Make any investment with the end goal in mind

Sound advice by Florbela Yates, Head of Momentum Investment Consulting

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Regulation 28 governs the maximum percentage that a pension fund can invest into each underlying asset class to limit the risk that individual investors have when they invest in a retirement fund. The trustees of the pension fund, together with their asset consultants and administrators, have a fiduciary responsibility to make sure that the regulations are adhered to.

Proposed amendments to Regulation 28 of the Pension Funds Act do not introduce infrastructure as a new asset class but allow for infrastructure investments to be recognised within the existing asset classes such as equities, debt instruments and property.

Treasury's aim with the proposed changes is to make it easier for retirement funds to invest in infrastructure and allow for better measurement of investment projects. The amendments allow for a total allocation of 45% into South African infrastructure and an additional 10% into infrastructure across the rest of Africa. They also impose an overall limit of 25% per issuer.

Another proposed amendment is the delinking of hedge funds, private equity funds and other assets not included under the other defined asset classes. Under the current Regulation 28 constraints, this alternative asset class grouping has a collective limit of 15%, with hedge funds and private equity each with a sub-maximum of 10% and 2.5% for all "other" alternative assets. Once the proposed changes come into effect, the overall limit of 15% for alternatives will be removed, and the limit for private equity will increase to 15%, while the limits for hedge funds (10%) and "other" assets (2.5%) remain unchanged.

In a low-return environment, such as the one we are currently experiencing, it makes perfect sense to consider alternative asset classes to access different investment opportunities in portfolios. Access to different asset classes provides additional levers to investment managers, allowing them to build more diversified portfolios with better return profiles for their investors. Research has also shown a close relationship between infrastructure spend and economic growth. In an economy like South Africa, which is experiencing low or negative levels of economic growth, it's no surprise that Treasury would be pro investments into infrastructure projects via private equity funds.

But how do these proposed changes affect pension fund trustees and asset consultants? For a start, they will need to conduct due diligences on the private equity and hedge fund providers in the same way that they would evaluate any other fund manager appointed to run the traditional asset classes in the portfolio. This includes evaluating the manager's skill, previous experience in this sector, the exposure to specific sectors or strategies within each fund, as well as the quality of their holdings. This may need adjustment to their current investment processes, evaluation models and optimisation tools. Where they don't possess the necessary skills in-house, it may be wise to appoint a consultant who can assist with this.

And let's not forget the impact on the administrators. Until now, retirement funds were not required to report the exact investment into hedge funds, or private equity investments, provided it fell within the overall alternatives limit as defined. The proposed changes now require full look-through reporting for all collective investment schemes and several insurance policies that are used as vehicles to house pension fund investments. Due to the nature of the strategies employed in hedge funds and private equity funds, unintended breaches of the specified limits may occur. These potential breaches would not be through the fault of the pension fund but because of the look-through requirements applied on hedge funds and private equity funds that include infrastructure investments. Most of the current administration systems have not been built to accommodate the proposed look-through requirements. Since system changes and investment in new capabilities takes time, it's unlikely that the proposed changes can be implemented without allowing administrators the necessary time to cater for the changes. It therefore seems highly unlikely that the proposed changes will become effective within the next year.

At Momentum Investment Consulting, we follow an outcome-based investing philosophy. We believe in building diversified portfolios that maximise the probability of getting our clients to their investment goals over the relevant investment horizon. We constantly evaluate the opportunities available to us and in a low-return environment, it is becoming increasingly important to consider alternative asset classes in addition to the more traditional asset classes. As such, we have already been investing in alternatives where legislation allows.

We welcome the increased flexibility and increased transparency that the proposals will bring but believe that investments into any asset class (whether traditional or alternative) should always be made with the end goal in mind. And financial advisors should be mindful of their clients' personal circumstances, their investment horizon, liquidity requirements and risk tolerance before selecting which portfolio or asset class best suits their needs. ■

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