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Bond call ups get out of hand - page 19

Cover Feature: Household debt and our reckless spending

Why passive management is better than active - page 23
At Santam, we know how important it is to stay up to date with the risks facing the modern farmer. Which is why we take an in-depth scientific approach to assess all the adverse factors that could confront your clients’ crops and assets. As the leader in specialised asset and crop insurance, we have the ability to develop innovative risk solutions so that no matter what risk their farm faces, we’ve got it covered. Santam. Insurance good and proper.

To find out more about Santam Agriculture’s unique insurance solutions, specifically designed for the modern farmer, visit www.santam.co.za

Santam is an authorised financial services provider [licence number 3416].
ALEXANDER FORBES and MMI Holdings Limited (MMI) have announced an agreement on the sale of Guardrisk (including Euroguard), to MMI for R1.6 billion. The conclusion of the transaction is subject to inter alia regulatory approvals by the Financial Services Board and the competition authorities.

MMI, a JSE-listed financial services group, is the successful bidder from a list of several investors who expressed an interest in acquiring Guardrisk, a wholly owned subsidiary of Alexander Forbes. Announcing the sale, Edward Kieswetter says, “The sale of Guardrisk was considered in the context of positioning the Alexander Forbes Group for growth in its employee benefits, investment and risk benefits institutional businesses, as well as leveraging off that established client base into three key growth markets: retail (individuals), the public sector and sub-Saharan Africa. This transaction will further enable us to deliver on our promise of securing the financial well-being of our clients – now and into the future.”

Nicolaas Kruger, Group CEO of MMI says, “The acquisition of Guardrisk is an important milestone to support our strategic intent to diversify our business to enable further growth. The Guardrisk transaction enables MMI to provide a comprehensive and exciting suite of specialist insurance solutions in the alternative risk transfer space to our large corporate clients and brokers. This enhanced product offering will be complementary to the innovative product offering of Momentum Employee Benefits.”

Herman Schoeman, Guardrisk Managing Director, who will continue to lead the company along with his current management team, says, “We have been a leader in the specialised insurance industry since our inception and we look forward to unlocking synergies and providing value enhancing products and services to our current and future clients. Our highly experienced employees will also have the opportunity to contribute their unique skills to MMI.”

The purchase price of R1.6 billion will be funded from MMI’s capital buffer, which remains healthy to fund other strategic growth initiatives. “We are comfortable that we will extract revenue synergies from the Guardrisk transaction, which are expected to enhance MMI’s earnings and grow embedded value over time,” concludes Kruger.

About MMI Holdings

MMI is an insurance-based financial services company listed on the JSE. It was formed in December 2010 through the merger of Metropolitan Holdings and the Momentum Group. MMI is one of the largest insurers in South Africa, doing business in 12 African countries.
outside South Africa and the United Kingdom. Its core businesses are long and short-term insurance, asset management, savings, investment, healthcare administration and employee benefits. Product solutions are provided to all market segments through the well-established Momentum and Metropolitan brands. Web site: www.mmiholdings.com

Cell Captives

As a cell captive insurance provider, Guardrisk enables clients to insure their risk exposures through owning a portion (known as a cell) of Guardrisk. Guardrisk provides underwriting, reinsurance, claims management, investment and accounting services to companies. These companies also benefit from an insurance solution without the inherent cost and administrative implications.

AboutGuardrisk

Guardrisk is a specialist cell captive insurance group and a leading alternative risk transfer provider in South Africa, comprising a short-term insurer, life insurer and an underwriting manager. Guardrisk pioneered the cell captive concept, which was introduced in 1993 and extending to the life insurance industry in 1999. Guardrisk provides structured insurance products, traditional cell captive facilities and access to a broad and diversified panel of related services and professional reinsurance markets through its businesses in South Africa, Mauritius and Gibraltar. The Gibraltar operation consists of Euroguard, a leading Protected Cell Company providing alternative risk financing facilities in first party only cell captive structures.

About Alexander Forbes

Alexander Forbes is a diversified global financial services group specialising in employee and retirement benefits, multi-manager and investment solutions, and health and risk benefits consulting and providing short and long-term insurance solutions. The Alexander Forbes Group employs more than 3 000 employees, and is based in South Africa with operations in Africa and Europe. For more information, please visit the Alexander Forbes website: www.alexanderforbes.co.za

AGRICULTURAL INSURANCE

Still propping crops

SANTAM SAYS IT has no intention of withdrawing its support from farmers. At a time when ‘they are facing challenging times,’ it notes that one of the largest re-insurers in South Africa is withdrawing from the crop insurance market.

Santam’s commitment comes despite the agriculture sector suffering large weather-related losses resulting in claims that have dented recent insurance underwriting. This year the crop insurance business has been adversely impacted by hail damage to summer crops in the Eastern region of the country, and saw drought insurance claims in the Central and Western regions.

Floods in Limpopo also had an adverse effect.

Some farmers are also still recovering from losses caused by the devastating natural disasters of 2012, with the year going down in records as one of the worst years for catastrophes in South Africa.

“We are the oldest insurer of the sector with 83 years of support to this class of business and have consequently gained deep experience in dealing with the highs and lows of agriculture. The fact is that the sector is of utmost importance to the country. It needs insurance partners to ensure its sustainability and to contribute to national food security, especially with South African commercial farmers being placed in the precarious position of having to produce more food with less arable land at their disposal,” says Gerhard Diedericks, newly appointed Head of Santam Agriculture.

In addition, Santam believes that despite Munich Re’s withdrawal, there is still adequate reinsurance capacity. Diedericks adds, “Crop insurance is part of the Santam service offering and we are going to continue to do it strategically and selectively. It has in the past proven to be profitable for the company, and we see opportunities for profitable growth in the future.”

“We target a certain balance between multi-peril crop insurance (MPCI) and hail. We believe this mix works well and will govern our approach to how we continue writing business into the future. Sound underwriting is key to insuring the agriculture sector sustainably. We will also continue to invest in research, people and processes to ensure we manage claims accurately,” says Diedericks.

Comments John Melville, Executive Head of Risk Services at Santam, “We understand the financial pressures farmers face and the next few years will be critical for the agricultural sector to adapt to its various challenges. It is going to be important for farmers and the agriculture community as a whole, including insurers, to reassess and develop risk management in the sector.”

According to Melville weather-related changes will increasingly emerge as a challenge in future. Inevitably this will impact the pricing and terms on which cover can be provided. However, the extent of such impact will be significantly determined by farmers’ response...
to adapting to and mitigating their risks and exposures.

“We have long ago made the decision to be there when our clients need us most. Our farmers need to know their insurance partners are committed to them, and we are, both in terms of settling claims, and working with them to help manage their risks,” says Melville.

**RISK INSURANCE**

**Popular or not?**

**Protection against the Protection of Personal Information law**

**SOUTH AFRICAN BUSINESSES** are set to face more legislation with the introduction of the Protection of Personal Information Bill (PoPi). It has taken current restrictions to a whole new level, since it even restricts the way in which you may go about collecting and analysing your own client data.

This is according to John Stebbing, General Liability Underwriting Manager at Camargue Underwriting Managers. Its partner company is Lireas, in turn, the strategic investment company of the Hannover Re Group Africa.

“PoPi is about to become law in South Africa,” he says. “It comes with numerous requirements, which I believe will have an impact on businesses throughout the country.” He explains that with the introduction of PoPi, personal information may only be processed in accordance with the following criteria:

- If the processing has been consented to by the data subject. The company must identify all third parties who have access to the personal information to the data subject;
- If the data subject is aware of the purpose for which the data is being collected;
- If it has been collected directly from the data subject;
- If it was collected for a specific, explicitly defined purpose and the data subject is informed of the purpose of the collection. Once the company has achieved that defined purpose, the data must be deleted or disposed of in a secure manner. Until the data is deleted, the company must ensure that the personal information is not misleading, incomplete or out of date.

Stebbing says, “Although there are exceptions to the restrictions above, they give an indication of what businesses can typically expect. In terms of PoPi there are three ways in which a business could find itself in trouble. Firstly there is civil liability. This means that people could sue the company for the harm they have suffered as a result of the company not obeying PoPi.

“Secondly, in terms of criminal liability, PoPi provides for fines and imprisonment of up to 10 years. Lastly, the law also allows for administrative penalties which the company would need to pay to the Information Regulator.” He says there are certain types of personal information which receive special attention in terms of PoPi. These include trade union membership, philosophical beliefs, political persuasion and criminal behaviour.

Stebbing clarifies that although these restrictions apply to brokers, they also apply equally to almost every other business that operates under South African law. Many business people will be dismayed at the prospect of facing even more legislation and it may seem as if there is an increasing number of ways in which a business could be tripped up and inevitably face some form of financial punishment. The irony is that these challenges actually create new opportunities.

“Many of the risks that businesses face in terms of PoPi can be covered by a cyber-risks policy, concerning any risk arising out of operating computers. With cyber-crimes on the increase globally and in South Africa, it is becoming increasingly important to have such a policy in place.”

“It will cover risks such as the wrongful disclosure of personal information to unauthorised parties. A mistake like this happens all too easily by simply sending an email attachment to the wrong person. Then there is the ever-growing threat posed by the dark world of hacking. Even though it might not be at fault, the business could be held liable for failing to secure its data. Fortunately, this too can be covered by a cyber-risks policy.”

“Although a cyber-risks policy doesn’t cover all the risks that are spawned by legislation such as PoPi, it has been designed to mitigate many of those risks. If one considers the pace at which society is changing, this sort of policy may soon become as common as general liability insurance.”

**LIABILITY**

**Teachers need educating**

**Schools must hold third party cover**

ONE OF THE largest damages awards to date, R23.5 million, was made in August 2013 to a student, Christian Rabie, the son of a high court judge, who suffered serious brain injury after a dangerous school playground game went awry. The magnitude of the award draws attention to the duty on schools to ensure the safety of their students. With an established duty to protect against harm befalling minors, it is vital that schools maintain sufficient insurance covering their liability to third parties.

A game was played in the school grounds during recess. A child would get onto a cricket net which had been pulled tight by other children, and the child would be tossed up into the air before being caught again. The child in this case, thirteen years and eleven years old, fell to the ground during this game and was injured.

A court order was made in August 2013 for the school to pay to the Information Regulator.”
months old at the time, was not caught in the net when he came to land. Instead, he fell to the ground and sustained serious head injuries. His father then claimed damages from the school authority on behalf of his son.

years old at the time, the law presumes that he lacked the maturity to appreciate the danger of his actions and the school failed to prove that he did.

The scale of this award should prompt schools to ensure that they have sufficient third party indemnity cover in place, particularly in light of the unique risks presented by the school environment.

By Edwina Pryce, Associate and Jay Page, Candidate Attorney of Norton Rose Fulbright South Africa

BUSINESS

Regular deals

Busy with mergers and acquisitions

The duty of care owed to learners and their parents requires that schools create and maintain a safe environment for learners by exercising control and supervision and taking reasonable precautions to prevent physical harm to learners. The school admitted that it was under this duty but raised a number of defences, including contributory negligence of the child (which did not succeed). It is difficult to imagine a school ever successfully arguing that it is not under such a duty.

Three characteristics of the school environment make the risk of liability particularly real.

Regardless of the teacher to student ratio, the supervision of large groups of children is an unenviably difficult task. It is arguable that all that is required is reasonable supervision in these circumstances, but the notion of what is "reasonable" is notoriously tough to define.

Secondly, and we have seen the impact of this in Rabie’s case, injuries to children have the potential to balloon because the effects of any injuries tend to have far-reaching consequences. If, for example, a child is injured and consequently disabled, the claim for loss of future earnings and future medical expenses alone may be massive.

Finally, and this is again illustrated in Rabie’s case, it can be very difficult to apportion liability in this type of case. The Court held that it was not for Rabie’s parents to have taught him not to engage in dangerous activities nor was it young Rabie’s fault for taking part in such a dangerous game in the first place. As Rabie was under fourteen

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 Contrary to what many people believe, mergers and acquisitions are taking place regularly in many different industries, jurisdictions and business sizes in South Africa. Not all of the deals are made public or make big news, as it is usually only the ‘big name’ deals that tend to reach the mainstream media.

This is according to Isaac Chindotana, Lireas Portfolio Manager, who says, “Taking the insurance industry, as an example, a number of mergers and acquisitions have been happening across the entire insurance value chain amongst: brokers, Underwriting Management Agencies (UMAs), and insurance companies. The past few years have seen more high profile activity in the broker sector, in some cases even extending to operations outside South Africa’s borders.”

Most role players in the short-term insurance industry are faced with uncertainty, limited organic growth and various other challenges that may be partially absorbed or overcome through a merger or acquisition. Further to this, a number of players in the market are holding large amounts of excess capital that is available for deployment, further creating appetite for such activity.

“In the deals that Lireas Holdings – as a strategic investment company for Hannover Re Group Africa - has done with its partners over the years, we have observed some of the benefits and the value unlocked through the merging or acquiring businesses. The current environment is therefore one that would encourage and in some cases necessitate mergers and acquisition.”

He says the UMAs provide specialised insurance products and services to brokers within specific lines of business, and they have also been quietly active in the past few years. “Indeed, we have been involved in a number of successful merger and acquisition deals involving UMAs, especially over the past five to 10 years. When businesses come together, it is usually as a result of voluntary and strategic moves to achieve certain business objectives.

“However, it is also not uncommon for companies to approach a suitable buyer of their business as a way to ensure their survival when faced with challenges. At the extreme end of the M&A activity spectrum, we also find businesses that have been acquired against their will in hostile takeovers.”

Chindotana says that, disregarding the risks or potential downside associated with mergers and acquisitions, the potential benefits or drivers for such deals are generally as follows:

Synergies – The potential efficiency gains achieved through sharing resources across products and increasing profit margins in the combined entity can create a major attraction for consolidation.

Growth – Mergers and acquisitions also help to improve operating scales, access to other markets, distribution channels, niche lines of business and customer bases. A number of players in the South African financial services arena have acquired businesses in lucrative emerging markets where these businesses are expected to grow faster than South Africa in coming years.

Diversification or sharpening business focus – Some organisations may choose to acquire another company in an unrelated industry to protect themselves from any downturns in their core industry’s performance. On the other hand, organisations seeking to sharpen focus often merge or acquire companies that have a similar business focus in a key area of their operations.

Response to a competitive and/or changing landscape – Organisations are sometimes better off combining forces to meet challenges that they would struggle with separately. The increasing compliance and regulatory requirements in the financial services space would encourage consolidation.

Supply chain control (vertical combinations) – A business may choose to buy one of its suppliers or distributors to achieve cost savings in its business or more closely control the chain. For example, in jurisdictions which allow this, some insurance companies have bought into brokerages in order to have control over product distribution channels.

Management of competition – M&A deals are sometimes specifically carried out to eliminate future competition or gain control of a competitor’s potential business advantage.
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With LIBERTY OWN YOUR LIFE REWARDS your clients don’t have to be in the top tier, or any tier, to get the best rewards.

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The Advantage of Knowing
Christmas crackers
Savings institute wants to curb reckless spending

In credit-hungry South Africa, where household debt is at 75.4% of disposable income and household savings level just 1.7% of GDP, the South African Savings Institute (SASI) is battling to change people’s habits. Consumers are persistently enjoined to spend wisely, and set aside a portion of their end of year earnings in order to meet both New Year requirements and future household financial demands. But this sound advice seems to fall on deaf ears.

“South Africans spend more than they earn throughout the year, and this is compounded over the Festive Season. Consumers are inundated with marketing and advertising coercing them to “enjoy the good life”, and pay homage to the God of Materialism. “People in all income brackets give in to debt just to make merry during the festive season,” says Prem Govender, Chairperson of the Savings Institute. “We must remember that while the Festive Season creates celebration pressure, this is soon followed by household financial obligations in the New Year, which people cannot avoid or delay, such as equipping children for school, getting to work, medical expenses as well as food costs.”

SASI provides financial education and relevant financial information to consumers through various campaigns throughout the year. This year’s Festive Season campaign, launched on 6th November 2013 under the theme, ‘Spend Wisely, New Year Ahead’, aims to re-focus consumers on wise spending, to guide them on how to avoid unnecessary consumption expenditure and to drive a culture of saving. Initiatives compliment ongoing campaigns by the Institute targeted at children (Teach Children to Save), university students, communities, the workforce and stokvels.

According to Govender, the steep rise in the cost of living has left little to save in 2013 and this will continue into next year. “The Consumer Financial Vulnerability Index indicates that the pressure on cash flow remains high. Yet, the celebrations will continue and many will pay for annual holiday expenses out of long term savings, annual bonuses or increased credit card debt. Gifts are bought on store-cards or through the many credit options available.

Yet, responsible spending over the season – without incurring debt – is a far healthier option for households’ long-term financial wellbeing. “We need to take heed of the message from the Finance Minister’s Medium Term Expenditure Framework, that without savings and investment, our aspirations will remain unrealised,” she says.

Govender points out that South African savings and investment rates, at below 20% of GDP, have remained low, particularly in comparison to the other BRICS countries, and the forecast for the next couple of years is not positive. According to the World Economic Forum, savings in China are at 51%, India is at 32% while South Africa is at 16.5% (Global Competitiveness Report 2012-13).

While the 2013 FinMark FinScope study does show increased penetration of savings vehicles, such as provident funds and informal savings or investment groups, long-term savings still remain a challenge. By 2012, 83% of South Africans did not have any formal retirement product; and 58% of adults admit they did not have enough money to save after covering all their spending needs.

What are the factors driving South Africa’s low savings rate?
Comments SASI CEO, Elizabeth Lwanga-Nanziri, “Our research shows that people are relying on government or their children to take care of their financial needs. And many lack knowledge and trust for savings vehicles and awareness of the appropriate options available.

“People are also concerned about where and how they should save, and resort to informal mechanisms. The big challenge is to get people, not only to open a bank account, but also to engage financially by transacting regularly and
using savings vehicles, rather than withdrawing all their money at once. The 2012 FinScope study, which shows that 34% of banked people would withdraw their full salary as soon as it is deposited, bears this out.

Recent survey results show that consumers are also turning to the financial sector to take advantage of unsecured borrowing, in part to pay for essentials such as food and paying utility and medical bills. In an environment where incomes are not increasing in tandem with households demands, this poses a threat to consumer’s welfare, especially where they are unable to service their debts in the required time.

The New Year brings new tax implications of which consumers need to be aware. "The Medium Term Expenditure Framework shows that our economy is challenged by slow growth, high unemployment and indebted households. Speaking in October 2013, Minister of Finance Pravin Gordhan stated that government expenditure substantially exceeded revenue and that South Africa's level of savings was too low to finance the investment needed," notes Lwanga-Nanziri.

"Low levels of individual saving add to the burden on government to provide retirement assistance, increasing the need to raise taxes for this purpose. A rising tax burden reduces disposable income available to save, compounded by rising inflation."

The National Treasury appointed a committee during 2013 to review tax policy, and any changes will be announced in the next budget. "While it is encouraging that the current tax reforms and policies incentivise savings and the creation of long term wealth, a potential tax increase to service the goals of the Medium Term Expenditure Framework would hit consumers hard, particularly the emerging middle class," she says.

"Limited knowledge of retirement savings and credit continue to pose a threat to accumulation of household savings. We are however, encouraged that the current tax re-
can lodge a claim involving millions of rand against you; third party cover will protect you from potentially losing everything.”

He also says it is crucial to provide accurate information during the application process and ensure you read the fine print, especially regarding the excess. “The calculations of excesses and premiums are based on several factors, including the age and risk profile of the driver. It is also important to check your policy for clauses allowing for the excess to be increased in certain events, such as the time of day that the accident occurs as well as hijackings.”

On a practical note, Vermaak says consumers should note that a policy with lower premiums may be subject to a higher excess during a claim phase. “It might therefore be useful to consider taking out a slightly higher premium with a lower excess, which may benefit you in the long run.”

He notes the insurance industry has also developed value added products to fill certain risk gaps and help consumers according to their unique needs. “These products include credit protection policies, which cover debts that you may have at the time of your death, permanent or temporary disability, retrenchment or dread disease. There are a number of variations on this type of insurance product, so getting advice from an accredited financial adviser is recommended.”

Other types of insurance will protect you in the event of a total loss, or offer you protection from the effects of vehicle depreciation. “So, for example, if your car is insured for its market value, that value might be less than the outstanding amount on your finance agreement. In such a case, in the event of an accident, you will have a shortfall with your financier after the insurance has paid out. To avoid this, you can take out a policy that covers you for such a shortfall.”

He adds that when buying a used car, if it doesn’t come with a factory warranty, or a service or maintenance plan, you can buy one from your finance company or dealer to give you added peace of mind. “Warranties cover mechanical breakdown only. A car service plan pays for the service of certain items, as recommended by the manufacturer in their service schedules, whereas a car maintenance plan provides you with cover for scheduled services, plus a range of specified wear-and-tear parts and labour costs.”

“It may seem like an inconvenient expense, but adequate insurance can save you from financial disaster if you are involved in an accident or your vehicle is stolen,” concludes Vermaak.

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**TRAVEL INSURANCE**

**Don’t trip up**

**Eight tips from Regent Insurance**

WHEN YOU ARE about to go on holiday the last thing you tend to think about is something going wrong. You leave behind everything that is familiar to you, your home, parents, loved ones and doctors. Will you be able to afford to pay for those unexpected expenses? Taking out travel insurance can protect you against the risks associated with globe-trotting, being away from home and unexpected health issues; and, provide you with peace of mind when on holiday.

However, travellers are often not fully aware of what is, or is not, covered by their policy, or spend more than they should.

Here are eight tips from Regent Insurance Travel and Personal Accident Manager, Louise Cockcroft, that will help you make informed decisions when it comes to taking out travel insurance that help you avoid common travel insurance pitfalls.

1. **Compare broker prices with those offered by a travel agency or airline.**
   - The premiums charged on a policy sold by a travel agent or airline should be the same as those charged by a broker as they are selling exactly the same products. However, it is not a bad idea to check this in any case.

2. **Don’t be hasty when it comes to choosing your excess.**
   - You need to make sure you balance the cost of a policy and the level of excess it will require you to pay in the event of a claim. A relatively ‘cheap’ policy could mean a large excess; there again, a more expensive policy, although it may demand lower excess, might not be worthwhile.

3. **The automatic travel cover provided when you charge a flight to your credit card might not be enough.**
   - This type of cover will only often provide for emergency medical expenses, excludes pre-existing medical conditions and may not cover travel inconveniences like baggage loss, travel delays or cancellations. Make sure you read what is covered by your credit card and whether you need to buy any add-ons to make sure you are fully insured for your holiday.

4. **Don’t duplicate your cover unnecessarily.**
   - Always look to see what is covered under your home insurance or credit card insurance policies so that you don’t insure certain possessions twice. Travel insurance policies have single item limits and therefore more expensive items would better covered under an All Risk policy.

5. **Frequent travellers may want to consider annual cover.**
   - If you travel several times in a year, annual cover is well worth your consideration. Performing a simple price comparison between, say, three single trip policies and one that has you covered for the entire year could result in some worthwhile cost savings.

6. **Going on an ‘adventure’ holiday? Make sure your thrills are covered.**
   - Even if you are planning to take a few risks on your holiday, don’t do the same with your insurance. Read the fine print of your policy and make sure the activities you intend to partake in are covered. Oftentimes activities like skiing, diving or mountain climbing will be excluded and require additional cover.

7. **Make sure the country you are visiting is covered in your policy.**
   - Some regional or worldwide policies may exclude some countries that you
About Regent Insurance

Regent offers a wide choice of innovative, tailored insurance solutions to the South African market. The Regent Group is part of the Imperial family. Imperial is a diversified multinational mobility group with activities that include motor vehicles and related operations across all modes of transport for people and freight, both locally and abroad. As part of this diversified group, the Regent culture is based on entrepreneurship, innovation and an adherence to industry-specific best practices that characterise the way Imperial does business. The Regent Group has become a model of best practices that characterise the way Imperial does business. The Regent Group has become a well-known specialist and market leader in its chosen markets and an exceptional range of short-term insurance and life assurance products are available under one Regent brand, offering a one-stop-shop. Regent operates in South Africa, Botswana and Lesotho.

Points of piracy

Price breakdown of a music CD

<table>
<thead>
<tr>
<th>CDs - who gets what</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Record Company</td>
<td>30.0%</td>
</tr>
<tr>
<td>Retailer</td>
<td>17.0%</td>
</tr>
<tr>
<td>Artist</td>
<td>13.0%</td>
</tr>
<tr>
<td>Manufacturer</td>
<td>9.0%</td>
</tr>
<tr>
<td>Distribution</td>
<td>8.0%</td>
</tr>
<tr>
<td>Copyright</td>
<td>6.0%</td>
</tr>
<tr>
<td>VAT</td>
<td>17.0%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100.0%</strong></td>
</tr>
</tbody>
</table>

As a whole, artists are perennially unhappy about their earnings from contracts with record companies, realising the bigger bands gradually escape their clutches. Indeed, album sales are just one way that artists make money. Much of the profits they make today come from touring. They can also make money from airplay. Meanwhile, there is a huge migration toward legitimate digital download with companies marketing that way increasingly agreeing to a 50/50 split with artists.

The music industry will never rid itself of piracy and, oddly enough, some artists have been quoted as suggesting it is an advantage up to a point. Indeed, some groups have issued selected music for free download as part of their marketing. The music is spread around a lot more, and this free marketing is a powerful driver of consumer interest in attending tours.

How much legitimate purchases would increase if there was no piracy is also debatable. Put another way, how much would the industry benefit by re-placeing 1 000 illegal downloads with legitimate CD sales: say, ten units? How much marketing would that lose? It has also been said that a consumer would still buy a 'really good CD', even if it could be downloaded illegally. The reality is that a vast number of albums are not of consistent musical quality with two or three tracks at best worth listening to. The consumer knows this, and has had much experience in disappointment after being lured by airplay of the best tracks.

The piracy that really costs the industry lost revenue would largely go away if it modernised its distribution and pricing structures, reduced bloated administration and management, improved the percentage paid to artists, and allowed consumers more freedom to sample music prior to deciding on a purchase.

CRIME

The life and short times of economic downturn

Insurance fraud up in 2012

About 70% of people committing insurance fraud were driven by desperate circumstances, including losing their jobs and loss of income to protracted strikes. This is according to the deputy chief executive of the Association for Savings and Investment SA (Asisa), Peter Dempsey.

Latest statistics reveal that the life assurance industry expects R669.9 million in fraudulent and dishonest insurance claims last year (up R70.2m on 2011). The number of claims rose by 157 to 5 466.

“Even if it is misrepresentation or non-disclosure of information, people are aware they are committing fraud.” Dempsey points out.

Asisa’s figures, which cover the life assurance sector, reflect worsening economic conditions, such as depressed households’ disposable income. Asisa said the majority of fraudulent claims detected last year were ‘soft fraud’, involving misrepresentation and material non-disclosure rather than criminal intent. Such claims increased to 4 939 in 2012 from 4 675 in 2011. The number of claims rose by 157 to 5 466.

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You aim to offer your clients peace of mind against life’s risks. No easy task, given the range of what life can throw at us. We can help to avoid the shortcomings in your client’s risk cover. It’s called Living Protector from Sanlam and it combines disability, impairment, dread disease, retrenchment and loss of income protection. You can also add additional benefits to suit each client’s specific needs. Consider Living Protector. It not only offers peace of mind, but can cost your client up to 30% less.
3 A fast growing market with clients for the long run.

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When opportunity knocks, open the door and let it in. It’s with this thinking that we developed Sanlam for Graduates, allowing us and you to tap into a market that has doubled in recent years. With the Sanlam for Graduates portfolio of solutions, people with a 3-year degree or 4-year diploma qualify for the Sanlam Sickness Benefit. This is a major addition to what Sanlam already offers graduates: accident cover, life cover, income protection, dread disease cover and disability cover, as well as the Cumulus Echo Retirement Annuity.

For more information go to sanlam.co.za/intermediary
were not their own to a funeral policy, while non-disclosure of material information included people hiding their medical history, state of health, family history, lifestyle or financial status, for example.

Short-term insurers have also seen a rise in fraudulent claims. Santam says that insurance fraud in the short-term insurance industry cost about R4 billion a year. But not all the attempted criminal activity here involved ‘soft fraud’. Indeed, many people seemed to commit fraud to “get back at the short term insurance companies.” Grievances, such as past claims repudiations or reduction in payments for losses could be sighted as some of the reasons.

Misrepresentation in this sector included exaggeration of the value of items to be replaced. Non-disclosure of material information was also a problem, such as when a learner driver was driving the insured vehicle at the time of the accident, but the insured substitutes the person involved for a more experienced, older licenced driver.

Santam’s head of audit and forensics, Helen du Toit, adds that what is worrying is the increase in commercial crime.

Hollard’s foray into Namibia followed on the group’s successful venture into Mozambique, where the local operation had been able to fund its own new life licence only four years after being established. The Namibian venture saw the company adapt the business model to suit local conditions, taking into account the population density and distances between towns.

A branch network has ensured better service delivery in the various regions, but this represented a deviation from Hollard’s South African model, which entailed operating on a centralised basis. The company’s eight regional branches make it the most broadly represented short-term insurer in Namibia.

Barnard says that his team is “passionately Namibian” and dedicated to decision-making in the interests of their country. “Everyone is committed to being good corporate citizens; paying the required taxes and levies in Namibia; employing local people and being active in community work. All this would be difficult if you had a foreign head office, trying to extract as much value as it could,” he says.

One community initiative of which Hollard Insurance Namibia is particularly proud is the Amos Meerkat School project – a rural farm school scheme that trains illiterate and semi-literate mothers to teach farm workers’ children to become school-ready. Barnard says that in the first year 48 teachers attended the training, and 40 schools were established on farms by a 10-women strong team of dedicated past teachers.

Other social investments have in-
Reducing the TCF burden

New tool for Sanlam’s financial advisers

Technology is changing the face of the financial services industry. Regulatory changes over the past few years have resulted in markedly increased administrative processes to ensure compliance, and technological advances are forming a critical path of creating an enabling business environment for intermediaries.

Jaco Coetzee, general manager at Sanlam Financial Advisers, says in response to the increased administrative burden faced by intermediaries, the company is introducing web-based technology that will lead to time and cost savings for financial advisers. It will also allow them to manage client relationships when the ‘Treating Customer Fairly’ (TCF) framework arrives the beginning of 2014.

He says the SanFin solution will see everything, from client risk tolerance assessment, initial needs analysis and recommendations, to provision and recording of advice, done electronically.

The product spans the entire financial adviser-to-client consultation process and allows for effective client management. It combines financial planning advice tools, investment portfolio construction tools and back-office tools, in an integrated package. Clients will be able to get the same quality advice but much quicker. The technology will also reduce the possibility of error and will help clients understand the advice they are being given through the use of clear explanations and graphs instead of pages of numbers.

Coetzee says Sanlam applied considerable rigour to the process of developing the financial adviser software. “After seeing the substantial increase in paperwork brought about by regulatory and compliance changes in 2004, we knew we had to get to the bottom of the technology needs of financial advisers and equip them to continue to work efficiently, while complying with requirements.”

In particular, the technology will help advisers adhere to the TCF framework. “The regulations require advisers to make good on their service-level agreements with clients, including regular follow-ups. Where back-office support and client administration take place manually, there is the potential for error, which can be very costly. Within this context, the new technology will prove to be invaluable.”

Coetzee adds that the costs of providing financial advice have led to increasing neglect of lower growth markets. “Intermediaries can’t afford to go through all the paperwork if the client can’t afford the products or fees to support this expense. We’ve seen the same thing happening in the UK. The more expensive it becomes for intermediaries to render advice, the more they are forced to up their market. With technology that can speed up the advice process and make it more cost-effective, more people across the economic spectrum will be able to access quality financial advice.”

He says SanFin offers a comprehensive set of solutions focusing not only on client administration and needs analyses, but also additional integrated software currently available to advisers as stand-alone tools. “It will, in short, be a ‘one-stop shop’ for our advisers. There will also be partial offline functionality which can be synchronised online afterwards.”

The SanFin technology should improve the client service rendered by the back offices of Sanlam’s BlueStar businesses, initiated in 2008 to empower financial advisers to build their own, independent financial services ventures, while still operating under the Sanlam brand. “The advisers in our BlueStar businesses could previously not share clients, but with SanFin they will be able to do so, since they will have access to the same central database. This will result in a much more professional service by Blue Star businesses.”

SanFin is currently being piloted by groups of Sanlam financial advisers and will thereafter be rolled out in phases to all advisers over a period of six months. For Sanlam supporting brokers, SanFin will not be compulsory. “We believe it will involve them, however, and make a huge contribution towards making advisers’ systems and processes much easier – moving towards what we hope will eventually become a 90% paperless industry.”

The features of the new SanFin technological solution include:

- Consolidating fragmented tools, bringing all investment tools into one space;
- A new risk tolerance questionnaire that is easier for clients to understand and complete;
- An online database enabling better sharing of data;
- Easy access to data through laptops and tablets;
- Fewer manual processes – reducing the need for paperwork; and,
- Efficient data mining and customised searches.

Missing the obvious

One way to solve road licencing fraud

During a recent performance review of one of our less-qualified staff members, we asked him whether he had attained the driver’s licence he said he was aiming to get the year before. To get the license would have involved writing his learner’s licence, completing driving lessons and successfully passing the driving test — something that could be reasonably attained within six to twelve months.

When asked if he had managed to...
complete his licence as intended, he confirmed that he had. We enquired as to when his licence had been issued and he proudly told us, “On the 16th of June last year.” The game was clear – considering that June 16 is Youth Day and a public holiday. The licence had obviously been bought.

This incident brought the issues that HCV perennially fights against, very close to home. In our business we are acutely aware of the flaws in the licencing system, corruption in the roadworthy centres, the general failure of the eNatis system and the problem of job creation in the transport sector. In the current situation, considering how easy it is for people to just pay a “fee” to obtain the necessary documents, all administrative processes such as roadworthiness and licencing are essentially “punishing” those who dutifully pay the applicable fees, book the relevant tests and complete the correct processes. Yet it is an “easy” process to follow – one in which the person who ends up bearing the brunt of the carnage on our roads and the R157 billion in road accidents that happen every year (according to the AA).

It is also becoming apparent that government is both unwilling and unable to address such issues. “But, I have a few ideas – and they all start with training,” says Chris Barry Managing Director Heavy Commercial Vehicle Underwriting Managers.

Allow me to set the scene: In SA there are 398 licencing centres and 273 roadworthiness centres. Taking some ‘cigarette box’ numbers (since the numbers are not easy to find) for the transport sector, amongst the big listed truck and motor groups, there are over 20 000 trucks, over 500 dealerships, over 200 000 employees and revenue of over R200 billion.

If training was provided to one out of 10 employees and government chipped in a double deduction training allowance, it would be a win-win situation. The employer would receive a four-year tax write-off benefit, which essentially brings a new employee into the tax base for an average career-span of 40 years. This means a training program of four years can essentially create a taxpayer for forty. I fail to understand why this kind of thing hasn’t been exploited before.

“If we stick with the figure of one trainee driver in ten, it would equate to 2 000 newly trained drivers each year,” Barry continues. “If trainee truck drivers earn a R10 000 a month, it would mean that on an annual basis it would equate to R240 million – which the large motor groups would get as a tax deduction. This is the equivalent of 0.12% of the turnover of those groups.”

Let’s consider another example. If each of the 500 dealerships have ten mechanics and one apprentice, again at an average salary of R10 000, that would be R60 million per annum. That figure could, again, be totally tax deductible and represents just 0.03% of the total revenue base.

“Lastly, consider my minimum estimation of 500 dealerships in the country, and 273 roadworthiness centres – this translates to a ratio of two dealerships to each roadworthiness centre.” If the dealerships could take over the RWC’s and run them as proper businesses, with profit margins, best practice and trained employees, it would solve the problem of corruption, improve standards and make it significantly more difficult to simply “buy” a roadworthiness certificate.

“Our government waxes lyrical about the importance of public and private participation. In practice, the most obvious ones in the transport industry are being missed,” Barry points out.

**INSURANCE INDUSTRY**

**Deloitte on market**

Insuring the uninsured’ a major challenge

The increasingly competitive insurance sector in South Africa may regard the virtually untapped lower earning segments of the market as a growth area. Yet, a great deal has to be achieved before corporate ambitions in these sectors can bear fruit.

“Traditionally, lower income earners have concentrated on funeral and life assurance and the benefits conferred by these policies. Driving this market are social responsibility belief systems that emphasise the importance of meeting the financial commitments of a funeral/ burial ceremony,” says Yusresh Maharaj - Assurance Industry Leader at Deloitte.

“Stokvels, the other predominant savings mechanism, have in some instances become virtual insurance companies’ by allowing people of similar socio-economic levels to contribute money to group saving schemes. Many of these have set agreed criteria for the utilisation of the cash generated, so that future costs such as burials and education can be met. These mechanisms function effectively because they are part of a community structure and peer pressure ensures that all members meet their financial obligations,” he says.

To enter this market at base level will require insurance companies to build their profiles through market education. To move beyond the base level, companies will have to meet the challenges of broadening the level of acceptance and trust in the market.

“Effectively, this will require changing the public perspective of insurers, and entail revisiting the products that are offered and packaging them at a low cost. New solutions for the challenges of these internal processes and distribution channels will need to be sought.”

High visibility within communities where ‘risk-type’ products are seen to be relevant will also be required. Funeral and life cover could be considered as a ‘lead’ product in marketing efforts to build market share. An insurer would also have to consider that in many families there is a dependence on a single breadwinner and income protection products also have a role in this market.

“Affordability and specific needs are therefore primary touch points with potential policyholders. "It would seem to be logical that a specially devised 'income protector' policy, that would cover loss of employment and temporary or permanent disability, would be an entry point to the market. The reality is that the type of products that can be sold into this market are limited by prevailing socio-economic factors,” says Maharaj.

He adds that traditional short-term products, such as vehicle insurance and household contents and cover policies would gain no traction in segments where privately-owned vehicles and housing are currently at low levels.

“Although the market has embraced funeral policies and is accessing them via mobile or telephonic contact, the move into new segments will entail education and explanations. People will Please continue on page 18......
We’ve got great relationships with our partners. Kind of like those annoyingly lovey-dovey couples who finish one another’s sentences.

Yup, in the world of insurance partnerships, we’re Those People.

To all our underwriting managers, brokers and distribution partners - no matter how long we’ve been partners with you, we’re still completely smitten.
have to understand the conditions of the 'investment'. This means having the implications of acquisition costs, exclusions and durations of policies being personally explained.

“For major insurers and banks providing 'bancassurance' services, as part of a suite of products, this is almost counter-intuitive in a market where mechanised and digital delivery is a major strategic objective and is essential in reducing the costs of traditional brick-and-mortar financial services. Direct marketing and delivery is therefore key in delivering low cost, high volume products,” explains Andre Rousseau - Insurance Industry Leader at Deloitte Consulting.

In conjunction with these requirements, legislation must also be considered. Micro-insurance legislation demands that products must be low-cost alternatives with low entry barriers.

“Needs analysis, lower costs and a viable choice of products will be requisites if commercial and legislative demands are to be met. Without education, understanding and trust, however, the industry’s ambitions of ‘insuring the uninsured’ could remain elusive,” says Rousseau.

**ESTATE AND WILLS**

**Ahead of time**

**Age of majority – a real problem for beneficiary funds**

A **KEY PLAYER** in the beneficiary fund industry has called on government to reverse the age of majority from 18 back to 21 as an exemption for this fast-growing financial services sector. The age of majority was changed to 18 by the Children’s Act of 2007.

Talking at a trustee roadshow recently, Richard Krepelka, CEO of Fairheads Benefit Services, says, “It is not uncommon for beneficiary fund service providers to pay out R100 000 or more on the termination of an account when the fund member turns 18. Yet the reality of social and educational circumstances means that the average 18-year-old in South Africa is not financially mature enough to invest or use large sums of money responsibly.”

Beneficiary funds and their umbrella trust predecessor vehicle manage approximately R19 billion of assets on behalf of orphans or single-parent children. They receive lump sum death benefit pay-outs from retirement funds in terms of section 37C of the Pension Funds Act. Accounts are set up in an umbrella beneficiary fund which pays out an income to beneficiaries usually their guardians, as well as capital amounts for expenses such as school fees. Once the beneficiary turns 18, they are entitled to the remaining funds.
According to Krepelka, “Exacerbating the problem, only 50% of 18 year olds are in matric, the rest are in lower grades, or have dropped out of school altogether. This leads to a very low literacy level, and an even lower financial literacy level.”

“At Fairheads we make a point of counselling beneficiaries before termination payments are made to advise them to leave the money invested in the beneficiary fund until they complete their education, but most of them opt to have the money paid out.

“This leads to more youngsters being insufficiently educated and dropping out of school, and therefore becoming unemployable, which perpetuates an already unacceptable employment rate. This is contrary to a key objective of a beneficiary fund which is to ensure children get sufficient education to be self-sufficient in society and the economy,” he says.

Fairheads has met with over 5 000 guardians and caregivers during an educational national roadshow this year. The age of majority is regarded as an issue by most of those consulted. Since 2011, Fairheads has been lobbying for the Pension Funds Act to be amended to allow minors benefits to be managed until age 21, so that they can at least complete their secondary education. Krepelka says Fairheads has made proposals to the FSB and National Treasury which have been met favourably. He called on other industry stakeholders to support the lobbying initiative.

Beneficiary funds

Beneficiary funds are aligned with the Pension Funds Act and are designed to receive lump-sum death benefit payments in terms of section 37c of that act. Upon the death of a retirement fund member, the trustees identify the dependants and use their discretion whether to pay the money into a beneficiary fund, administer it within the retirement fund or pay it directly to the guardian. They are guided in this complex decision process by service providers such as Fairheads, which has developed tools such as a guardian assessment process to assess whether a guardian is financially literate and capable of investing and administering minors’ assets for their benefit.

Once in a beneficiary fund, the trusteeship of the assets passes to the board of the beneficiary fund. Beneficiary funds are structured similarly to retirement funds. They offer greater protection for minors as they are regulated by the Pension Funds Act and all stakeholders have recourse to the Pension Funds Adjudicator; there are strict corporate governance requirements; and investments are prudentially managed in line with regulation 29.

Investment strategy

In line with best practice, Fairheads out-sources the investment of beneficiary funds to a number of leading investment houses. The investment strategy for a beneficiary fund is distinctly different from that of a retirement fund. Individual members of a beneficiary fund have very different needs and this requires an asset allocation matrix for each category of members. Essentially this is a type of life-stage investment model, but determined by the trustees in consultation with asset consultants. For example, a one-year old member will have very different needs from a 16-year old member in high school and therefore would fit into a separate asset allocation matrix (similar to a life-stage in a retirement fund.)

Legal flaws

Bond call ups get out of hand

EVIDENTLY THERE IS a call for legislation to prevent “unfair performance bond call-ups” in the construction sector. Recent statistics released by Performance and Customs Bond Services (PCBS), a specialist guarantee construction Underwriting Management Agency, indicate there has been a massive increase in on-demand bond call-ups since 2009.

An on-demand bond is an unconditional bond or bank guarantee as secu-
islated, Changamire says that within the local construction sector it is left solely to employers to make a judgment as to when to make a call on a bond. "In many instances call-ups are orchestrated where employers withhold from contractors, forcing them to call-up the guarantee. And as there are no conditions specified on the guarantee, the banks and insurers are forced to pay out. These withholdings filter down from the main contractors to the sub-contractors and as a result the sub-contractors non-perform due to non-payment. So in effect the entire process falls apart.”

On-demand guarantees are currently required by most employers to secure local contract work. Changamire says this leaves the smaller contractors, who are currently scrambling for jobs in the slow and fiercely competitive sector, powerless to negotiate on the terms of the contract.

"Ideally all relevant stakeholders — Joint Building Contracts Committee, Master Builders South Africa, and National Home Builder Registration Council, together with legislators — need to sit down and draw up legislation that allows insurers the opportunity to defend or avoid pay out where it is deemed as fraudulent, unfair, unjustified, or when there is an element of illegality in the underlying contract.

“Only through concrete legislation will the 'sacred cow' mentality currently surrounding on-demand guarantees be dissipated. It's critical that legislation be implemented that promotes transparency and looks beyond the contract and considers the cause of non-performance. Without it, all stakeholders in the sector will continue paying the price.”

INVESTMENT STRATEGY — 1

Gauging the ‘perfect’ break or storm

Opportunities are developing for the observant client

DURING THE LAST 10 years, we have often heard the phrase, "the Perfect Storm" applied to periods when both equity markets and interest rates fall. This is extremely problematic for investors for the following reasons:

➤ The investor has less capital because of the fall in equity markets (assuming that the client is invested in equities or a balanced portfolio)

➤ The investor's ability to fund liabilities decreases because of the fall in interest rates (assuming that the client has future obligations or cash flows linked to interest rates).

"While many investors have faced this challenge over the past years, indications are that the situation is changing completely, and opportunities are opening for investors who are aware of how the market is behaving," says Omigsa.

From the Perfect Storm to the Perfect Break

In snooker, the perfect break occurs when a single player consecutively pots all the balls on the table in a particular sequence to score the highest possible score. It is a rare feat and in professional tournaments there is usually a substantial prize for any player achieving such a break.

In the financial sense, the “Perfect Break” is the exact opposite of the Perfect Storm and refers to a period when both equity markets and interest rates rise.

Between the beginning of May 2013 and the end of August 2013, the All Share Index (ALSI) increased from a level of 34 364 to a level of 37 864 (refer to the right-hand vertical axis) – an increase of more than 10%.

Over the same period, long-dated inflation linked bond rates have increased from 1.9% to over 2.59% (refer to the left-hand vertical axis) – an increase of 0.69%. This implies a reduction of over 10% in the cost of purchasing protection on an investor's inflation-linked cash flows (assuming the cash flows have a duration of 15 years).

So what does this mean for investors?

Investors who recognise the signs and realise that the market is in a Perfect Break need to decide if the opportunity justifies the risk. Their decision will depend on a number of factors, including:

➤ The investor's objectives: If, for example, the client's objective is to pay pensions equal to 100% of inflation, then de-risking may be an appropriate solution.

➤ The risk appetite of the investor: If
his objective is to pay pensions equal to 100% of inflation and has a high risk appetite, then the client could retain his mismatched position in search of higher than inflationary increases or a further improvement in its funding position.

The investor’s time horizon: if the client has a short time horizon, he could use this as an opportunity to lock in the surplus generated over the period.

As with snooker, the Perfect Break is rare. Investors therefore need to be realistic and appreciate that the market can move out of a Perfect Break suddenly and unexpectedly. However, by closely monitoring its assets and liabilities, both institutional and retail investors can take advantage of the Perfect Break and achieve the prize of meeting their investment objectives. By Craig Aitchison, GM Corporate Customer Solutions Old Mutual Corporate and Trevor Abromowitz Head: Institutional Business (Liability Driven Investments) at Omigsa

INVESTMENT STRATEGY — 2

Tick the box

A simple checklist for domestic asset allocation

Michael J Mauboussin of Allan Gray said he recently read a fascinating book: ‘The Success Equation: Untangling luck in Business, Sports and Investing’, which explores, how much of one’s success or failure can be attributed to luck as opposed to skill (leading to much reflection).

Investing, as the author points out, by its very nature involves a fair amount of luck compared to other activities, which are less probabilistic. "For example, if I had to race Usain Bolt over 100m he would beat me 100% of the time, whereas if we both picked stocks he would have a relatively higher success rate than my zero."

The one story in the book that really stuck with me was the potential importance of checklists and how a simple checklist proposed by a specialist at Johns Hopkins Hospital, significantly reduced fatalities from infection during surgery in the US, despite initial opposition from surgeons.

A simple checklist for thinking about the appropriate weighting to local equities may look something like the table.

The justification for the placing of the ticks:
1. The FTSE/JSE All Share Index (ALSI) in inflation-adjusted (real) terms is far from depressed and is trading well above its long-term trend line. This is very different from 2003 or in the late 1970s when the market had gone nowhere for years.

   Over the last decade equities have returned 2.9x more than cash, whereas in the previous decade (1993 to 2003), equities underperformed cash.

2. The ALSI’s current price to earnings ratio (PE) is 16.9, versus its long-term average of 12. The PE rises close to 20 when using a more sustainable level of earnings. "Even if we ignore earnings and use a price to net asset value (NAV) measure," he explains, "the current ratio is 2.6, versus a long-term average of 2.1x."

3. Aggregate real earnings for stocks listed on the ALSI are at elevated levels and well above their own long-term trend.

4. Significant disparity in the market allows investors to allocate a high percentage to equities even if the overall market is expensive, as there are enough cheap shares to build the position. "For example, in 2002, even though we believed the market was expensive, we had a high equity weighting as local industrial and consumer shares were exceptionally cheap. Today we have less conviction despite the large underperformance of mining shares."

So the tick goes in the middle.

5. Interest rates on local cash are below the level of inflation i.e. real interest rates are negative. This presents a dilemma for savers, but does it mean you have to buy shares as is argued by many investment commentators? “It would appear to make intuitive sense, but history suggests it is wrong.”

The accompanying graph is a scatter plot diagram highlighting the sub-
Drugs of choice
Finding Value in European Healthcare

Despite a dramatic re-rating in valuations over the past several years, we have continued to find value in Europe, especially among pharmaceutical and healthcare firms. Healthcare, which includes pharmaceuticals, medical devices and biotechnology, was recently one of the largest sector overweights among our strategies.

Says Peter Wilmshurst, Executive Vice President & Portfolio Manager, Templeton Global Equity Group, “As we are bottom-up stock pickers, the overweight position in the healthcare sector has developed over time through a combination of our finding what we view as attractive stocks and the performance of the strategies’ portfolios since the end of 2009, rather than by a tactical or thematic decision. Since early 2009, shares of many of our European pharmaceuticals holdings have more than doubled in value, including dividends, due to a significant rerating of the price-earnings ratios from depressed levels.

“...Since early 2009, shares of many of our European pharmaceuticals holdings have more than doubled in value...”

“In our view, the sector still does not look expensive, and we continue to see value. For example, we have been seeing improving signs of pipeline productivity. Back in 2009, Research and Development (R&D) productivity was on the decline, with many companies investing significant amounts to research new drugs, only to see them fail. We saw a very long period of relatively few drugs coming to market, and those that did struggled to gain market share as they were largely undifferentiated from incumbent products.”

Over the past decade, many companies addressed the problem of diminishing R&D productivity, and we are beginning to see the organisational and strategic changes bear fruit. Many firms acknowledged that they were failing in this important function and made dramatic changes to their operations. Firms have been trying to return to a more scientific approach by splitting R&D into areas of specific scientific focus and engaging with the academic, medical and biotech communities rather than taking an “industrialised” view of the development process, which, in our view, had been a significant problem.

“Most importantly,” Wilmshurst adds, “many R&D groups shifted their focus to biologic and specialty products that targeted diseases with unmet medical need instead of simply developing their own versions of previously successful products. Largely as a result, companies are now realizing much higher probabilities of clinical success, less-competitive markets and stronger pricing power, even in Europe where pricing historically has been a headwind.”

In our view, he says the regulatory backdrop is becoming much more favourable, especially in the US market. We are seeing a greater level of beneficial interaction between industry and the US Food and Drug Administration in terms of the design of clinical trials and agreements on relevant data. These factors have, in our view, led to an increase in the probability that any single new product will be successful. We find the potential for volume growth, especially in emerging markets, to be another reason for optimism, even in the face of increasing, pricing pressures.

Many major European pharmaceuticals companies were the first to invest, and heavily, in emerging markets.

“The volume opportunity in emerging markets from rising Gross Domestic Product (GDP) and ageing populations is so significant that it is, in our view, likely to outweigh the cost consciousness of governments, which are the largest consumers (as payers) of healthcare,” comments Wilmshurst.

“We believe volume growth is likely to increase as healthcare spending growth has historically outpaced GDP growth, often by significant margins. Additionally, many governments, especially those of China and until recently, Latin America, have been committed to building out their healthcare infrastructure.

“Goverment influence and cost containment in emerging markets is a risk factor to consider, but we still believe that the volume opportunity is likely to outweigh those concerns and be a long-term, secular tailwind for growth for many European pharmaceutical companies.”

Wilmshurst is encouraged by the prospects for growth in European markets. In Europe, governments are the sole payers, and austerity programmes have resulted in an aggressive pursuit of pricing concessions from the pharmaceuticals industry.”

In the United States, private insurers are still tolerating significant annual price increases, but in Europe, we have been seeing significant price cuts as well as a robust review process to ensure that any new drugs brought to market offer a compelling value proposition relative to current, competing therapies. However, if an innovative new treatment demonstrates such a value proposition, even the austerity-conscious European market is willing to allow pricing that, in our view, yields a favourable return on investment.

The US market is the most profitable market for pharmaceuticals and the healthcare sector in general, due primarily to the pricing power that many firms enjoy in dealing with private insurers and Medicare. Medicare, by law, cannot directly negotiate prices with pharmaceuticals companies, and we do not expect that to change in the near future.

Additionally, while private payers are attempting to implement more sophisticated business models to reduce healthcare costs, until the fragmented insurance industry consolidates, which we believe is many years away, we do not anticipate any significant change,” says Wilmshurst.

“We are the re-ratings for many pharmaceuticals companies, we still think that, on a long-term basis, valuations for European pharmaceuticals firms offer a favourable risk-reward proposition.”
Expensive folly
Why passive management is better than active

National Treasury’s discussion paper, ‘Charges in South African retirement funds’, has caused waves in the retirement fund management industry. One of the statements in particular that seems to have touched a raw nerve reads: “Over the long term, in efficient markets, passive management is not demonstrably inferior to active management, and it is significantly cheaper.”

“This statement,” says Steven Nathan, Chief Executive of IX Investments, “has rekindled the active versus passive investment debate. However, it is rather a shouting match, because there can be no debate around a mathematical certainty.”

The bottom line is: investing is a zero sum game. The total excess (above average) market return (alpha) available to all investors is exactly zero. That holds true for every asset class in every market. It does not matter how efficient those markets are, or how small, or how concentrated – the aggregate alpha available to all investors is always zero. Let me repeat this crucial fact. Investors are paying billions of rands each year to fund managers who in aggregate can deliver zero in return. While some investors do earn an above-average return, they do this only at the expense of others earning a below-average return. “Collectively, they all pursue something that does not exist. It is an expensive folly as both winners and losers forfeit their stake, paid by way of higher active management fees. As a group, these investors go home with less than zero.” So do the passive investors, of course. However, because they have abandoned the quest for alpha and simply pursue the market return at low cost, their forfeit is lower. They pocket a higher average return.

In the words of Charles Ellis, ‘they win the losers’ game.’ That said, it is a game worth winning: every 1% per annum fee saving over a forty-year savings terms improves the real (after-inflation) savings outcome by 30%.

When average is above-average

“Yes, but who wants to be average?” protests the industry, suggesting that paying the higher fees begets a higher return. In hindsight, most investors would gladly settle for ‘average’, says Nathan Empirically, the great majority of fund managers underperform their benchmarks, after adjusting for fees and survivorship. “In addition to this, it is impossible to predict who will outperform. Certainly, no fund manager has yet guaranteed to do so. Index funds produce superior returns against most active funds after fees.”

Unfortunately, Treasury has done itself a disservice by referring to ‘efficient markets’ in its endorsement of passive investing. It gives active managers an angle to discredit it.

Recently, a large industry player cautioned against passive investing, highlighting that National Treasury puts great store on the validity of the efficient market hypothesis, in spite of it being largely discredited during the recent financial crises. “There is a delicious irony in this view,” notes Nathan. “Of course, it sounds compelling, that financial markets have price flaws and that active managers can exploit these. It implies that the market is a separate, sometimes irrational being, apart from investors. However, active investors are the market. It is they who trade against each other and who ‘discover’ prices, sometimes at irrationally high or low levels. If markets are inefficient, it is active investors who make it so. Why back more of the same?”

Most active managers believe they are smarter than all the others, arguing that “mistakes are made, but not by us”. That could be true if they alone traded against a thousand hapless day-traders. In reality, fund managers trade amongst themselves, including their own colleagues who run competing funds for the same investment manager, and the factors driving outperformance – skill and luck – tend to be quite evenly distributed across the industry.

He says many market bubbles have burst over the last ten years – the ideal time for active managers to prove their stock picking and market timing skills. Yet the majority lagged their indexing peers. This failure was inevitable, because the zero-sum rule applies at all times. Securities do not materialise in and out of cash. Every trade has a counter party; for every investor selling at the top, another buys at the top. With hindsight, perhaps the biggest bubble to burst was the idea that active managers protect investors from bad markets.

A common message active managers try to instill in the minds of investors is that passive managers believe that the market is efficient and therefore one cannot beat the market. “ Passive managers believe nothing of the sort.” Of course, some managers will beat the market, even over the long term. For them, the critical question is not whether markets are efficient or not, but whether investors should expect to exploit any inefficiency. Every independent study says ‘no’.

If you can’t beat them, scare them. “The industry insiders know this,” says Nathan. “Which is why their arguments don’t appeal to the real issue which is not to fear. After arguing that markets are inefficient already, active managers will shamelessly claim it is passive investing that would make markets (more) inefficient. In their post-active world, capital will become misallocated, Initial Public Offerings mispriced and small companies marginalised; liquidity will fall and volatility will rise. Lower economic growth and investor returns must follow.”

However, in the United States, where passive investing was once labelled as un-American, some 40% of all equity investments are now managed passively. “Their markets remain more or less efficient and impossible for most active managers to beat.”

In a fear-mongering hellbent to depict from the real issue which is, in the words of National Treasury, to: assist South Africans in getting the best possible value for the retirement savings they make.”

Retirement investing should give investors the optimal return at the lowest risk. It should not be about chasing the (low) possibility of earning an above-average return; it should be about avoiding the (high) probability of earning a below-average return. If passive management delivers similar, if not superior, returns to active management, it makes sense to follow this route, simply to avoid the downside risk.

The fact that passive is then also much cheaper turns a persuasive argument into a scientific one.

“Yet, active management does have a place, but not in retirement investing. There are many investors with sufficient spare (i.e. non-retirement) funds willing to speculate on a higher return.”
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