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**SOUTH AFRICAN  
INSTITUTIONAL INVESTMENTS**

**WHOSE MONEY IS IT ANYWAY?**

**A DISCUSSION DOCUMENT**

**SUMMARY & AUTHOR COMMENTS**

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# SUMMARY

South African workers depend heavily on the successful operation of their occupational retirement funds for their well-being in old age. Total assets in these funds have accumulated to some three-quarters of annual GDP and they form the largest set of institutional investors in the country.

This discussion document describes the operation of this part of the institutional investment market and identifies a number of areas in which, it would seem, the interests of service providers and the owners of capital are not in complete alignment.

Five themes find frequent expression throughout this paper:

- **Owners and agents.** Insufficient distinction appears to be made between the financial interests of the owners of assets – retirement funds and their members – and their agents, asset managers, investments consultants and a large number of supporting firms, all of whom are stewards of these assets.
- **Supporting the value chain.** The depth and complexity of the industry supported by retirement funds is probably not appreciated by the trustees of these funds. While market players provide an important service, a better alignment of interests would encourage them to do so more effectively.
- **The allure of the past.** Human beings are strongly inclined to seek meaning in a succession of events and often make the mistake of inferring causality where it might not exist. In the area of investment, this finds expression in an inappropriate attribution of good performance to skill, instead of recognising that at least some may be due to random factors. This in turn creates an unhealthy dependence on active asset management and on the information provided by sophisticated information intermediaries whose skills are difficult to assess objectively.
- **Conflicts of interest.** Providers of service to retirement funds have a variety of financial incentives that are not necessarily in the best interest of their customers. Conflicts of interest occur in a number of different ways, so commonly that it is not easy to find instances in which, with certainty, they do not exist.
- **Information inequity.** A large proportion of trustees are not experts in investment. They are representatives of the membership of a fund or its sponsoring employer and, to the best of their ability, seek to execute on their fiduciary responsibility to the fund and, by implication, to its members. Providers of service, on the other hand, are professionals in their fields and have the natural incentive to position themselves as well as possible, sometimes taking advantage of the information inequity in the process.

The market for institutional investments is enormously complex. This makes it easier for providers to price opaquely and to develop alternative sources of revenue, particularly with less skilled and experienced individuals serving as trustees. This also makes it difficult to provide a comprehensive analysis of the market. The discussion in this paper is therefore anecdotal in nature, asking questions in a number of areas rather than attempting to cover in detail the operation of the market.

After an initial description of the marketplace and its players and a synopsis of some of the legal principles underlying its operation, ten questions are asked. Some of these are relevant to the entire market, for example:

- Why is there such a strong emphasis on active asset management, as opposed to the index-linked alternative?
- Is the training provided to trustees independent and in the best interest of the trustees or does it tend to deepen their dependence on their service providers?
- Are fee models designed to align the interests of provider and customer?
- Is sufficient attention given to the fundamental principles underlying a socially responsibility investment approach?

A number of them are focused on particular parts of the market, for example:

- asset consultants,
- hedge funds, and
- multi-managers.

The remaining issues apply more to some parts of the market than others, but ask questions that are of relevance to trustee thinking generally.

- Do marketing activities enhance customer understanding or are they designed merely to attract a customer to a service, in aggregate moving retirement funds from one provider to another without adding significant value?
- Do performance surveys of asset managers provide a useful service and are they used responsibly?
- Are all asset managers executing all of their trades in the best interest of their customers?

The paper is aimed at retirement fund trustees. It does not name service providers, though in a small market identification by the expert is sometimes unavoidable. The express intention is not to identify business models that may be inappropriate, but to equip trustees to identify activity with which, if they understood all of its consequences, they might not be comfortable.

I hope that this work contributes to a more effective market and a better outcome for the millions of South Africans who are members of retirement funds.

# AUTHOR COMMENTS

This section adds to the summary a few thoughts on intent and style, making it easier for the reader to make best use of the information set out in the paper.

## Motivation

The purpose of the paper is to assist trustees. It is not intended to point fingers at providers. While much of its content addresses market conduct issues, these are not limited to the suppliers of service, but should provide food for thought to trustees as well.

Borrowing from the comments of two respected observers, it helps to categorise industry issues and to explain some of the economic rationale behind the activities of providers. But it should not be regarded as comprehensively achieving either of these goals, because it constitutes no more than the collected thoughts of an industry observer. If it motivates appropriate changes to thinking and strategy, it will have succeeded.

I am not agitating for government intervention in the market. I am philosophically committed to the operation of the free markets, but mindful of the warning of one of the greatest advocates for freedom of market operation, who was clearly aware of the potential for the informed few to gain advantage over the unaware many:

*People of the same trade seldom meet together... but the conversation ends in a conspiracy against the public. (Adam Smith, The Wealth of Nations, pg 148, cited in O'Rourke, 2007:24)<sup>1</sup>*

Some may suggest that my intention is linked to another recently issued paper, written for the Department of Social Development and covering the rules under which providers might be accredited to supply services to a mandatory savings market (Rusconi, 2006). The documents are not linked.

- This paper is concerned with issues of market conduct, but does not suggest sweeping changes. It is motivated by the intention to equip trustees to be more effective in the execution of their responsibility and was started before the commissioning of the research into accreditation standards.
- The accreditation paper considers an environment in which saving for retirement is mandatory, partly into a central fund and partly into private sector arrangements. It assumes substantial changes to the current retirement market.

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<sup>1</sup> The formal reference to Adam Smith is "An Inquiry into the Nature and Causes of the Wealth of Nations" (1937), edited by Edwin Cannan, **Modern Library**, New York.

While one of the implications of market conduct failure may be wide-ranging policy change, such a consideration is not within the scope of this paper.

## **Form**

Some may wonder why I have chosen to include most of the content in the form of questions. This contrasts the study that Paul Myners undertook of the institutional investments market in the United Kingdom (Myners, 2001), in which he assesses the operation of each part of the supply chain.

There are three main reasons why I have not taken this approach:

- This is not a formal national study, complete with draft studies, written comment by market players and a comprehensive report to the government. Resources are limited to personal time and perspective. I feel that those resources are better allocated to asking a series of probing questions than to attempting to uncover the underlying causes of any market conduct concerns.
- The South African market has become enormously complex. Providers have sought both to establish differentiated products and to build vertically integrated operations to maximize efficiency and cross-sell. It is becoming more and more difficult to pigeon-hole products and services and to assess them separately. Each chapter aims to stimulate debate and encourage trustees to ask themselves and their providers similar questions, and indeed much more probing alternatives as well.<sup>2</sup>
- This is a discussion paper, intended to be the first step in a wide-ranging debate, possibly triggering more formal writing. A series of questions should encourage this dialogue more effectively than alternative forms of writing.

What about areas omitted from the questions? Ten topics is plenty and this paper is quite long already. I am aware of a few gaps, but I hope that they are covered in other parts of the discussion.<sup>3</sup> Comments on omissions are most welcome.

Finally, each section is written in a way that is self-contained, forming an essay which need not necessarily be read as part of the longer discussion paper. This is designed to optimize the absorption of information, identification of error and feedback on the implications. The approach does result in a small amount of repetition.

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<sup>2</sup> *Some provider groups may feel hard done by because they have been identified specifically by a question. This is not necessarily negative. It suggests that such providers have a strong identity. Members of these groups who take seriously their commitment to their customers will enjoy the debate stimulated by these questions.*

<sup>3</sup> *Absolute return mandates, for example, raise concerns that are at least partly addressed in the discussions on active management (section 1), hedge funds (section 5) and marketing (section 6).*

**Style**

The paper is written to be accessible by trustees reasonably well versed in the language of retirement funds. This means that it is neither too complex nor inappropriately simplistic.<sup>4</sup> I have used first-person language from time to time in an effort to improve readability.

References are cited formally where they are publicly available or permission has been received to use them. The identity of the quoted party is protected where it would not be appropriate to name them as a more general point is being made, for example, where I comment on advertising material.

To those who do not like footnotes, I apologise; there are lots of them. They are designed to add to understanding without damaging the flow of the text. They ought also to make the paper a little more interesting.

**Acknowledgements**

This paper would not have been possible without the input of dozens of industry players and observers with a great variety of perspectives. Some of them would prefer to remain anonymous and it is probably fairer to them not to list the others, but I am very grateful to all of them and trust that I have represented their views fairly. Where sections have depended on the assistance of particular individuals, I acknowledge them explicitly in the relevant parts of the paper.

I deeply appreciate the thoughts of all of those who have contributed, but the responsibility for errors is mine.

One whose assistance I must note is the person with less knowledge of the industry than all those that I have spoken to. My wife is not a participant in this arena, except through her support for me, but she is a much better writer than I am. My thanks to Sue for willingly giving time from our summer break for her patient editing.

**Contact details**

This is a discussion paper and belongs to its readers. It may be cited with appropriate references, but please refer to it explicitly as a discussion paper. Comments are most welcome and should be sent to me at [rusconihome@wol.co.za](mailto:rusconihome@wol.co.za).

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<sup>4</sup> *My editor and 'waffle scanner' – my wife – takes care of jargon and has played a huge part in clarifying the writing and establishing an appropriate tone. Formal thanks to her later, but I would welcome comments on the writing style.*