GEPF ANNUAL REPORT 2018/19 15 FEBRUARY 2020

FINANCIAL RESULTS 2018/19: POSITIVE PERFORMANCE DESPITE POOR ECONOMIC CONDITIONS (PART 1)

Herewith the GEPF's snapshot SUMMARY of its 2018/19 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 CLAIM OF POSITIVE PERFORMANCE 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 already) 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, the Net Income % [NI%] not even matching the Consumer Price Index [CPI] AND cash generated on investments THAT CANNOT cover benefit payments ANYMORE, AND the cash generated from operations that moved from being a healthy positive to negative for the last 4 years already.

A picture is worth a thousand words. Herewith a list of the Graphics used in the remainder of this document to support my conclusions and comments:

GRAPHIC NR.	DESCRIPTION OF GRAPHIC	Look out for..
1	The GEPF'S PIE CHART on its positive performance indicators in 2019	The "poor economic conditions"
2	Nett investment income [NI] vs Inflation	The trend since FY2016
3	Coverage of benefits by Cash returns	The trend since FY2014
4	GEPF: Our blueprint works	What about the pension liabilities?
5	The Blueprint with added context	The decline in the actual reserve
6	Net Investment income VS CPI VS Fund assumptions for real returns	The trend since FY2016
7	Annual movements Assets vs Pension Liabilities	The trend since FY2016
8	The blueprints failure to establish contingency reserves	The trend since FY2014

1. 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.

The poor economic conditions in SA

1. Its interesting that asset managers, when very good returns and yields are in evidence, will attribute this to internal factors (such as business acumen, superior decision making and investment selections) YET when results are poor they attempt to attribute it to an External factors (such as the Economy, tough trading conditions, acts of god, natural disasters etc)

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 anywhere 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 to what Regulation 28

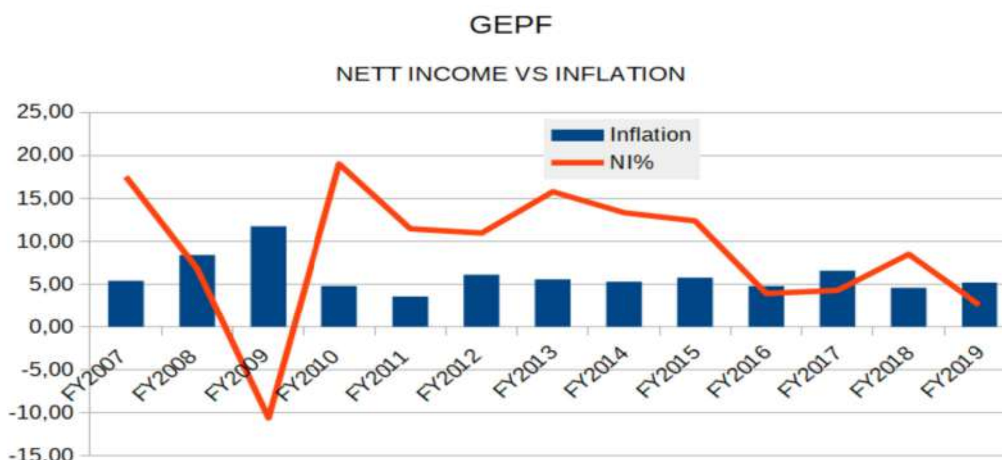
actually allows. This in an effort to mitigate the over-concentration of investments in a single country.

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. Because of delayed response, what is the opportunity cost?

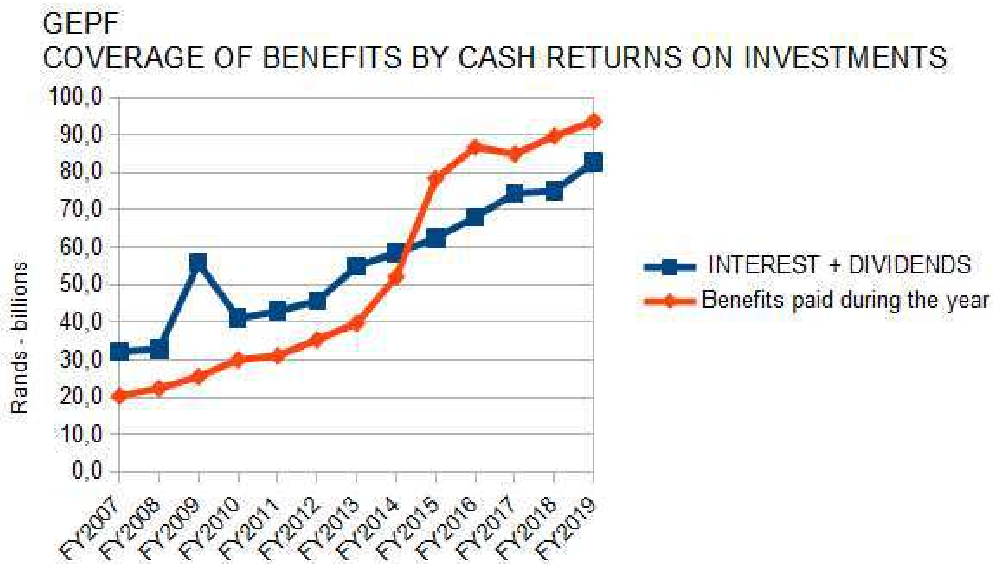
Still, the 2018/19 Annual Report confirms that the Trustees have opted not to actively pursue increased investments opportunities outside the SA Economy to reduce the country diversification risk.

What is interesting is, that notwithstanding the declining Funding rates, Net Investment returns [NI%] not even matching CPI AND cash generated on investments cannot cover benefit payments (See Graphic Nr 2 & 3 herewith) the GEPF continue to maintain the viewpoint that their Blueprint works. GRAPHIC NR 2



Its interesting that up to FY2014 that investments generated enough cash to cover benefit payments. So the investments portfolio was constructed fit for THAT purpose up to then.

GRAPHIC NR 3



What happened since FY2014? It appears that real reason (root cause) for the substandard results in 2018/19 is to be found in INTERNAL factors.

The single most important investment decision that pension trustees can make is **the asset allocation determination.**

The GEPF commissioned an Asset Liability modeling [ALM] study in 2016 already.[That is two years after cash returns on investments started to be less than benefits]

According to the Bid Documentation [Bid 6/2016], the key deliverables and outputs expected from the service provider was the following:

“*• An optimal strategic asset allocation including tactical asset allocation ranges and the structure of each asset class.*

• Possible options for the asset allocation based on the above and any other considerations.

• A proposed transition to the recommended portfolio structure.

• Consultation with the GEPF Board of Trustees to obtain approval for the strategic asset allocation.

• Consultation with the Minister of Finance to obtain approval for the strategic asset allocation”

Following this study, the Minister of Finance was consulted in 2016 already. **That was +- 4 years ago**.

The continued delay with the Finalisation of this matter, **has material consequences to the FUND**.

The finalisation and implementation of this, as its in the hands of Those Charged with Governance [TCWG] of the FUND, is an internal factor.

A FINAL POINT.

Regarding the delay with this matter, when compared with the purpose and definitions of the Promotion of Administrative Justice Act [PAJA], is this another example of non-compliance with existing legislation which is NOT DISCLOSED by the Trustees?

The definitions to PAJA includes the case where there is ..”any failure to take a decision”, As the Minister has not done so for 4 years, is PAJA not applicable?

2. THE GEPF's CLAIM – OUR BLUEPRINT WORKS!

GRAPHIC NR 4

The Government Employees Pension Fund blueprint continues to work

GEPF

your investment, your future

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 SINGLE criteria is rather simplistic AND creates a false positive because the GEPF does collect contributions (in 2018/19 it was R75 billion) 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 actually 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
- the extent to which the assets are productive to generate cash to cover in year benefit payments.

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?

3. THE 2018/19 ANNUAL REPORT FINANCIAL RESULTS

In a similar vein to the original Blueprint claim, the 2018/19 Annual report Graphic (Graphic Nr 1) 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

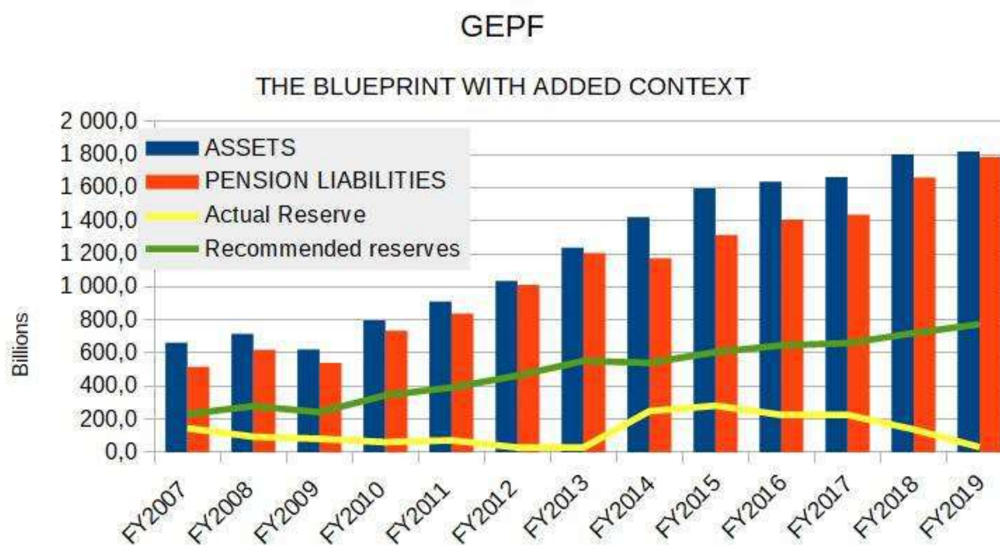
Context is everything.
Herewith an expanded view of performance where not only assets but also pension liabilities as well the reserves are considered together.

3.1 THE FUND'S SOLVENCY

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.

GRAPHIC NR 5



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 2018/19 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 Graphic Nr 5 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?

And the concept of BUILDING UP a FUND? This implies a steady and progressive INCREASE in the buildup of the Investment portfolio RELATIVE to the pension liabilities, not so? Herewith a calculation using the Funding rate in 2014 as basis.

WHAT SHOULD INVESTMENTS BE IF 121,5% WAS MAINTAINED? [Rbillion]		FY2018	2019PROJ
LIABILITIES BALANCE	A	1 663	1788
ASSETS ON 121,5% LEVEL	B	2 020	2 172
ACTUAL ASSETS	C	1 800	1 819
ASSETS SHORTFALL	B-C	220	353

So the 1,8 trillion investment portfolio at the end of 2018/19, IF THE GEPF's Blueprint actually worked, should have been 2,1 trillion already, an amount of R353 billion more!

At this assets level the reserves would actually have been maintained since 2014 AND the 100% affordability of the recommended reserves would not be A DREAM without real action.

3.2 THE ACTION PLAN TO ACHIEVE THE RECOMMENDED RESERVES

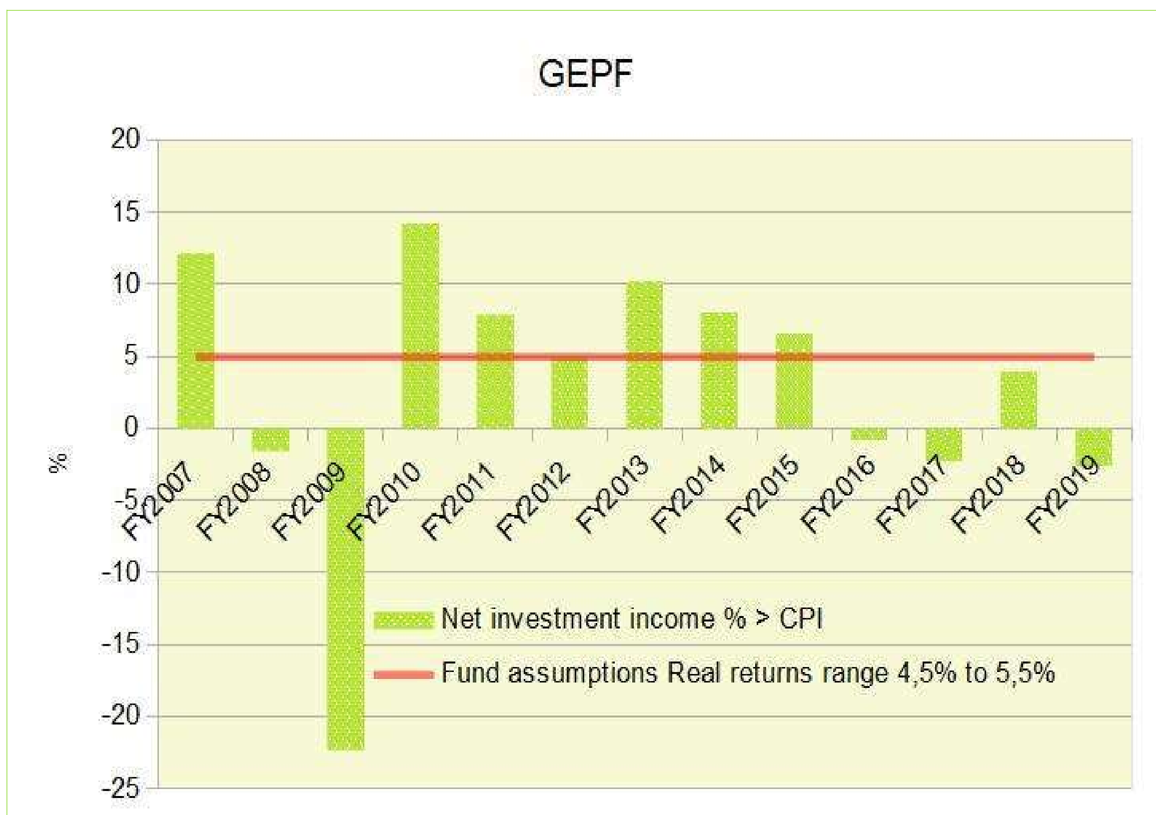
Graphic nr 5 indicates the extent to which the current Blueprint has NOT assisted the Trustees to pursue this dream. The articulation of an action plan (with annual objectives) to achieve this vision is the responsibility of the Trustees (an INTERNAL factor). In the absence of anything visible, we must assume that such an action plan, with regular milestones to move the FUND towards achieving the 100% recommended reserves does not exist. If such a plan existed, the Trustees should have measured their progress against it AND shared that information with members in a transparent manner and as required in S10(2)(b) of the GEPlaw as part of the 2018/19 Annual Report. Simply reporting on the status at a point in time is not the same as reporting against predetermined objectives.

So, unless there is a radical overhaul of the Blueprint, the achievement of the 100% Long-term Funding [LTF] level is highly unlikely to happen.
(NB! The last time the LTF level 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%. Graphic nr.6 reflects the Actual Net investment income % LESS CPI for that year. This % difference, which then represents the REAL RETURN (excluding CPI) and can then be compared directly against the Investment policy ranges mentioned above. [We basically exclude the effects of CPI this way]

GRAPHIC NR 6



The graph shows that in 7 out of the last 13 years the actual result is less than 5%.[The Midpoint between 4,5 and 5,5%]

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?

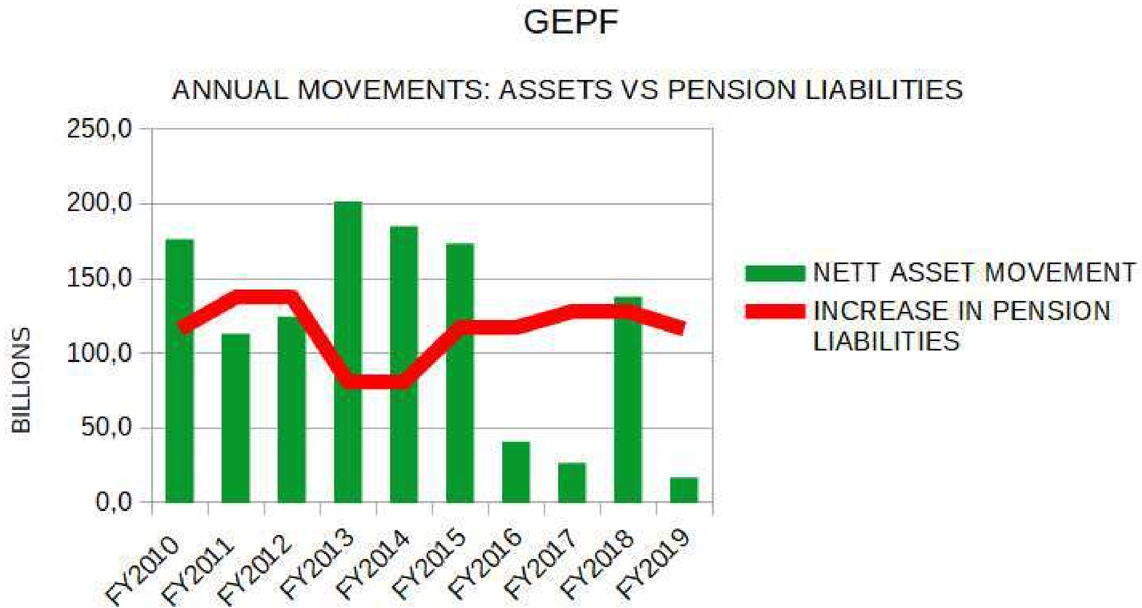
In this instance the mountain is represented by the ever increasing amount of the recommended reserves. The average increase per year is 8,29% or +-R45billion.

When we consider that the Pension Liabilities currently increase on average by R125billion p.a, 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 actual "growth" of the assets balance p.a over the last 4 years (FY2016 to FY2019) was R55billion.

Based on the calculation above, the inadequacy of this level of asset "growth" is short by +/-R115 billion (170 -55) p.a.

GRAPHIC NR 7

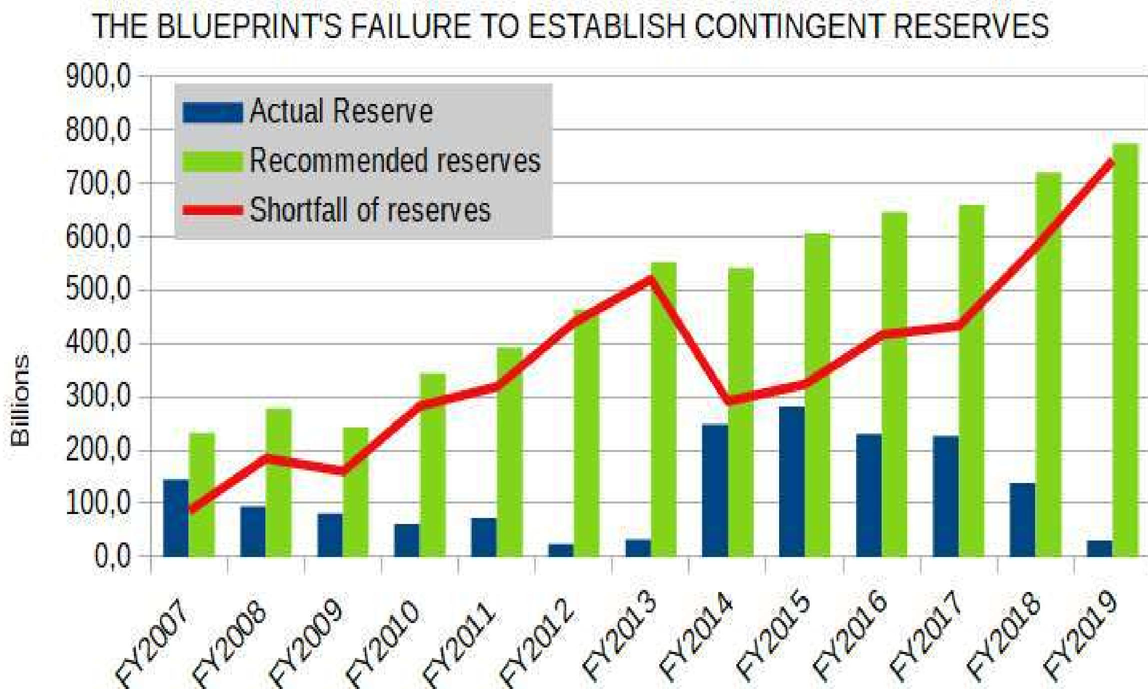


According to the Actuary's MOST RECENT THREE Valuations, the confirmed shortfalls between the actual and recommended reserves range between R292Billion AND R581Billion.

At a time when the Actual Contingent Reserves need to increase to safeguard the FUND, it is decreasing. If risk management is a process whereby risks are mitigated against, this is a good example of HOW NOT TO TAKE CONTROL OF THE mitigating factors.

GRAPHIC nr 8 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 trend-line (shortfall in reserves) is actually an indicator of the unmitigated risk to the FUND. This risk has not been successfully curtailed by the Trustees since 2014. Considering that it (the shortfall in reserves) is currently at its highest rand value level EVER, it contradicts the GEPFs assertion that members pensions is safer than ever. This assertion is increasingly dependent on the so called "Government guarantee" and not on the actual financial position of the Fund when viewed on its own. 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 as the amount is in the Actuary's most recent valuation.

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?

DOES THE GEPF HAVE SUCH A PLAN AND PROJECTIONS ON FILE SOMEWHERE? IF SO - THOSE PROJECTIONS, CAN MEMBERS PLEASE BE INFORMED WHAT IT IS?

Based on the trends and analysis done, plus the Economic growth forecasts for the Country, I can't see this happening very soon (if at all).

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

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

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* NB! Please note all the commentary above is based on the valuation basis used by the GEPF, namely the risk premium approach. The 2018 Actuary Valuation Report (p46 & 47) indicates the Pension liabilities values ito the bond-based approach. This is as per the guidance of the FSCA. This valuation is more conservative and ito it, the Pension Liabilities was VALUED AT R2,1bn and the minimum funding rate calculated as 83,4%.