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THE FSB BULLETIN

is available on the Internet:
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Investments: The suitability test

By Anton Swanepoel,
counsellor on FAIS

Providers are faced with an interesting challenge when giving advice to investors with certain financial needs, but whose risk profiles prevent providers from advising on products appropriate to their financial needs.

In this article I focus on the requirements in terms of paragraph 8(1)(a), (b) and (c) of the General Code of Conduct, contained in the Financial Advisory and Intermediary Services Act (FAIS Act), 2002, which states:

A provider other than a direct marketer, must, prior to providing a client with advice-
(a) take reasonable steps to seek from the client appropriate and available information regarding the client's financial situation, financial product experience and objectives to enable the provider to provide the client with

appropriate advice;
(b) conduct an analysis, for purposes of the advice, based on the information obtained;
(c) identify the financial product or products that will be appropriate to the client's risk profile and financial needs, subject to the limitations imposed on the provider under the Act or any contractual arrangement...

Although the General Code of Conduct gives investment advisors a sound framework for appropriateness of advice, it is not that simple in practice. The reality is that most clients have financial needs that are difficult, if not impossible to address.

Statistics for example show that less than 6% of South Africans are in a financially secure position to retire. This implies that more than 94% of people who want to retire are not in a position to do so. They simply do not have enough retirement capital to meet their needs. It may not be feasible for them to meet their financial needs at retirement. Such clients usually require an unrealistic investment return on capital to meet their income needs. It is therefore necessary to put the obligations of

providers under the aforementioned suitability provisions into perspective in order to understand the meaning of *risk profile* and *financial needs*.

Financial need(s)

Financial needs have not been defined in the FAIS Act and therefore the normal meaning of the words must be used. Financial means "connected with money and finance"¹ and need means "to require something because (it) is essential or very important, not just because you would like to have (it)"².³

A person may need R10 000 per month after tax to pay for a roof over his or her head and to feed the family. However, an investment of R800 000 may not be enough to sustain this need over the life expectancy of the investor. To achieve this outcome, it may be necessary to invest in a financial product offering a high return, but as we know higher returns are normally associated with taking on bigger risk.

It is for this reason that the General Code of Conduct measures the appropriateness of the financial product in accordance with the financial needs and the client's risk profile – not only one or the other. This means that the advisor will have to carefully consider both aspects before recommending a financial product. The general duty of providers serves as a reminder of what is expected from advisors.

*A provider must at all times render financial services honestly, fairly, with due skill, care and diligence, and in the interests of clients and the integrity of the financial services industry.*⁴

In this case the emphasis is on *due*

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skill, care and diligence, and in the interests of clients as it takes all those qualities to give appropriate advice to clients who can ill afford to take on too much risk.

Meaning of risk profile

The term risk profile has not been defined in the FAIS Act and therefore the normal meaning of the words must be used in its application under the Act. *Risk* means the possibility of something bad happening or a situation that could be dangerous. To risk something is to do something even though the result could be unpleasant.⁵ *Profile* is a description of something that gives useful or important information.⁶ A person's profile may also be defined as a *character sketch*.

Risk profiling has been a topic of debate over the past years and in March 2009, I conducted a survey to establish what 25 top investment advisors think about its fundamentals.

Objective of the debate

The objective was to agree on the basic fundamentals pertaining to appropriate risk profiling of investors that will:

- truly serve investors, contribute to appropriate advice and enhance the integrity of the financial services industry; and

- ensure compliance with paragraphs 8(1)(a), 8(1)(c) and 9 (adequate record-keeping) of the General Code of Conduct, which address the topic of adequate record keeping.

Profile of investors (clients)

The survey showed that all providers that took part had extensive experience in advising investors who require capital growth *and* income from their portfolios. These providers therefore have an understanding of both income and capital growth needs and objectives of their clients. Only a sound understanding of the risks and the ability to determine the risk profile of clients⁷ will enable providers to offer appropriate solutions as required in terms of the General Code of Conduct.⁸

Definition of risk

Of all the participants 73% defined risk as losing capital in nominal terms, or losing capital in real terms over a certain investment period.

Of all the participants, 9% defined risk as *losing capital in nominal terms* and 9% defined risk as *volatility*.

Conclusion

More than 80% of participants agreed that risk should be defined as the *risk of losing capital*. This is consistent with the

meaning of the word as defined in the dictionary.

Investment term

All the participants agreed that, when doing investment planning, the investment term is more important than the age of the investor. This view is also consistent with those expressed by:

- Benjamin Graham in *The Intelligent Investor*; and
- Warren Buffet, who at the age of almost 80 still invests in long-term assets.

Investment objectives

The majority of participants agreed that investment objectives should relate to matching or outperforming inflation, net of cost and net of tax. Eighteen percent (18%) of participants believe that outperforming cash is a better point of reference.

South African case study

In the matter between Melcolm Arnold Birken and Fidentia Financial Advisors CC, the FAIS Ombud issued a determination in favour of the provider on the following provisions in the agreement between provider and client:

- The client's investment objective was clearly defined;⁹
- There was agreement on the expected return (benchmark);
- The investment term was defined;¹⁰ and
- There was agreement on the fact that the investment capital and target return could not be guaranteed was disclosed to the client and agreed to.¹¹

What if there is a discrepancy between the client's cash flow, capital growth needs and risk profile?

This is where the FAIS Ombud will ask the ultimate question, namely: Did the provider render financial services

References

¹Oxford Advanced Learner's Dictionary, p 551

²My insert

³Oxford Advanced Learner's Dictionary, p 979

⁴See paragraph 2 of the General Code of Conduct

⁵See Oxford Advanced Learner's Dictionary: p.1264

⁶See Oxford Advanced Learner's Dictionary: p. 1160

⁷Par 8(1)(c) of the General Code of Conduct

⁸Par 8(1)(c) of the General Code of Conduct

⁹As required in terms of par 8(1)(a) of the General Code of Conduct

¹⁰As required in terms of par 7(1)(c)(vii) of the General Code of Conduct

¹¹As required in terms of par 7(1)(c)(xiii) of the General Code of Conduct

¹²My wording

¹³See paragraph 2 of the General Code of Conduct

¹⁴See par 3(1)(d) and 9 of the General Code of Conduct

Filling new shoes

New appointments at the FSB



**Abel Sithole,
FSB Board Chairperson**



**Hillary Wilton,
Deputy FSB Board Chairperson**



**James Cross,
FSB Board member**



**Dawood Seedat,
Chief Financial Officer**



**Patrick Ward, Head: Collective
Investment Schemes**



**Pieter Oosthuizen,
Manager: Supply Chain**

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honestly, fairly, with due skill, care and diligence, and *in the interests of the client*¹² and the integrity of the financial services industry?¹³

If the client's risk profile indicates that he or she could not tolerate

a capital loss of more than what the client had to accept to achieve a certain return, the client's risk profile would be the limiting factor and therefore the dominant force in the decision-making process.

Advisors should therefore make very sure that they are able to reach an

agreement with their clients as far as their needs and risk profiles are concerned.

Advisors should attempt to find the balance between the two and document the agreement between the parties.¹⁴



One securities exchange for South Africa



**By Norman Müller, Head:
Capital Markets, FSB**

On Monday, 27 October 2008, the JSE Ltd (JSE) announced its intention to make an offer to acquire all the issued ordinary shares of the Bond Exchange of South Africa Ltd (BESA).

The JSE and BESA decided that the most effective way to implement the transaction was by way of a Scheme of Arrangement between the JSE and BESA shareholders in terms of section 311 of the Companies Act, 61 of 1973. This would result in the JSE acquiring the entire share capital of BESA and BESA becoming a wholly owned subsidiary of the JSE.

The JSE's ultimate objective is to integrate the business of BESA into the business of the JSE, i.e. the take-over of the business and winding-up of BESA, with the latter ceasing to exist as a

separate legal entity.

Application by the JSE

Section 57 of the Securities Services Act, (SSA) 2004, requires that the Registrar of Securities Services approves the acquisition of more than 15% of the issued shares of an exchange. Furthermore, in terms of section 54 of the SSA, the Registrar must approve any merger of two or more exchanges or the transfer of assets and liabilities by one exchange to another. As a result of the interconnectedness of the two applications, the Registrar decided to deal with the two issues as part of a single process.

Approvals required

The implementation of the Scheme of Arrangement was subject to the fulfilment of the conditions of the Scheme document. This included

the approval of the Scheme by the majority of the members of BESA; the sanctioning of the Scheme by the High Court of South Africa; the registration of the court order sanctioning the Scheme in terms of the Companies Act; and the securing of the necessary approvals or consent from the Securities Regulatory Panel, South African Reserve Bank, Competition Authorities and the Registrar.

After extensive consultation with all stakeholders, the Financial Markets Advisory Board, and the National Treasury, the FSB approved the transaction on 11 May 2009, subject to the following:

- that the conditions in the Scheme of Arrangement are met;
- that the Registrar has approved the integration plan and the fixed income growth strategy;
- that the JSE trading costs will not be increased for the first two years following the approval of the fixed

FSB fundamental to sound financial environment

Abel Sithole, new chairperson of the FSB's Board, writes on leading the Board and the FSB's role in fostering a sound financial environment.

It is a privilege and a great honour to be tasked to serve the country and its people by leading the FSB, especially during this period when South Africa and the world weather a global financial crisis and an economic downturn of the magnitude likened to the Great Depression.

In steering the FSB for the next three years, I will be guided by and call on the support of very capable colleagues, independent Board members and executives. We will continue our risk-based approach to regulation and supervision while

engendering an appreciation of the role of the FSB.

The FSB's role is to oversee the non-banking financial sector comprising all insurers, collective investment schemes, financial services providers, retirement funds, friendly societies, nominee companies and securities exchanges, as well as associated matters such as securities brokers and dealers, insider trading and market abuse.

This means that the FSB is fundamental to the promotion, maintenance and preservation of a sound financial environment and efficient market for the benefit of investors and those who serve them.

This is a very broad ambit. It is not possible for the FSB to know the specific details of the products and services that underpin the relationships between investors and those who serve them and to have detailed and specific rules and regulations that apply. Hence,

our principle rather than rule-based approach to regulation and supervision.

It is therefore incumbent on the FSB to work closely with investors and market participants. Its success hinges on investors and market participants following the rules and playing fair and exposing market abuse, financial crime, unauthorised businesses and illegal activities. To this end, the Board will foster an environment where investors and market participants have confidence in the FSB and actively assist it in meeting its mandate through compliance and exposing non-compliance.

The task of running the FSB is the responsibility of the executive officer and deputies as both executives and registrar as provided in legislation. It is my and the Board's responsibility to

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- that the National Treasury shall be guaranteed two seats on the JSE Interest Rate Advisory Committee;
- that a technology plan for the interest rate market be submitted to the National Treasury and the FSB to ensure system reliability;
- that the Bond Market in South Africa will not be negatively affected; and
- that any further requirements or conditions that the Registrar may impose are met.

Development of a fixed income strategy

The JSE must, in consultation with the FSB and other stakeholders, formulate a fixed income growth strategy, which will serve as a tool for the implementation of the integration of the exchanges. For

this purpose, the JSE will establish an Interest Rate Advisory Committee, which will be representative of all relevant stakeholders.

In view of the National Treasury being an important role player within the bond market, two seats will be reserved for representatives of the National Treasury as members of the Advisory Committee.

Benefits of the transaction

In processing the applications, due regard was given to the regulatory implications on the South African capital markets and of the furtherance of the objects of the SSA.

The FSB views the following as benefits:

- Improved risk-management processes

will enhance efficiency in the South African capital markets;

- An enhanced trading model funded from the existing capital; a strong balance sheet;
- A variety of products allowing greater flexibility to meet customer needs;
- Increased liquidity;
- A reduction in costs through economies of scale, including lower regulatory costs;
- More effective supervision by the FSB;
- The elimination of risk of regulatory arbitrage;
- Defragmentation of the South African capital markets; and
- Enhanced global competitiveness of the South African markets.



FATF commends SA on fight against financial crime

By Themba Hlengani, Communications and Marketing Manager at the Financial Intelligence Centre

South Africa finds itself in a very fortunate position at the time of the worst global financial crisis in recent history. Our banks have not seen the same sort of liquidity crunch as those in countries such as the United States and the UK, let alone Iceland.

Although international credit rating agencies are not racing to upgrade local banks, they will find solace in a thumbs-up to South Africa from an international body.

In a report released in February by the

Financial Action Task Force (FATF), the Paris-based body commended South Africa for "its strong commitment" and for the "good progress in developing its anti-money laundering system" to combat terror financing. The report confirms the high supervisory standards of the local financial sector and shows confidence that our banks and other financial institutions offer limited scope for money laundering or terrorism funding activities.

Assesment

The FATF Report is the result of a recent assessment by a team of experts on combating money laundering and terror financing.

The FATF also found that key local law enforcement authorities, such as the South African Police Service (SAPS), South African Revenue Service (SARS), Asset Forfeiture Unit (AFU) and the

Financial Intelligence Centre (FIC) are co-operating efficiently in the fight against financial crimes.

Little is known about FATF in South Africa. This important inter-governmental body, consisting of members of 34 of the world's leading industrialised and developing countries, develops and promotes policies and standards to combat money laundering and terrorist financing. The FATF was created in 1989 to help bring about legislative and regulatory reforms to combat financial crimes. South Africa became a member in 2003.

Such is the success and stature of FATF, that several members of the G20, who met to discuss the global financial crisis, suggested that the FATF approach in dealing with money laundering should be utilised more broadly to track tax evasion and other violations of financial regulations.

The FATF regularly assesses its

members and their legal systems, looking at a variety of issues such as preventive measures on financial and non-financial businesses and professions, their enforcement mechanisms and the effectiveness of the country's implementation thereof through peer review.

It uses a comprehensive and detailed methodology to conduct the assessments. The resulting report and ratings are shared with the IMF, World Bank and other international institutions and then used, for example, by credit ratings agencies in their risk rating of countries.

Scored highly

Although South Africa has only been a member of the organisation for five years, it scored highly in most areas. South Africa is on par with, and in some areas, performed better, than many of the developed member countries.

The FATF report recognises that the process to develop a sound anti-money laundering environment has involved close cooperation and coordination between a variety of government departments and agencies.

The report also noted that South African authorities used as reference the United Nations Conventions and international standards to construct its systems.

Most of the laws and processes that were scrutinised during evaluation last year, were formulated and implemented in the past decade, such as the Prevention of Organised Crime Act, 1998, and the Financial Intelligence Centre Act, 2001. The latter Act paved the way for the establishment of a central financial intelligence point to receive reports of suspicious financial transactions. The Centre is commended for its pivotal role in giving coherence to the country's anti-money laundering system.

Money laundering activities in an economy undermine faith in the integrity of the country's financial markets, denting investor confidence. Effective controls serve to protect the integrity

of financial markets, attract and retain foreign direct investment.

The South African authorities have recognised that the incidence of crime, particularly white collar crime and other crimes which generate proceeds of crime, such as drug-dealing or transit cash heists, increase the risk of laundering activities.

The FATF notes that South Africa has established comprehensive mechanisms to cooperate on operational matters. According to the report, good working relations exist between the SAPS, SARS and units of the National Prosecuting Authority and the FIC. This ensures a holistic approach to fighting financial crime. It also notes that the South African approach seeks to build relationships with the private sector.

This partnership involves institutions such as the FSB, Bank Supervision Division of the SARB and the JSE Limited on the one side, and the banks, insurance houses, stock brokers and financial advisors on the other. This partnership has ensured that our financial institutions are well regulated and not vulnerable to criminal abuse.

This has a huge spin-off for local institutions pursuing business opportunities in foreign markets. The

FATF report sends a strong signal to regulators and investors in foreign markets of the high standards applied to local financial institutions. This should give confidence to international investors looking at South Africa as their business destination.

While the FATF praises South Africa for the progress it has made in recent years, it also notes that there remain certain deficiencies in the country's anti-money laundering system which need improvement.

Work is already underway to address these areas. Among these are issues such as the need for customer due diligence to be more comprehensively performed by financial and other institutions, the need to introduce measures to secure electronic funds transfers, and for the full disclosure of cross-border transfers of cash.

The report also suggests that while the laws and systems are now in place, the South African authorities should demonstrate their effectiveness by securing an increased number of successful prosecutions for money laundering.

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encourage them to work with investors and their providers, to listen to their concerns and to learn from their experience and independently use this to inform regulation and supervision.

The global financial crisis has resulted in calls to review financial market supervision and regulation to bolster and build a more resilient financial system at the local and international arena. There is therefore the real risk of overreaction that may lead to overly tightening regulation to the extent of stifling legitimate financial development and innovation that oils the functioning of the financial system. The challenge of supervision and regulation is striking the right

balance between restrictive regulation and laissez-faire deregulation. It is my and the Board's responsibility to ensure that we respond appropriately and prudently when there is a breach and ensure that regulation is proposed to correct any failures without hobbling the effective and efficient operations of the financial and investment market. Our task is the prudential management rather than the total elimination of the risk that is an inherent part of all business, especially of the entities that the FSB regulates. It is not the role of the FSB to curtail risk-taking and its rewards, negative or positive, but it is our responsibility to endeavour to ensure that such risk-taking is not detrimental to investors and the macro-investment environment.

(Presentation on financial literacy and the education system at the Hope Global Financial Literacy Summit in Washington DC.)

Why financial education?

The complexity of financial products; the increase in the number of financial products; increases in life expectancy; changes in pension arrangements with many countries shifting from defined benefit to defined contribution plans in which the risk is transferred to the consumer and low levels of financial literacy are some of the factors which point to a need for coordinated, accountable and measurable consumer financial education initiatives.

Why the formal education system?

Our values, attitudes and behaviour as adults are shaped at a very early age. Children, if well taught, know the difference between right and wrong before or by the age of seven. Children nowadays have pocket money which they may either spend or save; some of them are even given credit cards to use for various purchases. Finding and keeping a job, managing money and making it last for a month, income tax, not understanding how pension funds work or what unemployment insurance means are issues that many adults grapple with; so how much more critical isn't it for youth to have this information when starting their financial lives?

A survey on young people and financial matters in France in 2007 showed that the majority of youth overestimated their knowledge about control of money matters and how to budget, save or contact the bank. Their knowledge about pensions and insurance was found inadequate and they were afraid to talk about credit.

The Organisation for Economic Co-operation and Development (OECD, 2005) has drafted *Principles and good practices*

for financial education and awareness. In the section on Public Action for Financial Education, countries are encouraged to include financial education in schools. The good practice states:

Financial education should start at school. People should be educated about financial matters as early as possible in their lives.

What is the FSB doing about financial education of youth?

The FSB identified the formal education sector as a key area for creating awareness about financial literacy and consumer education. We promote and initiate programmes which will see learners leaving school with sufficient information and skills that will enable them to take responsibility for their financial future, make considered decisions and know how to act when things go wrong.

In 2003, the FSB and stakeholders recommended to the Department of Education (DOE) to include financial education in the National Curriculum Statement for South Africa. It was recommended to incorporate financial education into various subjects such as economics, business, accounting, maths and life orientation. This recommendation was implemented, although there is no policy requirement for financial education to be taught in schools.

Discussions with the Director-General of the DOE pointed to the need for teacher development in the management of personal finances. The Director-General gave the FSB a list of possible initiatives to strengthen the financial education of scholars.

A major priority was to give teachers resources such as actual lesson plans for identified learning areas and subjects, drawn up in line with curriculum requirements including learning outcomes and assessment standards. The identified learning area was Economic and Management Sciences (ages 6-15), and subjects



Making e

By Olivia Davids, Head: Consumer Education

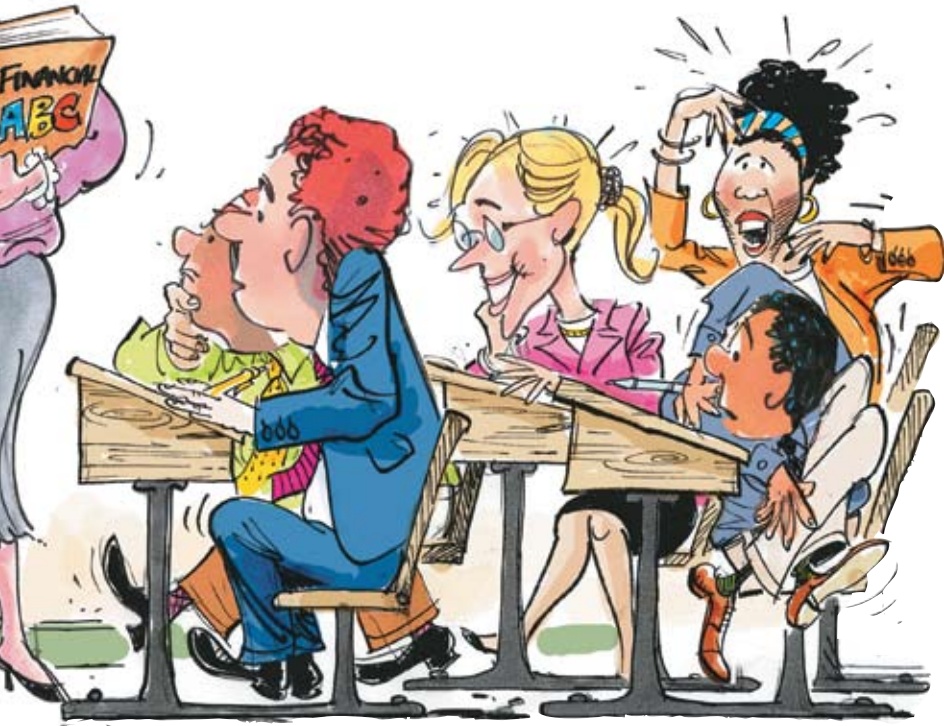
were Mathematical Literacy and Life Orientation (ages 16-18).

Teacher resources

The FSB and the South African Insurance Association proceeded to oversee the development of financial education resources for teachers. Mathematical Literacy resources, including lesson plans and posters for grades 10, 11 and 12, were prepared.

The key to the success of these resources is that they are in the form of lesson plans, based on South Africa's National Curriculum Statement and readily usable in the classroom.

Teachers were also provided with opportunities to engage with the materials in workshops around the country and to give input into the usefulness and appropriateness of the



Education relevant

n, FSB

materials.

The DOE played a major role in assisting with reviewing and quality assuring the materials to ensure they met the curriculum requirements. The appearance of the DOE's logo on our materials give the assurance that they have the DOE's approval.

Digitisation of consumer education booklets

Another partnership project involved the alignment of the three FSB consumer financial education booklets with the National Curriculum Statement in keeping with the Economic and Management Sciences (EMS) curriculum for grades 0 – 9, as well as Mathematical Literacy and Life Orientation for grades 10 – 12. These materials were digitised onto CD-ROM resulting in an interactive



resource which teachers can access. It has a voice over facility and cartoon characters for learners. The CD-ROM format is supported by four booklets covering each of the phases of the EMS curriculum. This project was undertaken by the FSB, the South African Insurance

Association and the Financial Services Consumer Education Foundation.

Financial guidance for the youth

The FSB developed a booklet specifically for youth between 18 and 22 years which includes information on opening a bank account, debt management, the unemployment insurance fund, income tax, life insurance, savings, budgeting, etc. Workshops on this booklet were completed with high school and university students, as well as newly employed youth.

Career fairs

The FSB participates in career fairs and uses these opportunities to talk to students about the importance of being aware of the need for personal financial management when starting careers or in the working world.

Lessons learned

The following elements contributed to the successful implementation of consumer education in schools:

- We engaged with the DOE at national and provincial levels and involved the DOE in these projects from the start.
- The DOE appointed staff from their curriculum development unit to work with the FSB and our partners.
- The DOE provided a letter of support for these projects which assisted access to provincial departments and schools.
- The resources developed were designed to be entrenched in the curriculum and were prepared according to curriculum requirements. They are not "add-ons" which are often not used.
- Four out of six professional staff members in the FSB's Consumer Education Department are qualified school teachers with experience in all levels of formal education, as well as adult education. We therefore have an

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understanding of how the education system works.

- The financial education resources were developed by those in the field, i.e. teachers, education officials and financial sector practitioners.
- All material is neutral with no marketing or mention of specific brands.
- Resources are not just handed out, but distributed as part of a workshop where trained facilitators can show teachers how to use the resource in the classroom.
- Using “professional development” of teachers regarding financial management to help overcome the hesitancy about engaging with students on these sometimes complicated concepts.
- Resources are workshopped with district, provincial and other DOE staff.
- Monitoring and evaluation systems were put in place at all phases of development, print, distribution, dissemination and implementation. Here the DOE also played a crucial role through feedback from its support personnel.

What is happening elsewhere?

A current OECD survey which deals with the prevalence of financial education in schools and other policy and structural issues found that out of 31 countries, 17 said that financial education was taught in schools, while 14 said it was not. There is a wide variety of interventions but the matter of evaluating the success of financial education programmes in schools remains a challenge.

Activities

Mexico has introduced a safety week at schools to teach students about the importance of insurance.

Japan has established a programme on the importance of disaster prevention in insurance. In Germany partnerships have been established to enhance the

integration of financial education into school curricula.

Teachers’ manuals are being produced as well as courses for secondary students and on-line financial education programs. In the UK, the FSA has produced resource materials for teachers while in the USA there is a wide range of courses through universities and on CD-ROM.

Poland has used media coverage for an annual competition for the best Masters or Ph.D research relating to insurance.

This is done in partnership with the insurance ombudsman. Mexico organises contests for research into insurance and prevention. Iceland has a computer game for elementary school students while only a few countries such as the UK and Malaysia have programmes for university students.

What are the educational resources being used?

Countries are producing a variety of resources in the form of games, print materials, internet programmes, websites, student competitions, and films for use in the formal education system. Ireland has produced resources for students while South Africa and the UK have targeted their resources mainly to teachers.

What are the challenges in establishing financial education in the formal education system?

Early indications from the OECD survey on financial education in the formal education system are that a low level of subject knowledge of teachers is a barrier to the effective education of students.

Other barriers include insufficient time, financial education not being part of exams, a lack of resources, fragmented training and staff turnover. In other cases financial education in the formal education system was not a priority for some national governments. There was also a lack of sustainable

funding in some cases. Whether or not financial education was taught in schools depended on the school or the individual teachers.

Conclusion

The inclusion of financial education in schools in a serious, sustainable and coordinated way is in its infancy. There is a need to review current practice and identify and implement workable and effective programmes to enable the youth to deal with the complexities associated with money and finances. The above challenges represent opportunities for making this a reality.

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Hedge funds pose new challenges

By Robert Foster, Chairperson of the Alternative Investment Management Association

Globally, the hedge fund industry is celebrating its 60th birthday while the industry in South Africa is only approximately ten years old. As in other countries, the industry in South Africa came slowly out of the blocks with only a handful of funds available for several years.

Since 2002 the growth in hedge funds and assets under its management has however been exponential and currently there are 160 such funds and assets to the value of R26 billion under its management.

In 2004 the FSB, the Alternative Investment Management Association (AIMA) and the Association for Savings and Investment SA (ASISA) penned a joint discussion paper on the regulatory position of hedge funds in South Africa

that described the industry as vibrant, growing and in need of appropriate regulatory supervision. The paper also acknowledged the high standard of self-regulation in the local hedge fund industry.

Even at this early stage, two potential key areas requiring regulatory supervision were identified. They are manager regulation and product regulation. It was proposed that hedge fund managers should be regulated separately from other investment managers as they require an additional set of skills as they manage funds within unconstrained investment mandates.

These are quite different from their conventional long-only counter parts. As far as products are concerned, the Collective Investment Schemes Control Act, 2002, was identified as the most appropriate environment to accommodate a regulated hedge fund product. In addition, the distribution and promotion of hedge funds were discussed. It was also decided that FAIS

regulation would need to be adapted to accommodate the promotion of hedge funds.

Although it took three years to develop and implement, the licensing of hedge fund investment managers has been achieved in 2007. Currently 125 managers are classified as FSP Category II, regulated discretionary investment managers, capable of managing a hedge fund. Currently the FSB is conducting regular on-site reviews of the authorised managers. This is proceeding well.

Most hedge funds focus on risk management, capital protection and real absolute returns. While all of these attributes are laudable and although the funds have delivered on their mandates in the past, it was difficult to illustrate their value proposition during one of the longest equity bull markets, as most investors were seduced by high and higher equity returns that eventually came to an abrupt end in 2008.

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Hedge funds *continued from p 13*

The global credit crisis hit equity markets in South Africa hard in 2008 with the ALSI down 24% in that year and down 40% at various periods over 12 months. South African hedge funds in contrast, showed their most prized value for delivering on average a positive return for 2008. The top ten funds averaged a pleasing 32% in 2008 while 42% of the funds beat money market returns. In total 70% of the funds delivered positive returns.

Hedge fund managers aim to outperform money market returns by 2% – 8% per year over time but with considerably lower levels of price volatility when compared to other comparable investment vehicles. They invest in shares, fixed income, money markets and derivatives that allow them to reduce the overall risk and volatility of the portfolios while achieving the return profiles. By all internationally and nationally accepted measures of risk, hedge funds generally outperform their long-only counterparts.

Investors in hedge funds are generally high net worth individuals and large institutions such as retirement funds. In South Africa the current split is about 50/50. Increasing demand from retirement funds is however shifting the new inflows in favour of institutions.

These investors have two things in common. They are looking at maximising investment returns with the least amount of risk possible and they usually

employ the most professional advisers to assist them. These investors insist on getting the best (alpha generating) investment management possible, often with unconstrained full discretionary mandates. Hedge fund managers fulfil this role.

The hedge fund industry is currently self-regulated. This does not mean that mistakes cannot happen. It is clear from conventional fund management that regulation does not protect an investor from poor investment management. The most significant example of hedge fund mismanagement happened recently. A manager of a single fund (as opposed to a fund consisting of hedge funds) took a short position in a share that continued to rise, resulting in significant losses for the fund. The manager exited the position, closed the fund and some investors lost 60% of their investment.

Other types of investments, such as significant weightings to small-cap shares have landed a few funds in trouble, especially when markets turned quickly in the first three months of 2008. These risks are however not confined to hedge funds only. From its peak in 2008 of R550 the Anglo American share price fell to below R170 or 70% over six months. For the first time in over 70 years the company did not pay a dividend. Anglo American is a popular share that most investment managers bought for investors in the past and therefore investors would have suffered considerable losses.

Currently the hedge fund industry,

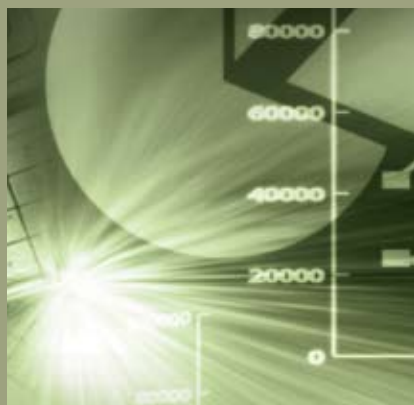
represented by AIMA and ASISA, The National Treasury and the FSB are now tackling the product regulation issue. All parties have agreed that regulation of hedge fund products will be beneficial. The challenge will be to balance the needs of the clients (for unconstrained investment management) with that of the industry (official recognition of hedge funds as investments). An appropriate level and workable regulatory framework will also have to be found.

In addition to local considerations the international environment also needs to be considered, as South Africa ideally needs to comply with or even set international norms and standards. The Regulator requested the industry to consider options that would work within the collective investment schemes framework and at a recent (2nd July 2009) hedge fund workshop investment managers, risk managers, custodians, prime brokers, administrators, legal advisors and asset consultants discussed a proposed framework.

The outcomes were presented to the FSB for comment. A working group consisting of representatives from AIMA, ASISA, the FSB and National Treasury will then draft a Hedge Fund Regulated Product Proposal. The industry has targeted the end of November 2009 as the date for final submission of the proposal.

The key factors emerging from the recent workshop are:

- The industry is confident that any hedge fund product regulation can be accommodated under the Collective Investment Schemes Control Act, 2002;
- Recommendations will be locally focused but must be internationally recognisable;
- Risk management will be key to the separation of duties and independence of pricing essential elements;
- The transparency and reporting frequency of pertinent information between the funds and the Regulator are fundamental; and
- Management of exposures (instruments), counter party risks and systemic risks are essential.



The challenge will be to balance the needs of the clients (for unconstrained investment management) with that of the industry (official recognition of hedge funds as investments).



Risk profiling questionnaires in financial planning

By Cobus du Plessis, Institute of Behavioural Finance

In the article “FSPs should warn clients of financial risks” (FSB Bulletin, First Quarter 2009), Advocate Ken Silke refers to the fact that FSPs are required to give advice on financial products, which are appropriate to a client’s risk profile and needs according to the FAIS General Code of Conduct.

He argues that since the words “risk profile” are not defined in the Financial Advisory and Intermediary Services Act (FAIS Act), 2002, it should be given a broader interpretation to include the numerous risks that a client could be exposed to.

What is the South African situation?

Most South African financial planners use some form of a risk profiling questionnaire.

In many instances they use a relatively simple questionnaire, probably provided

by a product provider. The client will complete it quickly, often with the planner’s assistance, since there is a perception that financial planners know the FAIS Act.

In most instances the completion of the risk questionnaire is linked to the selection of one of five investment portfolios ranging from conservative to aggressive, according to the client’s investment.

I am of the opinion that most financial planners don’t necessarily determine the risk tolerance of clients. Most use an “asset allocation questionnaire” which asks questions about the client’s investment experience such as situation and time horizon, to select one of four or five investor profiles, for each of which there is a model portfolio. There is no output from this process other than the asset allocation recommendation. It sometimes adds a brief description of the characteristics

of the recommended strategy and the type of individual it is thought to suit.

Understanding risk tolerance

Each person has a slightly different understanding of risk tolerance. When asked to describe risk tolerance, one may get answers such as:

“It’s the level of volatility an investor can tolerate.”

“It is where someone feels comfortable on the risk/return spectrum.”

Different terms such as risk tolerance, risk attitude, risk capacity and risk appetite are used to describe risk-related concepts, not necessarily with the same meaning. To avoid confusion it is necessary to understand what is meant by risk tolerance. Some commentators use terminology such as risk attitude (how much risk the client chooses to take) and risk capacity (how much risk the client can *afford* to take; how much money the client can *afford* to lose without putting the achievement of financial goals at risk). For others, risk tolerance is a combination of risk attitude and risk capacity.

For the financial planner it is important to distinguish between and understand both the client’s risk attitude (a *psychological* attribute) and risk capacity (a *financial* attribute). In this article “risk tolerance” means the psychological

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attribute. Since risk tolerance affects how individuals make decisions, the following definition best describes that the client has to decide between alternative courses of action:

“Risk tolerance can be defined as the extent to which a person chooses to risk experiencing a less favourable outcome in the pursuit of a more favourable outcome.”

What has research taught us about risk tolerance?

- Males are more risk tolerant than females.
- Risk tolerance decreases with age.
- Risk tolerance correlates positively with income, wealth and education and negatively with marriage and number of dependants.
- Test/re-test studies over 30 to 120 days produced strong correlations between the first and second tests. The studies provide strong evidence of the stability of risk tolerance. The risk tolerance of clients does not necessarily change as we move between bull and bear markets. However, the client’s perception of risk, risk capacity and/or financial goals may change. Personality traits do change, but usually gradually over time.
- Financial planners are not particularly good judges when estimating a client’s level of risk tolerance. One could not rely solely on a financial planner’s judgment to establish a client’s level of risk tolerance. The use of a valid test is therefore advisable.

Problems with traditional risk tolerance questionnaires

Many risk tolerance questionnaires deal with financial aspects that do not form part of risk tolerance. This can be ascribed to the use of “asset allocation calculator” questionnaires that are often thought of and incorrectly described as testing for risk tolerance.

Validity of questions

Although time horizons (client’s age, stage of life, when money will be needed) are relevant in the financial planning process, they are not relevant in a risk tolerance context. For example: “I plan to make withdrawals from the investment within the next five years” has nothing to do with risk tolerance. The question deals with financial goals and planning.

Questions requiring explanation

The client will need the help of the planner to complete the questionnaire in many instances. Once this happens, results are influenced and the objectivity compromised.

Over-reliance on investment issues

In most instances questionnaires rely heavily on questions focused on investment issues. Financial planning is not just about investment advice but financial issues in general. Risk tolerance is relevant to all financial decisions.

Why are clients unhappy even after they’ve completed a risk questionnaire?

Although risk tolerance questionnaires are mostly “asset allocation calculators”, financial planners should understand the value of a proper risk tolerance questionnaire and where it fits into the financial planning process. A questionnaire that only leads to some asset allocation in isolation will lead to an unhappy client. It is also important to distinguish between clients who are unhappy with their investment return but not the advice, and those who are unhappy with both returns and advice.

The first group will include clients with an *informed commitment* to a plan that includes proper consideration of risk tolerance, which is *but one of three* risk-related inputs into a portfolio

recommendation. The other two being the risk taken to achieve one’s goals (*risk required*) and the risk one can accept without changing one’s goals (*risk capacity*). Those clients that are unhappy with both advice and returns will be those where the financial planner did not get the full commitment from the client since there was no proper assessment of all of the risks involved.

When deciding on which portfolio best suits the client’s needs, the client and financial planner must take the three risk-related parameters into account: the client’s risk required, risk capacity and risk tolerance.

The following example illustrates the principle:

The financial planner calculates that the client needs a very aggressive portfolio to achieve his life ambitions. However, by questioning and analysing the financial planner discovers that the client cannot afford to lose more than 20% of his investment assets without having his lifestyle and ambitions changed, which means a conservative portfolio. After doing a risk tolerance assessment the financial planner discovers that the client has a low to medium risk tolerance, which would lead to a moderate portfolio.

Clearly there are three different asset allocations leading to three different outcomes:

- Is any one of the portfolios right for the client?
- Which allocation will cause the client the greatest and the least anxiety?
- Are there alternatives?
- What is the right way to proceed, recognising the substantial differences in long term outcomes?
- How should the client make those decisions?

The client needs to make the decision because he is the one who has to live with the consequences. The client must give his informed commitment to the asset allocation to be implemented.

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Spotlight on major providers

Source: Excerpt from *Business Day*, 22 June 2009.

Intermediaries' organisation recognises members' achievements in the most comprehensive analysis of insurance product providers undertaken in South Africa, writes David Jackson.

Triple award winner Santam was a major honours recipient in the short-term insurance category for the second year running at the Financial Intermediaries Association (FIA) annual awards ceremony in Johannesburg on 21 June 2009.

Santam scooped the pool this year in personal lines, commercial and corporate short-term insurance categories.

Momentum Wealth took the top award for best insurance investment product,

while Discovery Life and Discovery Health scored for the best life/risk and health care products respectively.

Liberty won a new category of employee benefits.

FIA president, Arnold van der Linde, says that it has been 16 months since the formation of the new intermediaries' representative body.

The FIA has amalgamated with the South African Financial Services Intermediaries Association (SAFSIA), the Life Underwriters' Association of South Africa (LUASA) and the Independent Broking Council (IBC), forming the basis for an enlarged FIA.

Van der Linde says the FIA members now account for about 85% of all short-term business placed in the South African insurance market and about 50% of all business placed in the long-term life assurance and investment categories.

The FIA has approximately 4 500 members, mostly made up of companies or financial services providers registered with the FSB. They in turn employ about 18 000 advisers throughout the country.

"We are very satisfied with the coming together of the three organisations to form the authentic representative body of intermediaries in South Africa," says Van der Linde.

"Our biggest challenge is to structure ourselves in such a way that we can carry out the tasks that our members have indicated they want us to tackle on their behalf, specifically issues arising from a recent survey to determine members' needs.

"The big message that came through – and the aspect on which we focus most – is that they want us to represent the intermediary in South Africa at all levels.

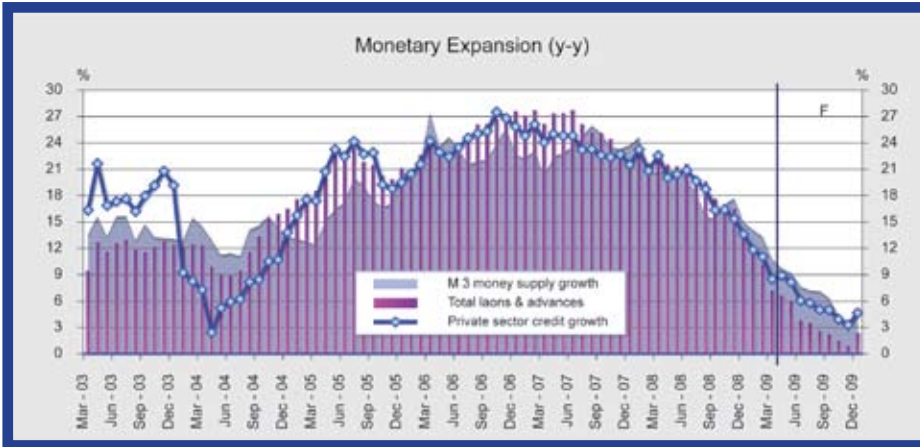
"This would include representation on other bodies in the insurance industry, as well as in interaction with the FSB and in submissions made by the FIA to Parliament, thus ensuring that we partake as intermediaries in improving the professionalism of the industry."

In April this year the FIA was represented at two international conventions, both of which it is a member. The FIA attended the Council for International Intermediaries Broker Associations in Hong Kong as well as the World Federation of Insurance Intermediaries.

"Feedback from member countries indicated that we all grapple with the same core issues, namely conflict of interest, disclosure and transparency.

"While listening to the problems in other countries, I felt proud of what the Financial Advisory and Intermediary Services Act (FAIS Act), 2002, has achieved in South Africa to date. We have tackled this legislation maturely. The FIA is proud of its role in this and we will continue to play an important role going forward in the formulation of insurance-related legislation," he said.

(Article shortened.)



Economic outlook

Rather look at trends than economists' predictions

By Flip Meyer*

Economists have underestimated the influence of the recession in South Africa. In February 2009 economists in general predicted a positive growth of just over 1%, but by June this year the consensus view was that for the full calendar year the South African economy would shrink by about 0,5%.

The bite of the recession has been severe due to the world economy being in turmoil. In some emerging markets of Eastern Europe, for example, Latvia, the economies have already shown negative growth of 16%. The South African experience has been far less negative than in many emerging markets.

The origin of the problem has been the crisis in the US and the developed countries in Europe. Due to the worldwide recession exports have fallen. Markets have been volatile and performing the function of an economist,

has almost become an impossible job. However, there are ways to read trends in times of uncertainty. Updating forecasts at least monthly has become more important than ever.

The more than 30 economists participating in the Economist of the Year Competition of the financial newspaper Sake24, became pessimistic as the months went by. For a long time the R-word (recession) was avoided but now it has become common knowledge that South Africa has not escaped the crisis. However it could have been worse if one views what is happening elsewhere in the world.

Sound fiscal and monetary policies have helped South Africa to manage the crisis better than many countries. However, the South African Reserve Bank (SARB) has come under criticism for waiting too long to lower interest rates. The Monetary Policy Committee raised the Bank's key interest rate ten

times between June 2006 and June last year, an action which trade unions blame for pushing the economy into its first recession in 17 years.

From December 2008 until the end of June 2009 the rate has been cut six times.

Although it has been left a bit late, rate cuts are already beginning to help households pay off debt. The economists foresee that the prime lending rate of banks would be 10,53% by the year-end. Inflation will come down nearer to the top end of the inflation target (6%). The inflation target set for the SARB is between 3% and 6%. Inflation is much higher than the target. Due to the fall in demand for products and services it is expected that the inflation rate will decline to 6,76% as an average for 2009.

Even though still above the top inflation target, South Africa would still have a high real interest rate should the prime lending rate of banks decline to 10,5% by the year-end. Compared to the expected inflation rate, the real interest rate would be about 4%. In a world economy where real interest rates are very low or zero, South African real interest rates should still be attractive to foreign investors.

South Africa needs capital inflow as the balance of payments is a major concern.

There is a mixture of good and bad news. Some of the good news is that economists expect South Africa to return to positive economic growth. This will happen early in 2010. The latest consensus view of the economists is a positive growth rate of 2,5% for 2010. Hopefully this becomes reality.

Unemployment

The bad news is that this will not be enough to make a meaningful contribution to the high unemployment rate in South Africa. The year 2010 can be described as one of moderate economic growth. South Africa needs a growth rate of 5% before any meaningful dent can be made in the high unemployment rate.

Unemployment has been stretched to the middle class as thousands have lost their jobs. It will take time for the

unemployed to enter the labour markets again.

At least a positive economic growth rate for next year will stop the bleeding. Labour unions have been putting pressure on the SARB to be more aggressive in cutting interest rates to soften the blow of the recession. On this point there have been some warm debates. Mr Tito Mboweni, governor of the Reserve Bank has to control inflation and protect the value of the rand. Labour unions view the reduction in unemployment as a priority and some demands have been that Mboweni and the monetary policy team should cut rates by 2% at a time and not only 1%.

The value of the rand has been volatile and the strength experienced in May and June was positive. However, the US dollar has been under pressure and much of the rand's strength has been the result of short term volatile conditions in the international exchange markets. The strength of the rand against the dollar brings some relief as all oil transactions are done in US dollars. This helps to take off the pressure on the petrol price.

Nevertheless, there is no guarantee that the dollar will not strengthen against the rand. Economists predict that the average value of the rand in the fourth quarter of 2009 would be R8,93 for one US dollar. In February these economists predicted a rate of R9,68 for one US dollar. The outlook for the rand has improved.

Predicting the value of the rand is a very difficult exercise as outside influences play a big role. What happens elsewhere in the world can have a big influence on the rand's value in a very short time.

Do not count on the rand trading under R9 to the dollar if you are an exporter or importer. Just be grateful that the rand has not weakened to levels above R10 to the US dollar.

As for the Euro, the consensus forecast is that the average exchange rate for the fourth quarter of 2009 will be R12,03 as opposed to R12,84 in February.

Economists differ on the value of the

rand and have reported their forecasts in terms of averages rather than fixed rates. For example, some economists foresee that the average value of the rand to the US dollar will be close to or over R10, while some predict a rate of under R8 to the US dollar. In this regard an average does not paint the full picture of what can happen to the value of the rand against the US dollar and Euro.

This shows us how volatile markets have become during testing times. The more volatile markets are, the more difficult it becomes to make forecasts. Business people and consumers need some sort of guide. Economists can change their predictions every month and therefore it is better to look at trends.

To conclude, here are some of the expected trends:

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powerful educational experience about risk and return. *The financial planner's role in this process is to suggest alternatives, to illustrate outcomes and to recommend, but not to decide.*

This process is called Gap Analysis and is usually resolved by a combination of:

- Increasing the resources through earning more and/or spending less, and converting personal use assets to investment assets.
- Easing the goals through delaying, reducing and/or discarding.
- Taking somewhat more risk than would be the client's preference (but not to the stage that in a downturn they might panic and sell.)

This process is at odds with much of standard industry practice where "asset allocator calculator" questionnaires are used to decide on the best portfolio. However, a short cut runs a high risk that there will be a poor match between the investor's needs and the portfolio recommended. This is bound to result in a greater risk of client unhappiness,

*A better economy in 2010 than the crisis in 2009;

*Lower inflation and a positive reaction to lower interest rates;

*A mild recovery in the job markets with fewer retrenchments;

*South Africa is still a long way from the booming periods when the economy grew by 5%. No economic boom is in sight for the next year or two;

*Mild increases in household spending as households will pay off more debt should their income increase.

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higher levels of product churn and the likelihood of dissatisfaction and complaints.

Financial planners will therefore need to investigate and take all aspects of risk into consideration and not blindly use the "risk profiling/asset allocator calculator" questionnaires currently found in South Africa.

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