

INVESTMENT STRATEGY

Investment Philosophy

- In this Fund, the Trustees have adopted a *long-term time horizon* in formulating the Fund's investment strategy. This means that the overall success of the strategy will be measured over periods of at least 5 years.
- The *main risks* carried by members of the Fund are:
 - **Inflation risk** - this is the risk that the Fund does not earn a sufficient return to be able to provide a reasonable retirement benefit.
 - **Loss of capital** - it is important that members are provided with an increasing degree of capital security for the period leading up to retirement age.
- The assumption is that the most appropriate indicator of investment risk is the age of the member. Younger members are assumed to place priority on management of inflation risk and older members on protection against loss of capital close to retirement.
- To this end the Fund has established 3 separate default portfolios. Younger members will be allocated a portfolio that has the potential to earn returns sufficiently higher than inflation to achieve a reasonable retirement benefit, and older members will be allocated a portfolio that offers a degree of capital protection close to retirement.

Investment objectives

The investment strategy has the following two objectives:

- To achieve close alignment between the **purpose** of the Fund and the **investment strategy**; and
- Greater focus on short-term protection of your retirement savings in the event that markets deliver weak investment returns.

Investment approach

The Fund invests a significant proportion of its assets in South African and international equities.

There are broadly three approaches to investing in equities, namely:

- One can simply hold a basket of shares that mirrors the FTSE/JSE All Share Index (or the MSCI World Index for international equities) – this is called **passive investing**.

- For example, with this approach if the share market goes up by 15%, the Fund's investments will also go up by 15%. On the other hand, if the share market goes down by 20%, the Fund's investments will also go down by 20%.
- The second investment approach adopted in South Africa is to be what we call a **market manager**. In this case an investment manager (for example Old Mutual, SANLAM and Stanlib) tries to out-perform the FTSE/JSE All Share Index. This means they will buy more of the shares that they think will do better than the index (and consequently hold fewer shares in companies that they think will do worse than the index).
- In reality a market manager tends to take relatively small "positions" away from the index and so will perform rather similarly to the index. The best market managers aim to beat the index by about 1% to 2% p.a. over the long term.
- The third investment approach is that of a **value manager**. A value manager believes that the market either becomes too optimistic or too pessimistic about a particular share.

Value managers believe that over-pessimism gives them the opportunity to buy shares in good companies at a cheaper price than the company is really worth. Value shares are most often good companies that have gone out of favour with the market.

The advantage a value manager has is that he is buying shares that are already cheaply priced by the market. *This means that if the market goes down sharply, these shares generally will not fall as much as the rest of the market.*

If the value manager is right about the company he has bought, the market will eventually find this out. In this case the share price will go up sharply and the value manager will make a tidy profit.

The main difficulty with a value manager is that it may take the market a long time to work out that the shares he is holding are in fact good companies. This most commonly happens when the market becomes over-excited about an idea (e.g. small South African financial services companies in 1998 and US internet shares in 1999.)

During such a "speculative" bull-market a value manager could under-perform a market manager significantly, but it is unlikely that he will lose your money.

Allan Gray Limited, Coronation and Kagiso Asset Management are examples of value managers in the South African context. Some managers, for example Investec have individuals who follow the value style.

More about value managers

Value managers do two things differently than most other managers, namely:

- They invest with a long term investment horizon (which is consistent with the philosophy of the Fund); and
- They focus on buying very good, but out of favour shares, which they can buy at cheap prices relative to the true worth of the Company. In this way they are contrarians.

This investment approach that was developed in the early 1930's by Ben Graham. Warren Buffett, one of the world's most successful investment managers, was a student of Ben Graham and applies the Graham approach to investment.

This approach takes the view that market sentiment and human behaviour result in the price of companies deviating from their long term intrinsic value. Another way of looking at this is that the intrinsic value of a business generally changes more slowly than its price.

This means that from time to time some companies become very cheap relative to their true value and sometimes they become very expensive. The cheap companies (but still good companies) are often those that have fallen out of favour with the market temporarily and these are the shares the valuation manager will buy.

The expensive companies (which may also be good companies) are those that are in fashion and strongly liked by the market, but the valuation manager will not buy these shares because he assesses them to be too expensive.

Whilst this “buying bargains” is a sensible strategy, the difficulty is that excessive market sentiment may result in such managers under-performing the index significantly, especially over short measurement periods (i.e. periods of less than 5 years).

Approach adopted by the PetroSA Retirement Fund

The main features of the investment approach adopted by the Fund, are set out as follows:

Specialist asset managers for the Market-Linked Portfolio

The Market-Linked portfolio is the “default” portfolio into which all of the savings of members under age 55 will be invested. The trustees have appointed different asset managers for each asset class (equities, bonds and cash).

The Trustees are of the view the specialist approach can be expected to deliver strong results in the long-term.

Investment Philosophy

The Trustees believe that over long measurement periods (typically 5 years and longer) investment markets are efficient and so the price of a traded asset is the most accurate indication of its underlying value.

However, over shorter time frames investment markets may be materially inefficient resulting in **big and non-random disparities** which cause the price of an asset to deviate from its underlying value. Such mispricing arises *inter alia* from:

- Many investment managers adopt too short an investment horizon, which results in decision-making based largely on forecasting (which is notoriously difficult to get right consistently)
- Many investment managers are over-confident of their abilities and will use short term results (which may be random, or fashion driven) to predict long term trends
- Most investment managers are subject to agent/principal conflicts. Often an investment manager will invest close to the benchmark as this minimizes the risk of under-performing the peer group (and ensures job preservation).
- Some investment managers are so large that they are unable to exploit the full opportunity set, thus leaving opportunities for their smaller competitors.

If markets are efficient over the long term, it follows that an intelligent and patient investor can earn superior returns over the long term by exploiting these short-term mispricings.

No single investment approach is necessarily superior to another and accordingly the Fund will invest with a number of investment managers in order to diversify by investment approach e.g. value, growth, momentum and quality investment styles.

The Trustees believe in the benefits of diversification and that the risk of poor investment outcomes can be mitigated by allocating the investments of the Fund between different asset classes. Further diversification is also achieved within a riskier asset class by allocating the assets to more than one investment manager.

The Trustees accept that in order to make provision towards retirement a member needs to earn a reasonable return compared to inflation on his/her retirement savings. The success of the investment strategy will therefore primarily be measured relative to inflation as opposed to the performance of the peer group.

HOW THE FUND CHOOSES THE ASSET MANAGERS

The trustees may delegate their duty to invest the Fund's assets if the rules of the Fund provide for it to a licensed investment manager, but they cannot relieve themselves from their responsibility to invest the Fund's assets appropriately, just by appointing someone else to act in their place.

If trustees delegate this function, they must enter into a proper agreement with the investment manager.

The Board of Trustees must:

- Ensure that the assets and contributions of the Fund are invested in accordance with the rules of the Fund;
- Draw up a document that sets out the Fund's investment policy, including delegation to investment managers and custodians where required, with the procedures necessary for monitoring investment performance and the appropriateness of investments;
- Declare its voting policy with regard to investments held by the Fund;
- Invest the monies and manage the assets of the Fund so as to receive an adequate return;
- Ensure that the responsibilities of investment managers are clearly defined in a written agreement;
- Ensure that the investment manager operates within the Fund's investment policy, and has adequate controls to ensure security of the assets;
- Ensure that clearly defined investment guidelines and performance benchmarks are in place.

The method followed by the PetroSA Retirement Fund

The Trustees first survey several asset managers, insurance companies and consultants to understand the different investment strategies that can be followed to achieve the stated purpose of the Fund. The critical step is to choose the actual managers who are most appropriate, given the purpose of the Fund. The Trustees apply many criteria in choosing the managers, but the main ones are:

- *Business ethics* – the Trustees want to ensure that the interests of the asset manager are aligned with the interests of the Fund.
- *Investment philosophy* – the Trustees look for a clearly defined investment philosophy, with evidence that this philosophy is working for its investors.
- *Quality of people employed* – the Trustees are interested in how the manager's business is structured to bring out the best in their investment professionals.
- *Investment process* – the Trustees want to know how investment decisions are made, how they manage their risks and how the investment decisions are implemented.
- *Performance* – the Trustees are interested in **future** performance, rather than past performance. Past performance was used as a guide to understanding how the managers use their investment skills, so that they could understand whether they are likely to continue their past successes or failures into the future
- *Black economic empowerment* – the investment manager must have a clear and cohesive strategy on black economic empowerment and employment equity and must be able to demonstrate success in implementation.

Due to the fact that the PetroSA Retirement Fund is not yet large enough to allow the trustees to construct "customised" portfolios with the asset managers for each of the Fund's investment channels, the trustees are generally limited to the "pooled" offerings (or even unit trust offerings) of the selected asset managers that offer the best "fit" to the trustees' requirements.

INVESTMENT MANAGERS OF THE FUND

After the interview process, the trustees then choose who they believe are the most appropriate investment managers. The Fund's investment managers are:

- For the Market-Linked Portfolio: Allan Gray, Coronation Fund Managers and ABAX (SA Equity Managers); Ninety One (previously Investec Asset Management), Coronation and Futuregrowth (SA Bond Managers)
- For the Stable Portfolio: Allan Gray; Ninety One and Coronation (multi-asset-class)
- For the Shari'ah Portfolio: 27four Investment Managers (multi-manager, multi-asset-class)
- For the Money Market Portfolio: Ninety One

Allan Gray Limited

Allan Gray is a strong believer in the investment approach advocated by Ben Graham.

Coronation Fund Managers

Their investment approach is to take "bets" away from the benchmark and will change their investment approach depending on market conditions.

ABAX Investments

Their investment approach is to invest in shares that are priced well below their intrinsic values offering relatively strong growth prospects.

Ninety One (previously Investec Asset Management)

Ninety One have an excellent SA bond team and an outstanding long term track record. The bond team works closely with the Investec global bond team, giving it a good understanding of international bond market trends.

Sygnia

Sygnia Life does not manage the Fund investments but provides a platform via which the Fund has access to a balanced portfolio of global equity, property and bond managers that are highly rated by the Fund's investment advisers, Willis Towers Watson.

27four Investment Managers

27four Investment Managers' key competency is Shari'ah compliant portfolios. Their underlying managers, however, do have a strong track record.

MANAGER REVIEW

The proper management of the investments of the Fund is a critically important component of the governance of the Fund. For this reason, a proper ongoing manager assessment process and review should be followed regularly by taking the following into account:

- It is important that the Board of Trustees ensures that the investment manager mandates are consistent with the investment objective of the Fund.
- Any contractual arrangement between a Fund and an investment manager should set out clearly the benchmarks against which the performance will be measured. This too needs to be reviewed and monitored regularly.