

INVESTMENT NOTE

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POTS, PENSIONS AND PORTFOLIOS



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The most far-reaching change in the South African retirement landscape in many years takes effect next week. After many years of negotiations between National Treasury, the savings industry, unions and other stakeholders, the two-pot system will finally be implemented on 1 September.

Old Mutual has undertaken a huge public education drive, and the details and implications for individuals can be found [here](#).

For the purposes of this note, we'll focus on what it means for investors, markets and the South African economy.

In a nutshell, the two-pot system, as the name suggests, will entail future retirement savings being allocated to two pots. One third will go to a savings pot, which retirement fund members access and two thirds to a retirement pot. Members will be able to withdraw from their savings pot for emergencies at any time,

but only once a year. The retirement pot must remain invested until retirement. There will also be a third pot (the vested pot) that will contain members' existing retirement savings as at the end of August 2024, where the rules will be the same as under the current retirement system. In addition, an amount of 10% of the retirement savings at the end of August 2024 (capped at R30 000) will be allocated to the savings pot, meaning it will be available for immediate withdrawal.

The compulsory preservation component (the retirement pot) will end the widespread practice of people cashing in their retirement savings whenever they change jobs. In fact, many people change jobs just to access their retirement funds. This 'leakage' not only leaves individuals without sufficient retirement capital when they reach old age, but also means the overall pool of South African retirement assets is smaller than it should be.



JUST BECAUSE YOU CAN, DOESN'T MEAN YOU SHOULD

It cannot be stressed enough that early withdrawals from retirement funds should be avoided unless absolutely necessary. The biggest friend any investor has is time, since time facilitates compound growth. Early withdrawals from a retirement fund robs that money of the time to grow. Even at a relatively modest growth rate of 4% per year, R30 000 will more than double to R65 733 over 20 years. At a 6% annual growth rate, it will more than triple to R96 214, and at 10%, will grow to R201 825.

Therefore, taking R30 000 out of your retirement savings today does not mean that your future self will be R30 000

poorer. It means in future you will be poorer by R65 000 or R96 000 or R200 000 two decades from now. It gets worse, since early withdrawals will be taxed at your marginal rate, whereas growth inside a retirement fund is tax-free.

Nonetheless, estimates from the government and various financial institutions suggest that somewhere between R50 billion and R100 billion will be withdrawn in the first month or two after the two-pot system takes effect. This will largely be a one-off event, as future withdrawals will be based on one third of new contributions from September onwards and will therefore be spread out over time.

IMPLICATIONS

This has three immediate impacts. Firstly, since these withdrawals will be taxed, government's coffers will swell. In the February Budget, an additional R5 billion in tax revenue was pencilled in due to two-pot withdrawals.

Secondly, consumers will have more money to spend. A portion of withdrawals will probably go towards settling debt, but the remainder will be spent since it is unlikely that people will withdraw savings only to save it again. Combined with lower inflation and coming rate cuts, the medium-term outlook for consumer spending has therefore improved.

Data released last week showed that consumer inflation declined to 4.6% year-on-year in July from 5.1% in June. This is close to the midpoint of the Reserve Bank's 3% to 6% target range and seals the deal for rate cuts starting at the September Monetary Policy Committee meeting.

Thirdly, there will be some selling of investments to realise the cash payouts. Could it have a disruptive impact on local financial markets? Probably not. The withdrawals will most likely be staggered over a few weeks or even months since not all pension fund administrators will be able to handle the expected volume of requests at the same pace. A SARS directive also needs to be issued in each instance, which

might delay payouts somewhat. Moreover, pension funds already hold cash that will act as a first buffer as the withdrawal requests come in. According to the Alexander Forbes Large Manager Watch, cash holdings in the country's largest balanced funds – a proxy for the broader pension industry – sat at 2.7% at the end of June. This is a relatively low percentage by historic standards, but if applied to the R4 trillion-plus pension industry, should be enough to cover expected withdrawals. Most importantly, however, is simply the fact that the JSE is a large and liquid equity market with an average daily equity turnover of around R20 billion. The average daily turnover on the local bond market is several times larger. As for global markets, these will not even notice if there is large selling by South Africans.

At any rate, market participants do not seem spooked by the prospect of two-pot withdrawals, as the FTSE/JSE All Share Index hit a new record close above 84 000 during the week. Investors are increasingly optimistic that a US soft landing will materialise, and that the Federal Reserve will cut interest rates next month, with the SA Reserve Bank not far behind. There is also growing optimism that South Africa is entering a phase of faster economic growth (from a very low base) and less political noise (also from a low base).

CHART 1: FTSE/JSE ALL SHARE INDEX



Source: LSEG Datastream

PRESERVATION NATION

Most of the media attention on the new retirement system has been on the ability to access the savings pot, and probably correctly so, since there is much financial education work to be done.

But the more important impact over time will come from compulsory preservation. At an individual level, people should end up with substantially higher retirement benefits all else being equal. Modelling by Old Mutual actuaries suggests that the average retirement benefit of pension fund members could rise from the current two to three times of final salary, to up to nine times of final salary, even with the full savings pot being accessed.

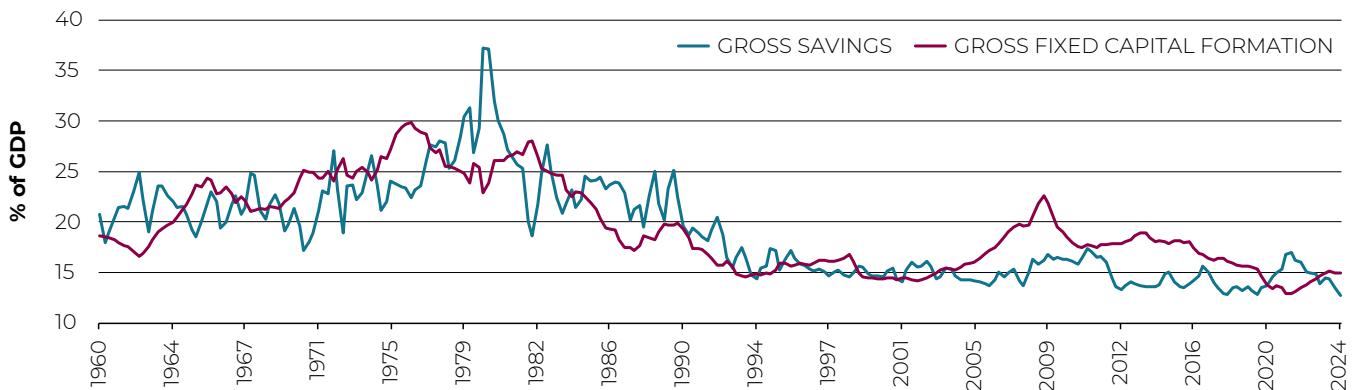
Compulsory preservation is a feature of pension systems in many countries, as is auto-enrolment or mandatory contributions. The South African government has proposed the introduction of auto-enrolment so that all formally employed individuals have some form of retirement savings, but it does not form part of the two-pot system and no timelines have been presented.

At a macro level, compulsory preservation (and auto-enrolment, if it is ever implemented) can contribute to raising South Africa's low savings rate. It is ironic that South Africa has an extremely sophisticated financial system, including retirement funds, asset managers and life insurers,

yet the country does not save enough. Partly, it is a victim of its own success: the sophisticated financial system also facilitates borrowing which is basically negative saving.

As chart 2 shows, there is a strong linkage between savings and fixed investment. A low savings rate implies a low investment rate unless foreign savings can be imported by running a current account deficit. This is fine under normal conditions but has the major drawback that these foreign flows can be reversed, especially if they are largely portfolio investments. This is the case in South Africa, where most foreign capital inflows head for the JSE to buy bonds or equities – 'hot money' that can leave at the click of a button – instead of being invested in long-term businesses as 'foreign direct investment'.

The chart shows a worrying decline in savings over time, partly because of increased borrowing and taxation levels, and partly because of rising unemployment. Investment rates have been depressingly low as a share of GDP over the past 30 years, apart from the period roughly between 2005 and 2015. However, as the chart shows, domestic savings were insufficient to fund this investment boom, and the country ran a large current account deficit during that time which gained it membership of the unfortunate 'Fragile Five' club.

CHART 2: SA SAVINGS AND FIXED INVESTMENT AS A SHARE OF GDP

Source: SA Reserve Bank

Domestic savings is a more stable source of funding for fixed investment, and fixed investment is crucial for sustainable economic growth. If there is one thing that economists agree on, it is that countries that enjoy long periods of rapid economic growth are countries with high investment rates. At 15% of GDP, South African investment levels are around half of where they should ideally be. The blame does not primarily lie with a lack of domestic savings,

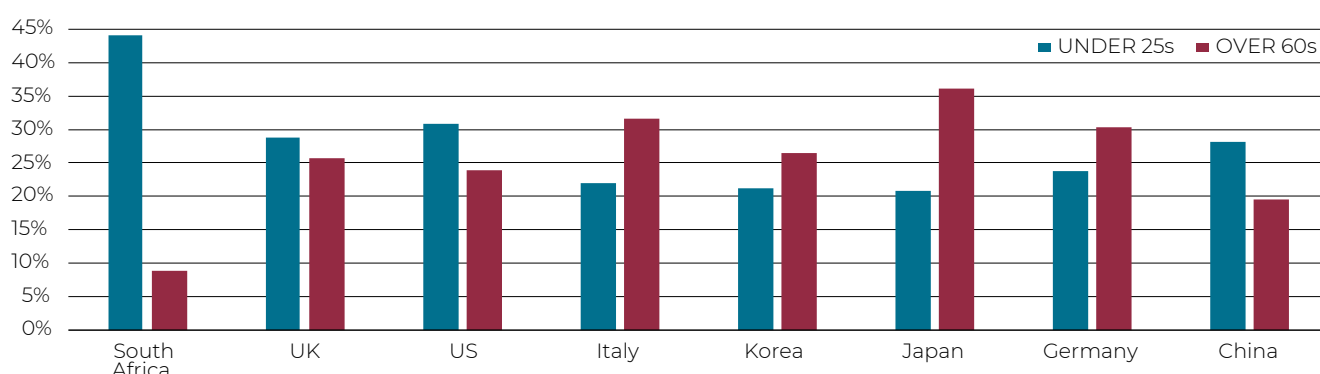
but rather with political and policy uncertainty, institutional bottlenecks and depressed business confidence. But if investment spending was to pick up as some of these challenges are addressed, a shortfall of domestic savings means the current account will start widening again, exposing the country to sudden swings in capital flows. A growing retirement system can ease this constraint over time.

GOVERNMENT DISSAVING

However, it will have to coincide with government borrowing declining relative to GDP. Government borrowing – dissaving – currently consumes a large portion of the domestic savings pool. This ‘crowds out’ private borrowers and raises interest rates, particularly because the market has a dim view of government’s creditworthiness. Despite the recent decline in government bond yields, they remain elevated. Moreover, the large increase in government debt levels over the past 15 years has not been associated with productive spending, such as large-scale infrastructure upgrades that could facilitate future economic activity.

Though the two-pot reforms took several years to come to fruition, the timing is right. South Africa has a young

population that will be moving into its peak earning and contribution years over the next decade or two. Meanwhile, the share of older people who will draw down from the retirement system is small. More money in, less money out means a growing pool of savings. The big challenge in South Africa is high unemployment, particularly youth unemployment. People cannot save for retirement if they don’t work. Nonetheless, South Africa has a better demographic profile than many richer countries in the Northern Hemisphere, with smaller cohorts of younger workers that must support an ever-growing number of retirees. No wonder that questions are being asked about the sustainability of these systems and the political implications of reforming them (such as raising retirement ages).

CHART 3: AGE DISTRIBUTION OF SELECTED COUNTRIES, % OF THE POPULATION

Source: populationpyramid.net

A final point is that while a growing pool of retirement savings should benefit the domestic economy, the extent of the positive impact will depend on where the savings are allocated. For instance, retirement funds can allocate up to 45% to offshore assets under Regulation 28, and this does not contribute to local economic development directly. However, it does contribute to national wealth and provides a natural hedge against periods of rand weakness. Assuming the prudential limits under Regulation 28 do not change, the remaining 55% will flow into domestic markets.

Ideally, a portion of retirement savings would go specifically to infrastructure projects. Some politicians like the idea of 'prescribed assets', forcing pension funds into a set of investments determined by government, to achieve a specific policy outcome.

However, this is neither welcome nor necessary. It is unwelcome because it can lead to inferior investment outcomes. It is unnecessary because Regulation 28 already provides ample room for retirement funds to invest in infrastructure. The biggest reason behind a lack of private investment in infrastructure to date has not been an unwillingness on the part of retirement funds but rather the lack of investable infrastructure projects. This is starting to change at both an ideological and practical level.

Ideologically, the government has backed away from the view that the state must control the country's network industries and it now welcomes private sector participation (not to be confused with privatisation, however). Practically speaking, much more attention is being paid to the regulatory impediments.

Deputy Finance Minister David Masondo made a similar argument recently at a conference hosted by Old Mutual, noting that government aims to "promote a policy environment that enhances pension portfolio returns, promotes market stability, and avoids compromising both the pre- and post-retirement lives of citizens".

In summary, most of the attention on the new two-pot system has been around the early access to savings for emergencies. But it is the introduction of mandatory preservation that is the game changer. However, its success will ultimately depend on it being combined with other reforms, including fiscal consolidation, private sector participation in infrastructure, and deregulation, to raise economic growth and employment levels. It can then become a self-reinforcing positive spiral with a powerful impact on the domestic economy and local markets in the years ahead.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	3 650.0	1.84%	2.18%	15.18%	24.23%
United States	S&P 500	US\$	5 635.0	1.46%	2.05%	18.13%	27.03%
Europe	MSCI Europe	US\$	2 210.0	3.03%	3.32%	9.41%	17.43%
Britain	FTSE 100	US\$	11 007.0	2.31%	2.31%	11.79%	18.14%
Germany	DAX	US\$	1 795.0	3.16%	3.82%	13.33%	19.03%
Japan	Nikkei 225	US\$	265.7	3.02%	1.91%	11.96%	20.21%
Emerging Markets	MSCI Emerging Markets	US\$	1 101.0	0.64%	1.47%	7.52%	13.51%
Brazil	MSCI Brazil	US\$	1 536.0	-0.19%	7.79%	-14.67%	-4.30%
China	MSCI China	US\$	56.8	0.07%	1.21%	2.34%	-1.88%
India	MSCI India	US\$	1 107.0	1.45%	-0.72%	20.06%	36.33%
South Africa	MSCI South Africa	US\$	468.0	1.74%	4.23%	12.77%	18.18%

EQUITIES - SOUTH AFRICA (TOTAL RETURN UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	84 352.0	1.84%	1.92%	9.70%	13.95%
All Share	All Share (Total Return)	Rand	15 201.0	1.92%	2.07%	12.17%	18.36%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	37 240.9	1.94%	1.98%	12.23%	18.91%
TOP 40/Large Caps	Top 40	Rand	13 720.0	1.76%	1.88%	11.45%	16.58%
Mid Caps	Mid Cap	Rand	24 551.0	1.94%	1.48%	12.69%	22.52%
Small Companies	Small Cap	Rand	39 322.0	3.20%	4.21%	20.39%	28.38%
Resources	Resource 20	Rand	5 074.1	0.00%	-5.28%	4.37%	8.65%
Industrials	Industrial 25	Rand	24 907.0	2.32%	4.34%	12.18%	14.78%
Financials	Financial 15	Rand	15 381.0	2.12%	4.15%	19.13%	28.44%
Listed Property	SA Listed Property	Rand	2 249.7	1.21%	5.57%	20.69%	34.39%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
IBOXX Global Government S&P Overall (USD Unhedged)		US\$	78.3	1.28%	3.00%	-0.21%	3.95%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	1 056.8	1.17%	2.35%	12.38%	18.91%
Government Bonds	BESA GOVI	Rand	1 040.8	1.17%	2.35%	12.28%	18.80%
Inflation Linked Bonds	BESA CILI	Rand	367.3	0.24%	1.24%	5.18%	10.57%
Cash	STEFI Composite	Rand	578.1	0.16%	0.51%	5.48%	8.56%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	79.0	-0.83%	-2.44%	2.62%	-4.80%
Gold	Gold Spot	US\$	2 512.0	0.16%	3.93%	21.76%	31.93%
Platinum	Platinum Spot	US\$	963.0	0.73%	-0.82%	-2.43%	3.66%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	17.72	1.05%	2.63%	3.25%	4.21%
ZAR/Pound	ZAR/GBP	Rand	23.41	-1.24%	0.00%	-0.47%	0.43%
ZAR/Euro	ZAR/EUR	Rand	19.83	-0.67%	-0.72%	1.85%	1.20%
Dollar/Euro	USD/EUR	US\$	1.12	-1.79%	-3.30%	-1.43%	-2.68%
Dollar/Pound	USD/GBP	US\$	1.32	-2.07%	-2.40%	-3.91%	-3.91%
Dollar/Yen	USD/JPY	US\$	0.01	-2.17%	-3.73%	2.40%	-0.30%

Source: I-Net, figures as at 23 August 2024

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