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THE IMPORTANCE OF A LONG-TERM APPROACH TO FUNDING RETIREMENT BENEFITS

EXECUTIVE SUMMARY: In our last Quarterly Commentary we introduced some of the main issues being debated in the South African retirement fund reform process. In this article, Christo Terblanche provides some insight into why Allan Gray believes retirement benefits should be based on a 'Fully Funded' rather than a 'Pay-As-You-Go' system.

Everyone will be affected by retirement reform and the outcome of the debates presently being conducted. New retirement system design decisions will have a material impact on how comfortable you will be, both during your working life and in retirement. These decisions include how contributions will be determined; how these will be administered; if and how your contributions will be invested; how benefits will be determined and the amount of choice that you will have in the process.

Current debates

The government, in collaboration with labour and the private sector, is still in the process of making many of the proposed system design decisions. Through a series of articles, we plan to consider a number of these issues, including:

- The choice between Defined Benefit (DB) and Defined Contribution (DC)
- A single fund versus individual accounts
- Public versus private administration and investment management
- The extent of individual choice in the system

In this article we examine how your retirement benefit will be funded. What we mean by 'funded' in this context is how your retirement benefit or pension payments will be provided. In other words, when you retire, will your pension be paid by:

- Those who are in the workforce at the time that you retire (also referred to as a Pay-As-You-Go or PAYG system) or
- The accumulated assets that you contributed when you were working plus investment returns (also referred to as a Fully Funded or FF system)?

Pay-As-You-Go and Fully Funded systems defined

Pay-As-You-Go (PAYG) systems transfer the contributions of today's labour force to pay the benefits of today's retirees. Contributions are not saved and invested. Rather, they are immediately spent on the pensions of current retirees. In exchange for their contributions, today's workers are promised that tomorrow's workers will pay their benefits.

Fully Funded (FF) systems retain the contributions of today's workers to pay them their benefits in their retirement. How these funds are managed and invested can differ, but the critical point is that contributions are put aside for the future rather than spent immediately.

The implicit rate of return of a PAYG system

The rate of return of a PAYG system may not be immediately evident, as assets are not accumulated. Rather, the rate of return is an implicit one. Each year, the total contributions from a PAYG system will be equal to the number of workers multiplied by the average wage multiplied by the contribution rate. Taking the contribution rate as a constant, the amount of money paid each year will increase (decrease) if there are more (less) workers and if the real wage has increased (decreased). Therefore, the implicit rate of return is the growth of real wages plus the growth of the labour force.

There are three key reasons why Allan Gray prefers an FF system to PAYG for retirement benefits:

1. We believe FF systems enjoy a higher rate of return in the long run

It may be tempting to argue for a PAYG system because the current generation of retired people may be more likely to experience immediate benefit. Relative to an FF system, a PAYG system is easy to put together and can start paying out benefits immediately. This means that those who have not contributed at all and those who will contribute for only a portion of their working life could get a higher and immediate return.

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However, we believe that, in the long run, the rate of return (to those who will enjoy the benefits in retirement) of an FF system is higher than the return of the PAYG system. After the initial windfall has been spent, the rate of return of a PAYG system diminishes considerably. The challenge is that an FF system is a long-term project which will take decades to mature.

Factors that affect the rate of return
Fully Funded
The rate of return of the FF system is the return of capital net of fees. It is affected by: • The rate of investment returns • Fees
Pay As You Go
The rate of return of a PAYG system is the growth rate of total real wages. It is affected by: • The growth of real wages • Population growth rate

Population growth can affect whether a PAYG or FF system is more attractive

The experience of a wide range of countries shows that, in the long run, the rate of return on a combination of stocks and bonds generally outperforms the growth rate of real wages by between two and three percentage points. This implies that, if a country's population is growing rapidly, i.e. by more than 2-3%, then a PAYG system is more attractive than an FF system. However, over the last 50 years population growth rates have slowed considerably and many countries across the world have stagnant or even declining populations.

Africa may be the youngest continent in the world with the highest population growth, but we are not immune to the problem of ageing. South Africa's population growth rate has been declining since 2001. Currently, the population growth rate is less than 1% and is expected to continue to decrease. This is largely due to the HIV/AIDS pandemic. HIV/AIDS is particularly harmful to a PAYG system's implicit rate of return because it is a disease which primarily strikes the working age population.

We believe that it is easier for the free market and competition (if need be, regulated by government) to control and thereby reduce fees (the factor that affects the return of an FF system) than it is to increase the growth of real wages and the population growth rate (the factors that affect the return of a PAYG system).

South Africa has the luxury of having a blank slate. We can learn from the experience of the countries that implemented PAYG systems 50 years ago and which are now paying the costs. In our view, we have an opportunity to be responsible and take a long-term perspective, choose to implement an FF system from the start and expect to enjoy the higher rate of return.

2. The risks present in an FF system can be better managed than those in a PAYG system

PAYG supporters argue that, while the returns on an FF system exceed those of the PAYG system, capital market returns are much too risky. While it is true that stocks and bonds are more volatile (as recent experience shows) than the real wage bill, PAYG benefits may be promised but they are not risk-free.

PAYG benefits are subject to political risk

PAYG benefits are subject to the risk that policies will be changed. Also, the sustainability of contribution and benefit rates are subject to future fertility, immigration, mortality and real wage growth rates – variables with highly uncertain future paths. Over time, the government would have to make periodic adjustments to the parameters of the system – by increasing contribution rates or decreasing benefit rates – in order to keep the system financially solvent. This means that people cannot rely on the benefits they have been promised. Benefits are up to the generosity of future generations – they must be willing to vote for an increase in contribution rates to support the benefits that have been promised. These policy changes are unpredictable, partly because they are subject to political will and partly because the costs of a PAYG system are less transparent than those in an FF system.

Investment managers are able to reduce or 'hedge' risk through diversified portfolios, governments can regulate investment options, and limit or restrict investment into 'risky' assets, but we believe that it is more difficult to anticipate, manage, limit or hedge against political risk.

The FF system adds capital market risk, but this is not correlated with wage growth and reduces individual portfolio risk

For the majority of people, salaries are the single most important determinant of lifetime income. An individual's salary is highly subject to the total real wage growth of the population. A PAYG system imposes even more of this risk onto people. If we seek to reduce the overall volatility of a person's portfolio, then we believe a PAYG system is not the appropriate choice. The better choice is an FF system because, although it adds capital market risk, this is not perfectly correlated with real wage growth (the two move up and down largely independently of each other) and therefore reduces individual portfolio risk.

"An FF system is better than a PAYG system because it can increase national savings and help to improve our current account balance."

3. FF systems can raise national savings and thus benefit the economy

Investment is essential for economic growth. In South Africa we have a current account deficit. The more South Africans save, the less dependent we will be on foreign capital inflows to balance this deficit. An FF system is better than a PAYG system because it can increase national savings and help to improve our current account balance.

An FF system will increase national savings if we assume that the mandated savings will not result in an equal decrease in voluntary savings. This is a reasonably safe assumption to make in the South African context. South Africans currently save very little. Household savings as a percentage of disposable household income has dropped sharply since the early 1990s, from 5.35% in 1992 to a negative (i.e. the amount of borrowing exceeds the amount of savings) 0.74% in the first quarter of 2008. While it is possible that people may choose to borrow even more, it is unlikely they will be able to, given the already high levels of debt, the 2007 National Credit Act (NCA) – which has made it much more difficult to borrow – and high interest rates. With household debt already at a historic high of 78.16% of disposable income as of the first quarter of 2008, it is not likely that South Africans will be able to offset the new mandated savings via increased borrowing.

A PAYG system may reduce national savings

In contrast, a PAYG system could decrease national savings to the extent that the mandatory system reduces voluntary savings. Why? In a PAYG system the mandated contribution is not actually saved, but rather transferred to retirees. This implies that, if people reduce their voluntary savings at all when the mandatory system is put in place, savings which may have been put in the bank, bonds, stocks or unit trusts will be handed over instead to retirees to be consumed. The effect is a reduction in overall national savings which will further increase our current account deficit.

Allan Gray believes in taking a considered and long-term approach to investment

Our arguments in favour of an FF system apply to the retirement funding pillar or component of retirement fund reform. Certain other parts of retirement fund reform may be better suited to other systems of funding. For example, a PAYG system may work very well for the basic state pension (social security). This is because individuals who need to rely on this do not have disposable income (if any income at all) and are therefore unable to save for themselves. Even up to a reasonable income bracket a wage subsidy may help alleviate the pressure of the contributions.

We believe South Africa needs an FF system for retirement benefit funding to increase savings and promote transparency and competition in retirement provision. This will enhance individual accountability and is in line with our investment approach of taking a long-term view.