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Heads up on Regulation 28 changes

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In his latest Budget Speech, Finance Minister Enoch Godongwana announced that the offshore limit for pension funds would be raised from an effective 40% (30% Rest of World + 10% Africa) to 45% (no distinction made between Rest of World and Africa). This is welcome news as it allows retirement fund members to further diversify their investments. However, a credible argument can be made that it hasn't gone far enough.

The stated intention of Regulation 28 is laudable, that is to protect those saving towards retirement against poorly diversified investment portfolios. However, even with the new amendments to Regulation 28, savers are forced to have 55% exposure to domestic assets within their retirement portfolios when South Africa's contribution to global GDP is a mere 0.6%. This 55% exposure also needs to be considered within the context of the typical saver's entire exposure to South Africa which may be north of 90% when one considers that their jobs are based here as well as their primary residences. They also face a dwindling number of investment opportunities as a result of companies delisting from the JSE.

Savers in the private sector find themselves in a very different position to government employees. Government employees are typically members of the Government Employees Pension Fund (GEPF), which is a defined benefit scheme. As such, their retirement benefits (plus an adjustment which is at least equal to 75% of the inflation rate per annum) are underwritten by the fiscus. Private savers are typically members of defined contribution schemes where they bear the full investment risk associated with their retirement savings.

They thus bear the costs of over- or under-exposure to South Africa. As is evident in the table below, a 75:25 portfolio which was fully invested globally would have outperformed one which was fully invested domestically over 5, 10, and 15 years. Less aggressive global portfolios would have performed less well relative to their domestic counterparts because we have seen the lowest interest rates for a generation post the Global Financial Crisis. This looks set to change.

	%Δ 5YR	%Δ 10YR	%Δ 15YR
75:25 portfolio			
- Fully invested globally	84%	343%	385%
- Fully invested domestically	71%	186%	337%
Outperformance global vs domestic (p.a)	2%	11%	3%

Source: Bloomberg, to 28 February 2022

In my view, the argument that the optimal offshore asset allocation (from a risk and return perspective) is below 45% for local high equity mandates simply does not hold water. This argument states that higher offshore allocations lead to higher rand volatility which impedes the goal of preserving capital in rands (as opposed to dollars).

Firstly, academic measures of risk and return focus unduly on market volatility and this would compromise the investment outcomes for most of those invested in high equity mandates, many of whom would be in their wealth accumulation phase and therefore have longer-term time horizons. In this respect, one is reminded of the Warren Buffet quote where he said that he would prefer a “lumpy 15% return to a smooth 12%”.

Secondly, it is irresponsible to focus on the preservation of capital in rands. Who would want to measure their returns in a soft currency (like the rand) rather than a hard currency (like the dollar)? In the short term, impacts of movements in the rand on local inflation may be minimal but in the longer term, they feed through to local CPI. This has led to a steady erosion in the purchasing power of domestic savers (and non-savers for that matter) because the unmistakeable trend in the rand has been downwards.

(All p.a.)	**%Δ 5YR**	**%Δ 10YR**	**%Δ 15YR**
ZA CPI	4.4%	5.0%	5.6%
US CPI	2.6%	2.0%	2.1%
Differential	1.7%	3.1%	3.6%
ZAR depreciation	1.7%	6.7%	4.8%
Nett	0.0%	-3.6%	-1.2%

Source: Bloomberg, to 28 February 2022

For each of the periods above (with the exception of the five-year period), the rand depreciated by more than the inflation differential between South Africa and the United States due to declining South African competitiveness.

This looks set to continue. Looking back over the last thirty years, unemployment has spiralled due to the failings of our education system, we have gone from a net exporter of electricity to having insufficient electricity for our domestic market and Transnet has gone from having surplus rail capacity to calling force majeure on many of its longer- term contracts. Policy changes to reverse this trend have been slow to materialise.

South Africa is behind the curve in relaxing the requirements to Regulation 28 to allow domestic savers to have greater discretion in investing their retirement funds. “Self-Invested Pension Pots” in the UK, for example, give UK savers almost full discretion to choose where they invest their retirement savings.

Despite the fact that many people are calling for domestic assets to perform well in the short term as a result of high commodity prices, over the long term the primary goal of domestic savers with respect to increasing their global exposure should be to achieve diversification. This will provide them with protection against a weaker domestic economy and declines in the rand should these scenarios unfold. In addition, it will also protect them against South African tail risks, which may be greater than one would like to think, if the ANC tries to arrest the decline in their electoral support by passing more popularist policies.

Glacier Research would like to thank Kyle Wales for his contribution to this week's *Funds on Friday*.

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