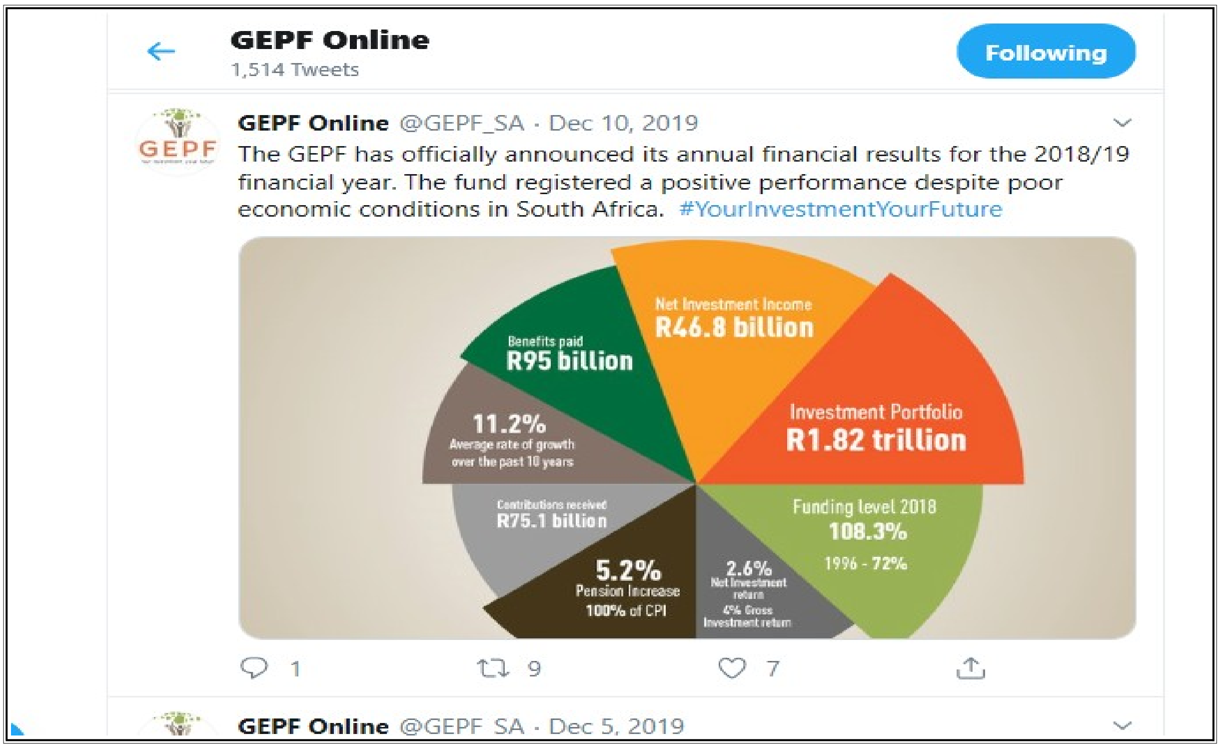
GEPF ANNUAL REPORT 2018/19 31 JANUARY 2020

FINANCIAL RESULTS 2018/2019: POSITIVE PERFORMANCE DESPITE POOR ECONOMIC CONDITIONS (PART 1)

Herewith the GEPF's snapshot SUMMARY of its 2018/9 financial results taken from its Twitter account. The GEPF makes the claim that the financial results depicted in the graphic, serves as examples of the FUND's *"positive performance despite poor economic conditions in South Africa"*.

GRAPHIC NR 1



<u>IN SUMMARY I WILL PROVIDE CONTEXT THAT CHALLENGES THE ASSERTIONS MADE BY THE GEPF:</u>

The Stifled Growth in the Investment portfolio is more attributable to inadequate risk diversification (90% invested in SA) AND delayed decision making (not revising the blueprint in 2016) AND not backing up an objective (achieve 100% recommended reserves) with a visible action plan THAN any other External factor..

The "positive performance" message conveyed by the GEPF is glossing over long standing red flags such as the declining Funding rates, NI% not even matching CPI AND cash generated on investments cannot cover benefit payments, cash generated from operations that moved from being healthy positive to negative for the last 4 years already.

TESTING THE GEPF'S CLAIM OF POSITIVE PERFORMANCE AGAINST OTHER AVAILABLE INFORMATION

Lets start with the last comment ie. the positive performance despite the poor economic conditions in SA.

<u>The poor economic conditions in SA</u>

1. Its interesting that asset managers, when very good returns and yield are in evidence, will attribute this to internal factors (such as business acumen, superior decision making and systems) YET when results are poor they attempt to attribute it to External factors (such as the Economy, tough trading conditions)

By reference to the Economic conditions in SA the GEPF is trying to blame-shift the poor financial results to an External factor. In this case the SA Economy. Unfortunately, the SA Economy is not empowered with fiduciary duties and accountability, the Trustees are.

2. The decision to remain 90% invested in the SA economy is one taken by the Independent Trustees. They are not forced to do so. We operate in a free market system.

The GEPFLaw allows the Trustees the freedom to invest any where globally. The prescripts and restrictions of Regulation 28 is not applicable to the GEPF, as the FUND falls outside the reach of the Pension Fund Act (PFA). The Trustees opted to voluntary apply the guidance contained in Regulation 28. They can reverse their prior decision, for instance to increase foreign investments in an effort to mitigate the over-concentration of investments in a single country.

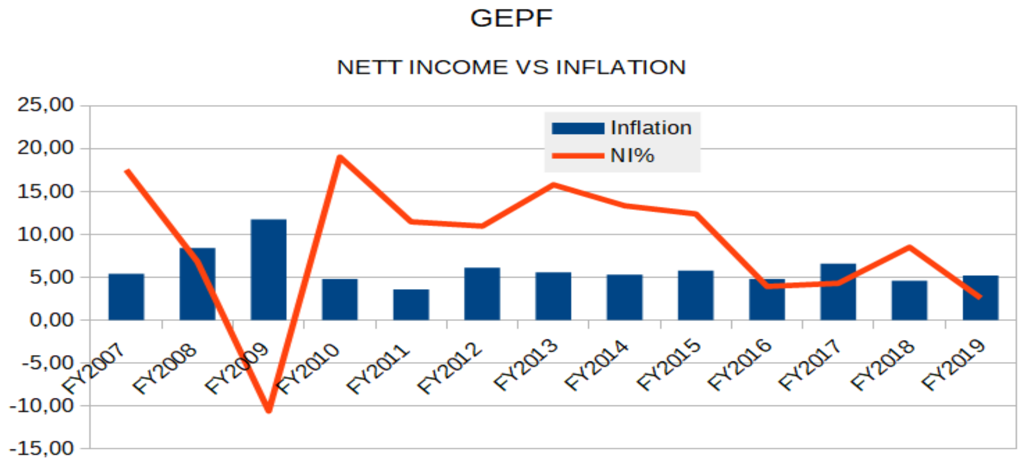
The independent actuary valuation of 2016 and 2018 lists other factors that the trustees and the employers should consider which included for instance the following:
"The fund holds a lower percentage of foreign assets than might otherwise be suggested purely in terms of the risk diversification of assets."

In addition to improved diversification, the returns on overseas markets compared to the JSE has been superior for a number of years already.

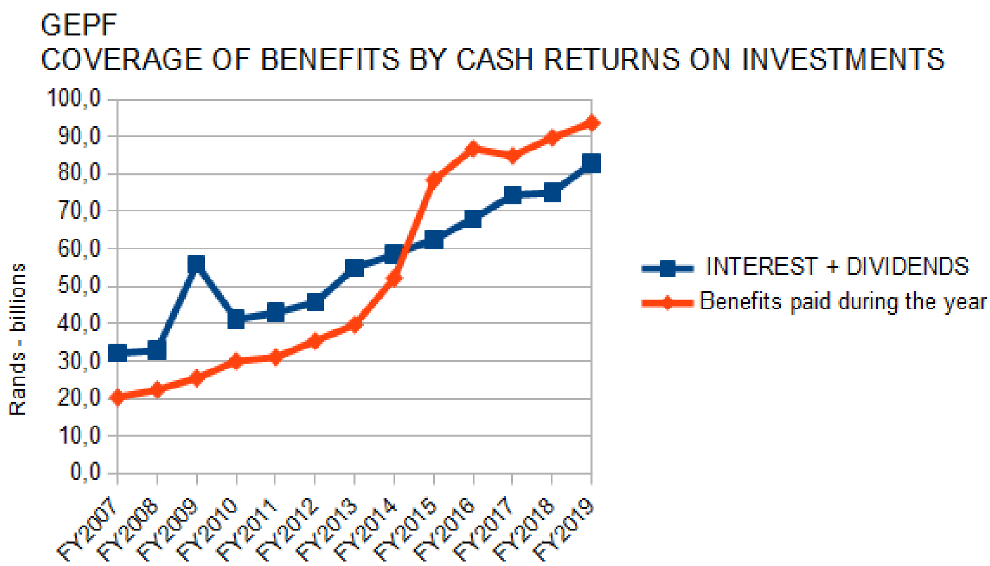
Still, the 2019 Annual Report confirms that the Trustees have opted not to actively pursue increased investments opportunities outside the SA Economy to reduce the diversification risk.

What is interesting is, that notwithstanding the declining Funding rates, NI% not even matching CPI AND cash generated on investments cannot cover benefit payments (See Graphs herewith) resulting in cash generated from operations that moved from being healthy positive to negative for the last 4 years already, the GEPF continue to maintain the viewpoint that their Blueprint works.

GRAPHIC NR 2



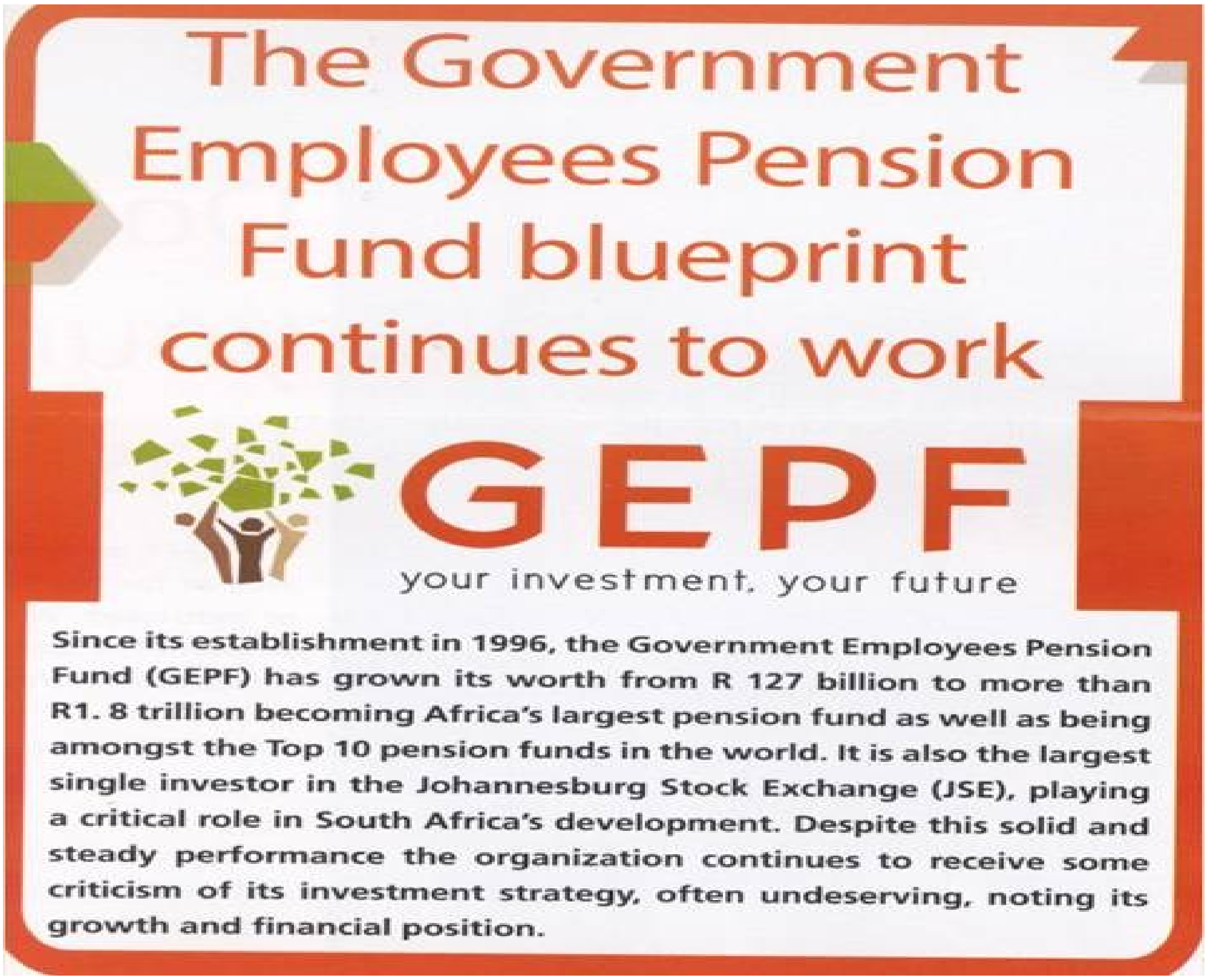
GRAPHIC NR 3



The real reason (root cause) for the substandard results in 2019 is to be found in INTERNAL factors.

2. THE GEPF's claim – Our Blueprint works!

GRAPHIC NR 4



Since its establishment in 1996, the Government Employees Pension Fund (GEPF) has grown its worth from R 127 billion to more than R1. 8 trillion becoming Africa's largest pension fund as well as being amongst the Top 10 pension funds in the world. It is also the largest single investor in the Johannesburg Stock Exchange (JSE), playing a critical role in South Africa's development. Despite this solid and steady performance the organization continues to receive some criticism of its investment strategy, often undeserving, noting its growth and financial position.

If proof of the success of the GEPF's Blueprint was linked to the single indicator of the "Growth" of the investment portfolio, then the Blueprint has in fact worked.

BUT This criteria is rather simplistic AND creates a false positive because the GEPF does collect contributions (in 2019 it was R75BN) which should be invested. So all things being equal, the investment portfolio should automatically "Grow" courtesy of the annual contributions being invested.

The degree to which the GEPF's investment portfolio can be regarded as sufficient is reflected in:
- the extent to which assets covers liabilities at all times,
- the extent to which the excess of assets over liabilities creates a contingency reserve to safeguard the FUND.

Furthermore, does the FUND not follow a Liability driven approach to determine its assets?

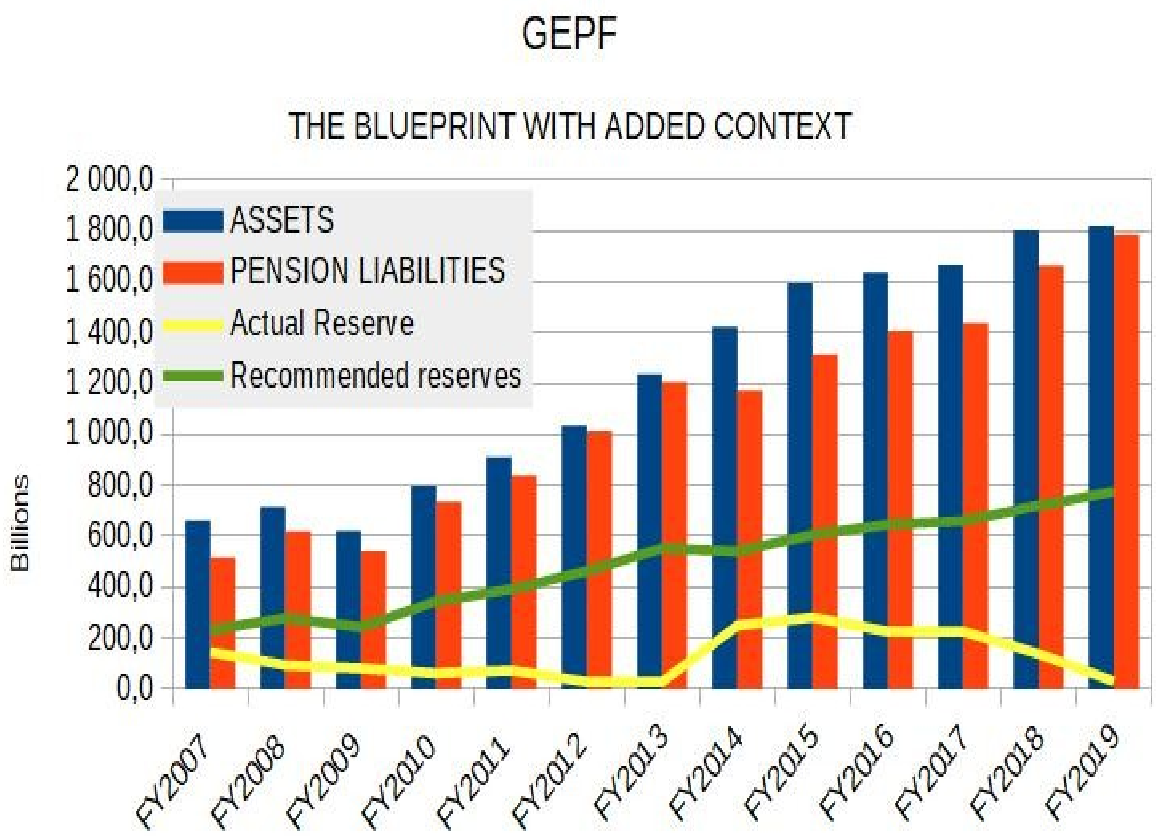
Surely these factors are the ones we should consider to determine if the Blueprint actually works?

THE 2018/9 ANNUAL REPORT FINANCIAL RESULTS

In a similar vein to the original Blueprint claim, the 2019 Annual report Graphic emphasizes the following "positive performance":
- Investment portfolio R1,82 trillion
- 11,2% Average rate of growth over the past 11 years AND
- the Funding rate being 108% in 2018 vs a 72% in 1996

Context is everything.
Herewith an expanded view of performance where not only assets but also pension liabilities as well the reserves are considered together.

GRAPHIC NR 5



The FUND is deemed to be solvent as long as assets exceeds pension liabilities. The difference between the amount of assets and liabilities on a particular date is regarded as the "Actual reserve". This is also described as affordable reserves or contingency reserves.
The recommended reserve is calculated by the actuary and is based on the wishes of the Trustees to create contingency reserves to protect the fund in the case of adverse investment performance, improvements in pensioner mortality and ensuring pension increases of a 100% of CPI.
The funding policy of the GEPF also states that the trustees should strive to maintain the long-term funding level at or above 100%. This implies that the Actual Reserve is equal to the Recommended Reserves.

In 2019 its estimated that the Pension Liabilities is almost equal to the Assets (It is my own calculation based on trends and available info). If true, this implies that there is zero contingency reserve compared to the recommended reserve of R720billion.

In my view this (the affordability of the recommended reserves) is the best indicator of how well the Blueprint has in fact served its purpose. Unfortunately, the end result is anything but positive.

Lets look at the Graph in more detail. The actual reserve trend-line (the yellow line) indicates the extent to which the excess of assets over liabilities has (and still is) declining over the years. The trend up to 2018 cannot be in dispute as its based on the actual actuary valuations.

The Graph shows the extent to which these two trend-lines never intersect. In fact there is no indication that it ever will. To the contrary, the Actual reserve (yellow trend-line) is moving further away from the Recommended Reserves (green trend-line).

SURELY THIS MUST BE AN INDICATOR THAT THE BLUEPRINT, IN ITS CURRENT FORM, HAS NOT ENABLED THE TRUSTEES TO MAKE GOOD ON MANAGING THE FORTUNES OF THE FUND TO MAKE STEADY PROGRESS TOWARDS A 100% AFFORDABILITY OF THE RECOMMENDED RESERVES?

Vision without action is a dream...The 100% affordability of the recommended reserves appears to be just that, A DREAM without real action.

The graph indicates the extent to which the current Blueprint has NOT assisted the Trustees to pursue this dream. The articulation of an action plan to achieve this vision is the responsibility of the Trustees (an INTERNAL factor). In the absence of anything visible, we must assume such an action plan to move the

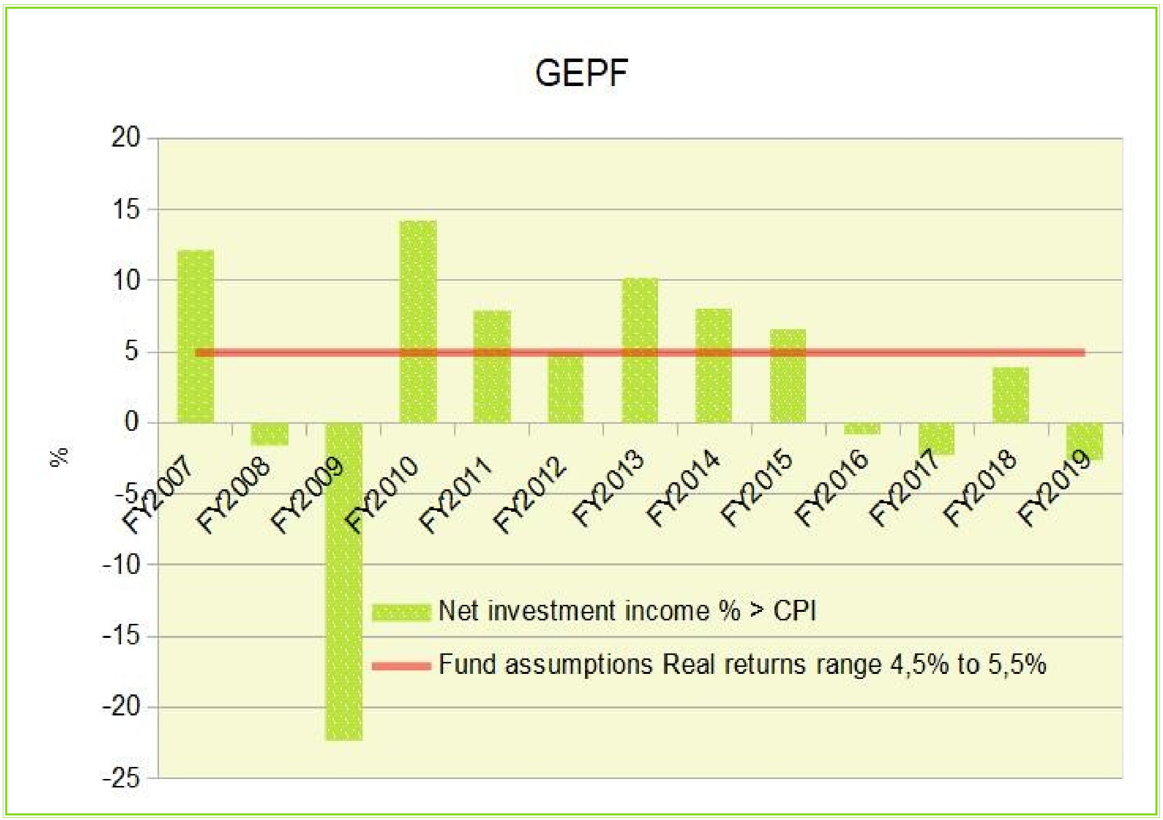
FUND towards achieving the 100% recommended reserves does not exist.

Unless there is a radical overhaul of the Blueprint, the achievement of the 100% Long-term Funding level is highly unlikely to happen. (NB! The last time this was achieved was in 2006)

Still not convinced about the inadequacy of the Blueprint in its current form? Please consider the following.

The GEPF has indicated in their Investment policy that they expect certain Real Returns of in the range of CPI plus 4,5% to 5,5%. The following Graph takes the Actual Net investment income % LESS CPI for that year. The % difference is reflected on the GRAPH and compared against the Investment policy ranges.

GRAPHIC NR 6



The graph shows that in 7 out of the last 13 years the actual result is less than 5%. More importantly, the result is below 5% in the most recent 4 years. Even with the global financial crisis in 2008/9 the duration of the below 5% results lasted for two years. The current situation, without a global crisis in evidence, is already twice as long AND there is no end in sight.

This below expected result is mirrored in the declining Funding level and erosion of the affordable contingency reserves as indicated above.

AGAIN, monitoring the results against expectation and adapting as needed is an INTERNAL factor. Did the Trustees respond timely to the indicators and deviations to ensure improved outcomes?

The graph indicates that this did not happen.

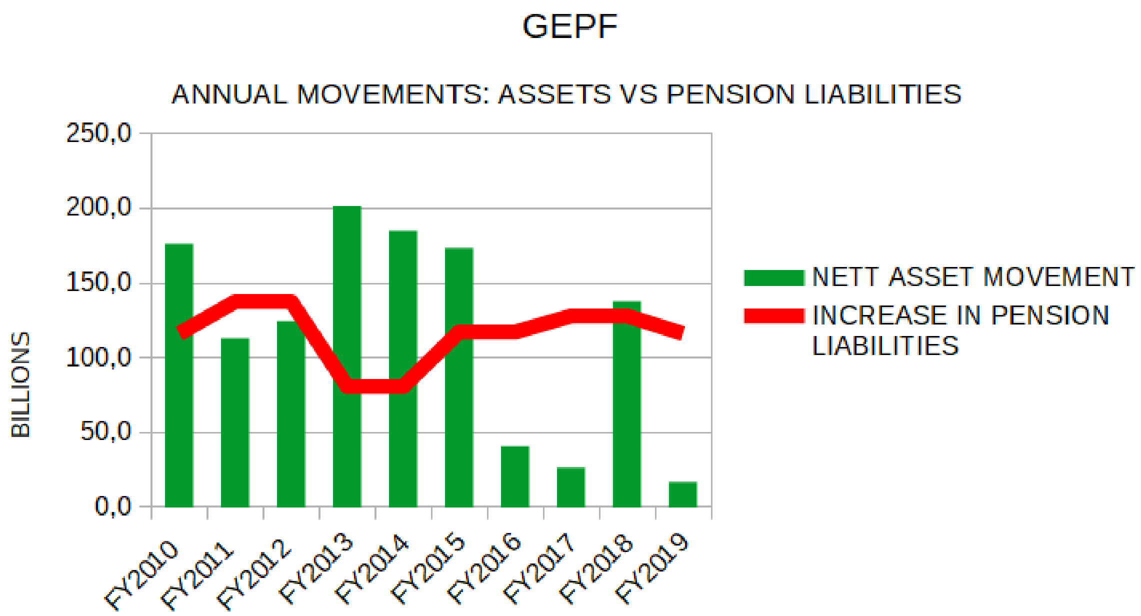
How big is the mountain that needs to be climbed?

In this instance the mountain is represented by the ever increasing amount of the recommended reserves. The average increase per year is 8,29% or +- R45billion.

When we consider that the Pension Liabilities currently increase on average by R125billion, it follows that for the Blueprint to retain the Long-Term Funding rate, Assets needs to increase ("Grow") by R170 billion per annum (R45Bn+R125Bn). Over the last 13 years, this has happened on only three occasions (FY2013, FY2014 AND FY2015)

The average "growth" of the assets balance p.a over the last 4 years (FY2016 to FY2019) is R55billion. The inadequacy of this level of asset "growth" is plain to see.

GRAPHIC NR 7



According to the Actuary's MOST RECENT THREE Valuations, the confirmed shortfalls between the actual and recommended reserves range between R292Billion AND R581Billion.

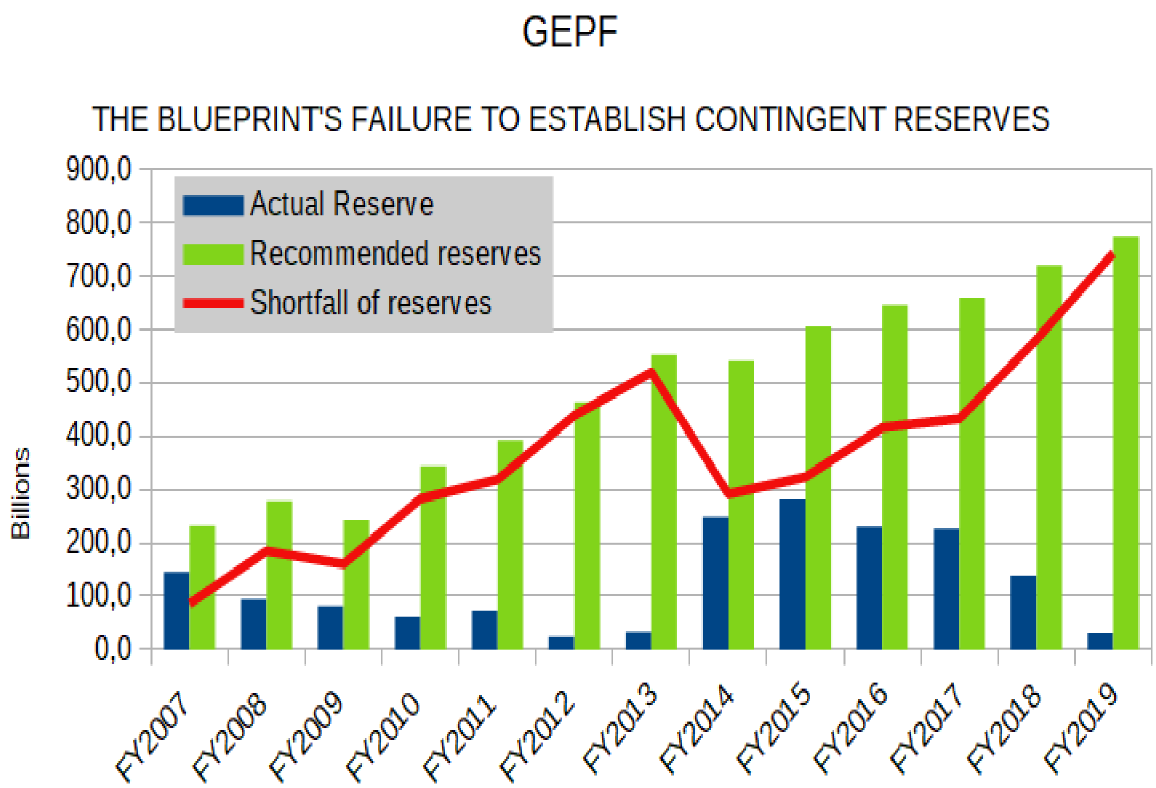
R'Billions	FY2014	FY2016	FY2018
Actual Reserve	249,4	230,42	139,18
Recommended reserves	541,4	647,05	720,89
Shortfall of reserves	292	416,63	581,71

At a time when the Contingent Reserves need to increase to safeguard the FUND, it is decreasing. This is a good example of HOW NOT TO DO proper risk management!

The following Graph indicates the degree with which the Blueprint has failed to move the FUND's contingent reserves to the level which the Trustees are supposed to "strive" towards.

The red trendline (shortfall in reserves) is actually an indicator of the increased risk to the FUND which is not curtailed or reversed by any action of the Trustees since 2014.

GRAPHIC NR 8



THE R581Billion SHORTFALL

It should be noted that the shortfall is a moving target which is increasing unabated. In my estimation it may actually be in excess of R720Billion currently.

But lets work with the R581BILLION.

..Based on the "success" of the Blueprint as claimed by the GEPF, HOW LONG will it take for the Assets to exceed the Pension Liabilities by this amount?

Based on the trends and analysis done, plus the Economic growth forecasts for the Country, I dont see this happening very soon (if at all).

The GEPF BLUEPRINT, in its current form, has outlived its purpose. Its overhaul is overdue since 2016 already.

Any comments and queries, please find my contact details below.

Christo van Dyk
31 JANUARY 2020
E-mail: x2vandyk@gmail.com

PS. In PART 2 - I will comment on the other "positive performance" items identified by the GEPF in GRAPHIC NR 1 including the reason why a Pension Fund exist, namely the payment of Benefits.