



# Derivatives

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Rob Southey & Dwayne Kloppers  
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# Agenda

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- Why consider derivatives?
- Introduction to current legislation
- Practical application by trustees
- Broader implications

Why consider derivatives at all?

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# Size of derivatives market...

**Derivative market = \$669 trillion**

(BIS 2011 Q2 Quarterly report & OTC derivatives market activity in the second half of 2010)

**All global wealth = \$195 trillion**

(as at mid 2010, Global Wealth Report, Credit Suisse Research Institute)



\$114.5 trillion, (US unfunded liabilities) <http://usdebt.kleptocracy.us>

# Commonly used in pooled portfolios

## Allan Gray Domestic Balanced Portfolio

ALLAN GRAY

Portfolio status: Currently restricted to existing institutional investors only  
Inception date: 1 September 2001

Portfolio Information on 31 August 2011

Assets under management:

R6 661m

### Portfolio objective and benchmark

This Portfolio is for institutional investors with an average risk tolerance. It aims to offer long-term returns superior to the benchmark, but at lower risk of capital loss. In terms of Allan Gray's risk-profiled range, this Portfolio has a higher risk of capital loss than the Stable Portfolio, but less than the Absolute Portfolio. The benchmark is the mean performance of the large managers as surveyed by the client's appointed consulting actuaries.

Performance (gross of fees)

Cumulative performance since inception (log-scale)



### Product profile

- Actively managed pooled portfolio
- Investments selected from all local asset classes
- Represents Allan Gray's 'houseview' for a domestic balanced mandate

### Investment specifics

- This Portfolio is available as a linked policy issued by Allan Gray Life Limited available only to retirement funds and medical schemes
- Minimum investment: R20m
- Performance fee based on outperformance of the benchmark

% Returns <sup>1</sup>	Portfolio	Benchmark <sup>2</sup>
Since inception	21.2	17.1
Latest 5 years	14.4	12.4
Latest 3 years	13.0	10.5
Latest 2 years	14.4	14.1
Latest 1 year	13.5	14.5
Latest 3 months	0.7	+0.7

## Asset allocation on 31 August 2011

Asset class	% of portfolio
	Total
Net SA Equities	56.2
Foreign Inward Listing on the JSE <sup>3</sup>	2.8
Hedged SA Equities	8.2
Property	0.5
Commodities (Gold)	3.8
Bonds	16.5
Money Market and Bank Deposits	12.0
<b>Total</b>	<b>100.0</b>

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<b>Total</b>	<b>100.0</b>

Note: There may be slight discrepancies in the totals due to rounding.

- Investment returns are annualised (unless stated otherwise), except for periods less than one year. Performance as calculated by Allan Gray as at 31 August 2011.
- Mean of Alexander Forbes Domestic Large Manager Watch. The return for August 2011 is an estimate.
- In December 2010, National Treasury announced, along with the increase in foreign reserve allowance, that the holding of foreign inward listed shares, such as British American Tobacco, are to form part of an institutional investors' overall foreign allowance.

# Costs

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- Derivatives can offer significant cost reduction (“efficient portfolio management”)
- Recent study by Peregrine Securities shows that on index trading, selling out and then back into a portfolio:
  - Physical: 49 basis points
  - Top40 futures: 1 basis point
  - Other implicit savings such as reduced market impact

# Introduction to Current Legislation

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# How is derivative usage governed currently

- Pension Funds Act, 1956
  - Regulation 28 (recently redrafted)
    - In effect as of 1 July 2011
    - Move toward compliance by *31 December 2011*
    - “fund may invest in derivative instruments subject to conditions as prescribed”
      - Conditions for the use and disclosure of derivative instruments
        - Currently in advanced draft form
        - No indication of release date yet
        - Alexander Forbes believes principles are unlikely to change significantly
- Fiduciary responsibility as a trustee

# Themes related to derivatives

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- Transparency and consistent treatment of assets
- Governance, risk management, processes and reporting
- Strong focus on trustees retaining responsibility for investments of the fund
- Trustee education
- Allowance for exemption

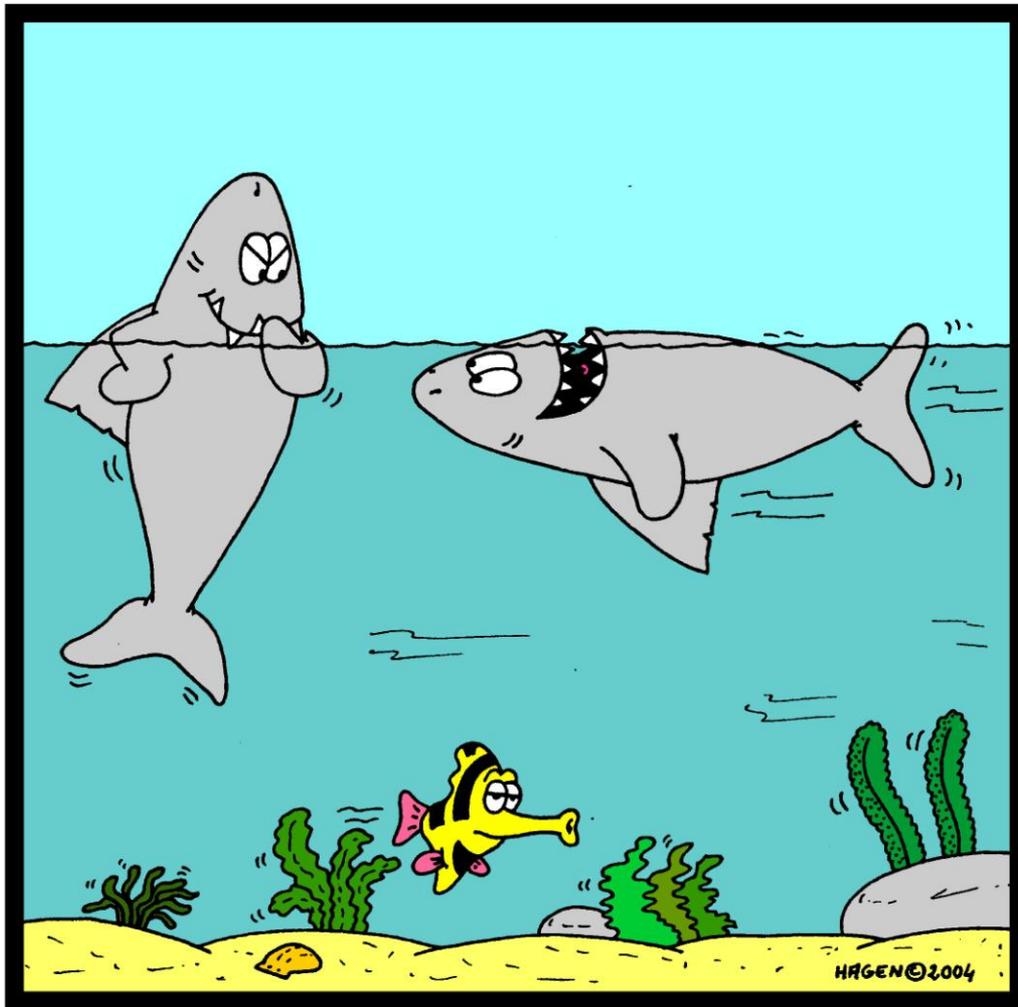
# Practical application by trustees

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# Look through principle

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You see, if we learn to swim upside down,  
they won't see us coming...

# “Look-through” principle

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- Reg 28 (law)
  - “economic exposure of the underlying assets”,
- Draft Board Notice (expected to become law soon)
  - “effective economic exposure means the exposure of a fund to an asset referenced by a derivative instrument  
.....”

## “Look-through” principle

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- Principle is for all assets, irrespective of form to be treated on a consistent basis
- How much effective exposure (risk and reward) the fund is getting
- *What physical holding would create an equivalent exposure?*
- These are subject to the numerical limits in main Regulation 28
  - *Example: No more than 75% exposure to equity*

## “Look-through” principle

- This protects members, by ensuring trustees fully recognize the risks of a specific strategy
- Also prevents ‘wrapping’ or disguising of products
- *Example: National Treasury used example of hedge funds wrapped as debentures by industry*

# “Look-through” principle & Delta

- The derivatives notice requires the use of a concept known as delta
- It is merely a sensitivity measure, but may be a new concept to many trustees
- Delta is (roughly) how much profit you will make per rand the underlying share price moves
- *Example 1: Option on R100 of exposure to TOP40 with a delta of 0.3 yields a R30 exposure to TOP40. This is due to the equivalent risk and reward characteristics to holding R30 in TOP40. This applies even if the exposure is capital guaranteed.*

# Reporting

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“Investment in derivatives should always be preceded by investment in controls”

*Arthur Levitt, SEC Chairman, Risk/Emerging Markets, April, 1996, p. 43*

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# Reporting

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- Derivatives guidance note introduces a comprehensive list of reporting requirements
- Trustees should request this from their asset managers
- Requirements of the board notice *should already be monitored by asset managers*; hence negotiate for no increases to fees for these services
- Aggregation is required where different managers are used (and using derivatives). May require a third party provider

# Reporting

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- At least monthly:
  - Listing of each asset
  - Effective exposure to each Regulation 28 category
  - Physical exposure to each Regulation 28 category
  - Report showing effect of netting credit exposure to each entity
  - Report showing aggregate credit exposures to each entity
  - Sensitivity report – show impact of market movement on portfolio value (extent of potential loss recognised)
  - Statement showing compliance with International Financial Reporting Standards

# Education

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- Many of these concepts may be new to trustees
- Board Notice & Reg still require a high level of engagement with the concepts and principles outlined
  - Regulation “at all times” “promote the education of the board” – Reg 28
  - “monitor compliance with this regulation by its advisors and service providers” – Reg 28
  - “board of the fund must apply its mind to understanding all risks related to the use of derivative instruments” – Draft Board Notice
  - “With the appointment of third parties ... the fund retains the responsibility for compliance with such principles.” – Draft Board Notice
- Hence if derivatives are allowed and used, trustees will need to engage adequately with these instruments, even if this requires significant up skilling

# Other Explicit Trustee responsibilities

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# Trustee responsibilities

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- Required to update investment policy statement:
  - When and how derivative instruments are to be used
  - Whether unlisted derivatives may be used
  - Include that all mandates allowing derivative usage will require
    - Compliance to the derivatives notice
    - Appropriate risk management by manager
    - Appropriate reporting by manager
  - Requirement to monitor compliance to mandates regularly
  - Requirement for board to “apply its mind to understanding all risks related to the use of derivative instruments”

# Board Responsibilities

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- Board is required to do due diligence on derivatives:
  - Consider all risks
  - Including credit, market, liquidity and operational
  - May consider credit ratings, but not to rely on these

# Implications for Industry

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# Implications

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- New Regulation 28 and the Draft Board Notice are a massive step forward from previous legislation
- Far greater clarity
- Focus on rigorous governance and risk management should ultimately offer better protection for member
- There will be an increase in what is expected from trustees and product/service providers
  - In some cases may require significant education of Trustees
  - In some case, compliance may imply an increase in absolute, direct cost, where third party providers and advisors are required.
  - Pension fund investment is a complex topic; this is particularly true of derivative usage
  - Hence adequate governance is required in administering member investments, even if this requires certain changes to be made

# Implications

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In the context of approximately 3 500 active retirement funds (recently consolidated down from 13 000 funds) and a general lack of investment expertise among trustees, the Regulation remains primarily rules-based. However principles are introduced into the Regulation to strengthen the investment decision making processes, and improve the transparency and accountability to a fund's members and the Registrar. In effect these

# Implications

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- May encourage consolidation of funds further
  - This is a trend the FSB appears not to oppose
  - Consolidation would allow for more rigorous management of Funds without increasing absolute cost to each member
  - Could improve the quality of trustees managing funds
  - Note that consolidation can take many forms:
    - Platform type solutions (e.g. umbrella funds)
    - Industry funds (rather than employer funds)
  - A balance will need to be struck between these benefits and the drawbacks of consolidation, such as the potential loss of customization to the needs of the membership of a small pension fund

# Implications

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- Whilst the Regulation and the Board Notice places a number of new responsibilities on Trustees...
  - ...both place derivatives in a greater spotlight
  - ...both encourage Trustees to actively apply their minds to finding investments that will be to members benefit
  - Offer a clear way to achieve compliance. The lack of clarity in the previous Regulation 28 on derivatives made many trustees weary of these instruments.
- May in fact encourage expanded usage of derivatives in an *appropriate manner*

# Conclusions

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# Conclusions

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- Derivative market is hugely powerful resource for asset managers & trustees (and hence members)
- Compliance to new Regulation 28 required by 31 December 2011
- Number of responsibilities trustees need to investigate:
  - Updating mandates
  - Updating investment policy documents
  - Updating reporting
  - Need to apply minds to various issues such as 'netting'

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# Thank you for your time

*“Blaming derivatives for financial losses is akin to blaming cars for drunk driving fatalities.”*

Christopher L. Culp

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