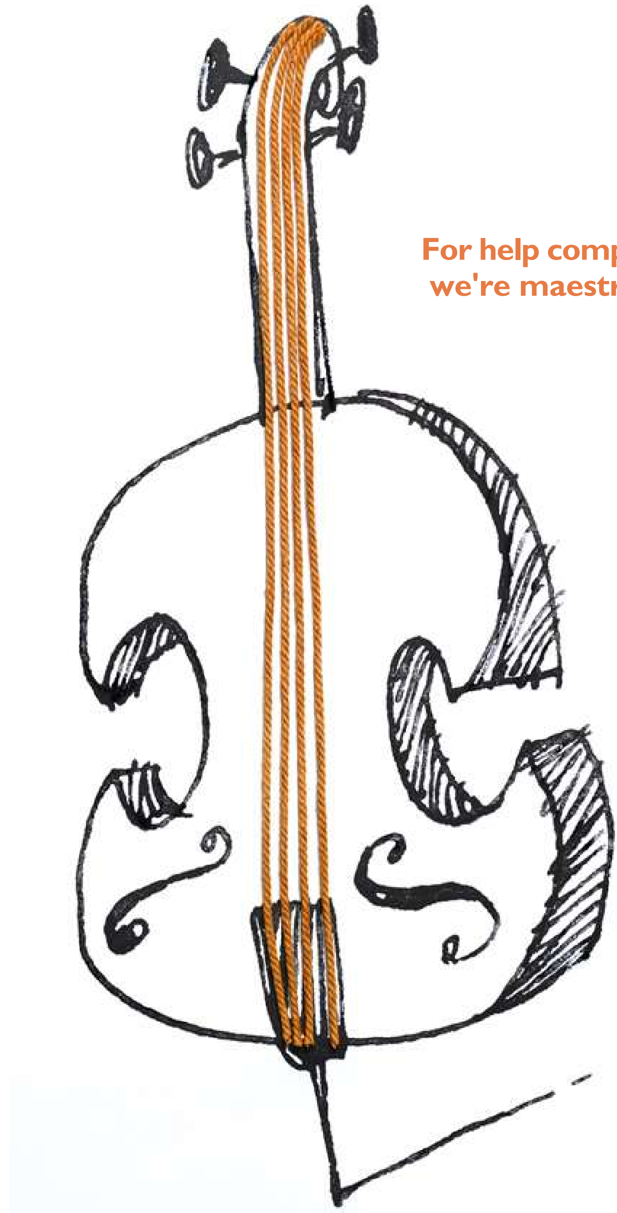
RisCura

good **thinking**



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thinktank

August 2005

Favouring specialist mandates

By Prasheen Singh, Consultant

Over the last 3 years, the retirement fund industry has undergone a big shift from balanced mandates (broad mandate to manage money across a range of asset classes and sectors) to specialist mandates (focused mandate to manage money within a particular asset class or equity sector). RisCura has been instrumental in facilitating this shift and the performance benefit to our clients' portfolios has proved significant.

Balanced mandates lead to average long-term performance

Over time, our analysis of the managers has indicated that most managers do not have the breadth of skills to successfully manage broad mandates. Very few managers have strong asset allocation, sector rotation and stock selection skills. Instead, most managers are very skilled at managing one particular asset class, or, going even further than that, some managers are skilled at selecting stocks within a particular asset class sector (for example, financial and industrial stocks or corporate bonds etc). Based on this, we believe that getting one manager to manage money across a range of asset classes and sectors can result in average long-term performance for the retirement fund - excellent equity performance will over time be diluted by below average bond performance, or vice versa.

Get the experts to asset allocate

Our research shows that asset allocation drives 95% of a fund's performance and is therefore a key aspect of a retirement fund's strategy to get right. RisCura has identified managers in the market who are skilled at tactical asset allocation, and

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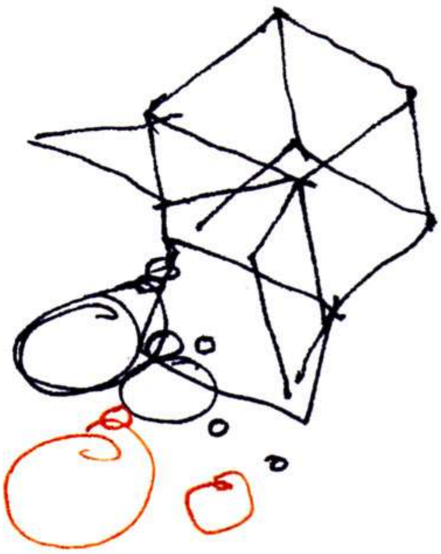
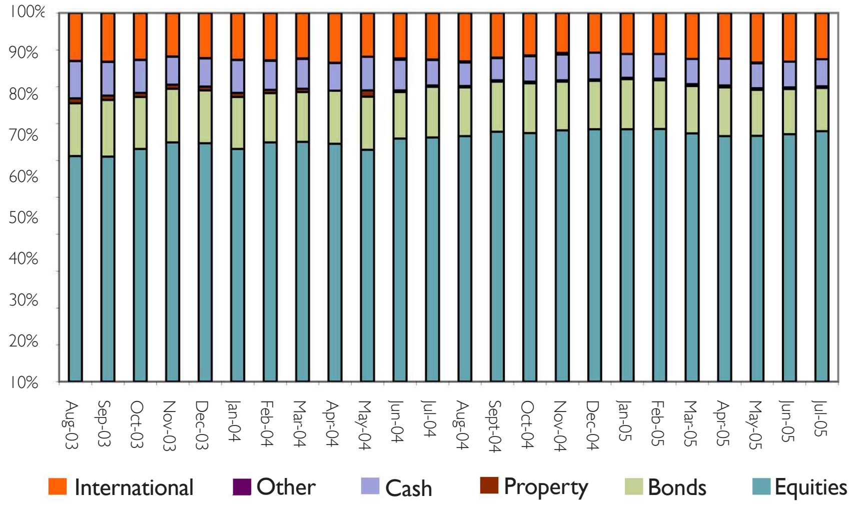


by employing these managers to do the asset allocation around a fund's strategic benchmark, significant value can be added to the retirement fund's performance. Our research further shows that most managers don't actively asset allocate. The diagram below shows the rolling monthly asset allocation bets of a range of investment managers' global discretionary segregated portfolios for the 2-year period ended 31 July 2005.

Specialist mandates encourage and reward excellence

Giving highly specialist mandates to managers based on their core skills, providing an appropriate benchmark as a performance target and then incentivising them via a performance fee structure should yield a much greater chance of the investment manager and retirement fund

Average asset allocation per month for the 2 year period ended 31 July 2005



Therefore, when a retirement fund blends a range of balanced mandates, the asset allocation bets that have been taken by the managers generally cancel each other out. Given that the fees on balanced mandates are more expensive than those on specialist mandates because of the asset allocation function, the fund is wasting money if the impact of the asset allocation decisions is not being felt.

Letting the liabilities drive the asset allocation

A retirement fund's asset allocation strategy must be driven by the fund's unique liabilities, rather than the managers' collective investment views. A good asset liability model, driven by the fund's liabilities, will provide the Trustees with the most appropriate asset structure, given their levels of risk aversion. This structure should be stable, and enable the use of specialist mandates to manage a specific asset class and mandate.

reaching its peak performance potential. Giving similar mandates across similar asset classes to a range of managers results in a herd mentality and an obsession with peer group performance. Specialist mandates on the other hand encourage and reward the individual skills of each manager, allowing them to be creative, focused and accountable. They are also beneficial from a cost point of view as specialist mandates are generally cheaper than balanced mandates because the required skills and decisions are so focused.

The move to specialist mandates will continue, and over time, should result in asset managers becoming more honed and skilled in their core focus areas. The effective blending of specialist mandates, using the most skilled asset managers, should result in significant performance benefits for retirement funds.

Selecting the managers - how to spot the BEST

By Laurett Jardim, Head of Consulting and Manager Research

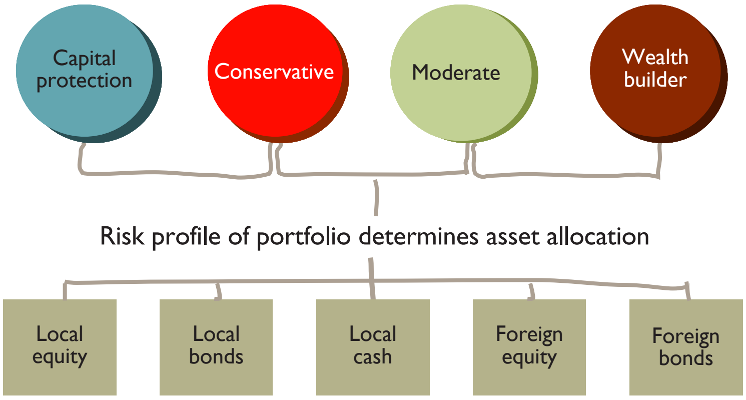
Choosing the best combination of asset managers to manage a pension fund is no small task for Trustees. There are a whole range of factors to consider and the process is a dynamic one with changes, both market and company-related, taking place all the time. Although the importance of manager selection on a fund's return has traditionally been overemphasised by most asset consultants, choosing the best combination of managers can have a material impact on a fund's long-term performance.

We believe a fund's return can be enhanced by effectively blending specialist managers in each asset class and by introducing investment style management. Asset managers' portfolio holdings often overlap, resulting in very little diversification benefits to the overall fund. It's therefore important to combine managers with different investment styles (such as value and growth) for diversification purposes.

RisCura's objective in manager selection is to identify managers that will enhance a fund's return at an appropriate level of risk and for a reasonable fee. We identify these managers via a rigorous process that includes both qualitative and quantitative analysis.

Before manager selection takes place, a retirement fund must develop an investment strategy and determine the most appropriate asset allocation to meet its members' objectives. This strategic asset allocation will become the fund's primary benchmark. Generally, not much asset allocation risk should be taken away from this benchmark, as the impact of errors could be serious. A risk budget is then constructed to allow managers to take stock selection bets around this long-term benchmark. Once the overall asset allocation strategy has been set, the asset manager selection process entails choosing the best managers in each key asset class and investment style.

The diagram below illustrates the specialist mandate approach for a range of risk profiled funds:-



Manager selection within each asset class and investment style aims to identify excellence in both qualitative and quantitative areas. An overall rating is determined by formulating a composite view of the below criteria. The criteria are not equally important but are combined into a view that reflects the ability of the manager to perform over the next 24-36 months, as well as the risk that under-performance may occur relative to the set benchmarks.

Qualitative analysis		
Factor	**Why**	**What we look for**
People	The most important qualitative factor in assessing whether the asset manager will perform. Excellent asset managers comprise passionate, driven individuals who believe in a singular process that has delivered consistently good investment results.	• Stable and experienced team that is passionate about investments; • Incentive scheme that rewards excellence and encourages team stability; • Experience, education and skill; • Good black empowerment credentials.
Process	A manager's investment process must eliminate "noise" and allow decisions to be implemented effectively. Managers need to understand what they are good at and why/when they will succeed.	• Clear and well structured process; • Good use of quantitative tools and technology; • Effective investment execution including acceptable turnover in portfolios and low broker fees; • Acceptable size in terms of assets under management; • Mandate compliance; • Good reporting to clients.
Costs	Costs must be fair and counterbalanced against expected rewards.	• Fair fees relative to industry standards; • Acceptable broker fees.
Business issues	Although these might not have a significant impact on performance, they must be sound to ensure no negligence, good administration and happy staff.	• Stable company; • Good corporate governance; • No conflicts of interest; • Sufficient indemnity/fidelity cover.

Quantitative analysis		
Factor	**Why**	**What we look for**
Performance	This is the "report card" of the manager. Although past performance is often a poor guide to the future, it is difficult to select an underperforming manager.	• Consistent and superior performance relative to benchmarks and peer group; • Three year track record; • Consistent and superior risk-adjusted performance relative to internal benchmarks and peer group; • Fund flows to or from the manager.
Risk	We look at factors that may prevent the retirement fund from meeting its key objectives. Risk is therefore assessed relative to the fund's goals and in line with the style and/or asset class mandate	• Volatility of return relative to risk budget; • Tracking error; • Liquidity of assets; • Credit risk; • Sensitivity to the market (e.g beta and duration); • Investment style; • Industry and stock specific risk.

It can be costly for funds to change asset managers on a regular basis, so a thorough manager selection process is an important part of a Trustees' fiduciary duty. Once the manager selection has been made, an ongoing monitoring process should be implemented to ensure that the managers are performing in line with the fund's long-term requirements, and allowing the fund to address any changes that may occur in market conditions or at the asset managers.

Shopping around for a Hedge Fund Manager?

Ask yourself these questions.

Jarred Glansbeek, CEO of RisCura

Selecting the right managers or multi-managers when it comes to hedge funds is very important. The risk that a hedge fund manager can default and lose all its capital under management is much higher than with long-only funds, and clearly an unacceptable risk for retirement fund money.

Why does the fund want to invest in a hedge fund?

A big threat to international markets is rising interest rates, which, if hiked too quickly, will damage asset values. In addition, it's likely that any interest rate movement offshore will be upward rather than downward, simply because rates are so low. This makes the alpha plus approach to asset management very appropriate. The profile of interest rates however is very different in South Africa. The Reserve Bank recently decreased rates, signalling that rates could fall further. This environment is particularly supportive of rising asset values and economic growth, which should lead to higher equity prices. In this environment, hedge funds may not produce the best performance, and a fund must look to risk management to support their inclusion in a portfolio.

Does the product make sense for the fund given its objectives and liabilities?

A retirement fund must make sure the hedge mandate is in line with its overall risk budget. If a fund requires a stable, cash plus mandate, it should not even consider the more volatile, aggressive hedge funds. The mandates must all fit in line with the broad objective of the fund.

If a hedge fund of funds is sold as a market neutral fund, all strategies used in the underlying funds must follow this approach. A 5% allocation to macro strategies, for example, is unacceptable, even if motivated in terms of its diversification benefits.

Does the product make sense given the fund's existing asset structure?

Adding a hedge fund to a portfolio must either enhance the fund's return or reduce its risk. In other words, it must DO something. Retirement funds must therefore ensure that the hedge funds they add don't have the same investment philosophies and objectives to products or portfolios already included in the fund.

How experienced is the hedge fund team?

It's crucial to use experienced people with the ability to adapt quickly to market changes. The investment processes of hedge fund managers are likely to change as managers learn more about the investment issues that are particular to this arena. The managers must show excellence as well as have a strong understanding of hedging strategies and the industry. The team should include members who have worked with very complex instruments and transactions. Unlike with long-only funds, past performance in these funds can change radically as risk is sometimes not well quantified and controlled.

One way to manage this risk is to allocate money to these managers over time, rather than adopt a big bang approach. This will allow a fund to resolve risk issues that may arise, with limited impact on asset values. We also recommend that larger funds initially split assets between a small range of multi-manager players, reducing this range as clear value add is realised.

How transparent are they willing to be?

Transparency is important in enabling a retirement fund to fit a hedge product into its asset liability modeling exercise and to fully understand the transactions, and therefore manage the risks. We recommend a high level of transparency from the hedge fund of funds and their underlying managers, even though this might limit the universe of managers available for inclusion in the retirement fund portfolio. Many managers are reluctant to provide this level of disclosure as it may prejudice their performance and strategies. Given that the hedge fund industry is still young in South Africa, and performance track records cannot always be relied upon, transparency of assets to help measure true risk is crucial.

How well do they manage risk?

A fund must assess what measures managers have in place to help them pre-empt and manage risks that may occur in market, valuation, credit, legal, transactional and operational areas. Operational risks are high in the hedge fund arena, and separation of administration activities from investment activities, as well as a clear due diligence process in the case of a fund of funds manager, is a must. The industry is dogged with fraud in transacting, asset valuation and accounting which means separating these issues is crucial.

Leverage is a key issue for a fund to understand, quantify and control. If there is a 5% adverse movement on a position that has been leveraged 20 times (or 10% on a 10 times position), the capital can be wiped out. If an extreme movement prejudices any position, it will reflect in the fund's performance, and should be noted, especially if stable performance is the goal.

(Cont'd on page 6)

What's new?

RisCInsight undergoes some surgery

RisCInsight recently underwent some nipping and tucking. Improvements to the system include:

- A dramatic increase in speed allowing for greater efficiency in downloading data and analyses.
- A reduction in bugs that have crept into the system over time.
- Greater number of products available.
- A thorough audit of all historical data.

RisCInsight can be found at www.riscura.com/riscinsight. For more information, please contact Russell Bodill on 011-214 9805.

What are the costs relative to the product's upside?

Hedge funds are expensive, especially a fund of funds product. Retirement funds must be sure, when evaluating such a fund, that real value will be added to the portfolio to justify these costs.

How quickly can you invest or disinvest in the hedge fund product?

A fund needs to comfortable with the possible liquidity restraints of a hedge fund. A 90-day liquidity period, which is sometimes the case with hedge funds, may well be too onerous for some retirement funds. Liquidity also becomes an issue should problems with fraud arise, which may prevent the retirement fund from liquidating its investments as desired.

Do they have a performance track record?

Assessing a hedge fund or fund of fund's track record is crucial. It needs to be analysed for any extreme outperformance or other distortions in performance. Should these exist, they may well point to a lucky investment decision or a process that is still underdeveloped. With retirement fund money there is no room to pay for "someone else's school fees". We would be very concerned if performance was extreme on either the upside or downside, and in the case of a market neutral fund, if performance consistency was lacking.

Given that the hedge fund industry is fairly new in South Africa, many multi-managers have short performance track records. Where older data is used for marketing purposes, the fund of funds were comprised of very few underlying managers, which is not representative of a true "multi-manager process". In addition, some of the multi-managers use simulated performance numbers in their track records, which is based on what their choice of underlying managers would have been - clearly not realistic or representative of their current skill.

Do they offer local client service?

Due to the complex nature of hedge funds, many retirement funds will prefer local client support facilities. These will allow the fund or advisor to obtain answers to queries quickly, which may provide a much needed element of comfort.

Profile:

Andrew van Biljon
Quantitative Analyst

Qualifications and experience: I have a Ph.D in Theoretical Physics, and have spent about three and a half years in the financial industry at RisCura.

Day to day my job involves: carrying out the research functions at RisCura, which includes working on ad-hoc research projects and giving advice on mathematical and advanced financial queries.

I believe in: the theories of general relativity, quantum electrodynamics and quantum chromodynamics, and open source software.

I wish I was: sitting on a beach in Mozambique - the weather is great there this time of year.

A good book I have recently read was: The Magus, by John Fowles - it had more twists than The Twist.

I think people need to know: how to think logically, and to approach life with an open mind.

Physics is all about: thinking logically, and using the Scientific Method in order to understand the world around us.

I make a difference because: I can.

Working at RisCura means I can: make a difference. RisCura is a dynamic company focused on improving the pension fund industry to the benefit of all pension fund members.

When I get home from work I: unwind and relax - usually in the company of the love of my life.

Holidays are spent: having fun and getting tired, sleeping late and resting.

RisCura

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