INVESTMENT NOTES

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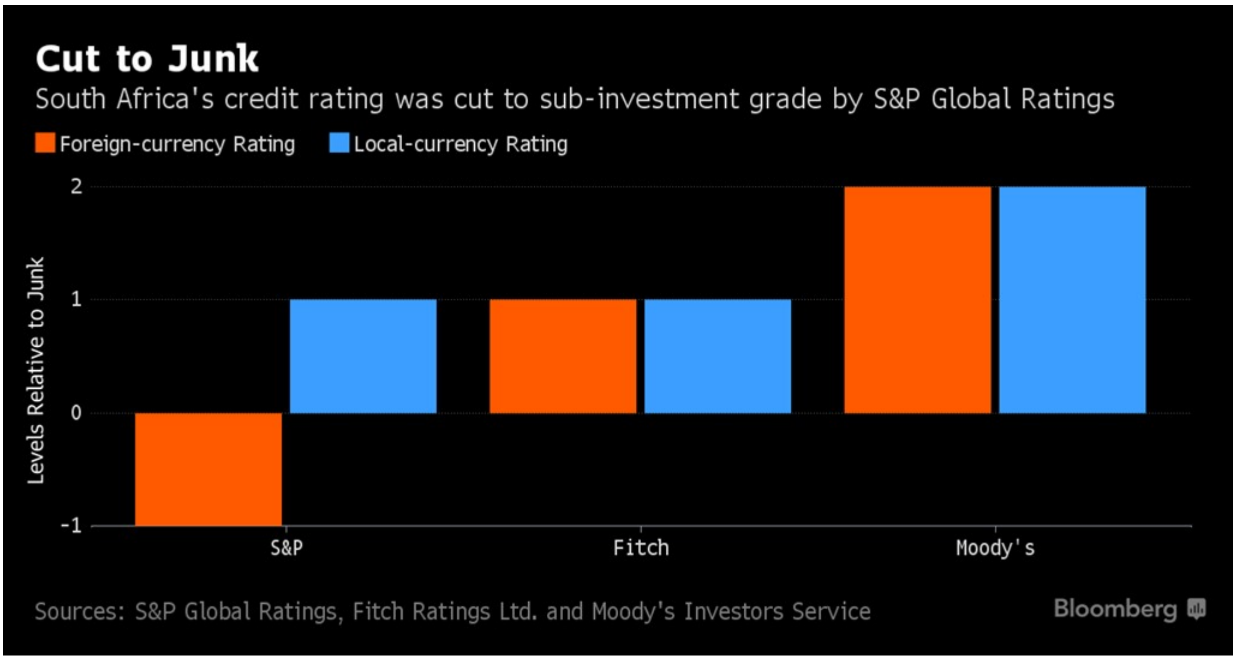
Impact of "Junk Status" on Retirement Funds

Retirement funds are important mechanisms whereby we pool our savings, invest the savings and then hope to earn a return on these savings as a collective. Retirement funds are therefore important funders in the economy, the investments of which would eventually lead to economic growth and jobs.

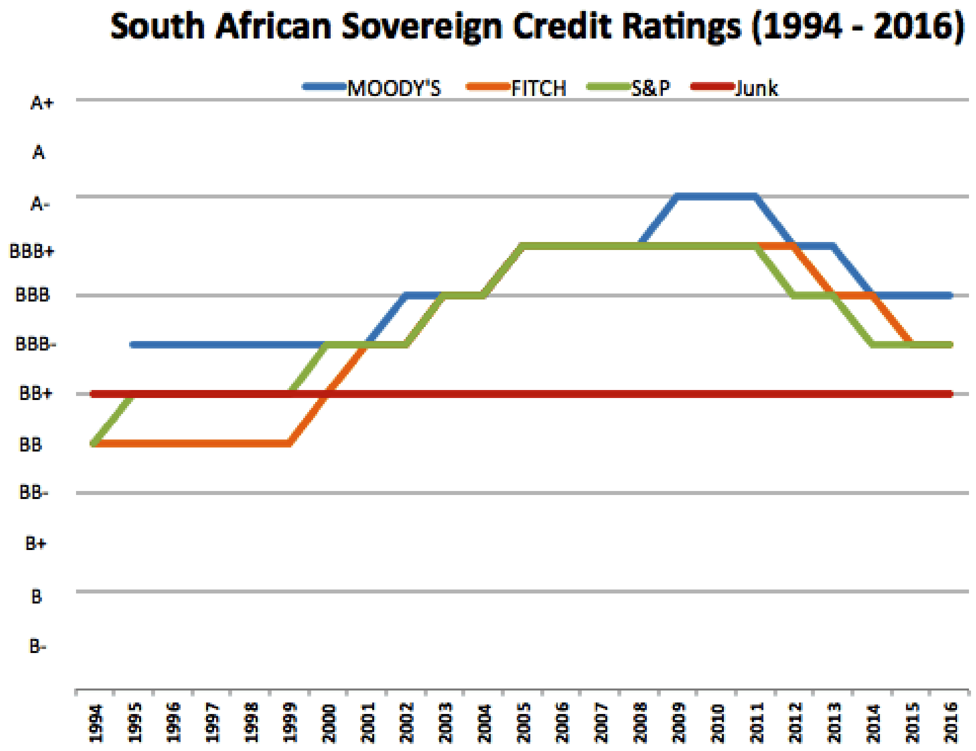
In South Africa retirement funds are obviously not alone in funding investments. In fact in the recent past the country has relied significantly on offshore investors (savers) buying our country's debt and even making significant equity investments, in some years up to R96bn in a calendar year. In 2015 we however experienced investment outflows for the first time since 2008/9 in the aftermath of the financial crises while in 2016 the country reached significant portfolio outflows with upward of R127.9bn outflow from equity markets. Recently we have also seen some offshore investors selling off their investments (e.g. resource companies) or giving notice of their intention to sell their investments (e.g. banking sector).

This is one of the reasons why we experienced a significant reduction in the value of the Rand. It is not too long ago that we spent R6/$ and now we have to spend more than R13/$. A very sharp deterioration in value, indeed! South African retirement funds have not experienced this decline in value as much as their co-investors from offshore measuring themselves in US$. It has been an uncomfortable place for these co-investors to be.

When taking debt a country has two broad currency categories, being locally denominated or foreign currency denominated debt. S&P recently downgraded our offshore denominated debt to below investment grade while Rand denominated debt has been placed on negative outlook. What one needs to bear in mind is that South Africa's offshore debt is a small portion (±10%) relative to total debt. S&P is one of three agencies rating our debt, the others being Moody's and Fitch who review South Africa's local and foreign currency denominated debt.



The job of these agencies are to express an opinion on the ability & willingness for, in this case the country, to make good on its debt obligations. The history of South Africa's ratings are shown in the graph supplied by National Treasury below:



Source: National Treasury

It is clear that South Africa has been on a downward path. A critical point being the red line where South African debt would be regarded as sub-investment grade. We have now crossed this red line! These grades also affect the grades of important lenders in the country such as banks. The effect of the reduction in these ratings over time will be that interest rates or the cost of capital will increase with the increase in perceived risk or to be a comparatively worse investment destination. Some mandates of offshore investors may even prohibit their asset managers to invest in sub-investment grade debt. As the country has to compete with many other countries for such capital, the demand for South African debt may become less and therefore negatively impact the value of debt based investments over time. As one of the objectives of a retirement fund usually is the preservation of capital, such downgrades will make reaching this objective more difficult. It has already been the case for our offshore co-investors!

Increasing interest rates are in general also not good for equity investments as interest payments become a larger expense before profits can be distributed or reinvested. Profit margins may therefore reduce in the process. If a company with local operations borrowed offshore, these borrowings have already become much more expensive to the decline in the value of the Rand! Retirement funds will therefore have to expect lower returns than what we have become used to in the last decade.

Interestingly though, annuities have an inverse relationship with interest rates. Annuities may therefore become cheaper when interest rates increase. Members reaching retirement age may therefore obtain better income at retirement due to this structural increase in interest rates. This aspect may be the only good news of the ratings downgrade for a retirement fund!

It is a lot easier to make investment decisions in a stable economic environment without the threat of a declining currency or increasing interest rates. South African retirement funds will therefore have to brace themselves for more volatility in the path as South Africa has become a lesser investment destination compared to other countries in the world. Other larger BRICs-partners such as Brazil and Russia have already reached this destination.

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