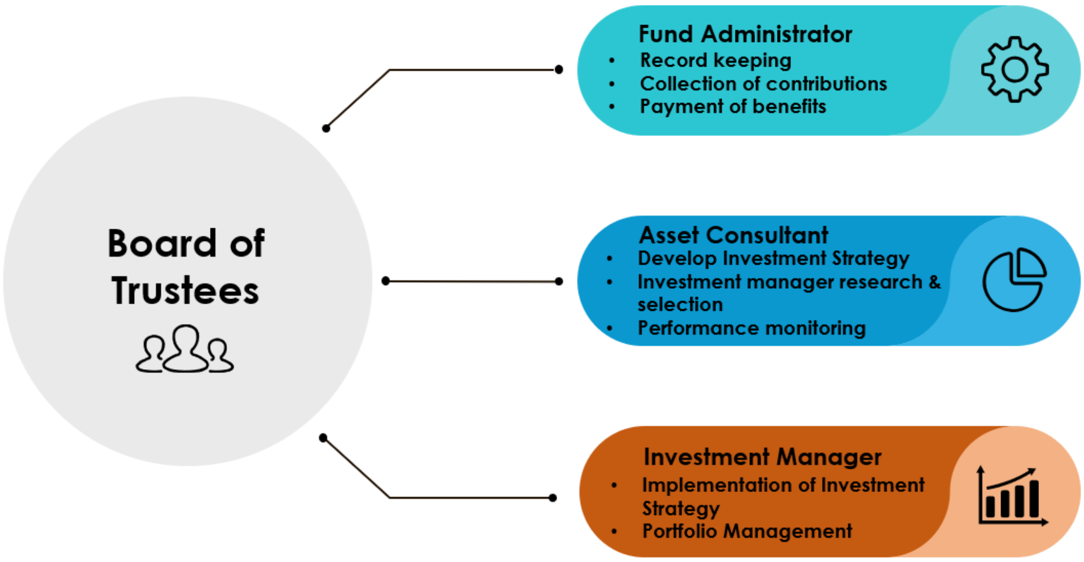
Framework for Investing Pension Fund Assets

Botswana's current pension funds setup is relatively new and constituted BWP118.8 billion in assets as at the end of January 2022. The early 2000s ushered in the Defined Contribution ("DC") pension plans, which replaced the Defined Benefit ("DB") regime. According to the NBFIRA 2020 Statistical Bulletin, the number of registered standalone retirement funds was 81 in 2019, comprising of 76 DC funds, 3 DB funds and 2 mixed funds. Under the DB regime, employers guaranteed employees specified retirement benefits based on the employee's years of service and remuneration, among other factors. On the other hand, the DC pension plan is such that the employers and the employees contribute to a pension fund, which is in turn invested to earn returns. As such, an employee's DC retirement benefit is determined by contributions into their pension "account" and the investment returns earned on these. With the switch to the DC regime, the burden of managing retirement savings has effectively moved away from employers and to retirement funds' Boards of Trustees.

Figure 1: Pension Fund Service Providers



The Retirement Funds Act (2014) prescribes that "*The object(ive) of the Board (of Trustees) shall be to manage a licensed fund in the best interests of its members…*". However, the Trustees are not alone in this responsibility; they rely on appointed service providers. These service providers include Pension **Fund Administrators**, Investment Managers and **Asset Consultants** (*there are more pension fund service providers, but we will focus on these three*). Fund administrators administer the day-to-day running of the fund's business, including maintaining member records and collecting pension contributions and withdrawals. On the other hand, Asset Consultants help pension funds develop investment strategies and advice on all issues relating to investments. Lastly, **Investment Managers**, such as Botswana Insurance Fund Management Limited ("Bifm"), play a critical role of implementing the fund's investment strategy by investing and managing pension funds assets.

It must be noted that Investment Managers invest pension fund assets' within the confines of a signed **Investment Management Agreement** (IMA), which contains investment parameters aimed at achieving the pension funds' growth objectives. Invariably, the terms of an IMA are unique to each pension fund and are drafted with the assistance of the Asset Consultant to implement the fund's investment strategy. Pension fund investment strategies are guided by both the risk profile of the fund's underlying members and the Non-Bank Financial Institutions Regulatory Authority ("NBFIRA") Pension Prudential Rules – Fund Investment Rules ("PFR2").

The PFR2 specify the exposure limits within which the pension fund assets should be invested and allocated to the different asset classes and jurisdictions (local vs offshore) [*For example, the 30% floor on the pension fund exposure to local assets by local pension funds is prescribed by the PFR2*]. Fund membership factors such as the average age, average years to retirement inform the levels of risk a pension fund can take. Younger membership allows for funds to take on more investment risk, thus informing more aggressive investment strategies. The reverse is also true.

Once an investment strategy is in place, a pension fund then appoints one or more investment managers to implement its strategy. Pension funds may elect to award balanced and/or specialist mandates to pursue their strategy. The balanced strategies allow Investment Managers to invest in more than one asset class. An asset class is a grouping of securities with similar characteristics, such as equities, bonds, cash or property. Balanced mandates can be local-only, offshore-only or global (both onshore and offshore). On the other hand, a specialist mandate allows the investment manager to invest in only one asset class, be it offshore or onshore.

An integral element of managing pension fund assets is the monitoring and evaluation of portfolio performance. For this reason, IMAs specify the portfolio's Strategic Asset Allocation ("SAA"). SAA is a combination of different asset classes exposures that the investment manager should maintain in the portfolio, and it informs the benchmark against which portfolio performance is to be measured. Pension fund assets are invested with a medium to long term view of about three to five years and even longer, guided by SAAs. As such, decisions made by Investment Managers are meant to optimize the portfolio returns over the long term. On an ongoing basis, the portfolio performance is compared to the benchmark performance to gauge an Investment Manager's effectiveness.

Most IMAs between pension funds and Investment Managers are for active management. This means that the Manager has leeway to deviate from the SAA, within the confines of the IMA, in search of excess returns. Broadly, Investment Managers use two sources of excess returns; (1) Asset Allocation and (2) Security Selection. Both of these are informed by the Manager's outlook and comprehensive research.

Asset Allocation entails strategically dividing an investment portfolio across different asset classes such as equities, property, bonds and cash. Asset allocation is especially relevant in balanced mandates and less so with specialist mandates. On the other hand, Security Selection is the process of identifying individual securities to invest in within a certain asset class. Security Selection applies in both balanced and specialists mandates. Given an opportunity set of asset classes and securities to invest in, investment managers would allocate more capital to asset classes and securities where they see value and have positive expectations and less to those they have a negative outlook.

In conclusion, the adage "*it takes a village…*" applies to managing pension fund assets. This responsibility involves the Trustees, Fund Administrators, Asset Consultants and Investment Managers, under the stewardship of regulators, including NBFIRA.

In essence, management of pension fund investments is an art of maximizing long-term returns while minimizing risk exposure, given the available opportunity set.

Retirement Fund Statistics Source: BoB Botswana Financial Statistics March 2022, NBFIRA Statistical Bulletin 2020

Prepared by: Thabelo Nemaorani, Bifm Client Relations Manager