

Prescribed Assets

Are Prescribed Assets on the Way?

"We are facing a situation where our developmental needs are enormous, and in a number of other places pension funding is utilised for developmental purposes, for infrastructure, and quite often those pension funds make good returns out of infrastructure developments."

"We need to discuss this matter and we need to discuss it with a view to actually saying what is it we can do to utilise the various resources in our country to generate growth in a purposeful manner"

These were the words of President Cyril Ramaphosa in response to a specific question at the Question and Answer session in the National Assembly on Thursday 22 August 2019. His comments came a few days after Enoch Godongwana (ANC economic policy head) said the ANC is investigating prescribed assets for pension funds.

As expected, the reaction from the press and the public has been one of concern and in some cases a degree of panic. As with any investment decision, an investor needs to identify the potential scenarios that may eventuate, assign a probability to each of those scenarios and estimate the impact of each. The following note sets out what prescribed assets are, the likelihood of them being introduced in South Africa and the potential impact their implementation may have.

What are Prescribed Assets?

Prescribed assets refers to a policy whereby the government changes regulation to force pension funds (and potentially other financial institutions) to invest a stated allocation of their assets into specific investments, such as government bonds or the bonds of State-Owned Enterprises (SOE's).

The rules governing the investment of pension fund assets are currently set out in Regulation 28 issued under the Pension Funds Act and sets limitations on how assets can be invested. For example, there is a maximum amount of 30% that can be invested in offshore assets plus an additional 10% allowed to be invested in the rest of Africa. There are also maximums on equity (75%) and property allocations (25%).

Prescribed assets would adjust these guidelines to force a minimum investment in specific local government and parastatal bonds. This would effectively ensure a steady flow of funding into the entities, reducing any reliance on foreign investors.

A history of prescribed assets in South Africa

South Africa has followed a policy of prescribed assets before under the apartheid regime, between 1956 and 1989. Investors in retirement funds were forced to invest more than half of their savings in local government and parastatal bonds (53% at one point, up to 75% for the then Public Investment Corporation's assets) and life companies had to invest a third of their capital. The National Party implemented a prescribed asset policy to help fund SOEs following sanctions. The negative impact on returns for investors was material – for many years in the 1970's, prescribed assets provided investors with negative real returns (more than 4% below inflation), however the real impact on retirement outcomes was more severe as the majority of assets invested in these assets were taken from local equities during a time of very strong markets.

How likely are prescribed assets in South Africa?

In our opinion, the probability of prescribed assets being implemented in South Africa at this stage is low. The risk is clearly not zero, but there are a number of factors that support this view:

- In their election manifesto in January 2019, the ANC mentioned prescribed assets as something they would look to investigate. It is not ANC nor government policy. President Ramaphosa was responding to a direct question in parliament and

concerns were that he didn't confirm that prescribed assets were not an option. The question is how much of the rhetoric is politics and how much is actually the current thinking?

- There has been talk that we are likely to require an IMF bailout if we don't go down the prescribed assets route. We would argue that prescribed assets are likely to accelerate any need for an IMF bailout rather than keep it at bay. We are also not sure what started the sudden "IMF bailout" talk. The IMF were even bemused by the talk of a bailout!
- We have seen an ongoing relaxation of exchange controls over the last 25 years with the most recent being the change in Regulation 28, which increased the allocation allowed offshore (from 25% to 30%, and an additional allocation into the rest of Africa). The effect of these changes has been to reduce the proportion of assets invested in local equities and bonds. This effectively has the opposite effect to prescribed assets.
- There is appetite from local asset managers to invest in the infrastructure and growth focused projects that the President referred to, provided that the investment case makes sense. An example of how this has worked well is the public private partnership of investment in renewable energy projects over the past decade. Investors want to know that the projects will be managed with proper governance and sound financial controls. It is not a lack of available investors, but rather a lack of trust which is hindering investment.
- There are important political considerations to the introduction of any form of prescribed assets given the sheer size of the membership of the Government Employees Pension Fund (the GEPEF, managed by the PIC) and the array of trade union and industry pension funds. Our read is that both Cosatu and the PIC have been sceptical of the development. There is a lot of political water to flow under the bridge before we get to prescribed assets.

Clearly circumstances can change – for example, a change in the ANC leadership could well change the view - but for now we believe the introduction of prescribed assets is unlikely.

The Impact of the Introduction of Prescribed Assets

In simple terms, the reason assets are prescribed is that the demand for those assets is insufficient to meet the funding needs. The reason for the lack of demand is that the investment case doesn't warrant investing in those assets, i.e. the return offered for the level of risk taken is not attractive. Therefore, prescribing an asset "forces" a demand for the asset which in turn results in a lower yield, and lower expected future investment returns. If individuals and companies have the option to invest without any prescription, they will generally choose to do so.

In our opinion, the introduction of any form of prescribed assets would be very negative. Clearly the extent of the negative impact would depend on the details of how it would be implemented, but our view is that regardless of the specifics, the damage to investor confidence for both global investors and local retirement savers would be severe. This would likely have material knock-on effects, including:

- a reduction in Foreign Direct Investment (FDI). President Ramaphosa has made foreign investment a key priority and has made progress in securing FDI. Introducing prescribed assets would be expected to stall and likely reverse this progress
- a reduction in retirement savings. This would come from individuals opting out of pension plans where possible, those over the age of 55 would look to divest the maximum amount allowable out of their Retirement Annuities (RA's), and new contributions into RA's slowing dramatically.
- an acceleration of capital exiting the country. We have already seen an increase in the amount of discretionary capital being invested offshore. We would expect many investors with excess capital to avoid local equities and bonds and invest in offshore assets.

In our view, the combination of these and other consequences of prescribed assets would have a severe impact on the South African economy.

What would the funds be used for?

The initial public reaction to the rhetoric around prescribed assets has been that the funds would be used to fund the debt-laden State Owned Enterprises (SOE's). They are clearly in need of capital to fund their high levels of debt and bloated budgets. The shortfall has been funded by tax payers up until now, but with tax receipts declining and the economy slowing, one questions whether this is



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sustainable. Attempts are being made to improve the governance of SOE's and to bring their budgets under control, but for now SOEs are in a poor financial state, are poorly managed and have grown to be inefficient, so the thought of being forced to invest pension savings into SOEs at lower yields is not compelling.

There is also a lack of confidence and trust in government's ability to use the funding to implement infrastructure projects and other growth initiatives. Our sense is that this would be preferable to funding the SOE's, but the reality is that both local and global investors would be willing to invest in these projects if the proper governance and financial controls were in place without prescribed assets forcing them to. Prescribed assets indicate that government doesn't believe it can provide investors with the confidence that projects will be properly executed.

In conclusion

We believe the introduction of any form of prescribed assets would be very negative for the South African economy and for investors regardless of how the funds are allocated. However, we do believe that all the talk of prescribed assets is premature and their introduction given the current situation is unlikely.

data provided by Reuters and Datastream

31 August 2019

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	-0.2%	6.9%	-2.6%	4.7%	4.7%	11.5%	11.4%	11.9%
FTSE/JSE SA Listed Property	ZAR	-2.6%	1.0%	-5.5%	-3.2%	3.6%	11.4%	13.8%	13.3%
SA All Bond Index (ALBI)	ZAR	2.5%	7.9%	11.2%	9.8%	7.8%	8.7%	7.7%	6.9%
SA Cash Index (SteFI)	ZAR	1.8%	4.8%	7.3%	7.4%	7.1%	6.5%	0.2%	0.3%
Balanced Benchmark	ZAR	2.2%	9.1%	2.3%	6.2%	7.2%	11.6%	7.5%	7.5%
SA Inflation (1 month lag)	ZAR	1.0%	3.1%	4.0%	4.6%	4.9%	5.1%	1.3%	1.3%
GLOBAL MARKET INDICES									
Global Equity (Datastream World)	USD	5.0%	15.6%	0.8%	10.2%	6.7%	9.8%	11.7%	13.1%
Emerging Markets Equity (Datastream EM)	USD	0.0%	4.2%	-4.0%	6.2%	0.8%	4.4%	15.9%	17.3%
Global Bonds (Barclays Global Bond Index)	USD	4.6%	7.7%	8.4%	1.9%	1.4%	2.1%	5.5%	5.6%
Global Cash	USD	0.6%	1.7%	2.5%	1.9%	1.3%	0.8%	0.3%	0.2%
MAJOR INDICES BASED TO RANDES									
FTSE/JSE All Share Index (ALSI)	ZAR	-0.2%	6.9%	-2.6%	4.7%	4.7%	11.5%	11.4%	11.9%
Global Equity (Datastream World)	ZAR	9.6%	22.1%	4.5%	11.4%	14.6%	17.4%	15.6%	13.9%
Emerging Markets Equity (Datastream EM)	ZAR	4.3%	10.0%	-0.5%	7.3%	8.2%	11.6%	13.6%	12.8%
SA All Bond Index (ALBI)	ZAR	2.5%	7.9%	11.2%	9.8%	7.8%	8.7%	7.7%	6.9%
Global Bonds (Citigroup)	ZAR	9.1%	13.7%	12.4%	2.9%	8.9%	9.1%	14.9%	14.0%
COMMODITIES									
Gold (US Dollars)	USD	17.6%	19.4%	27.2%	5.4%	3.5%	4.9%	13.3%	16.4%
Gold (Rands)	ZAR	22.7%	26.0%	31.8%	6.5%	11.1%	12.1%		
CURRENCIES									
Rand / Dollar	ZAR	-4.3%	-5.6%	-3.6%	-1.1%	-7.4%	-6.9%	15.9%	15.2%
Rand / GBP Pound	ZAR	-0.8%	-0.9%	2.9%	1.4%	-0.9%	-3.8%	16.7%	14.8%
Rand / Euro	ZAR	-3.1%	-1.7%	1.9%	-0.7%	-3.6%	-4.1%	14.8%	13.5%

Spot Rates		30-Aug-19	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US\$	Rand	15.18	14.10	14.65	10.64	7.79	6.08
Rand/GBP	Rand	18.49	17.95	19.05	17.66	12.62	9.78
Rand/EUR	Rand	16.72	16.06	17.05	14.01	11.18	6.42
RATES							
Libor 6m \$	US\$	2.04	2.20	2.54	0.33	0.76	5.92
Repo Rate	Rand	6.50	6.75	6.50	5.75	7.00	13.44
Prime	Rand	10.00	10.25	10.00	9.00	11.00	16.50
All Bond Index Yield	Rand	9.43	9.25	9.58	8.15	8.76	N/a
COMMODITIES							
Gold (\$/oz)	US\$	1,529.31	1,412.30	1,202.84	1,287.93	948.25	255.15
Platinum	US\$	939.00	818.00	792.00	1,424.00	1,244.00	349.00
Oil (Brent Crude) \$	US\$	60.48	66.87	77.66	101.54	68.72	21.35
INFLATION							
SA Inflation	%	4.0	4.5	4.9	6.5	6.2	N/a

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