a tax directive has been received from SARS (South African Revenue Services).
- Retirement fund contributions are tax-deductible, within limits, i.e. the Income Tax Act outlines rules for when contributions may qualify for a tax deduction, which results in a reduction in income tax for the payer.

The tax treatment of contributions towards tax-approved retirement savings and tax on benefits received from retirement funds, are aimed at encouraging people to make their own provisions for retirement and to preserve their retirement savings. The tax laws are also aimed at encouraging employers to implement and maintain a retirement fund on behalf of their employees, e.g. contributions made by an employer towards a retirement fund on behalf of its employees (members) are tax deductible, which results in lower tax being payable by the employer.

The minimum provisions to be included in the rules of a retirement fund under the Income Tax Act are:

- The purpose of the retirement fund must genuinely be for the provision of retirement benefits for the employee or member, and/ or benefits payable on the death of the employee or member.
- Contributions towards retirement must be described, and contributions must be made on a regular and ongoing basis.
- After a group retirement fund has commenced, everyone who is eligible to join must join the fund as a condition of service.



- A retirement fund must be set up in a way that the employer cannot gain access to members' retirement savings in the fund.
- At retirement, at least two-thirds must be used to buy a pension/ annuity (fund members may take the benefit in cash if the total fund benefit is R247 500 or less):
 - Provident funds were allowed a cash amount at retirement.

iii. Long-term Insurance Act, 52 of 1998

The Long-term Insurance Act impacts retirement funds in two ways:

- A retirement fund may be set up through policies of insurance.
- Additional benefits may be offered through policies of insurance to fund members directly from the fund, or as a separate policy.

Where a long-term insurer offers administration services for group retirement funds, among other specialist employee benefits services, it must be registered and approved as an administrator under Section 13B of the Pension Funds Act.

Where additional risk benefits are offered to a group, they fall under the class of insurance in the Long-term Insurance Act called a fund policy. This is a contract where, in return for a premium, the insurer undertakes to provide benefits to a retirement fund on behalf of members, or where an employer takes out the policy on behalf of employees. Examples of additional benefits include group life assurance (a death benefit), disability benefits, funeral benefits and dread disease benefits. However, group life insurance benefits through a retirement fund are the most common, with the majority of funds offering these additional benefits to members.

iv. Divorce Act, 70 of 1979

The Divorce Act, as amended, together with the Pension Funds Amendment Act of 2007, makes allowance for a claim to be made by an ex-spouse against a member's retirement savings. This was further supplemented by changes to the Income Tax Act, where the clean-break principle was introduced.

The clean-break principle allows the ex-spouse (called a non-member spouse) to take benefits awarded through a divorce order out of the member spouse's retirement fund, if all requirements have been met, e.g. a valid court order specifying the date, amount, and payment instruction from the non-member spouse. The level of benefit awarded is based on the member spouse's pension interest.

A pension interest is defined as the amount of benefit that the member would have become entitled to had he/ she resigned from a group retirement fund on the date of divorce. For retirement annuities taken out by individuals, it is the sum of the net contributions



(contributions less costs), together with simple interest at a rate prescribed by the Minister of Justice.

When a client who is a member of a retirement fund divorces, and a benefit is awarded to a non-member spouse, the implications must be evaluated, as it will result in a reduction of retirement savings. This will necessitate a revision of the client's retirement plan.



Activity:

If a fund provides a pension at retirement, what will be the legal requirements for that fund?

Answer:

It must be registered with the Registrar/Commissioner of Pension Funds.

5.2 General Terms, Features and Benefits

The general terms, features and benefits of retirement and related products outlined below, include:

- Pension and former provident funds.
- Retirement annuities and preservations funds.
- Annuity products; and
- Risk benefits most associated with retirement fund products.

5.2.1 Pension Fund Benefits Product Category: Group Retirement Funds

There are two main types of group retirement funds that fall under the Pension Fund Benefits category: pension funds and former provident funds. Members belong to group retirement funds by virtue of employment, as these funds are employer-sponsored retirement funds.

Important to note is that over recent years, the core differences between pension funds and provident funds no longer exist, with the same tax and annuity rules applying to pension funds now also applying to provident funds. The treatment of benefits accruing to members whilst a member of former provident funds is still relevant. As a result, many funds will still carry the name 'provident fund.' We will therefore discuss the structures of each fund and the implications of the changes for former provident fund members.

Once a group retirement fund has been implemented, membership is compulsory for all new employees who are eligible to join the fund. Members must make monthly contributions in terms of the rules of the particular fund (if applicable). The employer may also contribute



towards the fund in terms of the rules of the fund. Very often, administration and other costs are carried by the employer, in addition to retirement contribution amounts.

Employer contributions towards a retirement fund on behalf of members are tax-deductible, i.e. the employer enjoys a tax discount on contributions. Contributions made by members towards all retirement funds are also tax deductible, within limits. This is an important financial planning concept, which will be discussed in greater detail later in the module.

Contributions are invested on behalf of the member as per the rules, or where individual investment choice is provided, according to the member's selection of investment portfolio. Accumulated contributions form the basis of members' retirement savings benefits together with investment earnings.

Let us now look at the different types of group retirement funds.

Pension Funds

Pension funds offer a pension at retirement, otherwise known as an annuity. This is a regular payment made to the retiree from accumulated retirement savings.

The pension fund retiree has an option of taking up to one-third of the value of his total retirement savings benefit in cash at retirement. Cash benefits taken from a retirement fund are subject to tax, i.e. tax may be payable on the benefit before the balance is paid out to the member. Any cash taken from retirement savings reduces the pension paid. Under a pension fund, the retiree must use at least two-thirds of the total pension fund benefit to buy a life-long pension/ annuity.

Therefore, at retirement:

- The whole accumulated savings may be reinvested to provide a life-long pension/ annuity.
- OR
- Up to one-third may be taken in cash, with the reduced savings reinvested to provide a lower life-long pension/ annuity.

Former Provident Funds

Provident funds were launched in the 1980's. These funds offered a lump sum at retirement instead of a compulsory pension for various reasons, including the difficulties retired members in rural areas had in accessing a pension payment. The tax treatment of contributions made by members also differed from pension funds. Provident fund members' own contributions were not tax-deductible year on year, but only when the benefit accrued were these contributions deducted from the retirement savings benefit before tax was applied.



The tax deductibility of contributions towards any retirement fund, including pension funds, former provident funds and retirement annuities was harmonised on 1 March 2016, with one deductibility rule applying from this date. Tax implications are discussed further in the module.

Due to the reality of provident fund members typically spending the lump sum at retirement within a two-year period, leaving them destitute in old age, the lump sum benefit at retirement was stopped from 1 March 2021 (subject to rules outlined below). Also, developments such as electronic payments of pensions meant that pension payments were able to be drawn anywhere. The same rules at retirement as pension funds are now imposed on former provident funds, subject to the following rules:

- If a member was over the age of 55 at the effective date of 1 March 2021, the member may still take the retirement benefit in cash.
- Benefits for members younger than 55 on 1 March 2021 are split into 'vested' benefits, which represent the retirement savings value accruing before the effective date – these benefits, plus investment earnings, can still be taken in cash (a lump sum) at retirement. The benefit accruing after 1 March 2021, the 'non-vested' portion, including investment returns, is subject to the rule of a maximum of one-third in cash, with the remainder (or the whole benefit) used to purchase an annuity.
- At retirement, if a benefit from ANY fund is below R247 500, the entire value can be taken as a lump sum cash amount.



Take Note

Benefits are subject to tax.

- ***The 'two-pot' system.***

The two-pot system was implemented on 1 September 2024. This system divides retirement contributions into two components: a 'savings pot' and a 'retirement pot'. The savings pot allows for limited pre-retirement withdrawals, while the retirement pot is preserved until retirement to ensure long-term financial security.

This is in response to the financial difficulties experienced by members during the Covid-19 lockdown and subsequent job losses in the country where retirement savings benefits that could have helped for survival were not accessible. Retirement benefits will be divided into a 'two-pot' system where benefits in one 'pot,' most likely one-third of the retirement savings value, will be accessible, up to a limit and within set time frames.



This new system is aimed at improving financial security and encouraging long-term retirement savings in South Africa. In its current form, members of provident funds who were over 55 years old on 1 March 2021 can choose to continue with the old system or adopt the new one. There are three main features of the two-pot system. There is the vested component, the savings component/pot, and the retirement component/pot. The name of the system is derived from the fact that upon implementation, one-third of retirement contributions will go into the savings pot, and the remaining two-thirds will go into the retirement pot.

Under the two-pot system, retirement savings accumulated up to 31st August 2024, will be placed in a “vested component” and this component will not be affected by the two-pot rules, although a portion of the vested component (minimum of 10% or R30 000, whichever is lower) will be transferred to the “savings pot” (this is a one-off transfer). The vested component will be protected, hence, all rights, rules, and options available to a member prior to the implementation of the two-pot system will remain and still be applicable. Therefore, when a contributor leaves an employer due to resignation, dismissal, or retrenchment, all the rights and options that existed prior to the implementation of the two-pot system will remain the same for the vested component. So, if the contributor withdraws the money in cash, it will be taxed in line with the withdrawal lump sum tax tables.

The rules pertaining to the two-pot system will only apply to the savings and retirement components. After 1 September 2024, no further contributions will be paid into the vested component, and it will only grow with investment returns. The savings pot gives contributors access to their retirement funds in case of emergencies while the retirement pot will not be accessible until one retires. It is important to note, though, that early withdrawals from the savings pot may have long-term implications in terms of achieving one’s retirement goals.

There are also specific tax implications, particularly with respect to lump sum withdrawals from the savings pot. When a contributor withdraws from the savings pot before retirement, the amount withdrawn forms part of the contributor’s taxable income for that tax year and will be taxed according to the applicable marginal tax rate.

At retirement, if the savings pot is empty, the contributor will not be able to access any lump sum at retirement since the full retirement pot will be used to purchase annuity income. However, if the contributor still has any monies in the vested pot at retirement, some of this balance can be accessed as a lump sum.

There can only be one withdrawal from the savings pot each tax year, i.e., between 1 March and 28 February of the following year). There is a minimum allowable withdrawal of R2 000 before costs and tax, however, there is no limit on the maximum withdrawal amount. Where a contributor does not make any withdrawals from the savings pot, it will continue to build up, and any unused balance in the savings pot will be a lump sum benefit at retirement.



T-Day Rules

Upon retirement, a retiree can still decide to withdraw a part of the vested component as a cash lump sum, and this will still be taxed according to the retirement lump sum tax tables and thus enjoy the tax-free amount of R550 000 available to members to retire from their funds. The remaining amount in the vested component must be used to buy an annuity. Where the retiree was a member of a provident fund on 1 March 2021 (also called the T-day), the vested component will be made up of the T-day vested and T-day non-vested benefit. Once the member retires, the full T-day vested benefit and a maximum of one-third of the T-day non-vested benefit can be taken as a cash lump sum and the remaining amount in the T-day non-vested benefit must be used to purchase an annuity.

If the member was younger than 55 years on the T-day, the T-day vested benefit is the member's retirement savings on 28 February 2021, and the T-day non-vested benefit is all the retirement savings from T-day. If the member was 55 years or older on T-day and remained a member of the fund, the T-day vested benefit is the member's retirement savings on 28 February 2021 and all the retirement savings from T-day. The member will thus not have a T-day non-vested benefit. If the member was 55 years or older on T-day but transferred to a new fund after T-day, the member's T-day vested benefit is the retirement savings up to the date of the transfer to the new fund and the member's T-day non-vested benefit is all the retirement savings in the new fund.

- **Defined Contribution and Defined Benefit Funds**

Under group retirement funds, a fund may be structured either as a defined contribution or a defined benefit fund. The rules of each fund will describe its contribution and benefit structure.

In a **defined contribution fund**, the **level of contributions is described** in the rules, e.g. the member contributes 5% of the salary, and the employer contributes 10% of members' salaries, including the costs of the fund. At retirement, a defined contribution fund member's benefit is equal to:

- Own contributions plus employer contributions (if applicable)
- Less costs
- Plus, investment earnings.

A fund member's accumulated savings at any given point has various names, e.g. accumulated fund value, share of fund, and fund credit. All newer funds are structured on a defined contribution basis.

The value of the member's share of the fund at any given time is dependent on investment earnings. In times of poor investment performance, members of defined contribution funds are impacted negatively, i.e. the member carries the risk of poor investment earnings.



In a **defined benefit fund**, the **benefit at retirement is described** in the rules, e.g. pension benefit is equal to $2\% \times \text{annual final salary} \times \text{years of service}$.

The member may also contribute a set amount toward the retirement fund, e.g. 5% of salary.

The employer's contribution is the level deemed necessary by the fund's valuator (actuary) to meet the level of members' benefits at retirement, outlined in the rules of the fund. The employer, therefore, contributes whatever the balance of costs is to ensure that members receive the retirement benefit described in the rules.

At any given time, the member's fund value is equal to an amount calculated by the fund's valuator, usually called an actuarial reserve value.

The member's benefit is not impacted by investment earnings, as the employer carries the financial responsibility to meet retirement benefits as per the rules of the fund, i.e. the employer carries the risk of poor investment earnings. Because of this ongoing responsibility, most defined benefit funds are closed to new members, and a defined contribution fund has been set up instead for new members. Also, in the past, many defined benefit funds converted to defined contribution fund structures.

- **Structure: free-standing retirement funds versus umbrella fund arrangements**

A group retirement fund can be structured in different ways. The structure has implications on costs, administration, reporting and governance (management and control of the fund).

Privately Administered Funds and Other Free-Standing Funds

A privately administered fund is a free-standing fund, which means that the fund is fully independent. These may be administered in-house by the employer (self-administered) or administered by a professional administrator. A privately administered fund has its own bank account and has direct ownership of assets and investments.

If a free-standing fund has secured the benefits in a way that the assets are always sufficient to pay benefits and fund costs, it may be valuation exempt. In other cases, the fund will have to appoint a valuator to perform a valuation every three years. A valuator is an actuary or other suitably qualified person who is authorised to perform specific duties.

Free-standing funds are governed by their own Board of Management (trustees).

Valuation-Exempt Funds

Where the structure of a retirement fund has secured all benefits and costs through policies of insurance, it may be exempt from valuations. These funds are also called **underwritten funds**.

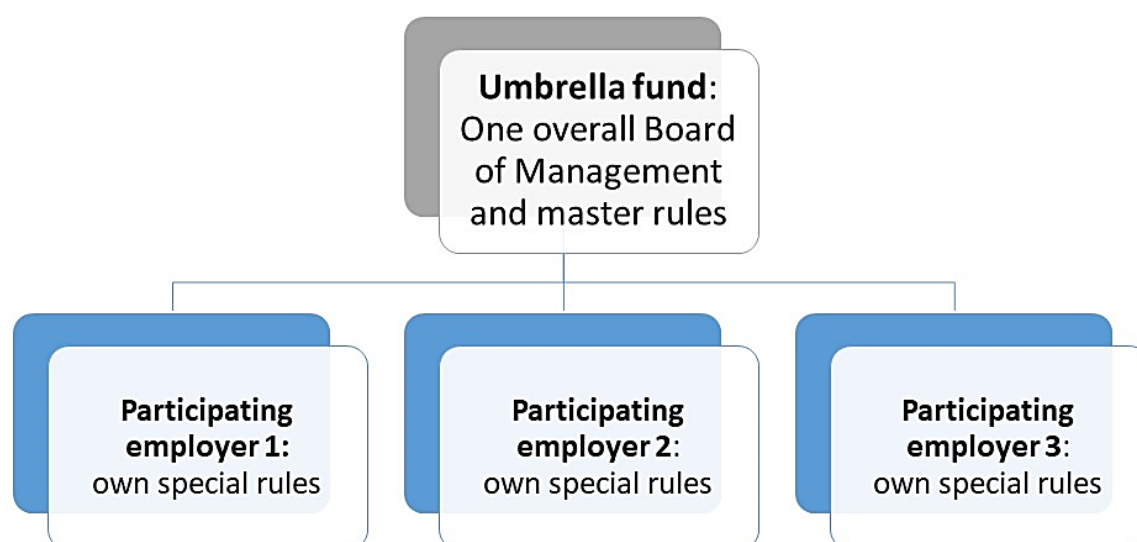


Small funds that have fully secured benefits may be valuation exempt.

Umbrella Funds

Umbrella funds are a special type of fund. A sponsor or retirement fund administrator establishes and manages a single ‘master’ fund. The fund is governed by a master set of rules. Any employer group can join as a participating employer. Participating employers can choose their own benefit structure, within the framework of the master rules. Hence, under an umbrella fund arrangement, the structure of benefits and investments is less flexible than for free-standing retirement funds. The participating employer’s fund arrangements are managed in terms of special rules specific to that employer group.

The running costs of the master umbrella fund are spread among the participating employers. Umbrella funds are, therefore, a cost-effective solution, especially for smaller employer groups. These concepts are illustrated in the diagram below.



The umbrella fund is already registered and managed by a single Board of Management (trustees), which includes independent, professional trustees. Participating employers often set up Management Committees to manage and monitor fund matters on behalf of their members. However, a Management Committee does not have power in law, in terms of overall fund decisions, nor do they take on the responsibilities of Board members, which means that the activities, underlying pricing, and Board decisions under umbrella funds, are not as transparent as those under a free-standing fund.

As the law does not, at this stage, outline requirements in relation to Management Committees, there may be some participating employer/ fund matters and decisions that are



better managed under some Management Committees, but that others are not as well managed on behalf of members.

Investments

A further variation under group retirement funds is the choice of investments. Retirement members' contributions are invested, and investment returns (less costs) are added to each member's accumulated contributions. Because the performance of the investments has a direct impact on the member's benefit at retirement, the choice and control of investments are of critical importance.

In terms of PF 130, Boards of Management are required to draft an Investment Policy Statement (IPS), outlining matters related to the fund's investments, including:

- Details of the fund's investment advisor.
- Where it applies, who the custodians of the investments are.
- If the fund has any socially responsible type of investments.
- Fund mandates.
- What the targeted performance will be for each asset class or portfolio.
- The level of risk on each asset.
- Whether or not the fund exercises ownership rights on the assets it holds.

For free-standing privately-administered funds, the fund – as a separate legal entity – owns the investments. This is a suited solution only for larger funds who can carry the full costs in relation to direct ownership of investment (assets). Underwritten funds, such as umbrella funds, usually offer a range of investment portfolios that are pooled portfolios, e.g. a range of collective investment scheme portfolios.

The needs and investment profiles of younger retirement fund members are very different to those of members approaching retirement. Therefore, many retirement funds offer their members a choice of investment portfolio from a range offered. Members may also switch portfolios as their needs change. One of the portfolios on offer could be a life-stage portfolio, where the spread of investments among the different asset classes changes based on age, with fewer equities and a higher focus on more secure asset classes such as money market and bonds for older members. Offering this type of portfolio (or a similar suited portfolio) to members of funds with investment choice is a legal requirement, both as an option and as the default portfolio for members who do not want to make a choice (Regulation 37). Where individual member investment choice is offered, higher costs apply.

For all retirement funds, investments must comply with the provisions of Regulation 28 to the Pension Funds Act. Regulation 28, also known as Prudential Investment Guidelines (PIGS), places limits on investments in certain asset classes, as well as limits on single securities; e.g. not more than 75% of retirement fund investments may be invested in equities (shares), and



not more than 15% may be invested in a single security with a large market capitalisation (shares in a company whose shares comprise a significant portion of total shares offered on the Johannesburg Securities Exchange). The purpose of the limits is to restrict the level of risk to which fund members' retirement savings are exposed.

With effect from 23 February 2022, the prudential limits in Regulation 28 for offshore (foreign) investments were increased to 35% for investments outside of Africa and 10% for African investments. Percentage limits are calculated as a percentage of the fund's total assets. The overall offshore limit is, therefore, now 45%.

A distinct advantage to investing in any retirement product is that investment earnings are not taxed.

Suitability for client needs

Due to the changes to provident funds where compulsory annuitisation has been implemented, there are no remaining differences between pension and provident funds. Where an employer or employment-related group (such as a trade union) requires a retirement fund, the primary decisions to determine suitability include benefit structure, whether additional risk benefits will be offered, administration structure, structure for the governance and management of the fund, investment needs and affordability constraints.

Let us consider the benefit structure, administration and governance and management options further.

Benefit structure includes:

- Type of fund, i.e. a free-standing or umbrella fund and whether the fund is a defined benefit or a defined contribution fund.
- Retirement fund benefit structure, e.g. contribution levels, retirement date; and
- Risk benefits, i.e. type, level of cover, level of flexibility, terms of cover and insurance factors.

Administration includes:

- Whether the fund will be (or is) privately administered, another type of free-standing fund or participant in an umbrella fund; and
- The appointment of an administrator.

Governance and management include the extent to which the group manages or wants to manage the fund themselves:

- Board of Trustees and Principal Officer, or
- Management Committee (umbrella funds).



Investment includes:

- Options available.
- Selection of asset managers.
- Flexibility considerations.
- Offering of choice to members with appropriate default portfolio; and
- Monitoring of performance.

The needs, preferences and priorities of the Board of Management, Management Committee or employer (new fund) in each of the main areas, determine the most suitable structure for a retirement fund for that group. Generally, the greater the range of options and flexibility, the greater the costs of managing the retirement fund. **Financial constraints** are, therefore, included as an important consideration when formulating or reviewing a fund's structure.

In reality, fewer than 50 new retirement funds are registered each year. Most of the funds that an advisor will deal with are already in existence. The considerations listed above remain key areas when determining suitability for existing retirement funds, especially where there have been substantial changes within the employment group to which members belong.



Research Activity:

Visit the following website to source information on the research results outlined in the Sanlam Benchmark Survey 2022, in relation to the current structures and practices within the group retirement fund industry:

[Sanlam Benchmark Survey | Retirement Fund Research](#)

5.2.2 Retail Pension Benefits Product Sub-Category: Individually owned Retirement Products

Separate to group retirement funds, individuals may invest toward retirement through a privately-owned retirement product. These products, classified as Retail Pension Benefits, include retirement annuities and preservation funds. Retail Pension Benefits products are separate from Pension Fund Benefits products. Knowledge of individually owned Retail Pension Benefits products is important as members who leave a group retirement fund and who want to preserve their retirement benefit tax-free have the option of investing their benefits in either a retirement annuity or a preservation fund (among other options).

i. Retirement Annuities

A retirement annuity is a retirement fund offered through registered insurance companies or approved service providers. A retirement annuity is essentially a personal pension policy.



There is no employer involvement, and anyone who chooses to invest may do so, subject to meeting the minimum requirements of the particular provider. The member (investor) may invest regular contribution amounts as well as once-off amounts. Furthermore, the member may stop making contributions towards a retirement annuity, in which case the benefit will become 'paid-up.'

A paid-up benefit remains invested until the member retires, and ongoing administration and investment costs are deducted from the benefit.

As a retirement annuity is an approved retirement fund, contributions towards the fund (policy) are tax deductible, within limits. Tax deductibility is discussed further in the unit. The member may select and change investment portfolio(s) from a range offered by the provider.

The member's benefit in a retirement annuity, i.e. the fund value, comprises contributions amounts, less costs, plus investment earnings.

In normal circumstances, the benefit of the retirement savings in a retirement annuity may only be accessed from a minimum retirement age of 55, or in the event of disablement. There is no maximum age at which a member must retire.

Where the total benefit is less than R15 000 or where a member emigrates, the benefit may be withdrawn. Clearly describing this limitation to potential clients is important because, even if in a financial crisis, the client/ member is not allowed to access or withdraw money from a retirement annuity unless one of the provisions applies. However, once the 'two-pot' system is implemented, a portion may be able to be accessed in the future.

When retiring from a retirement annuity, the retiree has an option of taking up to one-third of the value of his total retirement savings benefit in cash at retirement. Any cash taken from the savings will reduce the pension paid, but the retiree must use at least two-thirds of the total retirement benefit to buy a lifelong pension/ annuity.

Therefore, at retirement:

- The whole accumulated savings may be reinvested to provide a life-long pension/ annuity.
- OR
- Up to one-third may be taken in cash, with the reduced savings reinvested to provide a lower life-long pension/ annuity.

Retirement annuities cater for transfers of retirement benefits from group retirement funds where a member leaves a group retirement fund before retirement age. Transfers of benefits from group retirement funds into retirement annuities are tax-free, which is an important



advantage for members. There are two further tax advantages to investing in a retirement annuity:

- Contributions are tax deductible, within limits; and
- Investment earnings are not taxed.

ii. Preservation Funds

A preservation fund is also an individually owned retirement product offered by registered insurance companies. Preservation funds only cater for transfers of benefits from other retirement funds, i.e. no ongoing contributions are allowed. Transfers from another retirement fund to a preservation fund are tax-free.

Benefits in Pension, Provident, Pension Preservation and Provident Preservation Funds may be transferred to any approved fund. However, benefits in a Retirement Annuity Fund may only be transferred to another Retirement Annuity Fund.

The member may select his or her own preferred retirement age, as well as investment portfolio(s) from the range offered by the insurer. Switches between investment portfolios are allowed.

Currently, a once-off withdrawal up to the full amount (subject to tax) may be made on preservation funds.

Suitability for Client Needs

Where a member of a group retirement fund withdraws before retirement, i.e. the member has left the employment of an employer, withdrawal benefits become payable. If withdrawal benefits are reinvested in a retirement annuity or preservation fund, the transfer is tax-free. In this way, retirement savings can be preserved without tax implications.

Both retirement annuities and preservation funds are suited options to cater to tax-free transfers of withdrawal benefits.

If a client/ member wants to contribute towards retirement either to supplement existing retirement savings or to implement savings where membership of a group retirement fund is not possible, a retirement annuity is the ideal product option.

Advantages include choice of investment amount and investment portfolio, tax-free investment earnings, and tax deductions on contributions, within limits.

The diagram that follows summarises the main features of products falling under the Pension Fund Benefits product category and Retail Pension Benefits product sub-category (retirement annuities and preservation funds).



Comparison of the different retirement funds:

Group retirement fund	• Employer sponsored group fund • Belong to fund through employment • Contributions according to the rules of fund • Limit 1/3rd cash portion at retirement, remainder used for pension unless a former provident fund member – vested benefits may be taken in cash at retirement
Retirement annuity	• Individual retirement fund • Own selection of contributions and investments • Limit 1/3rd cash portion at retirement, remainder used for pension
Preservation fund	• Individual retirement fund • Preserve retirement savings transferred from other funds • Pension or provident preservation fund • No new contributions

5.2.3 Annuity Products

Annuity (pension) products do not fall under either the product sub-category of pension fund benefits or retail pension benefits unless a pension is payable through a retirement fund. However, they are an essential part of retirement planning and, therefore, have been included in this module.

When a member retires from a retirement fund, at least two-thirds of the benefit must be reinvested in a life-long annuity (unless a portion of the value from a former provident fund is vested). Such annuities are classified as compulsory annuities. An annuity is a pension that is paid regularly to a retiree. Most pensions are paid monthly, but annual and quarterly annuities/ pensions are possible. A retirement fund may pay pensioners directly from the fund, e.g. under a defined benefit fund, the fund typically pays pensions/ annuities to retirees from the fund, as a minimum benefit applies as per the fund's rules.

Alternatively, the rules of the fund may require retirees to source their own annuity product outside of the fund. If a retiree sources an annuity outside of the fund, all further obligations from that retirement fund toward the retiree ceases.

There are three main compulsory annuity products:

1. Traditional/ conventional annuities.
2. Living annuities; and
3. Enhanced annuities.



1. Conventional / Traditional Annuity

A conventional annuity is payable for the whole of the annuitant's life, i.e. once selected, annuity payments will continue until the death of the member. In this way, the pensioner (annuitant) has peace of mind knowing that the annuity will never run out. Before finalising the selection of the structure, it is essential that the retiree's financial advisor gathers sufficient information and analyses the information, in order to provide the best possible advice, because once implemented, it cannot be changed. A conventional annuity is, therefore, not flexible.

Unless other benefits are purchased at the outset, any remaining capital invested at the death of the annuitant is lost, and annuity payments cease. The insurer retains the remaining capital in the annuity reserve to pay annuitants who live longer than expected.

The implications of death and cessation of annuity payments must be taken into account when evaluating the most suited annuity structure for a retiree. If the retiree's spouse or another family member is also relying on the income provided through the annuity, additional benefits need to be added to the annuity to ensure that payments continue after the death of the annuitant.

Options include:

- i. Joint and last survivorship.
- ii. Capital preservation option (CPO).
- iii. Guarantee period.

i. Joint and last survivorship

The joint and last survivorship option as a pensioner of a retirement fund or through a private annuity purchase is structured on the same basis, i.e. there are two lives assured, and annuity payments will continue until the death of the second person. Following the death of the first person, the annuity usually reduces.

The addition of joint and last survivorship will result in a lower initial annuity compared to a standard annuity, where only the retiree receives the annuity until death.

ii. Capital preservation option

Under the capital preservation option, a life insurance policy is taken out at retirement for the same value as the initial retirement value invested in the annuity. Premiums are paid monthly from the annuity, and the annuitant receives the balance as a pension.

The premiums for the policy may be expensive, depending on the circumstances and health of the annuitant. If the annuitant dies, the proceeds of the policy payout to a nominated



beneficiary, e.g. the annuitant's spouse. The capital from the proceeds is then invested to create an income for the surviving spouse (or other dependant, as the case may be).

The addition of a capital preservation option will result in a lower initial annuity compared to a standard annuity where the retiree receives the annuity until death and no capital is preserved.

iii. Guarantee period

Instead of providing a lump sum or joint annuity, another option is to add a guarantee period, e.g. 10 years. Under this option, the annuity will pay as long as the annuitant is alive, as usual. If the annuitant dies before the guarantee period expires, the annuity will continue to be paid to a nominated beneficiary for the remainder of the guarantee period, e.g. if an annuitant has selected a 10-year guarantee period and dies at the end of the second year, the annuity will be paid for another eight years to the nominated beneficiary (typically the annuitant's spouse).

The addition of a guaranteed period is usually not as expensive as the joint and last survivorship and capital preservation options.

As with any benefits added to a conventional annuity, the addition of a guarantee period will result in a lower initial annuity compared to a standard annuity, where the retiree receives the annuity until death. This is not a suited option where a surviving spouse or other dependants will need the income for a period longer than the guaranteed period.

Annual increases

A further consideration when selecting a suited annuity is annual increases. If the annuity does not increase, the annuitant will become poorer over time because of the impact of inflation and will not be able to make ends meet if he/ she lives for a very long time.

Annuity increase options include:

- Increases at a set percentage, e.g. 5% p.a.
- Increases at the inflation rate (CPI).
- Increases linked to an investment portfolio, e.g. a guaranteed fund. This type of annuity is also called a 'with profits' annuity.

Once again, any benefit – such as the addition of annual increases – will result in a lower initial annuity compared to a standard, level annuity.

- Set increases

The annuitant can choose a specific annual annuity increase rate, e.g. 5% p.a. The risk of a set increase is that in years of low inflation, part of the annuity has been sacrificed to fund an



increase higher than required, and in years of high inflation the increase will not meet rising costs.

- Increases at inflation rate

Increases at the inflation rate is a good choice in that the annuity increases at the same rate as the current inflation rate, thereby securing the annuitant's living standards.

- Increases linked to an investment portfolio (with-profits annuity)

The rate of increase when linked to an investment portfolio can be higher following good investment years when compared to the other annuity increase options. However, if markets are poor for an extended period, the increases may not be sufficient. An analysis of the history of the annuity provider's increase rates versus inflation will provide guidance on whether this is a suited option through a particular provider.

In summary, the advantage of a conventional annuity is that the annuity is payable for the life of the annuitant. Additional benefits can be added to ensure that income is provided for a spouse or other dependant, and increases can be added to the annuity. The disadvantages are the lack of flexibility once implemented, and the reduction of the initial annuity if any benefits are added.

This is a good option where a retiree relies solely on the annuity income, for people who have longevity in their family and are healthy and strong at retirement, where a retiree prefers the peace of mind that the guaranteed annuity provides, and for less financially experienced clients.

2. Living Annuity

The other main annuity option is a living annuity. A living annuity is very different from a conventional annuity in that the retiring member's funds are invested separately from any other annuitant's money. The retiree may select the provider of his/ her choice, the annuity level and the investment portfolio in which funds are to be invested.

Furthermore, annuitants may make changes in the choice of investment, change the income level drawn (annually, within limits), and convert to a conventional annuity at a later stage. The annuity is drawn from the capital invested and investment earnings and must be between 2.5% and 17.5% of the capital. This is called a drawdown. The level of the annuity drawn may be changed each year, on the anniversary.

If the annuitant dies, any remaining capital is payable to the annuitant's nominated beneficiary or beneficiaries. If the annuitant dies soon after retiring, the capital invested is not lost.



The living annuity is, therefore, flexible, and does not need to make provision for benefits such as joint and last survivorship or guaranteed periods.

The annuitant, however, faces a risk of running out of capital. As annuities are drawn from the capital invested and investment earnings, an extended period of poor returns as a result of poor market conditions could result in the annuity having to be drawn from the capital alone. The capital and future earnings on the lower capital amount are less. Ideally, an annuity should be drawn from the investment earnings to prevent erosion of the capital. But because annuities are payable for many years, even decades, there will be times that markets perform poorly, resulting in the capital having to be drawn. This was not sufficiently managed in the past, and many living annuity annuitants whose capital has been reduced can no longer meet their financial needs on the lowered annuity amounts.



Activity:

In the table below, consider the compulsory annuity type that will be best suited for the individuals in the two case studies.

Case Study	Best-Suited Annuity Product?
70-year-old male with no dependants. His father lived till 98 and his mother until 104 years of age.	
65-year-old female with a spouse. She is the main breadwinner in the family and a breast cancer survivor.	

Answer:

Case Study	Best-Suited Annuity Product
70-year-old male with no dependants. His father lived till 98 and his mother until 104 years of age.	Compulsory annuity – conventional
65-year-old female with a spouse. She is the main breadwinner in the family and a breast cancer survivor.	Joint and last survivorship annuity to ensure income continues after death. If the spouse is financially responsible, then a living annuity would also be suitable.



A living annuity is good option for particular clients, e.g. a retiree who has other income at retirement and who wants flexibility in terms of annuity drawings; a retiree who is in poor health and wants to preserve retirement capital without the cost of buying benefits; or a retiree who has a high net worth. It is not the best solution for many clients, although the flexibility and retained capital in the event of death seem attractive when compared to the conventional annuity product.

Because of the risk of running out of capital, ASISA (the Association for Savings and Investments South Africa) has issued a combined code on living annuities to which providers and advisors must comply at the outset and on an annual basis. The objectives of the code are to:

- Lay down guidelines of good practice pertaining to the marketing and selling of living annuities to avoid mis-selling; and
- Ensure adequate and appropriate information is disclosed to clients to make informed decisions about the adequacy or otherwise of the living-annuity product.

Four specific standards of advice are included in the code:

- Is the drawdown appropriate? In other words, will the percentage drawn as an annuity from the living annuity (within the limits of 2.5% and 17.5% of capital) be adequate for the client's income needs?
- Is the investment appropriate? The annuitant is relying on a specific level of income for a long time. The investment, therefore, cannot be exposed to undue risk. An annuitant who has a specific income need cannot invest the capital in a higher-risk portfolio hoping for higher-than-average returns, because these are the very types of investments that are volatile and have negative performance during market fluctuations.
- Is the asset composition information communicated to the client? The annuitant must know and understand the choice of portfolio and underlying asset composition, as well as the implications of the particular asset composition.
- The code further describes the responsibilities of the providers in terms of industry-based analysis and monitoring. A status report must be submitted by providers to ASISA on an annual basis.

3. Enhanced Annuity / Impaired Annuity

An enhanced annuity is a variation of a traditional/ conventional annuity product. Enhanced annuities allow people who have a shorter life expectancy – due to health or other related factors – to receive a higher regular income in recognition of the fact that they, on average, have a shorter life expectancy than a healthy person².

² Source: www.justsa.co.za



Up until the release of these products in South Africa, people with a shorter life expectancy were provided with exactly the same level of annuity as those who may live long through a traditional annuity arrangement, as only age and gender were used as rating factors. Through an enhanced annuity product, socio-economic and health factors are evaluated, and where life expectancy is deemed to be reduced, a higher annuity level than through a traditional/conventional annuity product is offered.



Research Activity:

Visit the following websites to obtain more information on compulsory annuity products:

[Invest to Generate an Income | Investment Income | Liberty](#)

[Retirement Products offered by Just SA](#)

Summary of the main features of the different annuities:

Compulsory annuity – conventional	Compulsory annuity - living annuity	Voluntary purchase annuities
• Source of funds from a retirement fund • Not flexible – once selected, remains on basis for entire period • Income depends on capital amount invested and benefits selected • Life long guaranteed income • May choose to add joint and last survivor, guarantee period or <u>CPO</u> to ensure income continues after death • May choose to add annual increases • All additional benefits result in lower income • Annuity taxed as income	• Source of funds from a retirement fund • Flexible • Capital invested, income of between 2.5% - 17.5% can be drawn from capital • Life long • Select own investments • Growth as per investment performance • No guarantees and annuitant has risk of running out of money • At death, remaining funds inherited by beneficiary • <u>ASISA</u> Code – advice • Annuity drawn taxed as income	• Cater for income from capital already available • Source of funds NOT from a pension, pension preservation or retirement annuity fund • Access limited in first 5 years • Different options – income depends on amount invested, option selected • Capital element tax free – formula, remainder taxed as an income



Activity:

Which Annuity type will cease completely on the death of the annuitant?

Answer:

A conventional or traditional annuity, where the income is guaranteed for the whole life of the annuitant. This type of annuity will cease on the death of the annuitant, unless they take out a joint and last survivorship benefit, a capital preservation option or a guarantee period benefit.



5.2.4 Risk Benefits

'Risk benefits' is a general term for benefits that are payable if a certain life event occurs, such as death or disablement. Typical risk benefits offered to groups of employees or retirement fund members include:

- Benefits payable as a lump sum or pension to the family in the event of the **death** of an employee/ member.
- Benefits payable as a lump sum or regular income in the event of the **disablement** of an employee/ member.
- Benefits payable as a lump sum in the event of the employee/ member contracting a serious disease or suffering from a severe illness – these benefits have many names but are often called **dread disease** benefits.
- Benefits payable as a small lump sum to the family to pay towards **funeral** costs in the event of the death of an employee/ member or his/ her immediate family.
- Benefits payable in the event of **accidental death and/ or disablement** of an employee/ member.

Most members who belong to a group retirement fund also enjoy additional death benefits. A significant portion of funds also offer associated disability benefits to members, with fewer offering funeral cover, accidental cover and/ or dread disease benefits. Risk benefits may form part of the fund or may be set up as a separate arrangement. In most cases, however, additional risk benefits are insured and hence fall under the product sub-category: Long-term Insurance Category B1.

Group death, dread disease and accidental death or disablement benefits are typically expressed as a multiple of salary/ pensionable remuneration, e.g. 3 x annual salary.



Example: Structure of additional risk benefits through a retirement fund

Gerry is a member of a pension fund. According to the rules of the fund, in the event of death before retirement Gerry's family will receive the total of Gerry's retirement savings, plus an additional 3 x annual salary from the approved group life insurance. According to his benefit statement, Gerry's retirement benefit in the fund is R230 000, and his salary is R120 000 p.a.

If Gerry dies, what benefit will be payable, before tax?

Retirement savings: R230 000

Group Life insurance: $R120\,000 \times 3 = R360\,000$

Total benefit: $R230\,000 + R360\,000 = R590\,000$ before tax.



Not all benefits are insured, e.g. under a defined benefit fund, in the event of disablement before retirement, a monthly pension benefit may be paid to the disabled member. In the event of death, a pension may be payable to the deceased member's spouse and minor children.

Approved versus unapproved risk benefits

Where policy benefits are included in the rules of a group retirement fund, these benefits are **approved**, i.e. they form part of the approved benefits under the retirement fund, and costs form part of the tax deductibility allowed. Risk benefits that are insured by a retirement fund are called **fund policies**. The premiums are paid by the fund, and benefits are payable to the fund when an insured claim event occurs. In the event of the death of a member, both the retirement savings portion as well as approved group life benefits are payable.

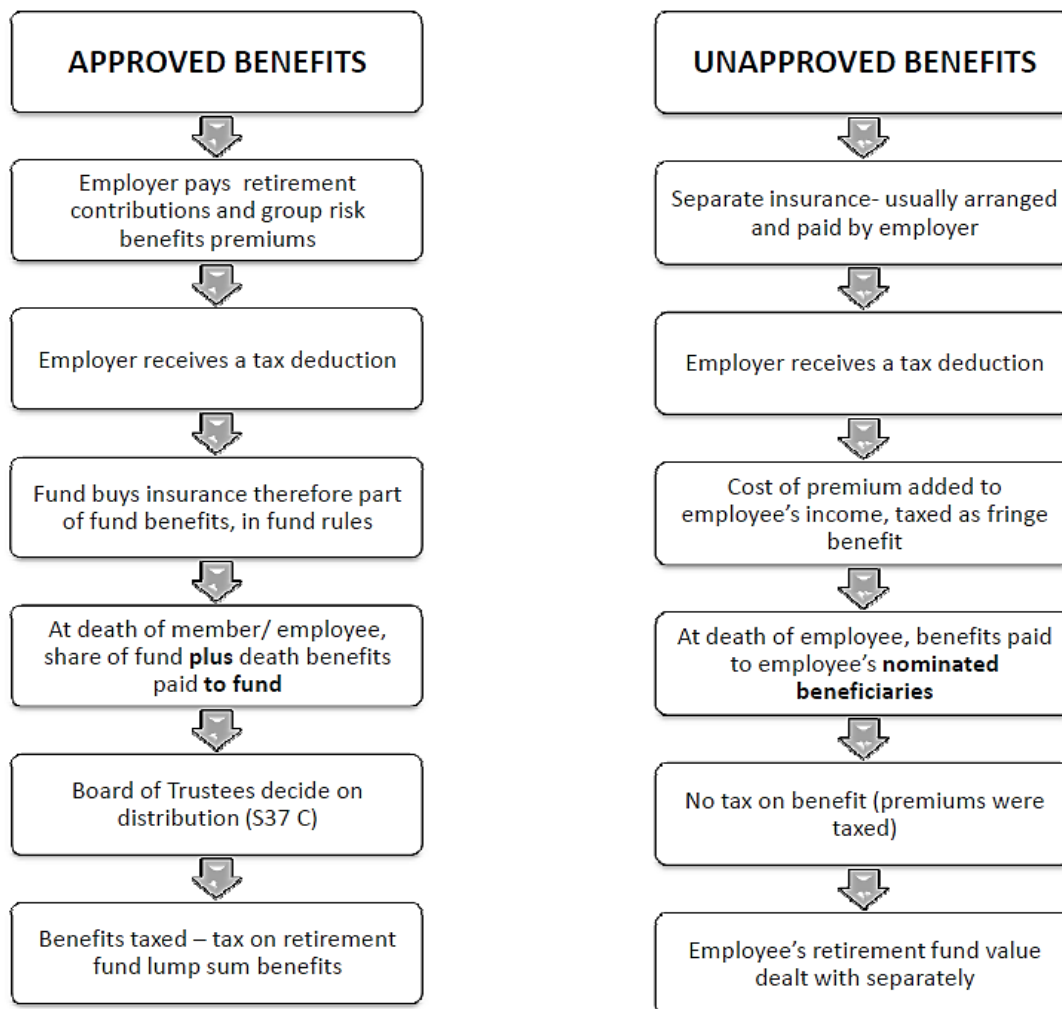
The Board of Management is responsible for disposing of the benefits to members (or the members' dependants in the event of death), in accordance with the rules of the fund and legal provisions under Section 37C of the Pension Funds Act. At death, retirement plus approved group life benefits are subject to tax on retirement fund benefits.

Where additional benefits for a group are separate from a group retirement fund, the policy is an **unapproved** policy. The policy is typically carried out by the employer, and costs may be paid by the employer on behalf of members. However, the corresponding premium cost is a taxable fringe benefit in the hands of the employee. Benefits paid from unapproved policies are tax-free and are distributed in accordance with the member's beneficiary nomination.

Due to the tax implications, some group risk benefits are implemented using a combination of approved and unapproved benefits, where the amount up to the tax-free portion is insured as an approved benefit, and the remainder of benefits are unapproved. The combination means that beneficiaries of deceased fund members receive a higher level of cash from the total benefit, as little or no tax is payable.



Key differences between approved and unapproved risk benefits:



Neither preservation funds nor modern retirement annuity policies make provision for additional risk benefits; additional risk benefit needs are catered for under separate long-term insurance policies. Under older retirement annuities, additional life and lump sum disability benefits were allowed – many of these policies will still be in existence.

Many factors are taken into account when determining the suitability of risk benefits, type of cover, level of cover, flexible cover options and tax implications in relation to whether the benefits are or will be approved or unapproved. Affordability is one of the key factors taken into account. The profile and needs of members are also major factors, e.g. where employees are mostly migrant workers, a lump sum benefit may be preferred rather than ongoing monthly benefit payments.



Activity:

An employer wishes to provide additional death benefits over and above those provided by the retirement fund. These death benefits will be an extra 2 x annual salary and should not be subject to tax. Will they use an approved or unapproved policy?

Answer:

The policy must fall outside of the retirement fund and will be structured as an **unapproved** policy for tax purposes.

5.3 Fee Structures, Charges and Costs

Advisors must have knowledge of the typical fee structures, charges and other costs associated with products in the **class of business**. Under product training and assessment, advisors need to know how the **financial product** and any underlying components of the product are structured and priced, as well as the fee structure, charges and other costs associated with the product. For investments, the impact of costs on the real return must also be understood.

Administration – Group Retirement Funds

All funds need to be administered. Administration may be in-house or outsourced to an approved benefits administrator. Whether the fund is administered in-house or outsourced, a fee is charged for administration services. Administration duties, other details of the service, and the fee structure are outlined in the service level agreement:

- Standard services, such as monthly processes and claim payments, are included in the standard administration fee.
- The standard administration fee is usually expressed as a percentage of payroll, e.g. 2.5% of total member earnings.
- Fees for non-standard services may be included in the service level agreement, or negotiated as and when these arise, e.g. a fee for Section 14 bulk transfers of members between funds.

The cost of administration depends on the structure and profile of the fund. For example, fees on umbrella funds are lower than on free-standing funds; a higher fee will be charged where there are multiple pay points that need to be processed each month; and funds requiring more regular administration reports or audits and valuations will be charged a higher fee.

Furthermore, the administration fees may be included in the employer's contribution rate (inclusive of costs) or be payable over and above the contribution rate (exclusive of costs).



Example: Exclusively and inclusively costed contributions

A fund's rules may specify that the employer pays a contribution rate of 10% of the members' salaries (payroll), exclusive of administration costs. If the administration fee is 2%, the employer actually pays a total contribution rate of 12% of payroll, of which 10% is invested toward retirement on behalf of the members.

Alternatively, a fund's rules may specify that the employer pays a contribution rate of 10% of the members' salaries (payroll), inclusive of costs.

If the administration fee is 2%, the cost is deducted from the employer's contribution rate of 10%, and only 8% is invested toward retirement on behalf of the members.

Where the administration fee is inclusive of costs, as described in the second example, annual increases impact negatively on the members – e.g. if, in the second example, the fees increase to 2.5% of payroll, the remaining amount invested towards retirement is now only 7.5%. Over time, less and less is being invested towards retirement. The impact of contributions inclusive of costs should, therefore, be discussed with the Board (or Management Committee).

Note that all fees are usually negotiated on an annual basis. Fees and charges that could apply are summarised below.



Retirement fund fees and charges:



Appointments – Group Retirement Funds

Where the retirement fund is not specifically exempt, the Board is required to appoint a **valuator** and an **auditor**. Valuation and/ or audit fees need to be agreed, in writing, and the actual cost will relate to the level of investigation required in performing a valuation or audit.

These fees are typically expressed in Rand values. Factors that impact on the fee level include:

- The structure of the fund benefits, e.g. a defined benefit fund must be valued by a valuator every three years, and annual audits must be conducted.
- Whether pensions are paid from the fund.
- The structure of the investments, e.g. a fund may own investments outright, such as properties that need to be valued.

The Board or Management Committee may also appoint:

- A **benefits consultant** (advisor).
- An **investment consultant** (investment advisor).

The fee structure in relation to consultant appointments under a group fund is also typically a fixed Rand amount. The level charged relates to the frequency of services rendered, and depth of tasks required, e.g. a fund may require the benefits consultant to arrange Board/



committee meetings in consultation with the Chairperson, compile and distribute agenda packs for meetings, take minutes of meetings, arrange and present the administration and other reports, and advise on various fund matters. The frequency of Board/ committee meetings will, therefore, impact on the fee charged for benefit consulting services, among other tasks.

A fund may need to appoint an **expert advisor**, such as an attorney or an actuary. Fees for these services will be negotiated according to the advice required.

Investments – All Funds

Retirement contributions less administration costs are invested in accordance with the fund rules and Board instructions (mandate). There may be multiple layers of fees, charges and costs involved, including, but not limited to the following:

- A fee for investment of money into a portfolio.
- A monthly fee for investment administration, payable to the investment manager.
- A fee for switching portfolios at fund or individual level, usually expressed as a Rand amount.
- An annual investment fee, expressed as a percentage of assets and based on a sliding scale.
- A performance fee for returns achieved above a particular target – these are usually a percentage of assets under management.
- Rebates or additional fees, such as platform fees (investment system fees), may apply.
- Additional costs related to directly owned assets may apply, e.g. stock-broking fees, costs for the administration, maintenance and valuation of property, transfer fees when purchasing a property, and the cost of the actual purchase.

Investment fees and costs mean that the net amount invested towards retirement is reduced. Costs relating to investment are, therefore, an important consideration in investment decisions and disclosures.

Under a retirement fund, as per ASISA's Retirement Savings Cost Disclosure Standard, the administrator must disclose all costs and charges incurred or that will be incurred under each of the following components:

- Administration charges.
- Investment charges/fees.
- Advice and/or consultant fees or commissions.
- Other charges, e.g. actuarial fees, levies.

Costs of Insurance



Boards of Management are required to hold fidelity insurance cover, the cost of which is borne by the fund. This is insurance to cover the risk of fraud, theft or dishonesty by Board members, resulting in losses to the fund. The premium is expressed as a set Rand amount.

The fund may have insured benefits payable in the event of a risk arising, e.g. death of a member. Wherever insurance is involved, the premium costs relate to the level of risk taken on, and the possibility of claims. Claims experience will, therefore, play a role in the cost of premiums.

Other factors that impact on the cost of insurance premiums include the level of coverage required, type of insurance and benefits offered, and the profile of the insured group.

Group risk benefits are typically quoted as a percentage of the members' payroll and may include commission.

Commission, Costs and Fees – Disclosures

The commission is often payable to the introducer of the fund and to the introducer of insurance policies, e.g. a broker who negotiated the fund or advised an individual client to implement a retirement annuity or preservation fund.

Where commission is payable, the frequency, amount and nature of the commission must be clearly disclosed, as well as who will be paying the commission.

Where any fees are charged, this must be agreed in writing. The fee must be clearly described, as well as the basis for calculating the fee.

Remuneration and Training of Board Members

Professional (independent) trustees, the Principal Officer and Board members of larger funds may be remunerated for their services. Furthermore, Board members are required to undergo training to fulfil their duties effectively. The fund will pay for these types of costs which will vary depending on the tasks undertaken.

Other Costs

When registering a fund for the first time, a registration fee applies. The fee is prescribed by the Registrar/Commissioner.

Once a fund has been registered, annual levies must be paid to the Pension Office of the FSCA, as well as a levy to the Pension Fund Adjudicators' office. These levies are based on a fixed amount plus a fee per member who actively contributes towards the fund. An overall maximum applies.



Approved administrators also pay an annual levy. This will only impact a fund that is administered in-house, e.g. the Eskom retirement funds.

There are many other costs that could arise, each of which would need to be agreed upon with the Board, e.g. cost of tracing beneficiaries, costs of calculating and processing surplus apportionment, securities-related fees, costs of travel for Board members or appointed advisors, etc.

Late-Payment Interest

Late-payment interest is payable on contributions that were not paid within the prescribed period. The employer is responsible for paying late-payment interest.

Late-payment interest is based on the prime lending rate and is calculated as follows:

Prime rate + 2%



Example: Calculating Late-Payment Interest

Contributions amounting to R9 000 for a pension fund were only received one month after the due date. Assuming a prime rate of 10.75%, what late-payment interest is payable?

Late payment interest for contributions = prime rate + 2%

$\therefore 10.75\% + 2\%$
= 14.75% interest rate to be applied.

Total interest payable: Contribution paid late of R9 000 x 14.75% = R1 327.50.



Activity:

Fund A is set up as inclusively cost. The employer elected the contributions to be 10% of the eligible employees' remuneration. Costs are 2.5% of contributions. What portion of the employees' retirement contributions will be allocated towards retirement?

Answer:

7.5% remains to be allocated towards retirement (10% contributions less 2.5% costs).



5.4 General Risks Associated with Investing, Purchasing or Transacting in Retirement Products

As Pension Fund Benefits products and Retail Pension Benefits products differ, the risks associated with investing, purchasing, or transacting also differ.

- **Pension Fund Benefits (Group Retirement Funds)**

For group retirement funds, provisions under the Pension Funds and Income Tax Acts, as well as the rules of the retirement fund, govern and regulate the business of a retirement fund. The first risk that applies is non-compliance with laws and/ or the rules of the fund. The Board of Management has a duty to ensure that they apply good governance principles in relation to all fund matters and ensure that the fund complies with requirements.

The performance of the fund's investments is of paramount importance, as this has a direct impact on the value of members' retirement savings. The fund's Investment Policy Statement (IPS) outlines duties in relation to the selection and management of investments on behalf of members. Furthermore, the Board must ensure that the investment remains within the limits outlined in Regulation 28, and that the required reports are submitted to the Pension Funds Registrar/Commissioner.

Under a defined contribution fund, members carry the risk of poor investment performance, while under a defined benefit fund, the employer carries the risk of poor investment performance. These risks need to be managed through the proper selection and ongoing monitoring of investments.

Only registered and approved administrators may be appointed. Before appointing an administrator, the Board should conduct a full investigation into the administrator's capability, systems and history, to ensure that the fund's administration is accurate; procedures are processed timeously; all processes comply with legal provisions, e.g. processing, allocating and investing monthly contributions; and the layout and issue of annual benefits.

In order to confirm that the costs are market-related, a fund should regularly go through the process of 're-brokering.' This is where the advisor/ benefit consultant or Board calls for quotes from other service providers to compare running costs and the cost of risk benefits, where applicable.

Where pensions are paid directly from a retirement fund, the reserve set aside for pensioners must be carefully managed to ensure that benefit obligations and increases, as per the pensioner increase policy, can be met on a continuous basis.



The employer who sponsors a group retirement fund is responsible for deducting contributions, as per the rules of the fund, from employees' (members') earnings, and paying these across to the administrator together with the employer contributions and costs for administration and risk benefits. Failure to pay contributions across is treated very seriously.

A fund must have appointed a monitoring person who has a duty to notify the fund's Principal Officer in the event of late or non-payment of contribution, or non-submission of the membership information for a particular month. If non-payment continues, further action needs to be taken, e.g. report to the Board, the Authority (the Pension Funds Registrar/ Commissioner) and if the arrears contribution payment has not been paid within 90 days, the South African police must be notified as well. In fact, the owners of the business may face criminal charges if contributions remain unpaid, especially where these were already deducted from members' income. Late-payment interest also applies, which is payable by the employer and not the fund.

- **Retail Pension Benefits (Individually Owned Retirement Products)**

Under a preservation fund or retirement annuity policy, the underlying costs are a major factor, as costs reduce the net investment value. Costs can vary greatly under a retirement annuity, especially as a number of providers apply up-front costs, resulting in very little being invested toward retirement savings in the early years.

The range of investment portfolio options should be evaluated to ensure that suitable portfolios are on offer for current as well as long-term investment needs.

Further considerations, which are very important for advisors to disclose, are the rules around access to the investment. Under a preservation fund, the investor can only access the funds once before retirement, up to the full amount, subject to tax. Because the source of preserved funds is a pension or provident fund that the investor withdrew from, any portion taken in cash or transferred to a retirement annuity at the date of exit from the original fund is treated as the once-off allowed withdrawal, and no further cash withdrawals are allowed before retirement.

For retirement annuities, the funds cannot be accessed at all before a minimum age of 55, unless the amount invested is below R15 000 (the current allowed amount), or the member is disabled or emigrating. There are no exceptions made in the event of the member being retrenched, as an example.

Access to a preservation fund or retirement annuity investment is further limited to only one-third of the total value at retirement unless the entire value of the fund is below the minimum (*de minimus*) of R247 500, in which case the full retirement interest may be taken as a lump sum.



Take Note

Access Rules Will Change Once Government's Two-Pot System Is Implemented.



Activity:

A taxpayer retires from his Retirement Annuity Fund. The total value of his retirement interest is R250 500. What lump sum may he take from the fund?

Answer:

He is not entitled to commute his interests in the fund, as R250 500 is greater than R247 500. He may only receive a lump sum of R 83 500 (one third).



Unit 5 Summary

Retirement funds are governed by a Board of Management (trustees), who manage the fund in accordance with its registered rules and laws. The Board is held responsible for all matters in relation to the retirement fund and must manage the fund on behalf of the people who belong to the fund (called members).

The rules of a fund must meet legal requirements. Retirement funds are registered by the Registrar/Commissioner of Pension Funds, if the fund's rules meet the minimum provisions for registration as laid out in the Pension Funds Act and Regulations to the Act.

The Registrar/Commissioner will also approve funds for income tax purposes on behalf of the Commissioner for Inland Revenue if the fund's rules meet the approval provisions of the Income Tax Act. Approval under the Income Tax Act means that contributions made by an employer on behalf of a member towards retirement as well as member contributions qualify for tax deductions. Where contributions qualify for a deduction, this will result in a reduction of income tax payable in the particular tax year. Tax deductibility of contributions is calculated according to formulae, with overall annual limits.

The structure of a group retirement fund (as per the rules) impacts on costs in relation to administration, and whether a valuation is required. A group retirement fund can be set up as a free-standing fund, in which case all costs are borne by the fund alone. A fund can also be set up under an umbrella fund arrangement, where a master set of rules applies, and participating employers who are not related may join. Participating employers' benefits are outlined in special rules that apply only to that participating employer. Benefit selections may be more limited than under a free-standing fund arrangement. Under an umbrella fund, costs are shared among participating employers.

Retirement funds that cater for saving up for retirement needs fall under two different product categories: Pension Fund Benefits (group retirement funds) and Retail Pension Benefits (individually owned retirement fund products). Payments towards retirement (contributions), less costs, are invested on behalf of the member, in accordance with the rules of the fund and selected investments. Where the fund is sponsored by the employer – i.e. it is a retirement fund for a group of employees – the Board is responsible for the investment function, including the selection of investment portfolios. Even where investment choice has been provided to members, the Board remains responsible for investments and the selection made available to members.



Where the retirement fund is an individual arrangement, e.g. a retirement annuity or preservation fund, the member is responsible for the selection of investment amounts and investment portfolio(s). At retirement, the total member's savings in the retirement fund is then used to make provision for retirement needs.

An investment policy statement (IPS) must be in place for group retirement funds. The IPS controls matters in relation to a fund's investments, including compliance with Regulation 28 on limitations of particular investments, and reporting on investments.

At retirement, various annuity (pension) options are available, including:

- Direct pension payments from a retirement fund in the case of defined benefit funds.
- Conventional/ traditional annuity, which is a guaranteed life-long annuity offering additional benefit options.
- Living annuities, which are not guaranteed, but offer greater flexibility than traditional annuity products; and
- Enhanced/ impaired annuities, which are a special form of traditional annuity taking a member's health and lifestyle risks into account and paying a higher annuity where life expectancy is lowered.

Many retirement funds offer additional risk benefits to members, including:

- Life insurance.
- Disability insurance.
- Funeral benefits.
- Accidental death and/ or disability benefits; and
- Dread disease benefits.

Additional risk benefits may be set up on an approved basis, where the benefits are described in the rules of the retirement fund, costs are borne by the fund, and benefits are payable to the fund.

The Board, in turn, makes benefit payments to the member in the case of injury, illness or disablement (where applicable), or to the member's dependants in the event of death. Approved benefits are subject to income tax.

Additional risk benefits may also be payable on an unapproved basis, where the benefits are payable through a policy separate from the fund. The employer typically pays costs, and the associated premium is then added as a fringe benefit to the member's salary, and taxed. Benefits, when payable, are tax-free and are paid to the member in the case of disability, accident and dread disease benefits, or in accordance with the member's beneficiary nomination in the event of death.



No additional risk benefits apply under a preservation fund. For retirement annuity policies, current products do not cater for additional risk benefits, while under older products additional risk benefits were provided.



6.1 Fund Options, Strategies, Legal and Tax Implications

6.1.1 Group Retirement Fund Options and Strategies.

Under a group retirement fund, multiple layers of options apply, including the benefit structure, administration structure, structure for the governance and management of the fund, investment needs, and whether additional risk benefits will be offered. As such, affordability constraints play a major role in determining the best overall structure for a particular group. There are overlaps between the areas that need to be considered when formulating a strategy, e.g. a decision on the benefit and administration structure impacts on fund governance and management.

For ease of reference, the most important areas that need to be considered are summarised below.

Benefit structure includes:

- Type of fund, i.e. a free-standing or umbrella fund and a defined benefit or a defined contribution fund,
- Retirement fund benefit structure, e.g. contribution levels, retirement date; and
- Risk benefits, i.e. type, level of cover, level of flexibility, terms of cover and insurance factors.

Administration includes:

- Whether the fund will be (or is) privately administered, another type of free-standing fund or participant in an umbrella fund; and
- The appointment of an administrator.

Governance and management includes the extent to which the group manages or wants to manage the fund themselves:



- Board of Trustees and Principal Officer, or
- Management Committee (umbrella funds).

Investment includes:

- Options available,
- Selection of asset managers,
- Flexibility considerations,
- Offering of choice to members with appropriate default portfolio; and
- Monitoring of performance.

Let us consider the benefit structure, administration and governance and management options and strategies further. We will also touch on some investment considerations.

Because the primary purpose of a retirement fund is to make financial provisions for the member during retirement, the level of contributions towards retirement is, therefore, one of the most important considerations, along with identifying the actual structure of contributions and costs, e.g. will the employer pay costs and, if so, will the costs be included in the employer's overall contribution (inclusive basis), or will costs be payable over and above retirement contributions (exclusive basis)? Or will another basis be considered, such as members paying half or all of the running costs?

Where contributions are inclusive of costs, the net amount invested towards retirement savings will be slowly eroded as running costs rise. Under an inclusively costed basis payable by the employer, the employer has an advantage, as there is a limit on contribution costs because the total payable remains unchanged. Members are disadvantaged as, over the years, less is being invested after costs towards retirement. Where contributions are exclusive of costs and costs are borne by the employer, increases in running costs become an employer liability, but members are at an advantage, as net contributions towards retirement are not affected by rising costs.

Previously, a key option was whether to register a pension or provident fund. With the legislative amendments to retirement funds that came into effect in March 2021, the consideration of access to the full benefit amount at retirement no longer applies.

Employers may also consider a retirement annuity fund where the employee is the member, as the tax deductibility of all funds is the same – this is only suited where membership is very small, and/or the contributions payable will not meet a retirement fund administrator's minimum requirement.

A further option available is whether to register a free-standing fund, or to join an umbrella fund arrangement as a participating employer. For smaller groups, an umbrella fund is more



affordable, but some restrictions will apply in terms of benefits and investment options available. A free-standing fund is only viable where a fund has a large membership, as additional running costs apply to free-standing funds, which are borne alone by the fund. However, the range of benefits and investments that may be selected are wider than under umbrella/ underwritten funds. Where flexibility is a factor, and the size of membership and assets is sufficient, a free-standing fund is, therefore, a better option/ strategy.

The choice of risk benefits, type and level of cover, and whether these will be approved (part of the fund and rules) or unapproved (separate to the fund), also form part of benefit option decisions. The actual costs, terms, and conditions of each specific insurance policy (or quote) are important, as these vary greatly. Risk benefit options are discussed in greater detail in Section 2.3.

Where a fund is to be free-standing (privately administered) or under an umbrella fund arrangement (underwritten), associated costs and other implications arise, including:

- Choice of umbrella fund/ administrator.
- Whether the employer group will need to form its own Board of Management/ trustees or, in the case of an umbrella fund, whether they will form a Management Committee.

The Board of Management, comprising the duly elected or appointed fund officials, is responsible and accountable for the management of a retirement fund. Board members, therefore, have the right and responsibility to take decisions on fund matters on behalf of the members of a retirement fund.

Section 7(1) of the Pension Funds Act requires that every fund have a Board of Management consisting of at least four Board members, at least 50% of whom the members of the fund shall have the right to elect. The Boards of Management for most free-standing retirement funds comprise 50% employer-appointed Board members, and 50% member-elected Board members. The Registrar/Commissioner may grant a fund an exemption from the minimum requirements outlined in certain circumstances, e.g. if the membership is too small.

Decisions on the structure of the Board of Management include:

- Number of Board members,
- Chairperson – how the Chairperson will be appointed, whether he/ she will have a deciding vote, term of office, etc.,
- Who will manage the secretarial duties, e.g. minute book and agenda,
- Term of office – how long a person will remain a Board member,
- Elections – how Board members will be elected,
- Meetings – how often meetings will be held,
- Whether Board members will be paid and, if so, how much,



- How many Board members must be present for a decision to become official (called a quorum),
- Who the Principal Officer will be (the appointed person responsible for legal matters on a fund).

Registering a free-standing fund, therefore, carries costs and duties that have an impact on the day-to-day management of a fund. Not every employer group is willing or able to take on Board duties and responsibilities, in which case participating in an umbrella fund arrangement is more suited.

Participating employers of umbrella funds may, of their own accord, form a Management Committee (Manco) to represent members' interests within the employer group. A Management Committee does not, however, hold legal powers in relation to a retirement fund, nor do they have duties of management of the fund.

Whether a retirement fund is free-standing or under an umbrella fund arrangement, sound administration is key to the smooth running of a fund. As so few new funds are registered, in most cases an advisor will be dealing with a fund already in existence.

Where a new administrator is to be appointed, it is critical to establish that the fund's benefit structure can be accommodated by the administrator, among other tasks and duties, e.g. comparing costs, confirming approval as a retirement fund benefits administrator, investigating the administrator's track record, skills and competencies, actual terms of the service contract, reporting, management of risks and conflicts of interest, and how services are or will be measured.

All retirement funds must formulate an Investment Policy Statement (IPS). For existing funds, the IPS must be reviewed before making any decisions on changes, to ensure that the strategy being considered aligns with the IPS. If a new fund is being considered, formulating the IPS is a major task undertaken by the Board of Management/ trustees.

Investment considerations include:

- Whether the preferred investment arrangements can be administered.
- Whether an investment strategy has been determined and documented in an investment policy statement and, if so, the details of the policy.
- Whether particular assets are required.
- If any portion is invested offshore (or to be invested offshore).
- The investment alternatives available.
- The costs of the different investment options, or the cost of the same options via different vehicles.



- Details of the profile of the members, e.g. mostly a younger workforce versus many people approaching retirement.
- For new funds, whether the members should be given a choice of investments and, if so, what portfolio options will be offered.
- What the default portfolio will be for members who do not want to make an investment choice.
- For existing funds, is investment choice offered to members and, if so, what options have been offered?
- How investments are/ will be monitored.
- Details of the investment-return objective.
- What benchmark (measure for investment returns) is/ will be used to evaluate returns.

If a group has decided on an umbrella fund arrangement, the portfolio options available may be limited to those provided under the umbrella fund arrangement. More recently certain umbrella fund administrators have broadened the scope of investment arrangements that may be selected.



Activities:

1. What are the two types of risk benefits offered in a pension fund?

Answer:

Approved or unapproved risk benefits.

2. Before appointing an administrator, what must the board first do?

Answer:

The Board must conduct a thorough investigation into possible administrators before they make an appointment.

3. What decisions must be included in the fund's IPS?

Answer

Every decision in relation to investments must be documented in the fund's Investment Policy Statement (IPS).

4. When would you use a default portfolio?

Answer

A default portfolio is used for members who do not want to make an investment choice.



6.1.2 Group Retirement Funds: Legal Implications

Activities of retirement funds are regulated to protect the interests of fund members. Hence, we will take a closer look at certain legal and fund business requirements:

- Duties of the Board of Management under Section 7 of the Pension Funds Act and additional PF Circulars,
- Duties in terms of contribution payments under Section 13A of the Pension Funds Act and Conduct Standard 1 of 2022,
- Control of transfers of groups of members under Section 14 of the Act,
- Restrictions under Section 19 of the Act in relation to housing loans and investments,
- The application of Section 37 of the Pension Funds Act,
- Restrictions under Regulation 28 in relation to limits on retirement fund investments; and
- Duties under PF 86 and 90 on member and pensioner communication and cost and charge breakdown under ASISA's Retirement Cost Disclosure Standard.

Section 7 and PF Circulars: Duties of the Board of Management

The rules of a retirement fund outline specific matters, including the size and composition of the Board of Management, how trustees will be appointed, duration of the term of office, etc. A Board of Management must manage a retirement fund in accordance with the law and rules of the fund. The Board members/ trustees have a fiduciary duty, i.e. a duty of trust, towards the fund on behalf of its members. As the main decision makers, their decisions impact fund members.

Duties of the Board include:

- Taking all reasonable steps to ensure that the interests of members, in terms of the rules of the fund and the provisions of the Act, are protected at all times.
- Acting with due care, diligence, and good faith.
- Avoiding conflicts of interest.
- Acting with impartiality in respect of all members and beneficiaries.
- Acting independently.
- Ensuring that the fund is financially sound and managed and governed in accordance with the rules and the Act and the provisions outlined in PF 130.
- Complying with any other prescribed requirements.
- Ensuring that proper registers, books and records of the operations of the fund are kept, including proper minutes of all resolutions passed by the Board (a resolution is a formal, binding decision).
- Ensuring that proper accounts of the income and expenditure of the fund are kept and have these accounts audited by a professionally qualified auditor.
- Making sure that meeting procedures are followed correctly, keeping minutes of meetings, and recording decisions taken by the Board.



- Making sure that membership records – with details and dates of joining and leaving the fund, contributions received, payments of pensions and benefits and other payments and receipts – are recorded and keeping records of these.
- Communicating with members and pensioners annually and before changes occur, where relevant.
- Appointing expert advisors where the Board does not have the expertise (the Board remains responsible for decisions).
- Following procedures before making any appointments.
- Maintaining fidelity insurance.
- Ensuring that contributions are paid timeously.
- Formulating and following provisions within an Investment Policy Statement.
- Managing risks.
- Arranging and attending training on duties.
- Distributing benefits at death in accordance with Section 37C of the Pension Funds Act.
- Addressing complaints.

Section 13A and Conduct Standard 1 of 2022: Contribution Payments

If contributions are not received within a seven-day period following the month-end in which they were due, or the membership data/ schedule is not submitted, is late or cannot be reconciled against the payment, the administrator (or other appointed monitoring person) must report the matter. The fund has 15 days following the month-end in which contributions are payable to submit the membership data/schedule.

Particular protocols must be followed, including reporting contribution or related membership information problems to the fund's Principal Officer or other monitoring person, who will report the matter to the Board. If non-payment continues, the Board must notify affected members and the Registrar/Commissioner. If the arrears payment is still not received within 90 days after it became due, the matter must be reported to the South African police. Late-payment interest may be incurred, which is payable by the sponsor employer.

With effect from 28 February 2014, the Pension Funds Act was amended to hold directors of companies or, in other cases, the business owners, personally liable for compliance with Section 13A requirements (contributions paid in full within the time period, and an accurate membership schedule has been submitted within the time period). Companies must appoint a specific person responsible for ensuring that the provisions of Section 13A are met and notify the administrator accordingly. Directors and business owners can face a fine and/ or imprisonment for withholding retirement fund contributions.



Section 14 and Conduct Standard 1 of 2019: Minimum benefits and control of bulk transfers of members

Section 14 of the Pension Funds Act deals with minimum benefits that accrue to members, deferred pensioners (paid-up members) and pensioners, where pensioners are paid annuities/ pensions directly from a retirement fund. Minimum benefits are benefits determined according to specific rules and represent that value that is payable when a member leaves a fund, or in the event of death, payable to the member's beneficiaries. In the case of fund pensioners, minimum benefits include the method in which annual pensioner increases are determined.

Section 14 of the Pension Funds Act, together with Conduct Standard 1 of 2019, further deals with changes that impact on a group of retirement fund members. A retirement fund caters for retirement savings of employees of a particular business. The employees belong to the fund because they are eligible through their employment with that business. If the business is sold, merges (joins) with another business, or is taken over, membership of the retirement fund(s) must be resolved. For example:

- Members of a fund may be required to transfer to a new employer's retirement fund in the case of a merger or takeover of a business – in this case the old fund may be discontinued by way of liquidation or deregistration.
- A specific group of members or pensioners may be transferred to another fund, with the original fund continuing for remaining members.

In these instances, the transfer of members from one fund to another is processed in bulk, i.e. all the active members are transferred at the same time to the new fund/ arrangement. This sometimes entails very large sums of money that represent the retirement fund investments of the members.

To protect members' interests, the process to transfer groups of members from one fund to another is strictly controlled under Section 14 of the Act, where minimum benefits apply, as well as the provisions laid out in the Conduct Standard and other communication. The transfer may only be finalised after approval is received from the Registrar/Commissioner.

Where both retirement funds are valuation exempt (and in some other instances), the Section 14 transfer process does not require the approval of the Registrar/Commissioner.

Where an individual member leaves a fund before retirement and transfers retirement savings to another approved retirement fund, a formal process must be followed, accompanied by documentation that records the details – this is a recognition of transfer and does not fall under Section 14 processes.



Section 19: Limits of Investments and housing loans

This section of the Act limits the amount that a retirement fund may invest or lend to a participating employer of the fund. The limit on investments in the participating employer's business is 5% of the fair value of the investments of the fund. This limit includes subsidiaries of the business or the same holding company. Furthermore, no investment or loan can be made even within these limits, unless it is in the best interests of the fund and its members. On application, the Registrar/Commissioner may consider an investment or loan up to 10% of the fair value of investments, subject to members knowing about and supporting the decision.

Section 19 (5) allows a fund to grant loans or furnish guarantees for housing, if its rules permit, up to a maximum of 65% of the member's retirement benefit and subject to certain conditions. The Act allows loans or guarantees for an immovable property belonging to either the member or his/ her spouse. The loan may be used to acquire a property, build a dwelling, pay for maintenance of a dwelling, or to pay for additions to an existing dwelling. The dwelling must be occupied by the member or a dependant of the member.

Under Section 19(5) of the Pension Funds Act, retirement funds may issue housing loans or provide guarantees for housing loans, subject to compliance with the National Credit Act. The maximum loan amount remains at 65% of the member's accumulated retirement savings, ensuring that a substantial portion is preserved for retirement security.

As tax applies on cash benefits taken from a fund, and limits apply at retirement from a fund, the rules of the fund and the housing loan agreements and processes must ensure that these factors are taken into account before a loan may be granted. This is to ensure that any outstanding loan can be repaid if the member exits the fund.

Section 37 of the Pension Funds Act: Benefits

In terms of Section 37A, retirement benefits cannot be reduced, transferred, ceded, pledged, loaned, or attached or subjected to any form of execution under a judgement or order of a court of law. However, there are some exceptions:

- Tax owed on benefits,
- Housing loans and/ or divorce orders – in date order,
- Arrear personal taxes,
- Section 37D deductions – damages claimed by an employer where the member acknowledged liability in writing, or a court judgement was obtained against the member,
- Maintenance orders,
- Judgement debt orders (Section 65) up to a maximum of R3 000.

Section 37B specifically excludes retirement benefits from insolvent estates.



Section 37C deals with the duties of the Board when deciding on how to distribute benefits that become payable in the event of the death of a member of a retirement fund. The benefits that will be distributed from the retirement fund include retirement savings and approved group life insurance benefits.

The first step to be taken is to identify all dependants, as defined in the Act:

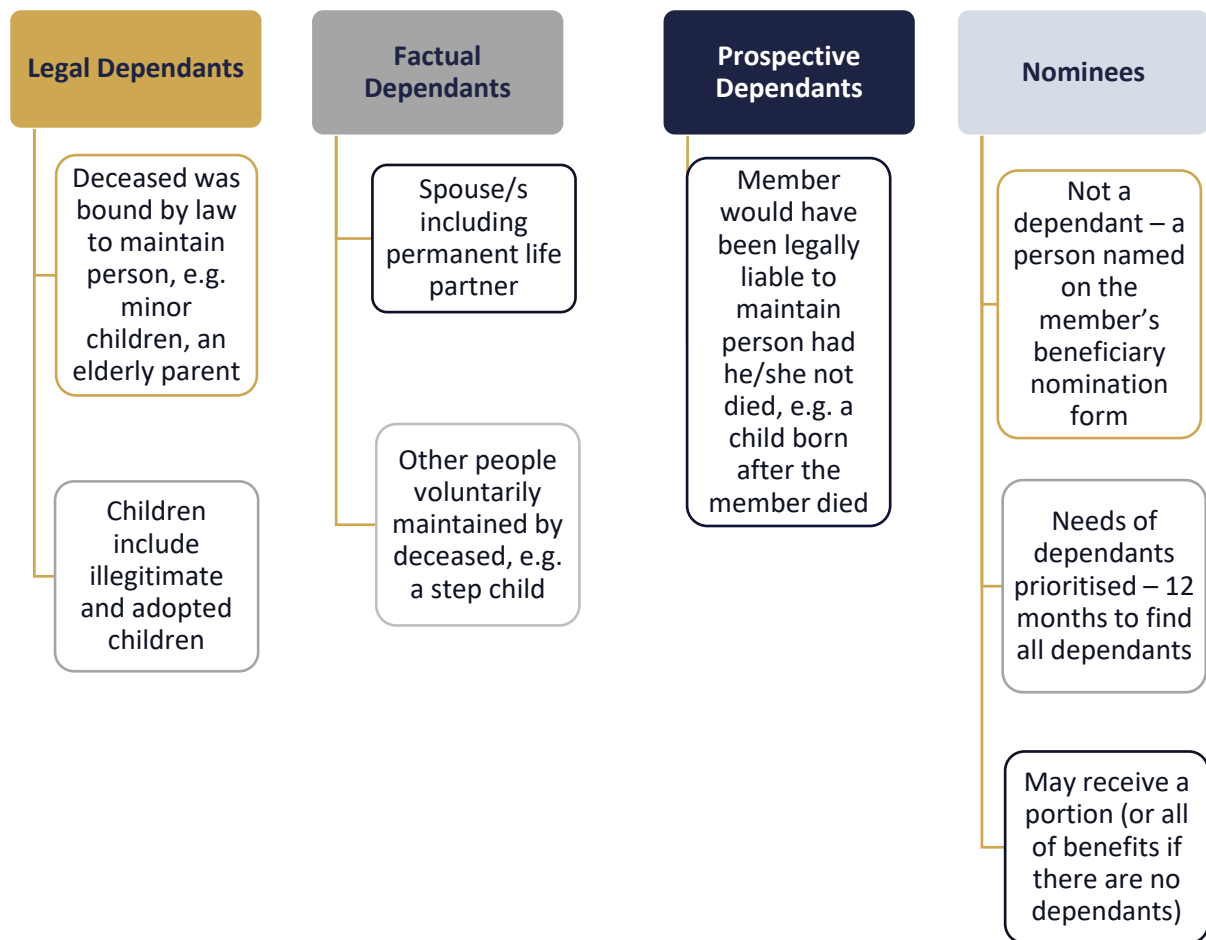
- A person to whom the member was legally liable for maintenance, e.g. children, ex-spouse,
- A person to whom the member was not legally liable for maintenance, but was factually maintaining, e.g. elderly parent, spouse (all types) or life partner,
- A person who would have been a dependant if the member had not died, e.g. fiancée/fiancé, a posthumous child (child born after the member died).

The Board must also consider the wishes of the late member, made in writing by the member, i.e. a person or persons nominated by the member to receive benefits in the event of death. The member may have nominated a person who was not a dependant of the member. Such a person is called a nominee.

The differences in dependants and nominees and how they are dealt with under Section 37C are summarised below.



Section 37 C – Dependants and nominees



The Board must consider all children, even if they are adults. Following a thorough investigation, it may be that the adult children receive no benefits.

The Board of Management has full discretion on the distribution of death benefits and does not have to distribute any benefits to the nominee but should take nominee(s) into consideration before making a final decision.

In practice, the employer usually assists in sourcing information about the deceased member's dependants and provides evidence to the administrators and Board.

If there are nominees as well as dependants, all the dependants must first be identified – the Board has 12 months in which to do this.



The decision on how to dispose of benefits comprises several considerations, including:

- The amount available for distribution.
- Age and extent of dependency of each identified dependant (an adult child may qualify as a dependant but may be fully self-supporting).
- Where the dependant is an adult, e.g. an adult child or spouse, the person's current income and qualifications and future earning potential need to be considered.
- Benefits received from other sources, e.g. the member may have life insurance policies and bequeathed assets or money in a will to one or more of the dependants.
- Wishes of the deceased expressed in the beneficiary nomination form.

Once the decision has been made on which of the dependants and/ or nominees will receive benefits, the Board must decide on how the benefit will be paid. Payment options include cash, payment via a caregiver/ guardian or a Trust or benefit fund set up for a dependant, annuity or in instalments from the fund.

The information provided here is an important financial planning concept, as fund benefits will NOT necessarily be paid according to the member's beneficiary nomination form, but be paid as per the Board's decision, based on the needs of the dependants as defined.

Section 37D (ii) refers to compensation of damages, including legal costs that may be deducted from a member's benefit. This deduction may only be exercised if all the requirements are met for these costs to be lawful.

Sections 37D (d) and 37D (e) refer to a divorce where the court has awarded a portion of the member's current retirement benefit to the ex-spouse. If all requirements are met, the member's ex-spouse may take his or her portion out of the fund in a process called a clean break.

The allocation of a portion of the member's benefit at divorce is based on the member's pension interest. This is the value of the benefit that the member would have become entitled to if he or she resigned or retired on the date of the court order. The court order or a certified copy thereof must specify the amount allocated to the ex-spouse, who is called a non-member spouse. The order must also correctly and fully name the fund, and the amount allocated. The administrator will verify the information, check if any prior deductions apply, and deduct these first. The administrator will also request that the ex-spouse (non-member spouse) elects the manner of payout, e.g. withdraw the amount in cash, or transfer part or all of the benefit to another fund.

There are timeframes that apply to these processes. With effect from March 2009, the ex-spouse is liable for any tax payable on their portion of the benefit taken.



Where benefits have been allocated through a divorce to a non-member spouse, a revision of the member's retirement planning strategies will be necessary.



Activity:

Thabo has three wives and twelve children. Three children are over 21 years of age and are financially independent. His parents live with him, as does his nephew and his cousin. His nomination form for the fund only identifies his parents as beneficiaries.

Thabo dies and the employer's retirement fund identifies two wives, the nephew and ten children as dependants. The fund pays a portion of the benefits to only these people. Is this correct or has the board of trustees erred?

Answer:

The board of trustees should have done full due diligence before making a distribution decision. The final decision on how to dispose of approved group life insurance benefits includes several considerations, including: the amount available; age and extent of dependency of each identified dependant (an adult child may qualify as a dependant but may be fully self-supporting); the person's current income and qualifications and future earning potential, as well as benefits received from other sources (such as through a will); and the wishes of the deceased expressed in the beneficiary nomination form.

As the Board allocated benefits to two independent adult children, this meant that less benefits accrue to minor children. Also, the parents, nephew and cousin who were living with Thabo may have been financially dependent, or financially independent. If the parents or cousin, who were excluded in the distribution, were financially dependent on Thabo, they should also have been considered.

PF 86 and 90: Communication to members

PF 86 describes the minimum information that must be provided (disclosed) to a member.

The actual information to be disclosed differs, depending on the specific occurrence:

What must be disclosed?	By when must this be disclosed?
An introductory pamphlet must be issued to a new member	Within three months of joining the fund
An annual benefit statement must be issued to members and pensioners	Within six months of financial year-end of the fund



Reasonable notice of special events must be given	Notice of not less than 60 days
Information regarding the benefit and/ or options	- To the member on withdrawal or retirement from the fund - In the event of death, to beneficiaries and dependants

When conducting retirement planning for a client who is a member of a retirement fund, the most recent benefit statement should be sourced, in order to confirm pertinent information such as current level of savings, contribution rates, benefits, and retirement date.

PF 90 deals with disclosures to pensioners and deferred pensioners (paid-up members) of a fund. Pensioners are any persons who receive a regular payment from the fund and may include dependants of a deceased member where a spouse or orphan benefit is paid as a pension. Deferred pensioners/paid-up members are people who have left the employer and are therefore no longer contributing towards the fund but have left a benefit in the fund until a future date.

The Circular outlines minimum general disclosures, initial disclosures, on-going annual disclosures, notice of special events, and dependant disclosures.



Activity:

Palesa joins her employer's pension fund on 1 April. What documentation should she receive from the fund and by when?

Answer:

Palesa must receive the introductory pamphlet, and this must be issued to her within three months of joining the fund (by the end of July).

Regulation 28: Prudential Investment Guidelines

The main aim of the Regulation is to impose limits on assets to assist the Board in managing investment risks, and to ensure an appropriate selection of assets for its members. The Board must take Regulation 28 requirements and limits into account when formulating the Investment Policy Statement.

The maxima outlined in the Regulation can be broadly summarised as follows:



- Not more than 75% of the fund's assets may be invested in equities (shares) and not more than 15% may be invested in private equity.
- Not more than 25% of the fund's assets may be invested in property.
- Not more than 90% of the fund's assets may be invested in a combination of equities and property.
- Not more than 5% of the fund's assets may be invested in the sponsoring employer (and its subsidiaries).
- Not more than 15% of the fund's assets may be invested in a listed equity with a large market capitalisation.
- Not more than 10% of the fund's assets may be invested in any other single-stock equity.
- Not more than 25% of the fund's assets may be invested with any single bank with a market capitalisation of R20 billion or more.
- Not more than 45% of the fund's assets may be invested offshore (some exceptions apply).
- Not more than 10% may be invested in regulated African investments in addition to other foreign/ offshore assets.
- Not more than 2.5% of the fund's assets may be invested in hedge funds,
- Not more than 2.5% of the fund's assets may be invested in 'other assets,' which are assets not specified in the Regulation.



Take Note

As of 2025, South African retirement funds are prohibited from directly investing in crypto assets, as per Regulation 28 of the Pension Funds Act. This restriction applies even if the assets are traded on regulated platforms, ensuring that retirement savings are protected from excessive market volatility.

Regulation 28 further deals with reporting that must take place, i.e. evidence of compliance with Regulation 28 must be submitted to the Registrar/Commissioner.

From the requirements, duties and obligations outlined above, it can be seen that taking on duties as a member of a Board of Management of a retirement fund is onerous, further fuelling the trend towards umbrella funds in the retirement fund industry.



Research Activity:

Visit the following website to find out more about Regulation 28 provisions:

[Treasury publishes final amendments to Regulation 28 of the Pension Funds Act | South African Government \(www.gov.za\)](https://www.gov.za/treasury/publications/2019/05/20/treasury-publishes-final-amendments-to-regulation-28-of-the-pension-funds-act)



Activity:

ABC Pension Fund is a defined contribution fund offering investment choice to members. Benu is to retire in January. In order to make up a shortfall in retirement savings, Benu selects an investment portfolio that includes the maximum equities allowed by Regulation 28. Although this is a higher risk portfolio, Benu is hoping to gain a better return than if he selected a more conservative option. Five months before his retirement date, the stock market crashes. Benu's retirement savings are reduced by 30% and new government policies place South Africa further into recession. What are Benu's options?

Answer:

Benu options are:

- Request his employer to allow him to keep working until markets improve, meaning that he will have to defer his retirement date.
- Retire from work but leave benefits in the fund until markets improve – this is if Benu has some other income source until markets improve.
- Retire now with a much lower benefit.

For this reason, most Boards offer a lower risk portfolio option for members approaching retirement age. A lower risk portfolio means that benefits are totally or partially secured because the underlying assets are not subject to market fluctuations.

6.1.3 Tax Implications – All Retirement Funds

The tax implications that follow apply to membership of any approved retirement fund.

Tax implications on any investment product, including retirement funds, include:

- Tax implications of investment amounts (contributions),
- Tax on investment earnings,
- Tax on benefits when accessed.



Tax deductibility of contributions

A tax deduction is essentially a 'discount' on tax given by SARS on retirement fund contributions. This results in lower taxes in the year of paying the contributions. This is an important financial planning concept, as contributions towards a retirement fund lower the investor's overall tax payable in the tax year in which contributions were made.

With effect from 1 March 2016, the following rules apply to the deductibility of contributions towards any retirement fund:

- Employer contributions made on behalf of an employee are tax deductible in the hands of the employer.
- Contributions made by an employer on behalf of an employee are first added as a fringe benefit and subject to PAYE (employee's tax).
- Members then qualify for a **tax deduction** on contributions paid to all retirement funds of up to **27.5% of earnings** – the member will claim these back at the end of the tax year.
- 'Earnings' is the higher of employment income (total remuneration) or taxable income.
- The allowable deduction includes employer and member contributions towards all types of contributory retirement funds, i.e. group retirement funds and retirement annuity funds.
- Premiums for approved group benefits are included in the limits.
- Deductions are limited to a maximum of R350 000 p.a.
- Contributions in excess of the tax-deductible amounts are carried over to future years.
- Any contributions that were not deductible will be tax-free at exit, e.g. withdrawal, death, or retirement, as they were already taxed.



Example: Calculate the tax-deductible portion of contributions made towards one retirement fund

A client belongs to a pension fund. His employer contributes 7% of his salary towards the pension fund, and the client (member) contributes 5% of his salary towards the fund. The client does not have any other retirement savings. How is the allowable tax deduction applied, assuming that the member's earnings are equal to his salary of R280 000 p.a.?

Employer: The employer may deduct the entire contribution of:

$$7\% \times R280\,000 = R19\,600 \text{ p.a.}$$

Furthermore, the employer must add the contribution made by them each month to the client's (member's) salary as a taxable fringe benefit. This means that the employer's contribution is taxed initially in the hands of the member.



Member: The member may deduct ALL contributions made towards retirement funds of up to 27.5% of earnings, subject to an overall maximum of R350 000.

$$\therefore 27.5\% \times R280\,000 = R77\,000.$$

The employer contribution of 7% plus the member's contribution of 5% of salary for the year = $12\% \times R280\,000 = R33\,600$. The full contributions are deductible, as they are below both the limit, as calculated, of R77 000, and the overall maximum in a year of R350 000.

Note: The member may substantially increase contributions towards retirement savings (up to R77 000) and still qualify for a tax deduction. Calculating tax deductibility and the level to which a client can increase contributions towards retirement and still receive a tax deduction, is an important financial planning concept.



Activity:

Mamphela has a taxable income of R10 million per annum. What is the maximum she can contribute to a retirement fund, which will qualify for the tax deduction in the current tax year?

Answer:

R350 000.



Example: Calculate the tax-deductible portion of contributions made towards more than one retirement fund

A member belongs to a pension fund where he and the employer each contribute 7.5% of his salary towards retirement. The member also contributes R1 000 p.m. towards a retirement annuity. Calculate the member's tax deduction on retirement fund contributions, assuming that the member's earnings are R180 000 p.a.

Pension fund

Employer: The employer may deduct the full contribution made by them of:

$$7.5\% \times R180\,000 = R13\,500 \text{ p.a.}$$

The employer must further add contributions made by them each month to the member's salary as a taxable fringe benefit.



Member: The member's contribution towards the pension fund amounts to:
 $7.5\% \times R180\,000 = R13\,500 \text{ p.a.}$

Retirement annuity

The member contributes an additional R12 000 p.a. towards a retirement annuity (R1 000 p.m. $\times$ 12).

Tax deduction

The member may deduct ALL contributions made towards retirement funds of up to 27.5% of earnings, subject to an overall maximum of R350 000 p.a.

$\therefore 27.5\% \times R180\,000 = R49\,500.$

Total contributions = R13 500 (employer pension fund contribution) + R13 500 (member pension fund contribution) + R12 000 (retirement annuity contribution) = R39 000.

The member may, therefore, deduct all contributions as they are below the minimum that applies.

By how much can the member increase contributions towards retirement savings and still receive a tax deduction?

The maximum deduction for the year as calculated is R49 500, and total contributions amounted to R39 000. The member may, therefore, increase contributions by R10 500 in the tax year and still receive a tax deduction (total deduction allowed of R49 500 less contributions made of R39 000).



Activity:

A client's income is R1 000 000. He has R750 000 of retirement funding income from his company salary and the balance is from rental income. His contribution towards a Retirement Annuity will be tax deductible up to which percentage?

- a) 35.5% of retirement funding income,
- b) 27.5% of retirement funding income,
- c) 27.5% of all income,
- d) 7.5% of non-retirement funding income,
- e) 15% of non-retirement funding income.

Answer:

c) is the correct answer.



Tax on investment earnings

Currently, investment earnings under an approved retirement fund are **not taxed**. This is a distinct advantage when considering different savings and investment products, as investments will grow at a faster rate under an approved retirement fund, compared to other investment products.

Tax on lump sums and pensions/ annuities

Tax on retirement lump sums from retirement funds changed significantly on 01 October 2007. One tax table now applies to the taxable portion of lump sums at withdrawal before retirement, and another tax table applies in the event of death, retirement and/ or severance.

Furthermore, all previous retirement lump sums that were accessed on or after specific dates are taken into account (called the 'aggregation' of lump sums).

Income tax can be avoided when leaving an employer and associated retirement fund by retaining the benefit in the fund or transferring the benefit to another approved retirement fund. At retirement, where the retiree will receive a lump sum from the employer as well as intends to take portions of retirement benefit(s) in cash, tax planning is advisable before making final decisions.

Remember that at retirement, members may only access one third of the value at retirement in cash, i.e. the maximum cash that may be withdrawn (called commuted) is one third of the value. The remainder must be used to purchase a life-long annuity, which is taxed as an income at the annuitant's marginal rate of tax. This is unless the member was a member of a former provident fund and has vested benefits that may be taken in cash at retirement.

Any lump sum cash portion is subject to tax.

Before a cash benefit can be paid out to a member, allowable deductions are subtracted off the benefit, and the balance (being the taxable portion) is taxed according to the relevant tax table for the event (withdrawal before retirement, death, retirement, or severance).

Therefore: **Lump sum less allowable deductions = Taxable portion**

If the member is withdrawing benefits before retirement, Table 3 below applies.

Table 4 below applies to lump sum/ cash benefits taken from a fund for reasons other than normal withdrawal from a fund. These include:

- The death of a member,
- Retirement; and
- Retrenchment or severance:



- Severance is when a member leaves the fund because of ill health, or where the employer is liquidating or reducing staff through retrenchments. Severance is treated as a special case in that the benefit that is taxed includes both the cash portion of retirement benefits as well as the severance package paid to the member by the employer.
 - If the employee owned 5% or more shares in the business, the retirement benefit taken in cash will be treated as a normal withdrawal and will exclude any severance package.

Allowable Deductions

Although retirement benefits cannot be reduced, transferred, ceded, pledged, loaned, or attached under an order of a court of law, there are certain exceptions where a deduction is allowable. These deductions are subtracted from the cash lump sum at death, withdrawal or retirement. To arrive at the taxable portion of the benefit:

- Transfers to approved funds, i.e. amounts not taken in cash but reinvested in another approved retirement fund.
- Contributions which did not previously qualify for a deduction, e.g. a member's own provident fund contributions that were not deductible.
- Previous pension to provident fund transfers (already taxed).
- Transfers to certain preservation funds which were already taxed.
- Amounts representing the member's fund value before 1/03/1998 if the member belonged to a government fund.

Approved transfers are tax free. In other words, approved transfers are an allowable deduction from the taxable portion of a retirement fund lump sum. In order to apply the rules on which benefit transfers are tax free, we first need to understand the changes that took place over recent years.

The concept of 'P-day' (preservation) was introduced via Regulations 38 and 39 where all transfers from one group retirement fund to another approved group retirement fund are allowed:

- Under these Regulations, all group retirement funds must allow members the choice of leaving benefits in the fund after exit:
 - Under this scenario, no tax applies as the benefit has not been transferred or cashed in.
- Further, funds must accept all transfers of benefits into the fund when a new member joins and wishes to bring previous retirement savings benefits into the fund:
 - Under certain transfers, tax may apply as the benefit leaves the previous fund, as per the table below.



Benefits in a retirement annuity may only be transferred to another retirement annuity fund. The following changes took place on the tax and rules on retirement funds since 2016:

- 1 March 2016: one tax deductibility formula was introduced for contributions towards all retirement funds, including employer contributions made on behalf of the member. This was the first part of the so-called 'T-day.'
- 1 March 2021: in the second part of 'T-day', provident funds became subject to the annuitisation rule, where a maximum of one-third of the benefit may be taken in cash, with the remainder being used to purchase a life-long pension:
 - As discussed earlier, if the member was age 55 or older at this date, the member may still take the entire benefit in cash at retirement.
 - For members younger than age 55, benefits up to that date are vested, i.e. this portion may still be taken in cash at retirement.
 - If the total benefit at retirement is lower than R247 500, the entire benefit may be taken in cash – this applies to all funds.
 - The benefit accruing after 1 March 2021 (the non-vested portion) for members under the age of 55 at that date are subject to the annuitisation rule.

The vested portion of the retirement savings for former provident fund members retains its characteristics in that this amount may be taken as a lump sum at retirement. An important aspect is that where a person was a member of a provident fund before 1 March 2016, the benefit will include contributions that were already taxed as provident fund members did not receive a tax deduction on their own contributions before retirement funds were harmonised on 01 March 2016.

Provident fund benefits

Vested Portion	Non Vested Portion
• Contributions and investment earnings before 1 March 2021 • Lump sum allowed at retirement • May include member contributions that did not enjoy a tax deduction before 1 March 2016	• Contributions and investment earnings from 1 March 2021 • Subject to maximum of 1/3rd cash at retirement (if the benefit exceeds the minimum of R247 500) • Tax deduction on all contributions



Taking the above into account, tax free/approved transfers are as follows:

Type of Fund	Approved Transfer (no tax):
Pension fund and pension preservation fund	New employer's fund Pension preservation fund Retirement annuity
Provident fund, vested portion of a provident fund, and provident preservation fund	New employer's fund Provident preservation fund – vested benefits Pension preservation fund – non vested benefits Retirement annuity
Retirement annuity	Retirement annuity



Examples:

Example 1: Calculate the taxable portion of a cash/ lump sum benefit at retirement from a provident fund

A member retires from a former provident fund. The value of his lump sum is R250 000. He made contributions towards the fund of R50 000 that did not qualify as a deduction. What is the taxable portion of the lump sum?

$$\begin{array}{rcl}
 & \text{Lump sum} & \\
 \text{Less: } & \underline{\text{Allowable deductions}} & \\
 = & \text{Taxable portion} &
 \end{array}$$

Therefore:

$$\begin{array}{rcl}
 & \text{R250 000} & \\
 \text{Less } & \underline{\text{R 50 000}} & \text{(contributions that did not previously qualify as a deduction)} \\
 = & \text{R200 000 taxable portion} &
 \end{array}$$

As the member's benefit is below R247 500, the entire amount may be taken in cash, regardless of the member's age.

Example 2: Calculate the taxable portion of a lump sum/ cash benefit at retirement from a pension fund



A member is retiring from a pension fund. The value of the retirement benefit is R930 000. She is taking the maximum cash allowed. What is the taxable portion of the lump sum?

A pension fund member may only access one third of the value at retirement.

∴ $R930\,000 \div 3 = R310\,000$. There are no deductions, therefore, the taxable portion of the lump sum is R310 000.

Example 3: Calculate the taxable portion of a transferred benefit

A member is retiring from a pension fund. The value of the lump sum portion is R236 000. As the member still wants to add to retirement savings for later in his life, he decides to transfer the lump sum to a retirement annuity. What is the taxable portion of the lump sum?

	Lump sum
Less:	<u>Allowable deductions</u>
=	Taxable portion

Therefore:

	R236 000 (lump sum)
-	<u>R236 000</u> (transfer to an approved retirement vehicle)
=	R0 taxable portion

Former semi-government, semi-government, and Government Employees Pension Fund (GEPF)

Lump sums received by retiring government employees are treated differently from other retirement lump sums:

- Members of the Government Employees Pension Fund (GEPF) with less than 10 years' service, receive a gratuity (a once-off cash lump sum) that is equal to their actuarial interest in the fund.
- Members with 10 or more years of service, receive a gratuity and a monthly pension (annuity) from the fund.

Any retirement lump sum is adjusted before applying the tax tables, as lump sums before 1 March 1998 were tax-free. The lump sum is, therefore, proportioned to establish the portion that represents service after 1 March 1998, i.e. the taxable portion. This will only affect long-serving members.

The formula to be applied, known as Formula C, is:



$$A = \frac{B}{C} \times \text{original lump sum}$$

Where:

- A is the deemed lump sum for tax purposes, i.e. the adjusted lump sum to use when calculating tax payable on the lump sum.
- B is the number of complete years of service from 1 March 1998.
- C is the total number of complete years of service.



Take Note

Only complete, whole years are taken into account.



Example: Adjusting the benefit for government fund membership

A member is retiring from a semi-government fund on 01 October 2022. The lump sum portion of the benefit is R810 000. The member joined the company and fund in January 1994. What is the taxable portion of the benefit?

Apply Formula C:

$$A = \frac{B}{C} \times \text{original lump sum}$$

Where:

- A is the deemed lump sum for tax purposes, i.e. the adjusted lump sum to use when calculating tax payable on the lump sum.
- B is the number of complete years of service from 1 March 1998.
- C is the total number of complete years of service.

Therefore:

$$A = \frac{24 \text{ (complete years of service from 1 March 1998)}}{28 \text{ (complete years of service)}} \times R810\,000$$



$$\therefore A = R694\,286$$

The taxable portion is the deemed lump sum (A), which is R694 286.



Activity:

Anele retires from the civil service on 1 March 2023. She joined the civil service on 1 March 1995 and became a member of the government pension fund at the same time. Her pension interest is R9 000 000 at her date of retirement.

What is the taxable portion of the benefit if she wishes to take the full lump sum available to her?

Answer:

This is a pension fund, so Anele may only access $\frac{1}{3}$ of the pension fund interest (R3 million) and the remaining $\frac{2}{3}$ (R6 million) must be used to purchase a life-long annuity.

The taxable portion will be:

$$A = \frac{B}{C} \times \text{original lump sum}$$

$$A = \frac{25 \text{ (complete years of service from 1 March 1998)}}{28 \text{ (complete years of service)}} \times R3\,000\,000$$

$$\therefore A = R2\,678\,571$$

Tax Table/Rates

The taxable portion of cash lump sums at withdrawal, i.e. a member's withdrawal benefit, less allowable deductions, is taxed according to the following table:



Table 1

TAX TABLE: WITHDRAWAL BENEFITS TAX YEAR ENDING 28 FEBRUARY 2025	
Taxable Lump Sum	Tax Rate
R0 – R27 500	0%
R27 501 – R726 000	18% of the amount above R27 500
R726 001 – R1 089 000	R125 730 + 27% of the amount above R726 000
R1 089 001 and above	R223 740 + 36% of the amount above R1 089 000

The first R27 500 is tax free but high tax amounts apply thereafter. A cash withdrawal not only incurs tax but also wastes valuable retirement savings and hence is never recommended.

The taxable portion of the lump sum, i.e. the lump sum at retirement, death or severance, less allowable deductions, is taxed according to the following table:

Table 2

TAX TABLE: RETIREMENT, DEATH, AND SEVERANCE BENEFITS TAX YEAR ENDING 28 FEBRUARY 2025	
Taxable Lump Sum	Tax Rate
R0 – R550 000	0%
R550 001 – R770 000	18% of the amount above R550 000
R770 001 – R1 155 000	R39 600 + 27% of the amount above R770 000
R1 155 001 and above	R143 550 + 36% of the amount above R1 155 000



Take Note

The tax rates and rules above apply for the tax year ending 28 February 2025. Always consult the latest tax information and rates.



Examples:

1: Calculate tax at retirement from a (former) provident fund

A member of a provident fund has retired at age 65. She was over the age of 55 on 01 March 2021 and therefore may still take the whole amount in cash, which is what she wants. She contributed R150 000 towards the provident fund and did not receive a deduction on these contributions. Her lump sum benefit is R750 000 which comprises of R700 000 representing the vested portion and R50 000 representing the non-vested portion. What tax is payable?

First calculate the taxable portion of the benefit:

$$\begin{array}{rcl} & \text{Lump sum} & \\ \text{Less:} & \underline{\text{Allowable deductions}} & \\ & = \text{Taxable portion} & \end{array}$$

Therefore:

$$\begin{array}{rcl} & \text{R750 000 (lump sum)} & \\ & - \underline{\text{R150 000}} \text{ (allowable deduction – contributions that were not previously deductible)} & \\ = & \text{R600 000 taxable portion} & \end{array}$$

Next – calculate tax payable on the taxable portion.

In order to calculate the tax, identify the tax line (bracket) into which this fall. In this case: (R550 000 – R770 000) 18% of the amount above R550 000 (Table 4 – retirement).

$$\begin{array}{l} 18\% \text{ of the amount above R550 000} = \\ 18\% \times (\text{R600 000} - \text{R550 000}) = \\ 18\% \times \text{R50 000} = \\ \text{R9 000 tax payable} \end{array}$$

2: Calculate tax payable at retirement from a pension fund

A member of a pension fund is retiring. The value of his retirement savings is R1 290 000. He wants to take the maximum allowed in cash, and will earn an annuity of R12 000 p.a. What are the tax implications?

Determine the lump sum benefit

The member is retiring from a pension and, therefore, can only take up to one third of the value in cash. $\therefore \text{R1 290 000} \div 3 = \text{R430 000}$.



Calculate the taxable portion:

$$\begin{array}{rcl} & \text{Lump sum} & \\ \text{Less:} & \underline{\text{Allowable deductions}} & \\ & = \text{Taxable portion} & \end{array}$$

Therefore:

$$\begin{array}{rcl} & \text{R430 000 (lump sum)} & \\ - & \underline{\text{R0}} \text{ (none)} & \\ = & \text{R430 000 taxable portion} & \end{array}$$

Calculate tax payable:

In order to calculate the tax, identify the tax line (bracket) into which this fall. In this case, using Table 4 (retirement) (R0 – R550 000): the tax rate is nil.

∴ R0 tax payable on the lump sum portion.

Annuity/ pension

The annuity of R12 000 p.a. will be taxed as income at the member's marginal rate of tax.



Activity:

From our previous activity, work out how much tax Anele will pay on her lump sum amount of R2 678 571. (Note we have rounded off to the nearest Rand for ease of calculation.)

Answer:

Calculate tax payable:

In order to calculate the tax, identify the tax line (bracket) into which this fall. In this case, using Table 4 (retirement) (1 155 001 and above): R143 550 + 36% of the amount above R1 155 000.

$$\begin{aligned} & \text{R143 550} + 36\% \times (\text{R2 678 571} - \text{R1 155 000}) = \\ & \text{R143 550} + (36\% \times \text{R1 523 571}) = \\ & \text{R143 550} + \text{R548 486} = \\ & \text{R692 036 tax payable.} \end{aligned}$$

In other words, Anele will receive:

$$\text{R3 000 000} - \text{R692 036} = \text{R2 307 964 after tax lump sum.}$$



Activity:

From our previous activity, what was Anele's tax savings due to the Government Pension Fund's tax-exempt status up until 1998, if Anele had paid tax on the full R3 000 000?

Answer:

If Anele had paid tax on the full R3 000 000, the tax rate is: R143 550 + 36% of the amount above R1 155 000.

$$\begin{aligned} & \text{R143 550} + 36\% \times (\text{R3 000 000} - \text{R1 155 000}) = \\ & \text{R143 550} + (36\% \times \text{R1 845 000}) = \\ & \text{R143 550} + \text{R664 200} = \\ & \text{R807 750 tax payable.} \end{aligned}$$

Difference in tax:

Tax if there was no discount for the Government Fund of R807 750 less tax payable with adjusting the lump sum for Government Fund membership of R692 036 = R115 714.

Anele has saved R115 714 in tax due to the Government Pension Fund's tax-exempt status up until 1998.



Example 3: Calculate tax payable on a withdrawal benefit

A member leaves a (former) provident fund before retirement age and is cashing the benefit in. He contributed R320 000 towards the fund, and the value of his benefit is R1 070 000. The member's own contributions did not qualify for a tax deduction. These contributions are now deductible.

$$\begin{aligned} & \text{Lump sum} \\ \text{Less: } & \text{Allowable deductions} \\ = & \text{Taxable portion} \end{aligned}$$

Therefore:

$$\begin{aligned} & \text{R1 070 000 (lump sum)} \\ - & \text{R 320 000 (allowable deduction – contributions that were not previously deductible)} \\ = & \text{R 750 000 taxable portion} \end{aligned}$$



Calculate tax payable:

In order to calculate tax, identify the bracket into which this fall. In this case:

(726 001 – 1 089 000): the tax rate is R125 730 + 27% of the amount above R726 000 (Table 3 – withdrawal before retirement).

$$\begin{aligned} &\therefore R125\,730 + 27\% \times (R750\,000 - R726\,000) \\ &= R125\,730 + (27\% \times R24\,000) \\ &= R125\,730 + R6\,480 \\ &= R132\,210 \text{ tax payable.} \end{aligned}$$



Activity:

1. Jay, aged 32, has resigned; and he is taking the benefits of R80 100 from his fund in cash. He contributed R23 400 that did not previously qualify for a deduction. Calculate his taxable portion.

Answer:

Our first step is to identify the lump sum, which is R80 100.

Our second step is to deduct allowable deductions, in order to determine taxable portion of the lump sum. In Jay's example, his contributions of R23 400 are an allowable deduction, with the reason being that these are contributions that did not previously qualify for a deduction.

Therefore:

$$\begin{array}{rcl} & R80\,100 \text{ lump sum} & \\ \text{Less} & \underline{R23\,400} \text{ which is the allowable deduction} & \\ = & R56\,700 \text{ which is the taxable portion} & \end{array}$$

2. What tax will Jay pay on the lump sum amount of R56 700?

Answer

According to the tax table, for amounts between R27 500 and R726 000, which applies to our example, the tax rate to use is 18% of the amount above R27 500.

$$\begin{aligned} &18\% \times (R56\,700 - R27\,500) = \\ &18\% \times R29\,200 = \\ &R5\,256 \text{ tax payable.} \end{aligned}$$

Jay will receive a cash amount of R74 844 (total benefit of R80 100 less tax of R5 256).



3. What could Jay have done to have avoided paying tax?

Answer:

He could have retained the benefit in the fund, or he could have transferred the benefit, tax free, to a pension fund, a provident fund, a provident preservation fund or a retirement annuity, rather than having wasted his hard-earned retirement savings and paying unnecessary tax.

Multiple Lump Sums: The principle of aggregation

At retirement, the tax-free portion is very generous – up to R550 000 is tax-free. A sliding scale applies where higher amounts are taxed at higher rates. When applying the tax rates, qualifying lump sums previously paid are considered; a retiring member certainly does not get R550 000 tax free from each retirement vehicle! The principle to be applied is called *aggregation*. This is where previous lump sums paid from retirement funds are taken into account, including withdrawal, severance and/ or retirement benefits. Only qualifying lump sums are included in the aggregation as described below. Note that aggregation applies whether withdrawing or retiring or in the event of death or severance.

Qualifying lump sums to be included in the aggregation are any lump sums paid from a retirement fund on or after the following dates:

Withdrawals: All taxable cash withdrawal amounts from 1 March 2009.

Retirement: All taxable lump sum retirement benefits from 1 October 2007.

Severance: All taxable lump sum severance benefits from 1 March 2011.

The steps to calculate the tax payable on a current lump sum where aggregation applies is outlined below.

Step	Action
1	Calculate the taxable lump sum for the current tax year (lump sum less allowable deductions).
2	Identify previous taxable amounts from withdrawals, retirement or severance benefits to be included in aggregation (check dates, calculate lump sum less allowable deductions).
3	Add amounts in Steps 1 and 2.
4	Calculate the tax payable on the total amount in Step 3 – apply the tax table for the current event.



5	Calculate tax payable on the previous amounts received, i.e. the taxable portion amount calculated in Step 2 – apply the current event tax table (answer = hypothetical tax).
6	Calculate tax payable on current lump sum: Tax calculated in Step 4 <u>Less hypothetical tax calculated in Step 5</u> = Tax payable on current lump sum



Example: Applying aggregation for calculating tax payable on a lump sum

A member of a provident fund is retiring on 01 December 2025. He intends to take the whole amount of R1 050 000 in cash to settle debts and buy a small business. As he was over the age of 55 on 01 March 2021, he is allowed to take the whole benefit in cash.

The fund is non-contributory – there were no member contributions. In January 2009, he withdrew from a pension fund. The benefit was R26 000, and he paid tax on the cash at the time. In December 2017, his retirement annuity matured. He retired from the retirement annuity and commuted one-third, i.e. he took one-third in cash of R87 000 and paid tax at the time.

What tax will the member pay now on the provident fund benefit?

1. Calculate the taxable lump sum for the current year

Taxable portion of the benefit: benefit less allowable deductions
 = R1 050 000 less nil deductions = a taxable benefit of R1 050 000.

2. Identify previous taxable amounts from withdrawals, retirement or severance benefits to be included

Previous benefits:

Withdrawal of R26 000 in January 2009 – not included, as it was before 1 March 2009.

Retirement benefit of $\frac{1}{3}$ from retirement annuity in December 2017 of R87 000 – included as it was after 1 October 2007.

Taxable portion of benefit

= total benefits less allowable deductions

= R87 000 less R0

∴ The taxable lump sum for this previous benefit is R87 000.



3. Add amounts in Steps 1 and 2

Taxable aggregated lump sums = R1 050 000 + R87 000 = R1 137 000.

4. Calculate the tax payable on the total amount in Step 3 – Apply the tax table for the current event

Tax rate for amounts between R770 001 – R1 155 000: R39 600 + 27% of the amount above R770 000 (Table 4 – current event retirement).

$$\begin{aligned} \therefore R39\ 600 + 27\% \times (R1\ 137\ 000 - R770\ 000) &= \\ R39\ 600 + (27\% \times R367\ 000) &= \\ R39\ 600 + R99\ 090 &= \\ R138\ 690. \end{aligned}$$

5. Calculate tax payable on the previous taxable portion amount calculated in Step 2

Previous taxable portion of previous benefits to be aggregated: R87 000.

Tax rate for amounts under R550 000: 0%, therefore, zero hypothetical tax for previous amounts (Table 4).

6. Calculate tax on the current lump sum (answer for Step 4 less answer for Step 5)

Tax payable now:

Tax payable on total aggregated benefits:	R138 690
Less hypothetical tax on previous amounts:	<u>R 0</u>
	= R138 690

$\therefore$ R138 690 tax is payable on the current lump sum benefit.



Take Note

The information provided here is an overview of the application of tax on cash portions of retirement fund benefits. The details of tax on divorce benefits and conditions to meet requirements for a severance benefit have not been included here.



Activity:

Tom is retiring from the ABC Pension Fund. One-third of the value is R682 000 which he wished to take as a lump sum. He has received no previous lumps sums prior to this. Tom wishes to invest R200 000 of this money in a money market product and the balance in unit trusts so he has ready access to money should he need it.

Over many years, the total contributions which did not previously qualify for a deduction in Tom's hands amounted to R50 000.

What amount will Tom have available to invest after tax?

Answer:

The transfer is not into an approved retirement fund and therefore the benefit will be taxed.

The gross lump sum on which normal tax will be calculated amounts to:

R682 000 – R50 000 (allowable deduction) = R632 000.

R632 000 falls within the taxable income bracket of R550 001 to R770 000. The normal tax is, therefore, 18% of the taxable income above R550 000.

$$\begin{aligned} \therefore 18\% \times (R632\,000 - R550\,000) &= \\ &= 18\% \text{ of } R82\,000 \\ &= R14\,760 \text{ tax payable.} \end{aligned}$$

The net lump sum after tax ("cash in pocket") for Tom is the lump sum of R682 000 less tax payable of R14 760 = R667 240.

6.2 Transferring Retirement Annuity Contracts

From 1 March 2023, the law relating to transferring retirement annuity contracts changed. Prior to this date, a member seeking to transfer contracts was required to transfer all contracts from one retirement annuity fund to another. For example, where the member has two contracts, the member cannot transfer only one contract. Currently, subject to some minimum requirements, a person with more than one contract in a retirement annuity fund can transfer one or more of those contracts to a new retirement annuity fund and leave the remaining in the existing fund.



Such transfers can be done if:

- The value of each transfer is more than R371 250, and
- The total value of the remaining contracts is more than R371 250.

For example, if a member has three contracts with the following values: Contract A – R500 000, Contract B – R250 000, and Contract C – R350 000, the member can transfer Contract A to another retirement annuity fund since the value of that contract is more than R371 250, and the total value of the remaining two contracts is also more than R371 250. The member cannot transfer Contract B alone or Contract 3 alone to another retirement annuity fund since their values are each less than R371 250.

Furthermore, a member cannot transfer a portion of an individual contract to another retirement annuity fund. For example, if a member has two contracts, Contract X - R1 400 000 and Contract Y - R800 000, the member cannot transfer 50% (R700 000) of Contract X or 50% (R400 000) of Contract Y to another retirement annuity fund. The member will have to transfer the whole of Contract X, or the whole of Contract Y, or both contracts to another retirement annuity fund.

There is no limit on the minimum amount transferable if a member wants to transfer all contracts from one retirement annuity fund to another. The retirement annuity fund making the transfer is required to complete a separate tax directive application for each transfer.

6.2.1 Retirement Annuity Fund Paid-Up Withdrawal

If the total value of a member's paid-up benefit in a retirement annuity fund is less than R15 000, the member can withdraw the benefit as a lump sum before retirement (i.e., 55 years). Once a member retires, if the total fund benefit is less than R247 500, the member can take the full benefit as a lump sum.

Where the member has more than one contract in the same fund and decides to stagger retirement (retire from each contract at a different time), the value of the previous contract(s) the member retired from will be taken into account by SARS before determining the R247 500 threshold. For example, a member has three contracts in a retirement annuity fund: Contract A – R150 000, Contract B – R80 000 and Contract C – R160 000. If the member retires from Contract A, the full R150 000 can be taken as a lump sum since it is less than R247 500. When the member retires from Contract B, SARS will add the previous retirement benefit (R150 000) to the current retirement benefit (R80 000). The combined value of these two contracts (R230 000) is still less than R247 500, so the R80 000 can also be taken as a lump sum retirement benefit. Once the member retires from Contract C, its value (R160 000) will be added to the previous two retirement benefits. The combined values of the current retirement benefit and the previous two (R230 000) are R390 000. This is more than R247 500, so the member can only take a maximum of one-third of Contract C as a lump sum retirement benefit.



In a situation where the remaining value of a member's living annuity contract is less than R125 000, this amount can be taken as a lump sum. And where the member has more than one living annuity contract in the same fund or with the same insurer, SARS will apply the same criteria as discussed above.

6.3 Retirement Annuity and Preservation Fund Options, Strategies, Legal and Tax Implications

6.3.1 Retirement Annuity and Preservation Fund Options and Strategies

Retirement annuities are individually owned retirement savings products and, therefore, the options and strategies differ from those under group retirement funds.

Costs are a major consideration under retirement annuities and preservation funds, as this impacts on the net investment towards retirement. Investment portfolio options are also a consideration, as some investors will seek a wider range of investment portfolio options than others, including offshore (foreign) portfolio options.

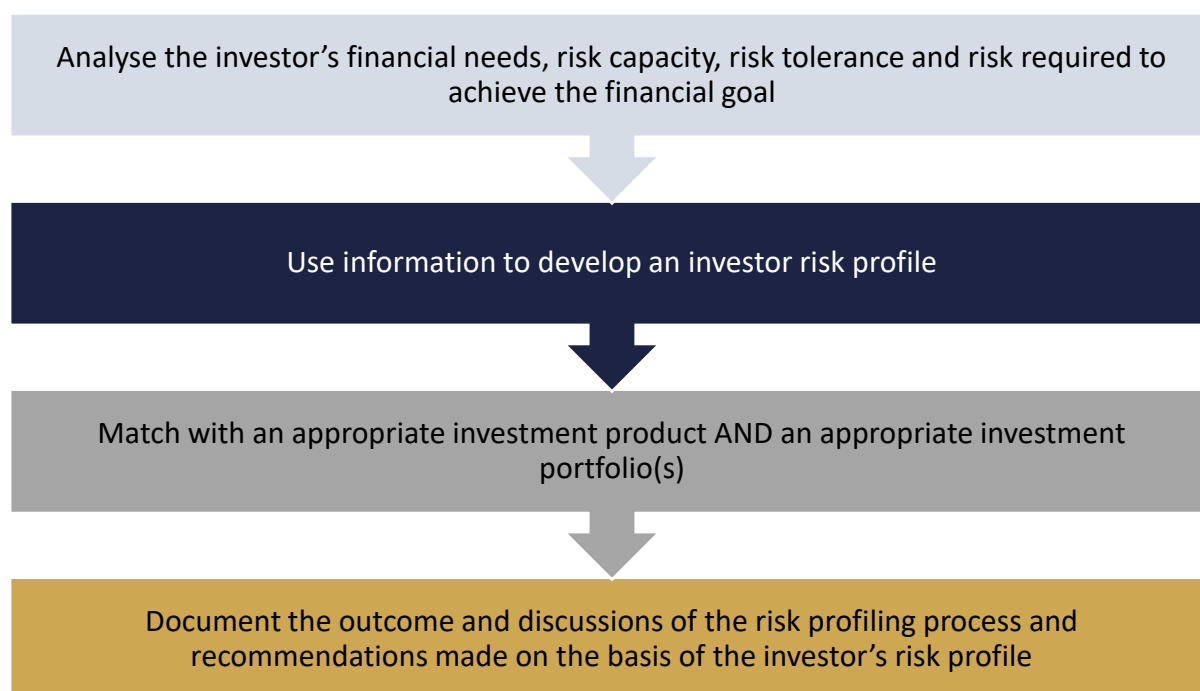
Because retirement annuities and preservation funds are taken out by individuals, the advisor can and should conduct risk profiling with the client to determine the most suited investment for the particular client in his or her circumstances.

The risk profiling process should include the following steps:

- Analysing the investor's financial needs, risk capacity, risk tolerance and risk required to achieve the financial goal.
- Using this information to develop an investor risk profile.
- Matching this with an appropriate investment product (e.g. a collective investment scheme) AND an appropriate investment portfolio(s), containing the correct mix of assets to achieve optimal growth within the level of risk specified in that portfolio.
- Documenting the outcome and discussions of the risk profiling process, as well as the recommendations made on the basis of the investor's risk profile.



Process flow to making a financial recommendation:



Please refer to the *Economic and Investment Overview* course for further details on risk profiling and investments.

6.3.2 Retirement Annuities and Preservation Funds: Legal Implications

Retirement annuities and preservation funds are classified as approved retirement funds. Provisions under the Pension Funds Act and Income Tax Act also apply, although not all requirements are relevant.

Legal areas covered under Pension Fund Benefits (group retirement funds) that also apply to Retail Pension Benefits (retirement annuities and preservation funds) include:

- Duties of the Board of Management under Section 7 of the Pension Funds Act and additional PF Circulars – registered retirement annuity and preservation funds are also managed by a Board.
- The application of Section 37 of the Pension Funds Act.
- Restrictions under Regulation 28 in relation to limits on retirement fund investments; and
- Duties under PF 86 on member communication.

Limitations on access apply – this is an important concept that must be communicated to a prospective client, as discussed earlier. In summary, only one withdrawal before retirement is allowed on a preservation fund; and currently (as of March 2024) a member may not access retirement savings in a retirement annuity policy unless aged 55 or older, disabled,



emigrating, or the value is under the *de minimus* (currently R15 000). Access to retirement annuities will however change in line with the two-pot system.



Take Note

The two-pot system came into effect on 1 September 2024. This system allows retirement fund members to withdraw a portion of their retirement savings before retirement, while ensuring that the majority remains preserved for retirement security. The system applies to all retirement fund memberships and distinguishes between a savings pot (which allows limited withdrawals) and a retirement pot (which is only accessible at retirement).

6.3.3 Retirement Annuities and Preservation Funds: Tax Implications

Retirement annuities and preservation funds are subject to the same tax implications as group retirement funds:

- In terms of deductibility of contributions, contributions towards all retirement funds, including group and individually owned funds, are included in the calculation.
- Investment earnings are not taxed.
- Benefits, when accessed in cash, are subject to tax, using the same tax tables (Table 3 for cash withdrawn before retirement and Table 4 for retirement or death).
- At retirement under a retirement annuity or pension preservation fund, at least two-thirds of the value must be invested in a compulsory purchase annuity. Such annuities are taxed as income.

Retirement annuities and preservation funds offer a member exiting from a pension or provident fund before retirement the opportunity to reinvest, i.e. preserve retirement savings by transferring, tax free, by transferring benefits to either a retirement annuity or preservation fund.



Activity:

Thandi has resigned. Would it be best for her to transfer her pension fund amount fund to a preservation fund or to a retirement annuity fund?

Answer:

The answer to this will be given in two versions. The first version pertains to the period before the implementation of the two-pot system. The second version pertains to the period after the implementation of the two-pot system.



Before the Two Pot System:

Pension Preservation Fund	Retirement Annuity Fund
Governed by the Pension Funds Act	Governed by the Pension Funds Act
One withdrawal allowed and no contributions permitted	No withdrawals allowed before age 55 Contributions permitted
$\frac{2}{3}$ of lump sum must be used to purchase a compulsory annuity	$\frac{2}{3}$ of lump sum must be used to purchase a compulsory annuity

Thandi would have to decide on the importance of the following:

- A preservation fund is more flexible than a retirement annuity. With a retirement annuity she can only access the money from age 55, and she must then use two thirds to buy an annuity. With a preservation fund she is allowed one withdrawal before retirement (earliest retirement age is 55).
- With a retirement annuity fund she can make further contributions to the fund, while she cannot contribute to a preservation fund.

If Thandi wants to invest further towards retirement, the retirement annuity is a better option as a preservation fund does not make provision for ongoing contributions.

If Thandi does not want to make further contributions, then whether access to the money is important, as is possible under the preservation fund, will be one of the deciding factors. The other main deciding factor will be costs.

After the Two-Pot System

Pension and Provident Funds, Preservation Funds and Retirement Annuity Funds must all comply with the Two-Pot system once it is implemented. However, some legacy retirement annuity policies will be exempt from the Two-Pot requirements. These policies include:

- Pre-universal life policies and/or conventional policies with or without profits,
- Universal life policies with life and/or lump-sum disability cover; and
- Reversionary bonus or universal life policies as defined or referenced in the insurance legislation.

If Thandi transfers her pension fund to a preservation fund, she will be able to make one full or partial withdrawal from a benefit preserved in a Preservation Fund. But since all contributions to any type of pension fund after the implementation will go into a savings pot (one-third) and a retirement pot (two-thirds), with limited access to the savings pot (once every tax year), the only major difference between the two would be that Thandi will not be able to make further retirement contributions to a preservation fund should she choose to transfer her funds into a preservation fund.



6.4 Risk Benefits Options and Strategies, Legal and Tax Implications.

Risk benefits have been included in this guide, as most group retirement funds also offer some form of additional risk benefits. The majority of risk benefits are insured through a policy of insurance. Where the fund owns the insurance policy on behalf of its members, it falls under the Long-term Insurance Class: Fund policies. Under FAIS, risk policies fall under the product sub-category: Long-term Insurance sub-category B.

Note that a retirement fund may make provision for a pension to be payable to a spouse and qualifying children of a deceased fund member – these are not risk benefits and are often not insured, as they are typically offered only through defined benefit funds. Furthermore, a disabled member may go on early retirement and earn a lower but life-long pension through a defined benefit fund. Again, ill-health early retirement pensions are often not insured.

6.4.1 Risk Benefits: Options and Strategies

Risk benefits are supplementary benefits offered to provide greater social security to employees/ members. The reality is that a portion of employees will die or become disabled before retirement. Providing for benefits at retirement only is, therefore, not enough to take care of employees' needs.

Most group arrangements recognise the need for making provisions in the event of the death of an employee or member. Death benefits therefore are the most common additional benefits offered to members/ employees. Disability benefits and funeral benefits are also fairly common. Accidental death, disability, and dread disease benefits are other risk benefits that may be selected.

Benefits in the event of death or ill health/ disability may be included in the rules of a retirement fund, i.e. approved benefits. In this arrangement, the fund becomes bound to settle all valid claims. To ensure that a fund has sufficient money to settle risk benefit claims, retirement funds typically insure risk benefits through a policy.

Client needs and affordability is two major factors that influence the choice of risk benefits. In this sense, the client is either the employer or the Board on behalf of a particular retirement fund. Client needs include the type and level of cover to be provided, e.g. group life cover of 3 x annual salary for all members.

The details of the terms and conditions of the particular policy (or quote) must be scrutinised to determine the specific benefits provided, exclusions that may apply, and any other relevant information, e.g. one provider may impose a longer pre-existing condition clause than another (where claims will not be paid if the claim is related to a medical condition that the member suffered from before joining the scheme).



Under disability benefits especially, definitions of disablement, how benefits will be paid, claim events that are not covered, the waiting period between disablement and claim payment, and whether partial or temporary disablement is covered in addition to total and permanent disablement, must be evaluated. Wider scopes of claim events covered, and shorter waiting periods result in higher premiums.

Policies of insurance for groups include a clause that the qualifying member must be actively at work on the first day that cover commences (or the next working day if the first day falls on a weekend or holiday). If the member is absent due to ill health, accident, injury or disease, the member will have to complete a set number of consecutive days of work before qualifying to become insured, e.g. 20 days. The 'at work' condition may be waived under certain circumstances.

Risk benefits are subject to underwriting, which relates to the process through which the insurer evaluates the profile of a prospective or existing group. This is done in order to set an appropriate premium for the risk taken on, and the terms and conditions of cover.

The fund or employer must provide minimum membership and employer information:

- Details of members, including name, date of birth, gender, occupation, and earnings,
- Details of the business, especially the type of industry and occupations,
- Details of cover required, including type of benefit, level of cover and normal retirement age,
- Claims history (see below).

All these factors have a great impact on the premium rates set for a particular group and particular risk benefits.

Claims history is a record of a group's previous, current, and pending claims over the last five years. Claims history is very important and must be provided in a standard format for each of the last five years.

Free-cover limit/ non-medical limit

Group risk benefits differ from individual policies in that one policy is implemented, and one premium is charged for a group of people.

Under personal policies, the individual may be requested to submit medical evidence of health. However, under a group arrangement, this is not cost-effective or necessary. Instead, the insurer will set a free-cover limit, also known as a non-medical limit.



Members whose cover is below this limit do not have to provide any medical evidence of health. Members whose cover is more than the free-cover limit will be requested to submit certain medical evidence of health.

BENEFIT EXCEEDS THE LIMIT: MEDICAL EVIDENCE REQUIRED

FREE COVER LIMIT

BENEFIT BELOW THE LIMIT: NO MEDICAL EVIDENCE REQUIRED

Medical evidence can be in the form of medical questionnaires and/ or blood tests and other medical examinations.

As group risk benefits are usually related to a member's earnings, e.g. group life cover of 2 x annual salary, a free-cover limit will impact on the members earning a higher income, and, therefore, posing a greater risk to the insurer of a large claim. It is these members that the insurer needs more medical information from, in order to assess the risk of a claim in more detail. The insurer will advise each member above the free-cover limit of the medical evidence needed from them. The free-cover limit is, therefore, one of the considerations taken into account when comparing group risk quotes.

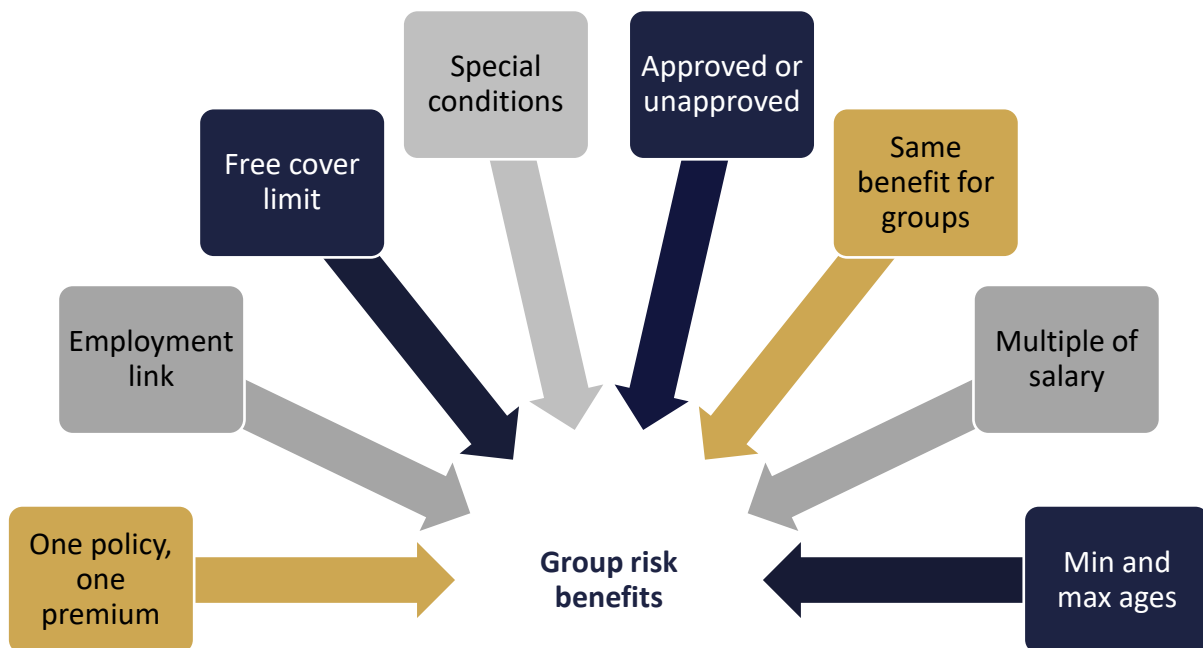
6.4.2 Risk Benefits: Legal Implications

Risk benefit policies are policies of insurance and subject to the provisions of the Long-term Insurance Act. As mentioned, approved benefits fall under the associated retirement fund, and when a claim event arises, benefits are payable to the fund. In the case of the death of a member, the Board/ trustees are responsible for the distribution of death benefits in accordance with Section 37C of the Pension Funds Act. Where a policy is unapproved, i.e. the policy for the risk benefits is separate to a fund, benefits are payable to either the member, in the case of dread disease or disablement, or to the member's nominated beneficiaries, in the event of death.

We will consider the following selected features of risk benefits:



Group risk benefits – selected features.



Where benefits are insured for a group of members or employees, insurers apply unique terms and conditions, including:

- One overall premium is payable for the group.
- One policy is issued which covers a group of people who have a common link, e.g. they work for the same company, or belong to the same retirement fund.
- The premium is based on factors such as the profile of the members, business of the particular group, and structure of the selected benefit.
- A free cover limit (also known as a non-medical limit) is imposed. Most often only the highest earners exceed the free cover limit and need to provide some form of medical evidence of health.
- A pre-existing condition applies to benefits where a member required, sought, or should have sought medical attention for a particular health condition before joining the scheme.
 - Where a claim is submitted in relation to a pre-existing condition that falls within the time limits as per the insurer's policy, no benefit will be paid to the claimant.
- The 'at work' condition applies, as discussed earlier.
- A retirement fund may own the policy and provide and pay for risk benefits (approved benefits):
 - Where a retirement fund provides death benefits, the proceeds of a death claim are subject to tax. The death benefits are also subject to Section 37C of the Pension Funds Act.



- Alternatively, the employer may arrange the risk benefit policy in which case the policy is issued to the employer (unapproved benefits):
 - Premiums paid by an employer for unapproved policies on the lives of employees are deemed to be a fringe benefit, and are taxed in the hands of the members, but benefits, when paid, are tax free. Benefits are paid in accordance with the member's beneficiary nomination.
- The same benefit levels apply to a broad group of people.
- Benefits are often expressed as a multiple of annual salary, e.g. 2 x annual salary.
- Benefits cease when membership or employment ceases, but, often, for a small additional premium, a rider may be added to the policy to allow a member to convert the cover to a personal policy and pay individually rated premiums, subject to limited or no evidence of good health.
- The costs of insurance benefits for a group as a whole are generally cheaper than the cost of individual policies with the same level of benefits.
- Minimum ages at entry and maximum ages at which cover terminates apply.

An important concept that advisors need to take into account when conducting personal planning for a client is the level of disability benefits offered to members. According to guidelines issued by ASISA (the Association for Savings and Investments South Africa) in relation to disability benefits, there may be a limit imposed on the amount that a disabled member/ client can earn, e.g. a maximum of 75% of pre-disability earnings. Not all insurers impose this limit.

Where disability benefits are to be implemented through an individual policy to supplement group disability benefits, the advisor must check whether the particular disability benefits are aggregated. This is where the insurers limit disability covers payable as per the ASISA guideline, taking the total disability benefits through all personal and group policies into account. Where a disability benefit is subject to aggregation, even if higher sums assured apply on the policies, the benefit payable to the disabled member/ client is capped (limited) to a maximum of 75% of pre-disability earnings (or other limit, depending on the insurers involved), resulting in over-insurance.

6.4.3 Risk Benefits: Tax Implications

Approved group life benefits, i.e. benefits that are insured by a retirement fund and included in the rules of the fund, are subject to tax. The total insurance value paid plus the deceased members' retirement savings or actuarial reserve value are added together and taxed in accordance with Table 4 tax rates and rules.

Monthly income disability benefits are always separate from a retirement fund. Income is not taxed, and premiums are not tax deductible. An additional rider may be added where employer contributions towards the retirement fund and associated life insurance benefit



costs continue, at disability, i.e. a disabled member receiving a monthly disability benefit may continue as a fund member, with contributions towards retirement and/ or life insurance continuing. For capital disability benefits, i.e. lump sum disability benefits, dread disease and funeral policies, no tax deduction applies on premiums, and benefits, when payable, are not taxed.



Activity:

Read through the sample benefit statement below and answer the questions that follow.

TECHCO (PTY) LTD PENSION FUND – MEMBER BENEFIT STATEMENT AS AT 1/05/2023	
MEMBER DETAILS	
Member Name	D. Jantjies
Date of Birth	03/11/1979
Date Joined Fund	01/07/2015
Normal Retirement Date	30/11/2039
Annual Pensionable Salary	R96 000.00
Member Monthly Contributions are 7.50% of Pensionable Salary	R600.00
Employer Monthly Contributions are 7.50% of Pensionable Salary, plus costs paid separately	R600.00
INVESTMENT PORTFOLIO(S)	
The net contributions are being invested in the following portfolio(s) and have been updated to 1/05/2023	
Trustee's choice (default portfolio): 100%	
ACCUMULATED CONTRIBUTIONS	
Accumulated Member Contributions	R128 882.50
Accumulated Employer Contributions	<u>R128 882.50</u>
Total fund credit including investment earnings	R257 765.00
WITHDRAWAL BENEFIT INFORMATION	
In the event of your withdrawal, your Full Fund Credit will be payable.	



RETIREMENT BENEFIT INFORMATION	
In the event of your retirement, you may take up to one third of your Full Fund Credit in cash. The remainder must be used to purchase a life-long annuity from a registered insurer.	
DEATH IN SERVICE	
In the event of death prior to normal retirement date, your beneficiaries/ dependants would receive the following benefits:	
Approved group life insured benefit of	R288 000.00
Plus, Your Full Fund Credit	R257 765.00
It is extremely important that your Employer has a record of your dependants/ beneficiaries. Please ensure that your nomination form is updated regularly and lodged with your Employer. The above benefit is based on current data and may change from time to time. This represents the amount of potential cover available, subject to accepted medicals.	
DISABILITY IN SERVICE	
In the event of disability prior to normal retirement date, the following benefits would be payable:	
A lump sum benefit payable on permanent and total disability, subject to a medical assessment	R288 000.00
Plus, Your Full Fund Credit	R257 765.00
IMPORTANT NOTES	
1.	This benefit statement advises the benefits available by the fund.
2.	If any information on this statement differs from the Rules of the Fund, the rules will prevail.
3.	Any benefit, including death benefits taken as cash, will be subject to income tax dependent on the tax regime at the date of exit.

1. What type of retirement fund does this member belong to? (Pension or provident fund)
Pension fund.

2. Is this a defined benefit or a defined contribution fund? Motivate your answer.
It is a defined contribution fund, as both the member and employer contributions have been described (7.5% of earnings for each).



Furthermore, the member's retirement benefit has been described as a fund credit, whereas under a defined benefit fund, the member's retirement benefit is described as an actual reserve value

3. Assuming that the fund is free-standing, who is responsible for its management and governance?

The Board of Management, being the trustees and Chairperson and supported by the Principal Officer, is responsible for the fund's management and governance.

4. Is the fund inclusively costed or exclusively costed, and who pays costs?

The fund is exclusively costed, as the employer pays 7.5% towards retirement plus costs which are separate to the retirement contribution.

5. How has the member's retirement savings benefit been determined?

As the fund is a defined contribution fund, the benefit is a total of member and employer contributions, less costs, plus investment earnings.

6. What is the fund's normal retirement age?

The member was born in 1979, and according to the benefit statement, his normal retirement date will be in 2039. Normal retirement age is, therefore, age 60.

7. If the fund offered member investment choice, what is a default portfolio?

A default portfolio is a suitable investment portfolio available to members of funds with investment choice who do not want to make a choice (Regulation 37).

8. Retirement fund investments are limited in terms of asset classes and ownership of securities under what legal provision?

Regulation 28 (Prudential Investment Guidelines).

9. If the member left the fund now, i.e. withdrew from the fund, what will he be paid, before tax?

If the member withdrew now, he will be paid his accumulated savings, also known as a fund credit or share of fund. In this case, his fund credit is R257 765.

10. If the member cashed in his withdrawal benefit, what tax will be payable, assuming that he has not withdrawn money from a fund in the past?

The member will be taxed according to Table 3:

18% of the amount above R27 500

$\therefore 18\% \times (R257\,765 - R27\,500)$

$= 18\% \times R230\,265$

$= R41\,448$ tax payable.



11. If the member left the fund now and wanted to avoid paying tax, what are his options?

The member could retain the benefit in the fund, or reinvest savings, tax free, in either a retirement annuity or preservation fund. He may also transfer benefits to his next employer's fund and avoid tax as all these options are approved transfers.

12. Does the fund pay pensions directly, or are members required to source their own pension/ annuity product at retirement?

Members are required to purchase their own annuities from a registered insurer.

13. If members must source their own pension/ annuity at retirement, what options are available to the member, assuming that his health is good?

The two main options are a traditional/ conventional annuity and a living annuity.

14. What additional risk benefits are provided?

Lump sum death and disability benefits are offered. Each is 3 x annual salary.

$\therefore R96\,000 \times 3 = R288\,000.$

15. In the event of death, what is the total payable before tax?

Fund credit (retirement savings) of R257 765 + life insurance of R288 000
= R545 765

16. In the event of death, who will be responsible for distributing benefits?

The benefits are approved and, therefore, form part of the fund and rules. The Board of management/ trustees are responsible for distributing death benefits. Benefits will be taxed.

17. In the event of death, what principles will be applied when distributing benefits?

The Board must apply the principles of Section 37C of the Pension Funds Act, where dependants must be identified and prioritised according to needs.

6.5 Options at Retirement

Options at retirement refer to cash and annuity options available to a person retiring from a retirement fund. The different annuity options were discussed earlier in Section 1.2.3, along with legal and tax implications. In this section, we will take a closer look at the options and strategies available to a retiree.



6.5.1 Retirement Options and Strategies

Retirement planning should be taking place long before the actual retirement date, to ensure that the retiree can, in fact, cover living costs through a pension/ annuity at retirement, and settle any costs as needed at the retirement date. For example, a person who has a company car may need to replace the car at retirement and, hence, needs a cash amount to do so.

Members retiring from a fund, must reinvest at least two thirds of the value in a life-long annuity. Where any amount is taken in cash, the cash portion will be subject to tax. The corresponding annuity purchased with the remainder of the retirement value will reduce if any portions are taken in cash.

A key factor to determine is the level of cash required by the retiree, the level of income required through the annuity, and the choice of annuity, i.e. how the pension income will be structured.

Cash lump sums are subject to tax. The first R550 000 is tax-free on retirement benefits taken at retirement, based on the principle of aggregation (refer to Table 4 on tax rates on retirement lump sums). Some clients/ members may prefer or need to take a portion in cash for a specific purpose and often take the tax-free portion in cash. An advisor would need to conduct a needs analysis to identify whether a client requires a cash portion for a specific purpose, and to identify and explain the implications in terms of income tax as well as lowered capital to reinvest to create an income during retirement.

Unless the pension is paid from the retirement fund where specific rules apply, further consideration is what type of annuity to choose. Options as discussed earlier in the module include:

- Traditional/ conventional annuity, with the different options for continued income in the event of death of the main annuitant and annual increase options,
- Living annuity; and
- Enhanced/ impaired life annuity – suitable only for persons with health issues that impact on longevity.

6.5.2 Retirement Options: Legal Implications

Some defined benefit funds still offer a pension payable directly from the retirement fund. In this case, the member remains active on the fund but becomes a pensioner of the fund at retirement. Where the fund provides an option to become a pensioner of the fund or to take the retirement savings out of the fund, the advisor should compare the pension/ annuity options to determine the best option for the particular retiree.

The pensioner increase policy should also be investigated, i.e. the practice and method that the Board/ trustees apply to determine annual increases on pensions paid from the fund.



Where the rules allow for an annuity to be purchased outside of the fund, once the annuity has been purchased, the fund's legal obligations towards the retired member cease.

If a living annuity is being considered, analyses and disclosures as per the ASISA combined code on living annuities apply. Note that the biggest risk facing annuitants is longevity. As such, an advisor should include a traditional annuity when evaluating options, as the annuitant can never outlive their income. Under a living annuity, there is a real risk that the annuitant runs out of capital over the long term. Therefore, the options at retirement for a particular client/ member should be carefully evaluated, taking his/ her circumstances into account, including health, the amount available and income needs.

A member who is able to take retirement benefits in cash (former provident fund members and where the retirement benefit is below R247 500) still needs to use the money to create an income during retirement. These members are not bound by law to purchase a compulsory life-long annuity. Options available depend on the size of the retiree's benefit and objectives and include solutions such as:

- Investing in a voluntary annuity to be paid a regular annuity income:
 - One of the advantages of a voluntary annuity is that a portion of the annuity income is tax free. The tax-free portion is called the 'capital element' and is determined through a formula.
- Investing in a bank account and drawing the interest as income:
 - Tax-free options are available, within limits, and up to R34 500 of interest earned by investors over the age of 65 is tax-exempt (tax-free) on other savings options.
- Investing in property and using the rental paid as income:
 - Running costs may be deducted.
- Investing in RSA Retail Bonds, a government bond available to individual investors which offers income options:
 - Income is guaranteed for the selected period, e.g. 5 years, and options for the income to increase at a set rate or the inflation rate are available.

6.5.3 Retirement Options: Tax Implications

Cash portions taken out of a retirement fund are subject to income tax. As of the 2025 tax year (1 March 2024 – 28 February 2025), the first R550,000 of lump sum cash commutations at retirement remains tax-free if no retirement fund lump sums have been taken in cash prior to retirement. Retirement benefits are aggregated if a member retires at different times from multiple funds, meaning that past lump sum withdrawals may impact the tax calculation on future withdrawals.



Income drawn or earned from a compulsory purchase annuity is taxed as income at normal marginal rates of tax.

The capital element, as calculated, is tax-free for income drawn from a voluntary annuity, i.e. part of the income is tax-free.



Unit 6 Summary

In this unit, we covered several aspects of the different retirement products available, ranging from group retirement benefits to the various options available to members upon retirement. Under a group retirement fund we discussed the benefit structure, administration structure, structure for the governance and management of the fund, investment needs, and whether additional risk benefits will be offered. Affordability constraints play a major role in determining the best overall structure for a particular group.

This unit also covered risk benefits as most group retirement funds also offer some form of additional risk benefits. The majority of risk benefits are insured through an insurance policy. Where the fund owns the insurance policy on behalf of its members, it falls under the Long-term Insurance Class: Fund policies. Under FAIS, risk policies fall under the product sub-category: Long-term Insurance sub-category B. Finally, the unit covered options at retirement, the different annuity options, as well as the legal and tax implications.



7.1 What is Financial Planning?

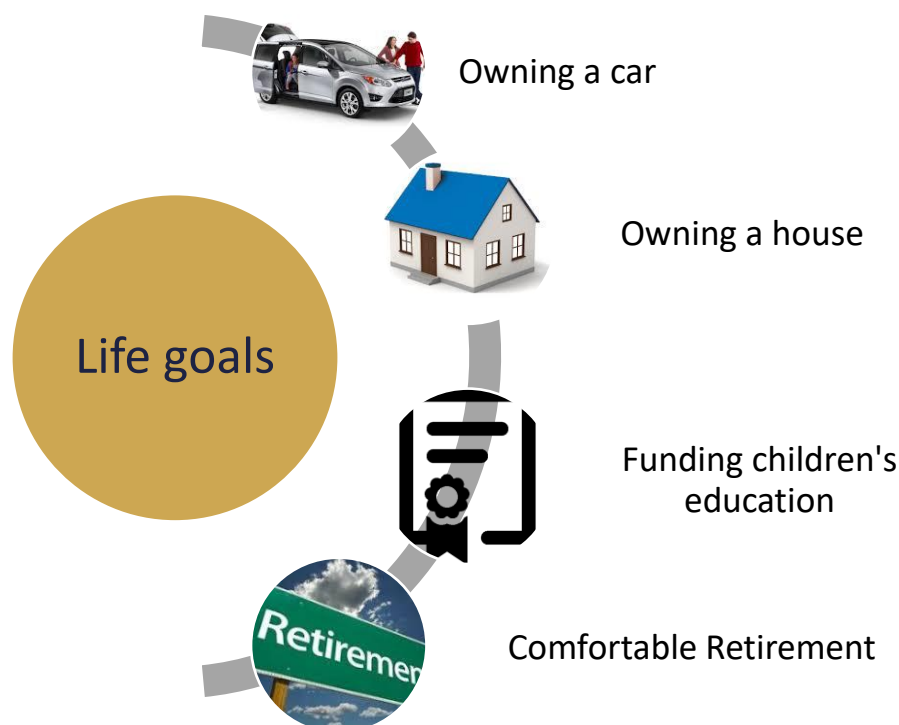
Have you ever had to draw up a budget and stick to it; or decide whether to buy an item on loan now, or save up for it and buy it only when you can afford to pay for it? Financial planning is a structured process that involves managing one's finances to achieve personal and financial goals. While individuals informally engage in financial planning by budgeting and prioritising expenses, professional financial planning is a strategic approach that includes short-term and long-term financial goal setting, risk management, tax efficiency, retirement planning, and investment strategies. Effective financial planning ensures financial security and sustainability over different life stages.

Looking at a more formal definition of financial planning, according to the Financial Planning Institute of Southern Africa (FPI), financial planning provides ***ways of managing one's finances to achieve one's life goals.***¹

¹ FPI (2018)



Example life goals:



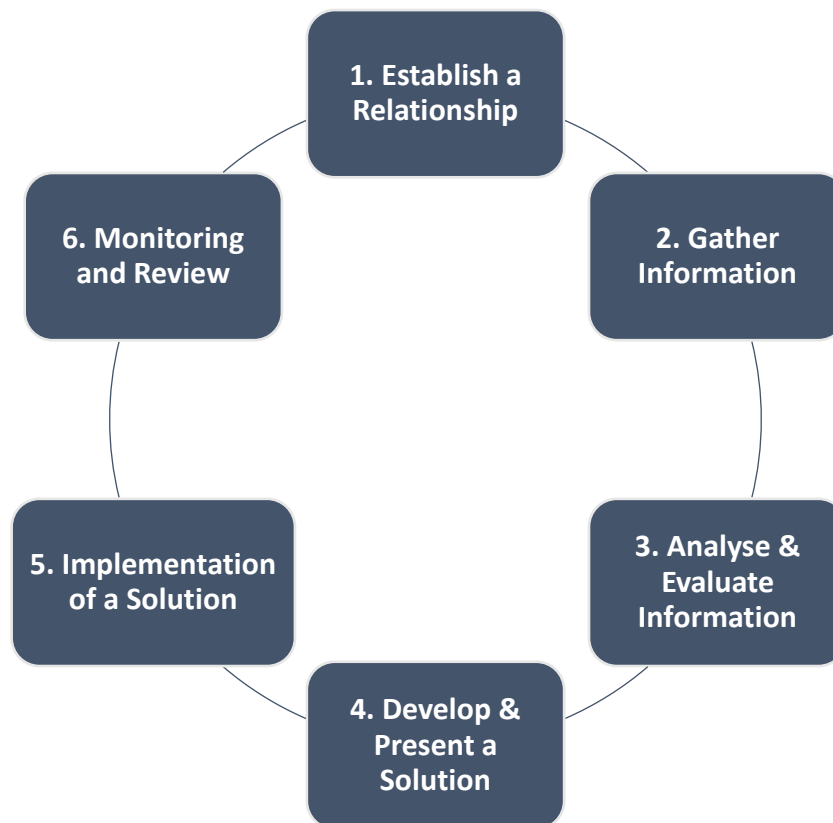
From this definition we can see that in order to manage finances and achieve life goals, a professional financial advisor will not only look at the short-term day-to-day planning, but will also look at the client's longer-term financial goals and financial needs and put into place effective strategies and plans to manage and achieve the client's long-term goals, such as retiring comfortably, or having an education fund for his children's university studies; as well as the client's financial needs, such as protecting income in case of adverse life events (death or disability), protecting assets against damage or loss, or even maximising opportunities to legitimately minimise the amount of tax payable on investments, amongst others.

We can also see from this definition that financial planning cannot succeed if it is done as a once-off activity, since on-going management and adaptations will be needed to a financial plan, in order to ensure that the actions are still on track to meet the client's goals, and that it can be adapted when the client's circumstances, needs and goals change. A financial plan includes budgeting, saving, investing, tax planning, estate planning, and retirement preparation. Tax planning plays a key role in optimizing financial outcomes by ensuring tax efficiency in investments, retirement contributions, and estate distribution. Proper financial planning includes strategies to minimize tax liabilities while maximizing financial growth

The FPI proposes the following six steps as part of the on-going management of the financial planning process, in order to ensure that clients can reach their financial needs and goals (information adapted from the FPI's website: FPI, 2018):



FPI six-step financial planning process:



Step 1: Establishing and defining a professional relationship.

The initial contact is dedicated to establishing a clear understanding of the client's immediate needs and/ or concerns, as well as providing information on what services (or products) the financial advisor provides.

Step 2: Gathering data, including goals.

The financial advisor should assist the client to define their personal and financial goals, develop an appropriate timeframe for achieving results, establish the client's existing knowledge about financial products and discuss how the client feels about taking investment risks, among other things.

Step 3: Analysing and evaluating the client's financial status (doing a financial needs analysis, or FNA)

The financial advisor should assist the client to establish where they currently stand in relation to achieving their financial goals. This could include analysing the client's assets, liabilities and cash flow, current short-term and long-term insurance coverage as well as healthcare coverage, estate planning, retirement planning, investment planning or tax strategies.

Step 4: Developing and presenting financial planning recommendations and/ or alternatives.

Once an analysis and evaluation of the client's financial information in Step 3 above has been done, the financial advisor should guide the client through various financial decisions (and



product options) available and make recommendations accordingly. The outcome of the plan is to ensure that the client has a plan to take them forward with confidence and provide certainty regarding their financial future.

Step 5: Implementing the financial planning recommendations.

The financial advisor will agree with the client on how the recommendations will be carried out. The financial advisor could be the one that carries out the recommendations, or could serve as the client's "coach," co-ordinating the whole process with the client and other professionals such as attorneys or stockbrokers.

Step 6: Monitoring the financial planning recommendations.

The financial advisor will agree with the client on who will monitor progress towards the client's goals. It is important that the client's financial plan and any financial solutions (product solutions) that were implemented are reviewed on at least an annual basis. This is done to ensure that the financial plan remains relevant and meaningful in light of any changes in the client's personal or financial circumstances.



Activity:

Why should clients have a financial plan?

Answer

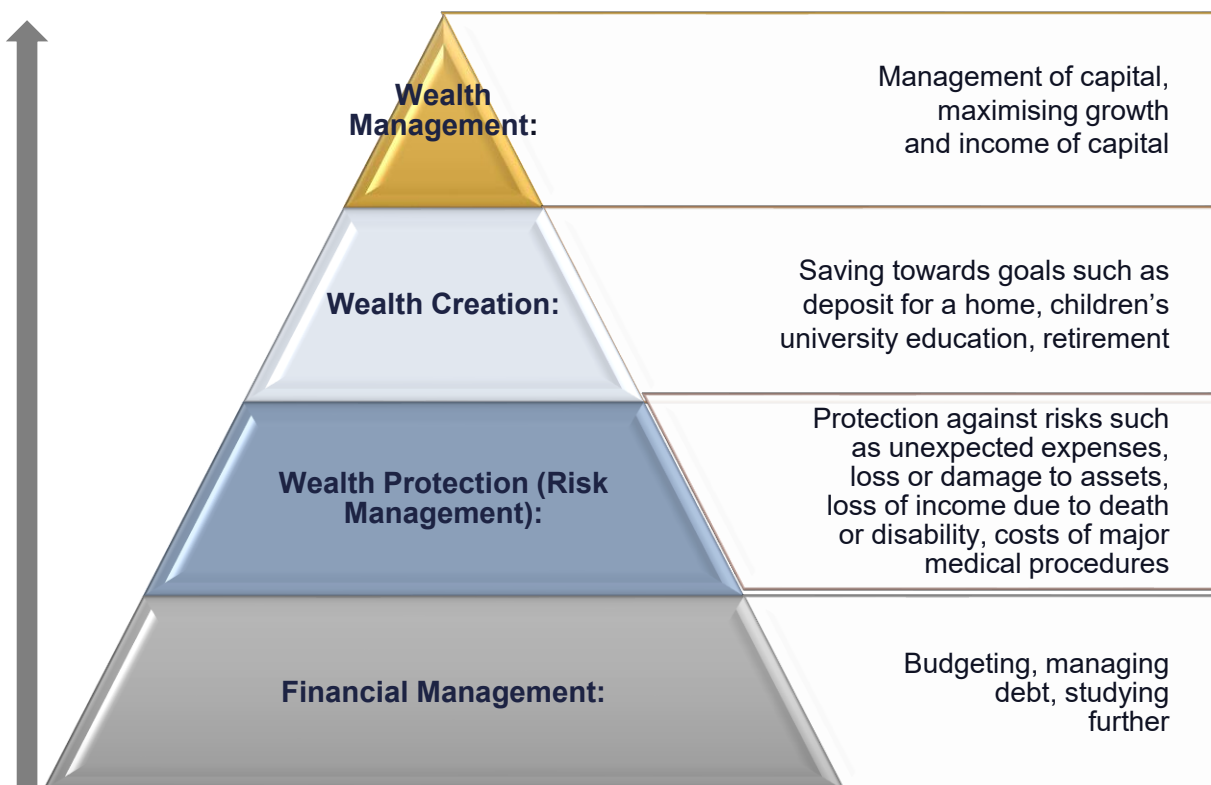
A financial plan includes budgeting, saving, investing, tax planning, estate planning, and retirement preparation. Tax planning plays a key role in optimizing financial outcomes by ensuring tax efficiency in investments, retirement contributions, and estate distribution. Proper financial planning includes strategies to minimize tax liabilities while maximizing financial growth.

In the next section we look at typical financial needs and goals of clients.

7.2 Client Financial Needs and Goals

Financial needs of clients can be broadly grouped into different levels, according to the client's current financial circumstances and how well they are managing their day-to-day living expenses, and according to their financial goals based on the aim of either risk protection needs (wealth protection), or investment growth and management needs (wealth creation/management).

The diagram below gives a broad overview of client personal financial needs/ goals. The pyramid is used to show that the previous level (or partial progress towards addressing the previous level of needs), should be in place before the next level of needs is addressed.



The diagram shows the typical financial goals of individual clients in their normal or natural order.



Activity:

Which financial need/ goal generally comes before the goal of managing capital for maximum growth?

Answer

Saving up to create capital, i.e. wealth creation.

i. Managing Income and Expenses:

The most important need for an individual is to be able to survive and take care of physiological needs, e.g. to have shelter, to eat and sleep. A client is only in a position to consider other needs if he/ she can make ends meet. An individual who has no disposable income, for whatever reason, is not able to sustain the payments towards financial products. Moving forward from this level may entail budgeting, manage debt and study further in order to increase skills and income.



ii. **Wealth Protection (Risk Management):**

Once an individual has a formal income and can meet expenses, the next level of needs relates to securing his or her financial position.

Wealth protection refers to a client's need to protect himself (and his/ her income-earning ability), his family and his assets against losses caused by unforeseen events. If a person has not planned properly (e.g. by taking out insurance), an unplanned event could result in assets having to be sold (or the client having to go into debt) to raise the money necessary to go on living.

Protection of Assets

Individuals need to protect themselves against the financial impact of damage, loss or destruction of assets. For example:

- Assets, such as cars, cell phones or household effects, may be stolen.
- An asset, such as a house, can be destroyed by fire.
- Clients may face a claim where they damage other people's assets, (e.g. from a car accident caused by the client).

Class of Business: Short-term Insurance (Personal Lines)

A client may want to insure his assets against certain loss events by taking out a short-term insurance policy. With this type of insurance contract, the client would receive a pay-out or re-imbursement of the cost of replacing the asset and/ or repairing the damage that was caused, in exchange for a set premium on the policy.

Examples are:

- Motor policy (motor vehicle insurance)
- Property policy (buildings or homeowner's insurance)

Protection of income/ lifestyle in the event of death, disability, and trauma

Individuals need to protect themselves personally, through insurance, against a number of unforeseen events.

Firstly, a client may die unexpectedly. Although all of us will die eventually, death at a young age can cause serious financial difficulty to loved ones who remain behind. A person may have outstanding liabilities, such as a mortgage bond, and other debts that need to be paid.

In addition, a client's dependants, such as his spouse and children, may require a regular income to maintain their standard of living. Also, whether a client is young or old, there will



always be costs involved in dying. These costs could include funeral expenses, estate duty, executor's fees, and other estate administration costs. It is important to provide sufficient cash to pay for these liabilities in the event of death.

Secondly, a client may be temporarily or permanently disabled. This disability may be so serious that he cannot return to work, which means that unless he has made provision for disability, he will be without a regular income. In fact, a disabled person often needs more income, as he may have high medical bills, and he may need assistance on a daily basis to perform basic tasks. In the event of disability, a client would need to have enough capital to settle liabilities and to generate a regular income.

Thirdly, a client may suffer from a severe illness, such as cancer, stroke, or heart attack. In these instances, he may need an amount of capital to pay extraordinary medical costs, or to pay someone to take care of him until he has recovered.

Class of Business: Long-Term Insurance

These needs can be covered with a long-term insurance policy. Long-term insurance cover can include life cover, disability and or severe illness/ trauma cover.

Examples are:

- Life risk policy (life cover, disability cover, severe illness/ trauma cover)
- Assistance policy (funeral policy)

Protection against Excessive Medical Costs

Medical expenses have continued to soar in South Africa in recent years. This problem is aggravated by the fact that the services in public hospitals countrywide are currently not up to standard.

Medical expenses can be split into two groups: major medical expenses, such as hospitalisation and other costs related to surgery and severe ailments; and day-to-day expenses, such as paying for medicine at the chemist or going to see the dentist. It may still be possible for people to provide for their day-to-day expenses from their regular income, but major medical expenses can amount to hundreds of thousands of rands, even for one operation. These costs do not only affect people who suffer from poor health, as anyone can unexpectedly end up in a car accident, resulting in emergency surgery and hospitalisation.



Class of Business: Health Service Benefits

The product that can address healthcare needs is a medical scheme.

Class of Business: Short-term and Long-term insurance

There are also insurance-related medical products available, such as hospital plans and gap cover plans.



Take Note

An individual may not be able to address all the wealth protection needs, in full, all at once, but may only be able to afford some provision towards these needs. This is why a financial plan should be regularly reviewed and cover increased as needed, and as can be afforded.

It is also important to remember that the purpose of wealth protection is to secure one's financial position in case of adverse risks, therefore none of the provisions made towards managing these risks will enrich a client.

iii. Wealth Creation

Wealth creation focuses on the need for a client to create new assets and to add to the value of assets he has accumulated. Wealth creation includes saving up for a particular goal (where the funds do not exist currently) or investing money (capital) which is already available, in order for that capital to grow in value.

Classes of Business:

When saving for a particular goal, the term and purpose of the saving is very important and affects which type of investment product is chosen. A wide range of financial products address the need for savings or investment. These include:

Long-Term Insurance

Long-term insurance contracts can be used for longer-term savings (five years or longer).



Examples are:

- Long-term investment policy (endowment)
- Sinking fund policy

Investments

The investment class of business includes a range of products that will suit clients with different terms and investment risk needs and profiles.

Examples are:

- Collective investment schemes (unit trusts)
- Retail pension benefits

Pension Fund Benefits

The pension fund class of business allows companies to make provision for their employees' savings towards retirement.

Examples are:

- Pension fund
- Provident fund

Short-Term and Long-Term Deposits

This class of business provides banking products where the return is in the form of interest, and your capital is, therefore, guaranteed (subject to the creditworthiness of the banking institution).

Examples are:

- Short-term deposit (bank savings product with a term of 12 months or less)
- Long-term deposit (bank savings product with a term in excess of 12 months)

Structured Deposits:

This class of business provides banking products which can either be long- or short-term deposits, where the return or value is dependent on the performance of, or derived from the return or value of, one or more underlying financial instruments or assets, rates or indices, or measures of economic value.

Example:

- Structured deposit (for example bank savings product linked to the Consumer Price Index, plus a certain growth in excess of this index, e.g. CPI +2%)



Forex Investments:

Clients can diversify investments by investing in a foreign currency denominated investment instrument.

Example:

- Forex investment (foreign currency deposit)

Saving for retirement is essential and should start as soon as a client can afford to do so. Other specific financial goals need to be considered, e.g. making provision for tertiary education for children. However, specific savings goals should not be implemented at the expense of wealth protection. In other words, implementing savings but failing to protect against risks is not advisable, e.g. if a client has decided to rather save towards a goal than implement short-term insurance on his car, a hi-jacking will set him back financially. He may no longer be able to get to work and back, and his job and survival may now be at risk, resulting in him having to cash the investment in, and possibly cancelling other products or selling off other assets to replace the car.

Investment for Growth

Clients need to save for a variety of reasons, for example:

- Saving for a new car or for a deposit on a house
- Saving for a holiday
- Saving for children's education
- Saving for retirement

Investment for Income

If the client already has an amount of capital, i.e. a lump sum of money, available from which he wants to receive a regular income, then he may use different investment vehicles to achieve goals, such as either securing an income during retirement, or to supplement his monthly income.



iv. Retirement Income (capital that must be invested to provide for a pension for life):

Class of Business: Long-Term Insurance

Long-term insurance contracts provide for the need of either receiving a guaranteed income for life, or for investing one's retirement capital in a market-related annuity.

Examples are:

- Guaranteed conventional annuity (capital is surrendered to the insurer in return for an income that is guaranteed to be paid for life)
- Living annuity (retirement income is invested in market-related asset classes, and the level of income is determined by the client on an annual basis – between 2.5% and 17.5% of the underlying capital)

v. Discretionary Income (capital that does not form part of the compulsory retirement capital and that can be invested at the client's own discretion):

Classes of Business:

When saving for a particular goal, the term and purpose of the saving is very important and affects which type of investment product is chosen. A wide range of financial products address the need for savings or investment. These include:

Long-Term insurance

Long-term insurance contracts can be used to provide for an income either for an agreed term, or for life.

Examples are:

- Voluntary annuity

Investments

The investment class of business includes a range of products that will suit clients with different terms and investment risk needs and profiles.

Examples are:

- Collective investment schemes (unit trusts)



Short-Term and Long-Term Deposits

This class of business provides banking products where the return is in the form of interest, and your capital is, therefore, guaranteed (subject to the creditworthiness of the banking institution).

Examples are:

- Short-term deposit (bank savings product with a term of 12 months or less)
- Long-term deposit (bank savings product with a term in excess of 12 months)

Structured Deposits:

This class of business provides banking products which can either be long- or short-term deposits, where the return or value is dependent on the performance of, or derived from the return or value of, one or more underlying financial instruments or assets, rates or indices, or measures of economic value.

Example:

- Structured deposit (for example bank savings product linked to the Consumer Price Index, plus a certain growth in excess of this index, e.g. CPI +2%)

Forex Investments:

Clients can diversify investments by investing in a foreign currency denominated investment instrument.

Example:

- Forex investment (foreign currency deposit)

vi. Wealth Management

Wealth management is different from wealth creation. While the focus of wealth creation is the accumulation of wealth through saving and investing, in wealth management, the client has already accumulated amounts of money through investments and savings made. Wealth management, therefore, involves the financial advisor managing and monitoring investments already in place, to ensure that the money is invested in such a manner that further growth is optimised, taking into account the investor's risk profile, time horizon and goals, and that the investment funds are structured in the most cost- and tax-efficient manner.

Holistic estate planning, investment planning, retirement planning, and tax planning are important additional aspects that are considered in financial planning, and become extremely important at the wealth management stage, to ensure the efficiency of the client's financial plan.



Activity:

Which class of business CANNOT be used for wealth creation purposes?

- a) Investments
- b) Short-term and Long-term Deposits
- c) Short-term Insurance
- d) Forex Investments

Answer

c) is the correct answer. Short-term insurance is used for wealth protection purposes (used to protect physical assets from loss or damage), and not for creating wealth.

7.3 Client Life-Cycle Stages

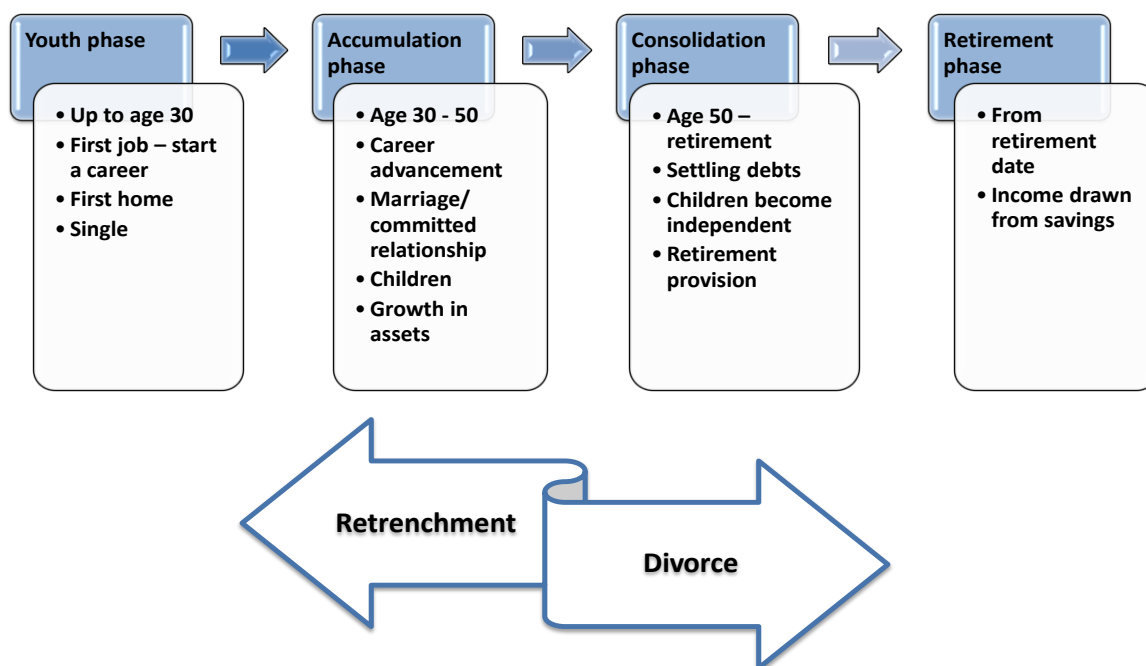
The broad financial needs discussed above, have to be prioritised and aligned with a client's specific needs (and wants), their priorities and the life cycle stage into which the client falls. A client's life cycle stage is broadly based on his/ her age and family circumstances.

Please note that the ages provided with the different stages are a general indicator only. As a client may have had children at a young age, or get married at a late stage in life, or never co-habit or get married, the main indicators of the client's life cycle are their specific circumstances.

Gathering information to determine the client's life cycle stage is important, and this has a direct link to financial planning needs:



Client life cycle phases:



7.3.1 Youth Phase

A young single client, who is starting a career, will be making his/ her first purchases, e.g. buying furniture and appliances once moving out of his parents' home, and/ or a car. As soon as any assets are owned, short-term insurance cover should be implemented.

Disability cover is important at any stage of a working person's life. Young people can also become disabled, although disablement at a young age is typically caused by an accidental event, rather than a health event.

Medical scheme cover should also be implemented as soon as this is affordable. Although it is recommended that retirement savings are started as young as possible, most clients in the youth phase have other priorities and limited affordability.

7.3.2 Accumulation Phase: Committed Relationship or Marriage (Partners)

During the accumulation phase, further assets are accumulated. This may include the purchase of a property. Where partners share a household, death or disablement will result in a financial burden for the other partner. Death cover becomes essential to make provision for death costs, as well as an income for the surviving partner.



Disability cover, short-term insurance, and medical scheme cover should be maintained, and cover levels increased as needed. Dread disease cover may be considered as a supplement to other insurance in the event of a serious illness.

Retirement savings should be implemented, and savings set aside for specific goals, e.g. saving for a larger home.

7.3.3 Accumulation Phase: Dependent Children

Whether both parents are involved in bringing up children, or whether the client is a single parent, making provision in the event of death or disability is crucial. Life insurance cover should be sufficient to cover death costs, as well as provide an income for the children. Even where a stay-at-home mom does not earn an income, for example, her death would result in a financial burden, as a helper would need to be employed to take care of the children and household responsibilities. Further financial provisions should be considered, e.g. drafting of a will, and consideration of the management of income and care for minor children in the event of death.

Disability cover, short-term insurance, and medical scheme cover should be maintained, and cover levels increased as needed. Medical scheme cover is particularly important where there are minor children, to ensure that they receive the best medical care possible. Dread disease cover may be considered as a supplement to other insurance in the event of a serious illness.

Retirement savings should be implemented and maintained, and savings set aside for specific goals, e.g. saving for tertiary education for children.

7.3.4 Consolidation Phase

In the consolidation phase, the client should aim at settling debt before retirement, in order to reduce financial commitments during retirement.

Disability cover, short-term insurance, and medical scheme cover should be maintained, and cover levels increased as needed.

Retirement savings should be increased, monitored, and reviewed in line with retirement goals. Where a client has any other specific financial goal, savings should be set aside.

7.3.5 Retirement Phase

At retirement, money accumulated in earlier phases is invested to create a pension income. Decisions need to be made regarding income options, e.g. a living annuity versus a conventional annuity. The client may decide to downsize or move to a retirement village.



Disability cover falls away, but medical scheme cover is more important than ever. Estate planning is very important, although this should take place at regular intervals throughout a person's life. Life cover may, therefore, be retained, although the need for income is lower, or possibly not needed; but enough money must be available to cover death costs. Short-term insurance should be maintained.

7.3.6 Divorce and Retrenchment.

Sadly, more than half the marriages in South Africa end in divorce, and most employed South Africans these days will be retrenched during their working life. These are, therefore, unplanned circumstances that could occur at any stage in the individual's life and are essentially trigger events that result in a review of an existing financial plan.

Divorce and retrenchment will necessitate a revision of the client's financial plan in line with affordability. Accumulated savings may need to be used for day-to-day needs.

Note: There are alternative models on life cycles and needs that may be used, but the essential element of all these models is to help identify important financial planning areas for a particular client in his/ her particular circumstances.



Activity:

At which life-cycle stage do clients generally focus closely on increasing, monitoring, and reviewing their retirement savings?

- a) Youth phase
- b) Accumulation phase: Dependent children
- c) Consolidation phase
- d) Retirement phase

Answer

c) is the correct answer. In the consolidation phase, retirement savings should be increased, monitored and reviewed in line with retirement goals.



7.4 The effect of Attitudes and Values on an Individual's Perception of Wants and basic Needs.

A person's attitude and values impact his/ her perceptions of wants and needs, which, in turn, impact on life decisions, including financial decisions.

7.4.1 Values

A value is a measure of the worth or importance a person attaches to something, e.g. one client may value free time with his family, while another may value his career advancement to a greater degree. Values shape attitudes and decisions, as they are the basis of decision making.

7.4.2 Attitude

An attitude is a person's point of view towards something. Attitudes and behaviour are influenced by a person's underlying values. The 'something' may be a product, an advert, a salesperson, a company, an idea, anything. Attitudes are important to understand, as they influence with whom the client wishes to deal and what products he or she may wish to purchase.

7.4.3 Impact on Perceptions of Needs and Wants.

A perception is an opinion or belief. Perceptions are based on values, attitudes, and experience, among other factors. These all combine to form the basis on which a person evaluates needs and wants and as mentioned, will have an impact on financial decisions.

7.4.4 Examples

Gerry believes that sustained financial security is of utmost importance (a value). As a result, he wants to ensure that he takes the right action to protect himself and his family from financial risk. He, therefore, has a positive attitude towards insurance as a means to protect himself and his family financially.

Cory's father passed away when Cory was a child. His father worked long hours and did not have time to really enjoy the fruits of his labour. Cory believes that you can die at any time, and that a person should not put off life's pleasures for a later date (a value). He would rather spend what he has today and worry about tomorrow when it arrives. He, therefore, has a negative attitude towards savings or spending money on covering risks that may or may not happen.

7.4.5 Cultural and Family Influences

Clients are also influenced by their community and cultural beliefs, e.g. among many South Africans, it is important to provide a dignified funeral for a deceased family member. Funeral policies are, therefore, viewed more favourably than other forms of insurance.



Middle-class people may also be more likely to purchase life- and disability-insurance products, as this has probably been the practice in the family for a long time.



Activity:

Indicate whether the following statement is true or false:

It is important to get to know your clients' perceptions (beliefs) about financial planning.

Answer

True. Knowing the clients' perceptions about financial planning (positive or negative) will enable you to evaluate the client's needs and wants, and their financial decisions.

7.5 Financial Needs Analysis (FNA)

Looking at the information discussed above, you will agree that financial planning is a complex process because of all the various factors that should be taken into consideration, and most importantly because every client is unique. Therefore, in financial planning, there is no 'one-size fits all' solution – every client's situation will have unique solutions.

A financial needs analysis is an important tool used by financial advisors to help them, not only to correctly identify a client's financial needs, but also to guide them as to the most appropriate solution to address those needs.

A financial needs analysis, as discussed under Step 3 of the financial planning process above, is a document/ questionnaire which is completed and signed by the representative and the client. The format of the FNA will differ from one services provider to the next and is usually either available in a paper format or electronically.



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Your FSP will provide you with the necessary training in order to complete their specific FNA.

Financial needs analyses also usually come in two different formats, depending on the level of advice being provided to the client:



i. Product-Centred Financial Needs Analysis

A Financial Needs Analysis is often used before giving advice on various products. However, the depth of an FNA can be very superficial, e.g. the advisor may simply establish that the client needs life insurance cover but not examine the level (actual amount) of cover suited to the client's specific financial situation. Cover or the level of investment recommended is typically in line with affordability and not really related to a defined level of need. The danger of this approach is that the solution recommended may be a suitable product, but there may be serious shortfalls in the level of cover or investment necessary to address a client's specific needs.

ii. Client-Centred Financial Needs Analysis

A much higher level of professionalism is required for a client centred FNA, which aims to identify needs in terms of risk areas or specific financial objectives, identify products that may address each identified need, and **quantify** the level of cover or investment required. For the professional financial advisor, a needs analysis should always be client centred.

Consider the information that follows, which has been adapted from an article published by the Safe Bridge Financial Group, on insurance planning principles.

Some of the key principles that are important as part of the needs analysis have been touched on in this article, i.e. how much does the client have, how much does the client need, and how will we find this information out?

Five Basic Insurance Planning Principles²

Whether your client needs insurance to cover their mortgage, protect their family or replace their income if they lose the ability work, they want the peace of mind that comes with having the right plan in place. Here are five basic principles that will ensure their insurance needs are fully taken care of.

1. Know what they have.

Before starting your research, it is essential that you know what your client already has in place. If they have a group plan at work, they already have some amount of life insurance attached to it. Make sure you know how much coverage they already have. This helps you understand the client's current financial position, identify any gaps or unnecessary duplication in cover, and ensure your advice is tailored to their actual needs. It also assists in simplifying your research process and client discussions.

² Adapted from: <http://www.safebridgefinancial.com/insurance/insurance-basics.html>



2. Educate Yourself

It is almost impossible to ensure that you have chosen the right insurance product for your client if you don't know which insurance products actually exist. Do your research and learn as much as you can about each type of life insurance, health insurance, or disability insurance – depending on what your clients are looking for.

3. Define Their Insurance Needs

Defining how much insurance your client needs can be as easy as using a basic insurance formula, or as complicated as completing a full Financial Needs Analysis. Regardless of the level of complexity you want to undertake, it is essential that you take the appropriate steps necessary to ensure you learn exactly how much insurance your client actually needs.

4. Think Long Term

In most cases, buying insurance is not a quick fix, nor is it a one-time decision. When deciding between options, don't forget to consider the long-term costs beyond the ten or twenty years you are focused on today. Ensure whatever product you propose to the client can be reviewed, and changed, in the future, if necessary.

5. Ask Questions

Never hesitate to ask your client questions to discover more information, as they will be posing questions to you too.

The following are possible questions in the mind of your client:

- How will you determine my insurance needs?
- How will you take care of me after I set up insurance with you?
- What do your other clients think of their experience with you?
- Best of all, what product and how much of it do you currently own?
- If you do not even own a product from the company you work for, how will you convince clients to invest with your company?

Before getting into the detail of the FNA, let us examine a model that can be used when recommending financial solutions to a client.



How would you make financial planning work for your clients?³

To achieve the best financial planning results for clients, summarise the factors that must be taken into account by the financial advisor and understood by his clients as well:⁴

- **Set measurable financial goals.**

Make sure that specific targets are set of what the client wants to achieve, and by when the results must be achieved. Words such as 'comfortable at retirement' or 'good education,' amongst others, must be quantified, so that the client knows when he has reached his goals.

- **Understand the effect of each financial decision.**

Each financial decision made will affect several other areas of the client's life. Remember that all financial decisions are interrelated.

- **Re-evaluate the financial situation of the client periodically.**

Financial planning is a dynamic process. Goals might change over the years due to changes in lifestyle or circumstances, such as marriage, inheritance, birth, purchase of a house or change of a job. A financial plan must be revised to reflect these changes so that the client stays on track with his financial goals.

- **The earlier clients start to plan the better**

Explain to clients that people who save or invest small amounts of money early and often, tend to do better than those who wait until later in life. Similarly, discuss with clients that by developing good financial planning habits such as saving, budgeting, investing and regularly reviewing their finances early on in life, they will be better prepared to meet life changes and handle emergencies. At the same time, it is never too late to start!

- **Explain to clients that expectations must be realistic.**

It is important that clients understand that their financial situation cannot be changed overnight. It is a process that depends on current circumstances, goals, and objectives. Financial planning is a common-sense approach to managing clients' finances to reach their life goals. It is a lifelong process. Remember that events beyond the control of a client, such as inflation or changes in the stock market or interest rates, will affect the financial planning results of the client.

³ Fundamentals of Financial Planning, LexisNexis, Chapter 4

⁴ Financial Planning Institute of Southern Africa



- **The client is in charge.**

It is important that the client understands what can be done for him, as well as what the financial planning process is about. Ensure that the client provides all the information needed to develop the plan. Encourage clients to ask questions about the recommendations made and to play an active role in the final decision making. Use every consultation as an opportunity to educate your clients.

For our purposes, it is important to understand that an FNA will address the following information:

iii. **Personal Client Details**

Although this may seem obvious, it is very important to keep a record of with whom you are dealing. To a client, this area of information often represents a personal interest of the advisor in them, and a commitment to thoroughness and accuracy. The information gathered will form the basis of the financial analysis tasks, as well as the record of advice, and is, therefore, a very necessary step.

Personal details gathered may include:

- The client's full names
- Date of birth/ ID number
- Contact details, including telephone numbers, email, and postal addresses.
- Occupation
- Split of occupational activities between administration, supervisory, travel and manual labour (for quote purposes)
- Business interests (where a client is a business owner or co-owner)
- Marital status and marital regime (e.g. community of property)
- Education level (for quote purposes)
- Smoker status
- General state of health (for quote purposes)
- Spouse's name
- Spouse's date of birth
- Dependants' statuses (children and anyone else supported financially by the client) and dates of birth of children.

It is recommended that the client is requested to provide a copy of his/ her ID book and proof of residence at the first meeting, to ensure that FICA requirements are met.

iv. **Information on the Client's current Financial Situation**

Information that relates to the client's financial situation includes:



Income Information:

Income from all sources needs to be gathered, as many clients have multiple sources of income, e.g. salary, rental property income, investment income, income from a hobby, business earnings, etc.

Monthly Deductions:

Income tax, medical aid, pension contributions, etc. that need to be provided for.

- A copy of the client's salary slip is useful to identify these expenses (where applicable).

Monthly Budgeted Expenses:

Any monthly payments and regular expenses must be taken into account, including those to maintain an asset, e.g. maintenance costs on a rental property.

- Note that the client may provide a detailed monthly budget instead.

Assets and Liabilities:

Detailed information on assets owned and debt owed is needed.

- For short-term insurance cover, extensive details regarding the asset, any security features e.g. alarms, regular driver of cars, etc. is required.
- For debt, the total debt, repayment information and terms of each debt is recommended, e.g. term and interest rate.
- Where the client holds multiple investments, a copy of the most recent statements may be used.
- For property investments, an estimate of the market value will be adequate.
- A benefit statement from the fund is recommended where the client belongs to a pension, provident or retirement annuity fund.
- The annual statement provided by an insurer is useful where insurance policies are held.
- Where estate planning is to be conducted, the current market value, as well as costs to purchase and improve each asset, will be needed.

Other Relevant Information:

Further relevant financial information may be needed, for example:

- The client's will,
- Information on other financial obligations, such as maintenance payments to a former spouse,
- Trust information; etc.



v. Information on the client's financial objectives and goals

This area covers the client's current and future objectives and goals for which financing would be required. It can broadly be divided into four areas:

Personal Goals:

This can include almost anything that money can buy, from an educational programme to an overseas trip. Personal goals would be heavily dependent on a client's stage of life.

- Where possible, the goals should be clarified, e.g. what percentage of income does the client want to earn during retirement?

Family Goals:

If a client has dependants, how does he/ she intend to provide for them? In what way does the client see his/ her role in providing for their financial needs?

Future Financial Growth:

Questions can include how does the client provide for emergencies? What does the client's need to improve his/ her financial situation?

Legacy Needs:

Many clients may have a need to make charitable contributions or leave behind a financial legacy for their loved ones, in the event of death.

A client does not always identify all areas that should be assessed. Many clients overlook the need for financial protection in the event of disability, or other areas that could be assessed.

The purpose of obtaining information on goals and objectives is to uncover any special goals and, where relevant, to obtain sufficient information to conduct a needs analysis. It is the advisor's role to identify all the financial needs of the client.

vi. Other Information

During the first meeting or two, the financial advisor and the client need to agree on financial planning areas and parameters. Planning areas include:

Short-term insurance planning, i.e. financial protection against loss due to damage or theft of physical assets, such as one's car or house.

Risk planning, i.e. financial protection against an unforeseen event, such as death or disability.

Retirement planning, i.e. planning to assess current savings levels and to ascertain what investment is needed to meet the identified retirement savings need.



Investment planning, i.e. savings/ investment for specific goals, such as saving for the tertiary education for a child, or investment of money already saved up to draw an income. Although retirement planning products are essentially investment products, these analyses are usually conducted separately.

Estate planning, i.e. assessing the impact of a client's financial situation and the terms of his/ her will, in the event of death.

Business planning, i.e. assessing the needs of the client in relation to business risks and objectives.

'Parameters' refers to the assumptions to be used in the analyses. Very often these are built into a financial needs analysis programme, but where a paper-based needs analysis is being conducted, the advisor and client may discuss and agree on the expected growth rate of investments and inflation rates to use in the calculations, amongst other information.

Where solutions will include investment alternatives, the advisor needs to conduct a risk profile analysis. To be able to analyse the client's investment risk profile and identify suitable investment portfolio options, important information needs to be gathered from the client, including:

- The client's level of investment knowledge
- The client's appetite for risk
- The client's capacity for risk (e.g. income and assets, liabilities)

Making use of a risk profile questionnaire is common, as relevant questions in relation to the client's knowledge, appetite and capacity for risk are included in these questionnaires.

You will learn more about risk-profiling when you complete the module ***Economic and Investment Overview***.

Since an advisor needs to access client information, requesting authorisation from the client, in writing, to investigate his/ her financial affairs, is required.



Activity:

Which of the following details of the client would generally be contained in a typical financial needs analysis capture form?

- i) ID number
- ii) Religion
- iii) Goals
- iv) Cultural group



Select the correct combination:

- a) i) and ii)
- b) ii) and iii)
- c) iii) and iv)
- d) i) and iii)

Answer

d) is the correct answer. A client's ID number would generally be collected/ captured under *Personal client details*, and the client's financial goals would be collected/ captured under *Information on the client's financial objectives and goals*.

7.6 Example of a Financial Needs Analysis (FNA) Form

As previously mentioned, advisors often use standard forms to gather relevant information from a client, and to ensure that all required information has been gathered. These standard forms are often linked to a computer programme that will then also calculate the amount (or quantity) of cover/ savings needed in order to achieve the relevant financial goals and objectives.

For example, if a client has a need to ensure that his spouse and children's lifestyle will be maintained after his death, you can recommend a life cover product and also the amount of cover that will be required to meet the client's need. The calculation and determination of the actual monetary values, however, falls beyond the scope of this training. This training and training on the related calculations, is covered as part of the 'qualification' studies that you will undertake in order to meet the fit-and-proper requirements in terms of the FAIS Act (if you do not already have a recognised qualification in place).

Below follows an example of a generic paper based FNA form that could be used to do a holistic, basic financial needs analysis (however, *without* the calculations to quantify the correct amounts of cover required).

The format of the example questionnaire is built up in such a way that it starts with general questions (to help start the conversation with the client and establish current financial position and priority goals) and then moves on to the more specific financial planning areas related to wealth protection and wealth creation.



Example FNA form:

Financial Needs Analysis Questionnaire		
Section 1: Personal Information		
First name:		
Surname:		
Date of birth:		
Marital status:		
Contact email:		
Contact telephone:		
Physical address:		
Postal address:		
Highest educational qualification:		
Occupation:		
Employer:		
Since (<i>date</i>):		
Type of work: (<i>tick applicable option below</i>)		
Full-time		
Part-time		
Self-employed		
Health status: (<i>tick applicable option below</i>)		
Smoker		
Non-smoker		
Dependents: (<i>complete details per dependent below</i>)		
Name	Relationship	Date of birth
Section 2: Personal Financial Goals		
1. Which personal objectives with regard to financial planning are most important to you at this stage? (<i>State most important goals below.</i>)		
2. What short-term insurance needs do you and your family have? (<i>Tick applicable needs below, and/ or provide details of existing short-term insurance in Section 6.</i>)		



Financial Needs Analysis Questionnaire		
2.1	Insurance to repair/ replace car in case of theft or damage.	
2.2	Insurance to repair/ replace household contents in case of theft or damage.	
2.3	Insurance to repair/ replace buildings in case of theft or damage.	
2.4	Insurance cover against a party suing us, in our personal capacity, for financial loss, physical injury or death.	
3. What long-term insurance needs do you and your family have? <i>(Tick applicable needs below, and/ or provide details of existing long-term insurance in Section 7.)</i>		
3.1	Insurance to provide a dignified funeral for my loved ones.	
3.2	Insurance to provide a replacement income for my family in case of death.	
3.3	Insurance to provide funds to pay off all my debts at death.	
3.4	Insurance to provide a replacement income if I become disabled.	
3.5	Insurance to provide funds for lifestyle changes as a result of disability or severe illness.	
4. What healthcare benefit needs do you and your family have? <i>(Tick applicable needs below, and/ or provide details of existing healthcare benefits/ healthcare insurance in section 8.)</i>		
4.1	Medical aid cover to defray medical costs.	
4.2	Health insurance benefits to provide gap cover/ hospital plan cover.	
5. How do you feel about saving for your children's tertiary education? Why? <i>(Please provide details of any existing education plans in Section 4.)</i>		
6. What percentage of the family income do you feel should go towards savings? Why?		
7. What do you feel is a reasonable return rate to use when calculating investment growth?		
8. What do you feel is a reasonable inflation rate to use in calculating future income/ investment needs?		
9. Is saving for retirement important to you? <i>(Indicate Yes/ No.)</i>		
9.1	At what age do you wish to retire?	
9.2	What are your lifestyle goals/ objectives once you've retired? <i>(State below.)</i>	



Financial Needs Analysis Questionnaire		
9.3	Are you familiar with the benefits provided by your pension/ provident fund? (Indicate Yes/ No and provide details of existing pension/ provident fund provision in Section 5.)	
9.4	Are you contributing to a retirement annuity to supplement your retirement income? (Indicate Yes/ No and provide details of existing retirement annuity provision in Section 5.)	
Section 3: Income and Expenses		
INCOME		
Gross monthly income (salary):		R
Other income		
	Rental:	R
	Interest earned:	R
	Dividends:	R
	Pension:	R
	Other (please specify below):	
		R
		R
Total gross monthly income:		R
Total net monthly income (after-tax and company deductions):		R
EXPENSES:		
Housing expenses:	Mortgage/ rent:	R
	Maintenance/ repairs:	
	Monthly rates and taxes:	
	Electricity:	R
	Telephone/ internet:	R
	Insurance:	R
	Other: (Please specify below)	
		R
		R
Living expenses:	Groceries:	R
	Clothing:	R
	Healthcare:	R
	Personal care:	R
	Bank fees:	R
	School fees and day-care:	R



Financial Needs Analysis Questionnaire			
		Other: <i>(Please specify below)</i>	
			R
			R
Transportation:	Fuel:	R	
	Maintenance and repairs:	R	
	Lease/ loan/ savings <i>(towards new car)</i> :	R	
	Licence and registration:	R	
	Insurance:	R	
	Other: <i>(Please specify below)</i>		
		R	
		R	
Miscellaneous:	Donations:	R	
	Entertainment/ recreation:	R	
	Gifts:	R	
	Holidays:	R	
	Debt repayments:	R	
	Restaurants:	R	
	Subscriptions:	R	
	Hobbies:	R	
	Other: <i>(Please specify below)</i>		
		R	
Savings and insurance:	Short-term insurance cover:	R	
	Life insurance:	R	
	Disability insurance:	R	
	Severe illness insurance:	R	
	Retirement savings:	R	
	Education savings:	R	
	Other: <i>(Please specify below)</i>		
		R	
		R	
Total expenses:		R	
Section 4: Assets and Debts			
ASSETS: <i>(Include all investments, savings plans, savings policies, real estate properties, etc.)</i>			
Description/ contract number	Owner(s)	Purchase cost/ monthly contribution	Current market value



Financial Needs Analysis Questionnaire				
DEBTS: (Include all mortgage payments, loans, retail/ shop accounts, etc.)				
Description	Amount borrowed	Loan repayment (monthly)	Interest rate	Outstanding balance
Section 5: Retirement				
Retirement date (age/ year):				
Life expectancy (age/ year):				
Desired annual net income at retirement (in today's values):				
Sources of retirement income:				
1.	Pension fund details (it is preferable that estimated values be obtained from the latest pension fund statement)			
	Retirement age as per fund rules:			
	Contribution frequency: (Indicate monthly/ yearly)			
	Current percentage of contribution by employer and employee:		Employer	
			Employee	
	Current fund value:		R	
	Estimated fund value at retirement:		R	
2.	Retirement annuity details (it is preferable that estimated values be obtained from the latest retirement annuity fund statements):			
Policy number	Insurer/ Retirement fund	Monthly contribution	Estimated retirement value	Retirement date



Financial Needs Analysis Questionnaire				
		R	R	
		R	R	
		R	R	
Section 6: Short-Term Insurance Details				
In case of damage or theft to your physical assets, what are your main concerns regarding the impact these events would have on your financial situation?				
1.	Personal lines short-term policy details:			
Policy number	Insurer	Monthly contribution	Benefit details	
		R		
		R		
		R		
Section 7: Long-Term Insurance and Estate Planning:				
In case of death, disability, or critical illness, what are your main concerns regarding the impact these events would have on your financial situation?				
1.	Life insurance/ funeral cover benefit details (<i>it is preferable that estimated values be obtained from the latest insurer statements</i>):			
Policy number	Insurer	Monthly contribution	Type of cover (whole life/ term)	Life cover amount
		R		R
		R		R
		R		R
		R		R
		R		R
2.	Disability cover benefit details (<i>it is preferable that estimated values be obtained from the latest insurer statements</i>):			



Financial Needs Analysis Questionnaire				
Policy number	Insurer	Monthly contribution	Type of cover (income/ capital)	Disability cover amount (lump sum/ monthly benefit)
		R		R
		R		R
		R		R
3.	Severe / critical illness benefit details (<i>it is preferable that estimated values be obtained from the latest insurer statements</i>):			
Policy number	Insurer	Monthly contribution	Type of cover (income/ capital)	Disability cover amount (lump sum/ monthly benefit)
		R		R
		R		R
		R		R
Do you have a will? (<i>Indicate Yes/ No.</i>)				
When was your will last updated?				
Where is the will kept?				
Who is the executor of your estate?				
Section 8: Healthcare Benefits Details				
In case of medical expenditure, what are your main concerns regarding the impact of medical costs (major and day-to-day) on your financial situation?				
1.	Medical scheme details:			
Membership number	Medical Scheme name	Monthly contribution	Benefit option	No. dependents covered
		R		
2.	Other healthcare benefit policies:			
Policy number	Insurer	Monthly contribution	Type of benefit	No. dependents covered
		R		
		R		
		R		
Other financial goals and additional comments: (<i>Use this section to enter any financial goals and other information not mentioned above, that you feel will be relevant to your client's financial plan</i>)				



Financial Needs Analysis Questionnaire



Take Note

If you are doing financial planning for both spouses, it is recommended that you complete an FNA questionnaire with both spouses to ensure that the holistic financial needs of the family unit are taken into account.

To get a more practical idea of how the financial needs analysis questionnaire assists us to identify clients' financial needs and goals, complete the activity below.



Activity: Calibri (Body) 12

Complete the above FNA form using your own financial goals and objectives, and your own financial circumstances as an example, then answer the questions below.

1. What financial needs can you identify in terms of:

- financial management.
- wealth protection (short-term insurance, long-term insurance, healthcare benefits, etc.).
- wealth creation (savings for education, retirement and other goals)

What are your priority goals? Are these typical of the lifecycle stage that you fall into?



Unit 7 Summary

Financial Planning is something we all do daily. The professional financial advisor is not only there to assist with day-to-day planning, but also to assist clients in reaching their life goals – such as owning a car/ house, providing tertiary education for their children, and retiring comfortably – by putting in place strategies to achieve these goals, and managing the process. Two critical elements of financial planning are wealth creation and wealth protection. Wealth protection entails safeguarding oneself, family, and assets from potential losses due to unforeseen events. This can be achieved through the use of insurance products and health service products. Wealth creation, on the other hand, entails accumulating wealth for specific goals or investing existing capital for growth. This can be achieved through various investment products and solutions.

The needs of clients will differ based on their culture, upbringing, and attitudes, among other factors, and this introduces a lot of complexity in financial planning for clients. Given such complexity and diversity, it is important to conduct an appropriate financial needs analysis for the client. This helps to understand the unique financial needs and goals of each client and enables the financial advisor to provide personalised and effective financial planning services. It also ensures that the advisor's recommendations are aligned with the client's financial situation, risk tolerance, and life goals. An appropriate client financial needs analysis is therefore not only desirable, but also, indispensable in financial planning.