DISCUSSION PAPER ON RETIREMENT FUND REFORM

Representation On The Use Of Exchange Traded Funds, Such As Satrix, For The National Savings Fund And Individual Retirement Funds

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Representation on Retirement Fund Reform – A Discussion Paper

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1. BACKGROUND

The Discussion Paper on Retirement Fund Reform, released by the National Treasury in December 2004, envisages that saving for retirement by South Africans would be enhanced by the possible introduction of a National Savings Fund (NSF) and Individual Retirement Funds (IRFs). Clearly suitable low cost investment products or funds are required in order for the Government to meet its objective of encouraging long-term retirement savings in South Africa. Other features which would be of benefit in such investment products include simplicity, sound regulation, transparency and tradability as well professional management and administrative controls. Such products would provide for capital growth over long periods of time, as well as the generation of income in the form of regular interest or dividend payments. Equity-linked investment products, particularly given the extremely good medium to long-term performance of the JSE Securities Exchange, are ideally suited for retirement savings in South Africa.

Index tracking products meet all of these requirements, particularly those of cost containment. It is understood that some 25% of all institutional retirement funds invested in the United States are now in passive (mainly index tracker type) investments. The fastest growing portion of this index tracking market is Exchange Traded Funds (ETFs). Exchange Traded Funds are portfolios, such as index tracking portfolios, that are listed on major stock exchanges.

A recent paper published by Merrill Lynch – Growth in US Equity Derivatives and ETFs (March 14, 2005) – highlights the growing public acceptance and popularity of ETFs. Despite equity turnover in the United States, measured by the S&P 500 volumes, falling by 11 percent in 2004, turnover growth in ETFs increased by 50 percent in 2004. ETFs turned over some US$13 billion per day in 2004, or over 33 percent of total turnover in all S&P 500 stocks.

The rising demand for ETFs in the US, from both institutional and individual investors, is due to the convenience of being able to capture an entire portfolio of equities (or bonds) with the convenience of transacting in one instrument and the fact that ETFs have low management fees.

In South Africa, Exchange Traded Funds were introduced with the listing of the Satrix 40, which tracks the FTSE/JSE Top 40 Index, in late-2000. There are now five ETFs listed on the JSE Securities Exchange. The three Satrix ETFs have also been registered with the Financial Services Board as a Collective Investment Scheme. This means that they are fully compliant and regulated under the terms of the Collective Investment Schemes Act (2002); are operated in accordance with the Regulation 28 guidelines of the Pension Fund Act; and are also subject to the regulation and rules of the Securities Services Act and the JSE's Listings Requirements.

2. PASSIVE INVESTMENT PRODUCTS

Passively managed investment funds, where the manager merely seeks to replicate the performance and yield, of major market indices, have become popular for personal savings schemes and retirement funds around the world. Such investment instruments, which do not seek to outperform the market, provide low risk and easily measurable performance. They are also simple to understand and provide a low cost investment product suitable for low to middle income workers and savers.

In particular, index tracking passive investment products have been favourably received and promoted by the Fiscus in many countries where tax concessions are provided for entry into savings and retirement fund products. Utilising tax concessions for products where asset managers seek to actively outperform or to speculate on markets, or to accommodate high fees and costs, is less palatable for taxpayers than to promote low cost passively managed investment products through fiscal incentives.

3. EXCHANGE TRADED FUNDS

These products provide index tracking with the additional benefit of being listed themselves on major stock exchanges. This makes it very easy for investors to buy into the funds. The best known products of this sort in South Africa are the Satrix securities, which are listed on the JSE Securities Exchange. There are three Satrix products listed on the JSE: the Satrix 40, which tracks the FTSE/JSE Top 40 Index; the Satrix Fini, which tracks the FTSE/JSE Financial 15 Index; and Satrix Indi, which tracks the FTSE/JSE Industrial 25 Index. The three products together have just under R6 billion funds under management.

Satrix securities are listed on the JSE Board and trade just like any other listed company. They provide the investor with the convenience of purchasing the performance of the basket of shares that make up the index tracked, but with the cost savings of purchasing only a single security. This makes ETFs a far more transparent and cost-effective vehicle than traditional collective investments.

4. THE BENEFITS TO INVESTORS OF EXCHANGE TRADED FUNDS

➢	**Transparency**	The price of Satrix securities is available on the published JSE price pages, available in the media or through the internet.
➢	**Open Price Discovery**	The purchase and sale of Satrix securities takes place on the JSE through the open market and is therefore entirely transparent. Satrix securities always trade at 1/1000th of the index. So if the FTSE/JSE Top 40 Index is trading at 12000, the Satrix 40 price is R12,00 per security. If the index falls to 11500, the price of Satrix 40 drops to R11,50. If the index rises to 13000, the price of Satrix 40 increases to R13,00 per security. The simplicity of this pricing structure makes it easily understood by all types of investors.

➢	**Intra-day Trading**	Exchange Traded Funds trade throughout the day as long as the stock exchange is open. This enables investors to take advantage of intra-day price movements on the index. Most investment products price only once a day and it can take many days in which to conclude a transaction. Transactions on ETFs, such as Satrix, are instantaneous.
➢	**Guaranteed Settlement and Clearing**	The JSE market model ensures that: all trades in Satrix securities are settled (there has not been a failed trade on the JSE since the implementation of STRATE some years back); that central registration of investors takes place electronically; and that all central order trades are reported instantaneously.
➢	**Trading Accuracy**	There are various mechanisms in place to ensure that Satrix products, accurately track the index being followed: ▪ ***Open-ended* –** new units can be created or units redeemed, should demand exceed supply or visa versa, in order to ensure that all participating unit holders receive equal participation in the index tracked. ▪ ***Physical delivery* –** Satrix unit holders can take delivery of the basket of shares that make up the index, in exchange for their securities (subject to a minimum size of the transaction). Equally, investors can bring the correctly constituted and weighted basket of index shares to Satrix Managers and be issued with Satrix securities. This physical exchange ensures that Satrix securities trade at their net asset value at all times, through the arbitrage activities of market traders.

➢	**Hedging**	Because the indices are traded both in spot form through Satrix and in futures markets through the JSE, arbitrage activities between the spot and futures markets on the same index similarly ensure that Satrix securities trade at the exact value of the index.
➢	**Market Making**	Official market makers have been appointed, by Satrix Managers, to ensure that prices are made for investors - in any size – at the current index level throughout the trading day.
➢	**Dividend Distributions**	All dividends received from the companies constituting the index are distributed to investors on a quarterly basis to ensure that minimal cash gets trapped in the Satrix structure. In this way investors receive the capital value and yield of the index ensuring accurate total index tracking performance.
➢	**Distribution**	The purchase and sale of Satrix securities through the stock exchange, the recording of these transactions and registration of investors through the stock exchange systems, enables the back office functions of the product to be handled through the normal market mechanisms, considerably reducing administration costs and overheads.

5. COST SAVINGS ARISING FROM EXCHANGE TRADED FUNDS

The biggest single benefit to investors of Exchange Traded Funds, such as Satrix, is their relatively low cost structure when compared with traditional collective investment schemes and other forms of managed investments. The key factors contributing to the low costs of Satrix products include:

➢ ***Scrip Lending***. The stable nature of the Satrix portfolios (the index seldom changes) enables Satrix Managers to lend out the shares that make up the index in the scrip lending market. There is always a steady demand for index basket shares in the securities market. In terms of the Collective Investment Schemes Act, up to 50% of the securities held in the portfolio can be lent out, subject to certain counterparty limits and collateral requirements.

The income received from scrip lending enables Satrix Managers to cover the bulk of its administration and management costs. Accordingly, unlike the majority of investment products, it is not necessary for Satrix to levy any annual or periodic management fees, advisory costs or other administration fees on its investors. Once the investor has purchased Satrix securities, no further management fees are payable. This provides a considerable cost saving on other investment products.

- ***Administration***. The transaction of Satrix securities through the JSE Securities Exchange takes care of most administration and regulation issues. The savings in administration costs are considerable as there is no necessity to operate a large back office to undertake such administration.

- ***Passive Investment***. The Satrix asset manager is instructed to purely replicate the correct basket of shares that make up the index being tracked. Accordingly, the asset management fees are lower than would be the case for an actively managed portfolio. By sticking to a rigid formula of the exact duplication of the index, tracking error risks are minimised and costs are kept low.

- ***Distribution Costs.*** Over 95% of Satrix investors purchase the product through the Stock Exchange and merely occur the transaction costs of purchasing the securities on the market. However, the product is flexible in that fees can be paid to a distribution channel if necessary. For instance, the Satrix Investment Plan, which is managed by Absa Investment Management Services (AIMS) caters for about 20 000 individual investors in Satrix. An upfront fee of 0,3% (with transaction costs of 0,35%) i.e. 0,65% in total, is payable by the investor. An annual management fee of 0,8% is levied by AIMS. If the investor is introduced to the Investment Plan by a registered financial adviser, a commission of up to 3% can be paid to the adviser. In practice, most of the Investment Plan clients are cost sensitive and sign up directly to the Plan, thereby avoiding the payment of commissions.

However, the Satrix structure does allow for the payment or waiver of commissions to intermediaries. In the way, commission fees can be designed to accommodate any outside distribution channel. For instance, Satrix has for some period been negotiating with the South African Post Office (SAPO) to distribute Satrix to its clients (in much the same manner that SA Government retail bonds are distributed). In such a case, a negotiated commission would be provided to SAPO.

- ***Transaction Costs***. The cost of purchasing or selling Satrix securities through the JSE can be as low as 0,05% to 0,10% brokerage (if utilising a discount or institutional stockbroker). When tax, settlement and clearing charges are added, the total transaction costs amount to around 0,40% (40 basis points) on purchase and about 0,15% on sale. As mentioned earlier, no ongoing management or other fees are payable if the Satrix securities are purchased directly on the Stock Exchange.

6. SUMMARY

The National Treasury has emphasised, in its Discussion Paper on Retirement Fund Reform, that low cost, easily understood and simple to transact products should be made available for the purposes of the National Savings Fund and for Individual Retirement Funds. Where the State is providing special tax concessions and other incentives for the use of such savings products, it makes sense that these fiscal incentives should not be provided for products where high returns to the providers of products, in the form of fees, are facilitated by the State. Equally, it is important that fund manager should not be encouraged to speculate on the markets with such tax facilitated savings funds and that the risk to the investor is minimised. Accordingly, passively managed products, particularly in the form of index tracking funds, have found favour with a number of governments around the world, where savings are encouraged by special concessions provided by the Fiscus.

Exchange Traded Funds, such as Satrix, are ideal for this purpose. They are well regulated, low cost, transparent, simple to transact in, easily understood by the investors and can be administered effectively . Satrix is registered as a Collective Investment Scheme with the Financial Services Board. As such, it needs to comply with the Act in terms of capital adequacy, public accounting, reporting to investors, portfolio construction and management, scrip lending and is required to report regularly to the FSB in all of these issues. In addition, because Satrix is a listed security, it falls under the regulatory control of the JSE and the Stock Exchanges Control Act. It has to comply, as does any listed public company, with the reporting, compliance and governance rules of the Stock Exchange.

Accordingly, the Satrix product is subject to extensive regulatory control and administration which increases the peace of mind for investors.

It is our proposal that the National Treasury should consider incentivising the use of ETFs as an essential aspect of retirement funding reform. We would be most happy to work with you in developing proposals in this regard.