INVESTMENT NOTES

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Is "irregular accounting" code for the deliberate intent to deceive?

The sheer number of enquiries from individual members about the impact of the Steinhoff International debacle on their savings shows that members are concerned about their retirement savings, and that diversification and portfolio construction are not fully appreciated at a member level.

Steinhoff International reported that it could not release its audited financial statements after Deloitte refused to sign the annual financial statements. Steinhoff International then announced that there had been "accounting irregularities" and also announced the resignation of CEO Markus Jooste. One week later the chairman, Mr Christo Wiese, resigned. Steinhoff International's market capitalisation of R242 465 million as at 30 November 2017 was reduced to R25 858 million on 8 December 2017, a loss of R216 607 million.

Well-known South African business leaders who were on Steinhoff International's supervisory board at the time include Messrs Wiese and Jooste (resigned since), Ms Heather Sonn (former CEO of Legae Securities), Dr Len Konar (doctorate in accounting and professional independent director and retirement fund trustee), Dr Theunie Lategan (doctorate in accounting and formerly from RMB and FirstRand), Dr Johan van Zyl (former CEO of Sanlam) and Dr Steven Booysen (doctorate in accounting and former CEO of ABSA) and Mr Jayendra Naidoo (struggle veteran and successful businessman). The independent non-executive members of Steinhoff International's supervisory board are as strong as any board globally.

The concern voiced by many is how investment managers or retirement fund trustees are expected to detect accounting irregularities if the panel of esteemed independent and/or non-executive members on the supervisory board failed at it.

The Steinhoff International saga again emphasises the need for retirement funds to practise responsible investment. One of the more important aspects deals with business leadership and the remuneration of directors.

While it cannot be said that such a responsible investment policy would have prevented events at Steinhoff International, shareholders who ask **uncomfortable questions** may have prompted the independent and/or non-executive members of the star-studded supervisory board into action sooner.

It is difficult to anticipate how the challenges faced by Steinhoff International will be resolved, especially as the financial statements of multiple years have been reopened and are subject to review or restatement. Presently, we stand by our initial assessment that the sharp fall in the share price (from as high as R60 per share to as low as R5 per share) is likely to reduce the value of members' portfolios by approximately 1%.

We also know that despite what some apparently talented market commentators and/or portfolio managers would have the world believe, financial malfeasance could not easily have been identified before Steinhoff International's SENS announcement on 5 December 2017.

What we need to understand is how promises of imminent doom that appeared in the newspapers daily, resulted in a mere 1% loss in the value of our savings. This is why it is necessary to understand diversification and portfolio construction. An eminent investor once said that risk cannot be eliminated or avoided, but it can be understood and the possible impact on our investments perhaps reduced.

To achieve the best possible investment return, active investment managers aim to include as many of their best ideas as possible in the portfolios they manage. The result of focusing on best ideas is often to reduce the number of different investments in a portfolio (and increase the size of their holdings in each investment). Should disaster befall one of the best ideas in the portfolio (e.g. the Steinhoff International share price falling 85% to 90%), the impact on the portfolio would be severe, but not of equal proportion.

Conversely, portfolio managers who consider risk to be as important as potential investment returns, would be concerned with concentration risk, regardless of how promising the prospects of their best ideas may be. These investment managers would look to reduce the size of their exposure to individual investments and spread their investment portfolios over smaller holdings of more individual investments (**diversification**).

The positive effect of one of the best ideas doubling in price would be much more subdued than in a best ideas portfolio.

This does not mean that portfolios holding a bigger variety of investments are necessarily better than portfolios holding fewer investments. By including more investments in a portfolio, the portfolio's investment return will be lower and closer to the average of the market, or will even underperform the market. This would have been the case with a passive investment or index tracking investment.

Best ideas portfolios are generally less diversified. To find the ideal balance between a best ideas approach and suitable diversification is what makes investment management as much an art as a science, and a portfolio manager's experience is often a key factor.

The process to include best ideas in a suitably diversified portfolio is called **portfolio construction**. There is no set or single technique for portfolio construction and investment managers often use their insight and understanding of portfolio construction as a competitive advantage. What we know for certain is that it is foolish to construct a portfolio giving consideration to expected investment returns only; and it is equally foolish to construct a portfolio giving consideration to risk only. When constructing investment portfolios, many talented money managers ask themselves what the impact of their best ideas will be on their portfolio if a particular investment goes wrong. This approach should be followed not only with share investments, but also with interest-bearing investments, such as exposure to state-owned enterprises that have weak financial controls.

In South Africa, **Regulation 28** in Annexure B of Pension Funds Act 24 of 1956 prescribes maximum exposure to risky assets such as shares.

For instance, a retirement fund's exposure to shares may not exceed 75% of the market value of the portfolio; exposure to individual shares with a market capitalisation (number of shares in issue times share price) above R20 billion may not exceed 15% of the market value of the portfolio; and exposure to individual shares with a market capitalisation below R15 billion may not exceed 10% of the market value of the portfolio. Regulation 28 contains many more limits on exposure.

The reason for the limits imposed by Regulation 28 is to ensure that investment managers diversify members' investment savings by including different assets and asset classes – both inside and outside South Africa – in investment portfolios (e.g. shares, bonds, property and money market instruments).

Should the share price of an apparent blue-chip share such as Steinhoff International fall say 85%, the impact on a member's savings portfolio is a lot less because of diversification. Many Regulation 28-compliant global balanced portfolios in South Africa invest approximately 42% of their portfolio in domestic shares. If 2.8% of the market value of shares had been invested in Steinhoff International, the net loss would have been approximately 1% (2.8% x 85% x 42%).

While this does not excuse Steinhoff International's directors and senior management, it is hardly the calamity that it is made out to be in the press.

In summary, members' investment savings are guarded over by the approach to investment management required by Regulation 28, investment managers' ability to weed the underperforming shares from their portfolios, the principle of diversification and the contribution of intelligent portfolio construction.

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