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# Report on sound investment principles for pension funds – part 2

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## Section 1

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### Introduction

#### A. Reason for part two of the report

At the request of the Registrar of Financial Institutions, the Investment Analysts Society of Southern Africa undertook to report on the subject of sound investment principles for pension funds. The first report was dated June 1985 and some aspects were discussed with the Financial Institutions Office in August. At this meeting, the Society undertook to write a second report, part 2, which comments exclusively on the following additional topics:

1. Should a pension fund's investment in the equity of a company be limited by imposing a maximum percentage shareholding in a company?
2. Should a pension fund's investment in any one share be limited to not more than a specified percentage of the value of the pension fund's portfolio?
3. There are a number of investment strategies and products such as warehousing, forward transactions, bear sales, options and financial futures. Are these sound investment media for pension funds and are any restrictions required?

#### B. Members responsible for the preparation of this report

The Society established a sub-committee to consider these topics and this is its report. Members of the sub-committee are:

Mr P B Eustace	Assistant General Manager Investment Division UAL Merchant Bank Limited (Chairman)
Mr W T Floquet	Senior Research Director Martin & Co Inc Member of The Johannesburg Stock Exchange
Mr P Milburn-Pyle	Partner Shepley and Fitchett Consulting Actuaries

The report has been approved by the main committee of the Investment Analysts Society.

#### C. Structure and guidelines of the report

1. The report is divided into three main parts: Section 1 – introduction; Section 2 – discussion of the three main topics; and Section 3 – recommendations. The recommendations are drawn from the discussion in Section 2 and are set out in detail in Section 3.
2. In the report, frequent reference is made to "investment management". This phrase embraces all those people directly responsible for the investments of a pension fund. They include the investment committee appointed by the trustees, the investment manager and the principal officer.

3. The investment management of a pension fund has two prime objectives:

(a) The assets of the fund must produce a flow of cash that adequately finances the benefits due from time to time.

(b) The investment return on the assets of the fund must be kept at the highest possible level subject to "acceptable risk". This will contain, within reasonable limits, the financial burden of the fund on the employer and provide the best possible pensions. The discretionary cash flow of pension funds should in most circumstances be invested in assets that are likely to benefit from the same inflationary trends as those that will increase the outflow on pension benefits.

The term "acceptable risk" requires that there is adequate diversification of the investment portfolio and that investment management acts prudently on such issues as price, marketability and quality of investments.

Sound investment principles are those which assist investment management to achieve the above objectives.

4. Such principles are reasonably static in concept but their interpretation will vary with changing circumstances. In this report, it has been recognised that investment management should be allowed considerable flexibility to achieve its objectives but there are some issues which require controls.

5. Sound investment principles for pension funds should apply both to privately administered funds and funds which are managed by life offices. This report has been written from the point of view of the privately administered funds but the recommendations also apply to the funds managed by life offices.

## Section 2

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### Discussion of the three main topics

#### A. Should a pension fund's investment in the equity of a company be limited by imposing a maximum percentage shareholding in a company?

1. There is some concern, on the part of the Financial Institutions Office, about a pension fund being a major shareholder in a company. This applies to a shareholding of say 20% or more of the company's equity capital. The concern arises from the following:

(i) the holding may imply involvement by the pension fund in the directorate and management of the company. This may be an undesirable state of affairs if the pension fund does not have the capability to take on such responsibilities and if, as a result of such involvement, the normal business of the pension fund is neglected.

(ii) the holding may provide scope for abuse. For example, the pension fund may hold 40% of the capital of an engineering business owned by a relative of one of the pension fund trustees. There is the additional problem that such a shareholding is likely to be an unquoted investment that is not freely tradeable.

2. (a) With regard to 1(i) above, even if there is a major shareholding in a particular company it does not necessarily follow that this will be a major investment of the pension fund. Most SA funds are well aware of the need to diversify portfolio shareholdings and more than a 20% investment in a particular company's equity could represent a very small percentage of the pension fund's total assets. Similarly a large percentage shareholding will not necessarily involve the pension fund in the management of the company or if it is involved, the pension fund might well be easily able to handle such management. An example of the latter is a major share in an investment company, or a property company, possibly bought at a discount to the underlying value. To the pension fund, this is merely an extension of its normal investment business. Another example is where a pension fund in a particular industry takes a major shareholding in a venture capital company in the same industry. The returns from such an investment can be exceptionally high and as the trustees of the pension fund will be familiar with the company's business it does not involve much of management's time.

(b) The Society believes that the majority of pension funds follow the prudent practices mentioned in the preceding paragraph. However, it is appreciated that not all funds will act in a responsible way and controls, therefore, may be necessary. If the Financial Institutions Office believes this to be the case and proposes that a ceiling be set on the percentage exposure to a company's equity it is recommended that the maximum proportion a pension fund should be allowed to hold should not be set at below 30%. This 30% limitation is chosen on the grounds that special resolutions, passed in terms of the Companies Act, require a 75% majority. Therefore, a pension fund holding the allowed 30% maximum would be in a position to block such resolutions if this was in the fund's interest. Exclusions to this general rule should include investments in investment companies, holding companies and property companies provided that the fund's interest in any underlying company, held either directly or indirectly through these exclusions, does not exceed the said 30%. As these would be new requirements, existing holdings in excess of these limitations should be allowed to continue but no further investment should be permitted. It is suggested that the pension fund's auditors be made responsible for certifying that these limitations have not been exceeded. Provision should also be made for a pension fund to exceed these limitations but only if application is made to the Financial Institutions Office and such application is approved in writing.

3. With regard to 1(ii) above, the question of abuse is covered by the provisions of the Financial Institutions (Investment of Funds) Act No 39 of 1984. This legislation requires that investment management observes the utmost good faith and exercises the usual care and diligence required of a trustee and that investment management does not make use of the funds of the pension fund in a manner calculated to gain directly or indirectly any improper advantage at the expense of the pension fund. If any member of investment management is directly or indirectly personally interested in a transaction, he must declare his interest to the governing body of the pension fund before the action concerned is taken. It is recommended that the Financial Institutions Office issue a circular reminding pension funds of the important provisions of Act No 39. At the same time, it is suggested that the following additional instructions should be given:

(a) When a member of investment management declares his interest to the governing body of the pension fund, this declaration should be minuted by the fund.

(b) Any directors' fees received from a company should be for the account of the pension fund or employer company and not for the personal benefit of any member of investment management.

**B. Should a pension fund's investment in any one share be limited to not more than a specified percentage of the value of the pension fund's portfolio?**

1. There is some concern on the part of the Financial Institutions Office about pension fund equity portfolios being inadequately diversified. It has already been mentioned, in this report and the previous report, that the Society believes that most SA pension funds are well aware of the need to diversify shareholdings. However, there are no doubt some funds that act in an ignorant or imprudent way on this issue. The Unit Trust Control Act provides a precedent in generally restricting the size of shareholdings to 5% of the market value of portfolios or in the case of shareholdings in investment companies to 10%. In the previous report, it was stated that the Society is opposed to similar restrictions being introduced for pension funds. The reasons for this are:

(a) Investment performance would frequently be impaired. The fund may have recognised an investment opportunity in a good quality, high growth company but it would be unable to benefit fully from this if it is restricted to only 5% of the fund's portfolio.

(b) The rather arbitrary 5% limitation does not acknowledge the material imbalance in the South African investment scene. For example, Anglo American's market capitalisation was, at the end of 1985, 14% of the total capitalisation of all mining shares while Sasol comprised 13% of the total industrial market capitalisation. Limiting the investment in Anglo and Sasol to 5% each, the same limitation as would be imposed on investments in Cons Murch and Abercom, which are less than one hundredth of the size of Anglo and Sasol respectively, is illogical and would probably be counterproductive as a measure designed to protect pension fund beneficiaries.

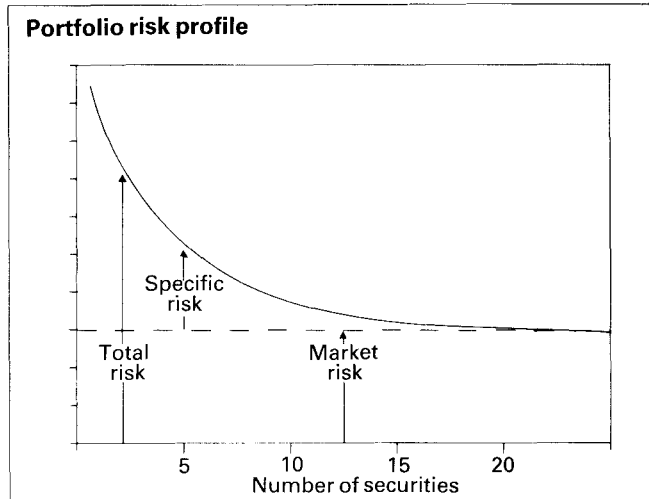
(c) The imposition of a 5% limitation on a shareholding does not necessarily guarantee adequate diversification over the various sectors of the equity market. For example, a pension fund could hold 10 gold share of 5% each. In other words, after providing for the prescribed requirements, the entire equity portfolio would be made up of gold investments.

2. The Society recommends that the Financial Institutions Office issue an information circular to pension funds that discusses the principles of diversification of equity portfolios. A suitable way of covering this subject is set out in the following two guidelines:

(a) The well-known portfolio risk profile, which is shown below, illustrates that each share which is added to a portfolio brings the risk down. When the number of shares has reached between 15 and 20, there is no further diversification benefit from the addition of more shares. In other words, the specific risk (the risk attached to an individual share) has been diversified and the portfolio is then only exposed to "market risk".

(b) "Market risk" relates to the variation in returns of an equity caused by fluctuations in the returns of the market. In this context "market" refers to either the total equity market or a specific sector of the market, that is, mining, financial or industrial. If investment manage-

ment of a fund wishes to diversify the risk associated with a particular equity sector, it is clear that the portfolio will have to include shares in other sectors of the market. Whereas, diversification from the risk of the equity market as a whole would imply investing in other markets such as cash, gilts and property.



3. The information circular mentioned in 2 above should lead to some improvement in the diversification of pension fund equity portfolios. However, the Financial Institutions Office may believe that control on the size of an individual shareholding is still necessary. If this is the case, the Society recommends, for the reasons discussed above, that the limit be significantly higher than that contained in the Unit Trust Control Act. It is suggested that the limit be 15% of total assets of the pension fund, expressed in terms of either market value or book cost, whichever is the greater. This limitation could of course be exceeded through appreciation of the particular shareholding or depreciation of the other shareholdings in the portfolio. Mergers or takeovers could also lead to an excess. In these situations a pension fund should not be permitted to make further purchases of the share and within 24 months should be required to reduce the shareholding to 15%. The same time limit should be given to pension funds to adjust shareholdings if and when the control legislation is introduced. Pension fund auditors should be made responsible for certifying that these conditions have been fulfilled.

### C. Investment strategies and products

1. There are a number of investment strategies and products such as warehousing, forward transactions, bear sales, options and financial futures. The Registrar has asked the Society to comment on whether these are sound investment media for pension funds and whether it is necessary to introduce any restrictions on their usage.

2. The following paragraphs of this section discuss these particular strategies and products. An attempt will be made to show how they work, their benefits and disadvantages and where restrictions are necessary.

3. A feature of some of these products is that they are a form of borrowing on the part of a pension fund. Therefore, it is necessary to start with a clear understanding of the Registrar's conditions under which a pension fund may borrow. Circular No PF 21 dated 18 August 1972 sets out some useful guidelines on borrowing. These are as follows:

(i) Attention is invited to the necessity for pension funds to maintain sufficient liquidity to satisfy their normal cash requirements and thus ensure that their borrowings are limited strictly to temporary loans for bridging unforeseen cash shortages or for taking advantage of attractive investment opportunities.

(ii) Temporary loans conforming to the requirements of Paragraph (i) above, will . . . not be deemed to constitute the carrying on of business other than pension fund business, provided that the aggregate amount of such loans does not at any time exceed one-half of the fund's gross income from all sources during the immediately preceding financial year. For the purpose of the aforementioned limit, a loan obtained by a company which is controlled by a pension fund or pension funds, must also be regarded as a loan obtained by the fund or funds unless the fund itself or the funds themselves granted the loan to the company.

(iii) Should a fund find it necessary under exceptional circumstances to borrow a larger amount than the amount referred to in Paragraph (ii) above, this Office would be prepared, upon receipt of full particulars of the exceptional nature of the circumstances, to consider a relaxation of the limit laid down above."

#### Warehousing (or buy back)

4. These terms refer to a pension fund temporarily relinquishing ownership of a stock or an equity in exchange for cash. At a specified future date, this exchange is reversed for a predetermined consideration which will include an acceptable return which will be paid by the pension fund to the warehouse. It is usual not to re-register stock which is being warehoused for a short period of, say, three months. In such circumstances the warehouse would keep the scrip, in negotiable form, as security. For longer periods of warehousing, stock may be re-registered. The warehousing of equity tends to be for relatively long periods and the shares are usually re-registered to give the warehouse the dividend income and the tax benefits on such income. Warehousing agreements are usually in writing and take the form of an exchange of letters. Some examples are mentioned below together with the advantages of these transactions:

#### (i) Warehousing of stock

A pension fund may have a surplus of prescribed stock but insufficient cash to purchase a good equity investment. The surplus stock could be warehoused for a period of, say, three months in exchange for cash which would be used to buy the attractive equity investment. The stock would be repurchased with accumulated cash flow at the end of the three-month period.

#### (ii) Warehousing of shares

A pension fund pays no tax on income whereas a bank is taxed on interest but not on dividends. It is therefore profitable for both parties if the pension fund warehouses, with the bank, an equity giving a dividend yield of, say, 10% and exchanges or invests the sales proceeds in stock yielding 16%. The initial 1% stamp duty on registration is usually for the account of the pension fund. If the warehousing of the equity is for, say, four years, the pension fund would be entitled to any increases in dividends but any reduction in dividends would have to be made up by the pension fund on an after tax basis. At the end of the warehousing period, the bank would sell the shares back to the pension fund at cost and pay the 1% stamp duty on registration. It is normal to make

provision to substitute other shares for those that are being warehoused. This gives the pension fund the necessary flexibility to dispose of the shares if, for example, a decline in earnings and dividends is expected.

*Forward transactions*

5. The most common forward transaction is the forward purchase. This is a useful technique for a pension fund which has inadequate cash to acquire an attractive investment. In such circumstances, the pension fund arranges for, say, a bank to purchase the investment on its behalf. At a specific future date, the pension fund agrees to purchase the investment from the bank for a predetermined consideration. This will include an acceptable return for the bank for holding the investment until it is acquired by the pension fund.

6. A forward sale is less common than a forward purchase. An example of such a sale is when a purchaser has inadequate funds to buy a stock from a pension fund. However, if such funds are available in three months' time and there are no other immediate buyers, the pension fund may decide to enter into a forward sale with the sole purchaser.

7. Forward transactions were fairly common some years ago. Since then, the option market has developed and this has tended to replace the forward transactions mentioned in paragraphs 5 and 6 above.

*Bear sales (selling short)*

8. A pension fund may sell shares that it does not possess in the expectation of being able to buy them at a lower price before they are due for delivery. Such action might be taken by a pension fund if a share was thought to be significantly over-valued. By law, all bear sales of equity have to be disclosed as such and cover of 100% in cash, or shares to the value of 200% of the market price must be deposited with the stockbroker conducting the sale. Theoretically, the potential loss on bear sales is limitless in that the price of the asset can rise to any level.

9. A pension fund may also become involved with short selling of stock. Such action might be taken if, for example, the pension fund believed that long-term interest rates were likely to rise sharply. Bear selling of stock does not have to be disclosed and no cover for the transaction is required. Another example of bear selling of stock occurs where a fund has, as is often the case in the South African market, significant holdings of unmarketable stock which it is unable to sell. To protect itself when interest rates are expected to rise, it sells quantities of highly marketable RSA or Escom stock, which it does not own, to reduce the loss which would otherwise be suffered.

10. It is believed that the incidence of bear selling on the part of pension funds is minimal, particularly as regards equities.

*Options*

11. In South Africa, pension funds deal largely in stock options and the interest in equity options is very limited. This report comments exclusively on the former.

An option is an agreement whereby one party acquires the right to buy or sell to another party a specified stock at a specific price at a predetermined date or period. The categories of options are:

- (a) Call Option                      the right to buy
- (b) Put Option                        the right to sell

Each kind of option can be bought or sold. A pension fund can, therefore, participate in the option market in any of the following ways:

- (i) Write Call Options              sell the right to buy to another party
- (ii) Buy Call Options                buy the right to buy from another party
- (iii) Write Put Options              sell another party the right to sell
- (iv) Buy Put Options                buy the right to sell to another party

12. It is outside the scope of this report to give detailed examples of the arithmetic of the various types of options mentioned in Paragraph 11 (i) to (iv). However, it is useful to give one example and this will relate to Writing a Call Option. Before looking at this example, it is necessary to describe some of the common features mentioned in the definition of an option contained in paragraph 11. The features are described, firstly, in general terms, and secondly, in specific terms for the purpose of the example:

Stock description	Escom 10% stock 1/11/2007
Period	Three months 29/8/84 to 29/11/84
Spot rate	The last traded market rate at the time of entering into the option agreement. 16%
Strike rate	Level to which rate must either decline (call option) or rise (put option) in order for option to be exercised. 15,80%
Premium	This is the price paid to the seller of the option. It is determined by three factors, that is, volatility, intrinsic value and time value. The greater the volatility of the price of the stock the greater the chance of a move in favour of the option holder and the higher the premium. The intrinsic value is the profitable difference between the strike and spot prices if the option is exercised immediately. Time value refers to the fact that a longer dated option will have a higher premium than a shorter dated one. R13 000
Types of option	There are "American" options and "European" options. The former implies that the holder may exercise his right at any time during the option's contract period. This is the more common type of option in South Africa. A European option may only be exercised for settlement on a specified date. The example given below is an American option.

13. Having defined the features of the option, the next task is to look at an example of Writing a Call Option. The purpose of such writing is to protect the stock portfolio

from, say, a 1% rise in long-term interest rates which would lead to a decline in the market value of the stock.

Let it be assumed that the nominal value of the stock-holding is R1 million and that rates rise by 1% from 16% to 17%. The portfolio would then be adversely affected as follows:

	Market clean price %	Market value of holding
Starting yield 16%	R63,51523	R635 152
Closing yield 17%	59,77516	597 752
Capital loss		37 400
Income at stock coupon rate for three months		25 206
Total return (capital and income)		Loss R12 194

However, the loss of R12 194 could be converted into a profit of R1 551 if the pension fund Writes a Call Option. In this instance the arithmetic is as follows:

	Market clean price %	Market value of holding
Starting yield 16%	R63,51523	R635 152
Closing yield 17%	59,77516	597 752
Capital loss		37 400
Income at stock coupon rate for three months		25 206
Option premium		13 000
Interest on option premium		745
Total return (capital and income)		Profit R1 551

14. It should be noted that the investment outlook is never certain. The Writing of the Call Option was done on the grounds that rates would rise by 1%. They could, of course, remain unchanged in which case a calculation will show that the total return would be R38 951 compared with R25 206 without the option premium. On the other hand, rates could decline by 1%. In this instance, the pension fund would receive a total return of R47 707 with the option premium, whereas, if the call had not been written, the total return would have been R68 591. These various possibilities highlight an important feature about options. That is, the total cost is known from the outset and it is possible to calculate minimum profits or maximum losses.

15. Some other beneficial strategies using stock options are given below:

Buy a call option when it is believed that rates will decline.

Buy a put option with the purchase of stock. If rates rise significantly, the option can be exercised and this will reduce the loss.

Write a put option if it is believed that rates have peaked.

16. In Section 2 (C) 8 it was mentioned that the potential loss on bear sales is limitless in that the price of the asset can rise to any level. The same applies to options which are written when the writer does not have possession of the asset concerned. This is commonly known as a "naked option". The writing of such options is considered to be an imprudent practice for pension funds unless the investments concerned are highly marketable and can be easily acquired to meet the commitments. To take one example of an acceptable strategy; if a pension

fund believed that interest rates were likely to rise, the fund could write a naked call on a marketable Escom stock. The premium could then be used to offset the expected loss on unmarketable stocks in the fund's portfolio. On the other hand, if the pension fund's view on interest rates was incorrect and rates fell, this would mean that the fund could easily buy the marketable stock and deliver this to the buyer. The premium would reduce the cost of this purchase.

17. It is recommended that pension funds be cautious about the option documents which they accept. Such documents should be from persons or institutions whose financial qualifications (in terms of net assets) meet acceptable criteria. Alternatively, such transactions should be restricted to those persons or institutions whose open risk positions are monitored and acceptably regulated. In this context, it is felt that the criteria of the Gilt Clearing House should be used.

#### Financial futures

18. A futures contract is an agreement to buy or sell, on an organised exchange, a standard quantity of a specific financial instrument or currency, at a future date, and at a price agreed between the parties. Although contracts are traded between buyer and seller on an exchange floor, each has an obligation, not to the other, but to an exchange clearing house. The clearing house performs the role which the name implies and also acts as the guarantor of the contract to both the buyer and the seller.

19. South Africa does not have a financial futures market and it may be some time before such a market is established. In view of this, the detailed mechanics of futures will not be commented on in this report. However, the following two broad examples are given to show how the investment management of a pension fund could usefully use financial futures:

(a) In the recent past, the yield curve has been negatively sloped. That is, higher rates have been paid on the shorter end of the market than on the longer end. If a pension fund has money to invest it is faced with a difficult decision. Does it make a long-term investment at a lower rate, where it might have potentially greater appreciation in price in future, or does it maximise immediate return by purchasing shorter term money market instruments? By using the futures market, the pension fund can have the best of both worlds. It can invest its cash in short-term money market instruments earning a high current yield but not lose advantage of capital appreciation in the long-term market. It can do this through the simultaneous purchases of a long-term gilt futures contract and high-yielding short-term money market instruments. The purchase of the long-term futures contract locks in today's prices on long-term gilts.

(b) Market conditions do not always allow investment management sufficient time to execute the right strategies. Often, investment management may decide to purchase a block of shares but will find that the securities are not readily obtainable from the market. Even if the securities are available, the size of the purchase, if executed immediately, could raise the price. A simple way of overcoming these problems is to purchase a futures contract on the price level of the share market and this will be closely correlated with the price movement of the required security. This allows investment management the time to accumulate the securities in the cash market without being subject to the full risk of a change in market prices. As the cash securities are purchased, in-

vestment management will sell the futures contracts that had been bought. The profits and losses from the futures contracts would then be applied to offset the change in the purchase price of the cash securities.

20. The main disadvantages of futures include the following:

the potential profit/loss of a futures contract is virtually unlimited as it corresponds to the future price of the asset;

most futures markets generally demand daily settlement of losses and gains. Thus, using a futures contract can have a very real impact on the cash flow of a buyer or seller.

#### **The society's views on the suitability of warehousing, forward transactions, bear sales, options and financial futures**

21. From the preceding comments on these investment strategies, it is evident that they have two common characteristics. Firstly, they can be successfully used to achieve the main objective of investment management, which is to achieve a high investment return on the assets of a pension fund. Secondly, they are often equivalent to borrowing on the part of a pension fund. However, borrowing is permitted in terms of Circular PF 21 provided that it has certain characteristics. These are that it must be of a temporary nature and used for bridging unforeseen cash shortages or for taking advantage of attractive investment opportunities. Moreover, the aggregate amount of such borrowings should not exceed one-half of the gross income from all sources during the immediate preceding financial year. The meaning of "gross income" is not clear but it is assumed to be total income from investments plus profits or less losses on the sale or redemption of investments and before the deduction of any expenditure. Gross income will vary from one pension fund to another and from one period to another but it will probably represent about 10% of the total assets of a pension fund at market value. Circular PF 21 provides that half of this, that is, 5% can be in the form of borrowings. This is a very modest level of borrowings by any standard.

22. It is believed that many pension funds are not aware of the guidelines on borrowing mentioned in Circular PF 21. It is suggested that a new circular be issued on this subject incorporating the following changes and additions:

(a) The limitation on borrowings be changed from that based on "gross income" to "not more than 10% of the total assets at market value or book value, whichever is the greater". This will simplify the current definition and raise the level of borrowings to something a little more meaningful.

(b) That forward purchase transactions, the sale of naked options and bear sales be regarded as borrowing and should be defined as such.

(c) A pension fund's auditors should be made responsible for verifying that the 10% borrowing limitation is not exceeded.

(d) Short selling and the writing of naked options are considered to be imprudent practices for pension funds unless the investments concerned are highly marketable and can be easily acquired to meet the commitments.

(e) Financial futures are not available in South Africa. If they become available, it is recommended that the definition of borrowing be extended to include future

purchases. Pension funds should then also be made aware of the almost unlimited loss that can arise on future sales as well as the cash flow strains that are caused by the demands for daily settlement of losses.

### **Section 3**

#### **Recommendations**

1. The text of Section 2 discusses, firstly, whether a pension fund's investment in the equity of a company should be limited by imposing a maximum percentage shareholding in a company. Secondly, consideration is given to limiting a pension fund's investment in any one share to not more than a specified percentage of the value of the fund's portfolio. Thirdly, comments are made on the investment strategies of warehousing, forward transactions, bear sales, options and financial futures and whether these are suitable for pension funds. In this final part of the report, the various recommendations are collected under the headings of the three topics.

#### **2. Should a pension fund's investment in the equity of a company be limited by imposing a maximum percentage shareholding in a company?**

(a) The Society dislikes imposing a maximum percentage shareholding in a company. However, the Financial Institutions Office may believe that a constraint is necessary to control a relatively small number of imprudent pension funds. If a constraint is imposed, it is recommended that the maximum percentage a pension fund should be allowed to hold be set at not less than 30% equity interest in a company and this will enable the pension fund to block special resolutions where necessary. The exclusions to this general rule are investments in investment companies, holding companies or property companies provided that the direct and indirect interest of the pension fund in any of the underlying companies does not exceed the said 30%. As these are new requirements, existing holdings in excess of these limitations should be allowed to continue but no further investment should be permitted. The auditors of pension funds should be made responsible for certifying that these limitations have not been exceeded. Provision should also be made for the Financial Institutions Office to grant exemption from these limitations (Section 2 (A) 2).

(b) One of the problems associated with a large percentage shareholding in a company is that it provides scope for abuse. In this regard, it is recommended that the Financial Institutions Office issue a circular to pension funds which draws attention to the important provisions of the Financial Institutions (Investment of Funds) Act No 39. This legislation requires that investment management observes the utmost good faith and exercises the usual care and diligence required of a trustee and does not make use of the funds of the pension fund in a manner calculated to gain directly or indirectly any improper advantage at the expense of the pension fund. If any member of investment management is directly or indirectly personally interested in a transaction, he must in terms of the Act, declare his interest to the governing body of the pension fund before the action concerned is taken. It is recommended that such declarations be minuted by the fund. It is also recommended that directors' fees received from a company should be for the account of the pension fund or employer company and not for the personal benefit of any member of investment management (Section 2 (A) 3).

**3. Should a pension fund's investment in any one share be limited to not more than a specified percentage of the value of the pension fund's portfolio?**

(a) The Society also dislikes a restriction of this nature. As an alternative, it is recommended that the Financial Institutions Office issue an information circular to pension funds that reiterates the principles of diversification of equity portfolios. The circular should include the well-known "portfolio risk profile" which illustrates that specific risk is diversified by having about 20 shareholdings. This profile also shows market risk which relates to the variation in returns of an equity caused by fluctuations in the returns of the market. In this context, the "market" refers to either the total equity market or a specific sector of the market such as the mining sector. Adequate market diversification implies that the portfolio shareholdings are spread over a number of sectors rather than being invested in one sector (Section 2 (B) 1 to 2).

(b) The information circular mentioned in 3(a) above should lead to an improvement in the diversification of pension fund equity portfolios. If the Financial Institutions Office subsequently finds that controls are necessary, the Society recommends that the maximum size of a shareholding be 15% of the total assets of the pension fund, expressed in terms of either market value or book cost, whichever is the greater. This limitation could, of course, be exceeded through appreciation of the particular shareholding or through mergers of companies. In such situations, the pension fund should make no further purchases of the share and within 24 months should reduce the shareholding to 15%. The same time period should be given to pension funds to adjust excessively large shareholdings when control legislation is introduced. A pension fund's auditors could be made responsible for certifying that these limitations have not been exceeded (Section 2 (B) 3).

**4. The investment strategies of warehousing, forward transactions, bear sales, options and futures**

(a) These investment strategies can be used to achieve superior investment returns for pension funds and are therefore regarded by the Society as being suitable stra-

tegies, subject to certain qualifications mentioned below (Section 2 (C) 1 to 20).

(b) It is believed that many pension funds are not aware of the guidelines on borrowing mentioned in Circular PF 21. It is recommended that a new circular be issued drawing attention to these guidelines and incorporating the following changes and additions:

(i) The limitation on borrowings be changed from that based on "gross income" to "not more than 10% of the pension fund's total assets at market value or book value, whichever is the greater".

(ii) That forward purchase transactions, the sale of naked options and bear sales be regarded as borrowing and should be defined as such.

(iii) A pension fund's auditors should be made responsible for verifying that the 10% limitation is not exceeded (Section 2 (C) 3 and 22 (a) to (c)).

(c) Short selling and the writing of naked options are considered to be imprudent practices for pension funds unless the investments concerned are highly marketable and can be easily acquired to meet the commitments (Section 2 (C) 16).

(d) Pension funds should be cautious about the option documents which they accept. In this regard, the Society believes that the criteria of the Gilt Clearing House should be used (Section 2 (C) 17).

(e) Financial futures are not available in South Africa. If they become available, it is recommended that the definition of borrowing be extended to include future purchases. Pension funds should then also be made aware of the almost unlimited loss that can arise on future sales as well as the cash flow strains that are caused by the demands for daily settlement of losses (Section 2 (C) 18 to 20 and 22 (e)).

**5. The Society appreciates the invitation to prepare this report and offers to provide any amplification, either verbally or in writing, that the Financial Institutions Office may require.**

Johannesburg