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INVESTOR's PERSPECTIVE ON RISK, THE PIC CASE

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INTRODUCTION

The context of this intervention is the role of a global investor, straddling financial performance and developmental investing, as a dual objective function. That is the PIC of today. With its extended mandate and having to deal with doing business across the globe, after 100 years of being inward looking.

There is a plethora of risks that an entity such as the PIC faces: market risk, reputational risk, legal risk, operational risk, political risk, credit risk, sovereign risk, geography risk, policy and so on. How does one make sense of all these risks? How does one take them into account in decision making? Measure and quantify them? Yet still run a business, in our case, that of an asset manager of over a trillion rand, expected to generate decent returns, at least those outlined in each of our client mandates?

In the PIC, there is a division that looks primarily at operational, credit, compliance and market risk, but we believe it is not solely a risk department's responsibility to worry about risk. Risk is every employee's responsibility, not necessarily in the building of models, but in the way in which they conduct business, assess threats and opportunities as well as conduct due diligence into a specific investment or counterparty they are assessing.

More importantly, understanding the macroeconomic environment within which they are operating.

Complicating this process is that, the macro environment does not concern itself with the domestic economy but also the global economy, whether or not the investor is a global or domestic player. The interplay of these, will have both direct and indirect effects on the long term sustainability of any investment made.

The key trade off in this regard is balancing risk and reward – which is always a delicate balance. As the traditional idiom goes, "no pain no gain". But as we think about this, we also need to think about how we design incentives that ensure a sustainable balance.

Risk Methodologies

For operational risk we use the standard risk ranking approach following the ISO 31000 standards where likelihood and impact of a risk event are assessed. The focus is on significant risks. Controls are developed to manage the risk taking into account the cost/benefit trade-off. Risk acceptance criteria are established. For operational risk it important for the legal department, the compliance department and risk managers to work closely together to minimize the risk of surprises.

Market risk in the investment portfolio context is measured using tracking error (the variability of a portfolio returns around the benchmark returns) in relation to the tracking error limits as per investment management agreements. The idea behind risk-adjusted investing is to measure the sources of tracking error and thus make appropriate portfolio composition adjustments to stay within mandated portfolio risk limits. We use the relative value at risk (VaR) which is related to the tracking error. The The limitations of Value at Risk are well-known. Scenario analysis and stress-testing are used to complement the use of the VaR.

Credit risk is managed by establishing minimum credit quality requirements for counterparties. For example, we may stipulate not to invest in a security or counterparty with a credit rating lower than A- according to S&P or Fitch ratings. A thorough credit analysis is performed before an investment is made to mitigate against the risk of default by a counterparty.

Risk versus return

We asset managers are however in the business of taking risk. We thrive on risk. So these sorts of risk assessment and monitoring tools guide us, warn us and highlight the dangers, but they cannot make investment decisions for us. Given also that an investment is framed and bounded in terms of time and possible risks from all angles, it may not be possible to readily quantify the exact rand amount of risk at stake.

This is where sound business judgment, experience and risk appetite come into the decision making process. Albert Einstein famously said: *"Everything that can be counted does not necessarily count; everything that counts cannot necessarily be counted."*

The PIC also does not always view risk and return as a strict trade-off in the finance textbook and efficient frontier sense. In terms of return, it has to be said that we view return in the context in which it is generated as well as the extent to which the mandate guides. In other words, pure financial return for us cannot be delinked from South Africa's development and the broader concept of a social return from investment. This is not easily quantifiable, the benefits sometimes delayed far into the future and sometimes not even necessarily full spelled out at inception when making an investment.

Being an asset manager that manages assets with a long maturity, namely pension funds, predominantly, our aim is not to try and shoot the lights out. Ours is to make sure that we make sufficient return to meet the promises made by the employer to members of the fund. Therefore, the incentive structures are designed to match this expectations frame.

This is especially true in the unlisted space in which the PIC operates through Isibaya fund, which has approximately R55 billion available for investment, of which about one third has already been allocated. Here projects often have both financial and social return aspects. The building of schools, funding of tertiary education or affordable housing all have inherent in them aspects much broader than merely financial return.

That is not to say that the risks associated with these types of investment are ignored in the name of “social good”. Our clients have granted us specific parameters within which to invest and benchmarks to beat. Underlying our biggest client, the GEPF, are over a million pension promises made by the Fund to its members. This means we need to manage the assets allocated to the PIC by the GEPF in a way that can meet those pension promises. Both the liability profile of the Fund and the assets backing the pension promises are critical to the long-term success and ability of the GEPF to manage to pay the benefits of members.

Even though the GEPF is backed by the State, as employer in a DB fund context, this does certainly not mean that we can be careless in the management of its assets. In fact, the contrary is true. It is the taxpayer who is ultimately at risk. The state and members are contributing each month to the fund for a specific purpose and that purpose cannot be undermined by poor investing or the knowledge that the State will ultimately act as back-stop or “funder of last resort”.

This means the risks inherent to any investment are important and are certainly factored into our decision making.

We also believe that it is important to look at what the government has identified as priority outcomes or growth areas for the South African economy, and where we can add value. The PIC continually looks out for regulatory developments and government policy that may impact (positively or negatively) on the operations of the PIC. This means we try to be forward-looking as a business, anticipatory in our outlook, rather than reactive.

Co-investing, partnerships & shareholder activism

Another way that we mitigate risk, beyond solely risk assessment, due diligences, Value-at-Risk and so on, is to consider not only setting maximum rand amounts we are willing to invest, but in the unlisted space, to often look for partners to go alongside us in investing in specific ventures.

This approach benefits us in at least three ways:

(1) It reduces our concentration risk;
(2) It often allows us to invest alongside other well-known institutions and build a relationship with them; and
(3) It may allow us the benefit of even stronger due diligence and information sharing as each entity in a major venture which is going to invest a significant amount of capital tends to have its own team, even if it is of modest size, doing a thorough analysis.

Broadening scope to both unlisted and listed investments, it is important to mention the inherent risk reduction benefits of active ownership. As a large investor, the PIC is very engaging. We meet management, we question, interrogate and monitor our investments. Shareholder activism for us is not so much about shouting from the rooftops, but about holding management and boards accountable, honest and transparent. Ultimately, this adds to the company's and investment's efficiency and return.

The experience and investment that we are rolling out in South Africa, will be replicated elsewhere where do business. In particular, we will be applying our developmental investment programme in the rest of the continent, where similar social and economic imbalances characterise those economies. That means, we will have to contend with a new set of risks, both in complexion and magnitude. Given the nature of the economies in the rest of the continent, as well differential levels of development and financial deepness, we have identified information asymmetries as being one of the biggest risks we will have to contend with. As a result of financial market deepness, or lack thereof, the key vehicle of entering the rest of the African economy will be private equity. Unlike in South Africa, where the bulk of our investments are in listed equities, the experiences will be more challenging.

Therein, lies the importance of partnerships to manage down risk as well as steepen our learning curve.

Other challenges noted include:

- Geopolitical
- Policy
- Regulatory
- Labour market
- China.

What do we need for sustainable investing?

Having made the above observations, it is becoming clear that to invest in sustainable manner, we need sound risk management. To achieve this, we need a set of characteristics, that will get us there and these are:

- Independence
- Principled
- Objectivity
- Critical mind and eye
- Deep knowledge of markets and macroeconomy
- Long termism
- Technical competence
- Invest in investing
    a. Build capacity for sound investment provision
    b. Reduce unit cost of capital
    c. Dynamic Reduce risks that we can influence
- Quality instinct
- Animal spirits versus rules
- Global mindset.

This is the underlying origin of enterprise wide risk management. However, this has been a very challenging framework to implement for many establishments, owing to three main factors, namely that it is an evolving concept, culture has not been embedded and poor mechanisms.:

Conclusion

Risk, just like investing, is a complicated animal in our environment. Experience is teaching us that we can never truly be fully prepared for any eventuality, but we certainly can be *better prepared*. Because investing is dynamic so is how we will need to think about risk going forward. We are learning even more as the PIC spreads its wings into investing in the rest of Africa. That brings with it risk as always and of course opportunity.

I would like to leave you with thoughts to ponder:

- Has the practice of risk management developed to catch up with developments around us?
- Risk management done badly could be as devastating as no risk management at all
- Have we, as practitioners, behaved as risk-takers or influencers.

Thank you.