PENSION FUND BUSINESS IN A FLUID ECONOMIC ENVIRONMENT

By Lazarus Masunungure

Coming from another period of economic stress just a decade and half ago, when local pension funds faced bankruptcy as a result of hyperinflation, this may be yet another scary period for pension funds. As the global economy was starting to show signs of recovery from the domino effects of Covid-19, it experienced another blitz as geo-political tensions took center stage. The Russia-Ukraine conflict rekindled the destructive flame as commodity prices hiked and peaked at the back of severe shortages of grains and energy traditionally sourced from the two countries. Locally, the economy has seen alternating episodes of galloping and hyping inflation, with the local currency constantly depreciating against the US Dollar. The fiscal and monetary authorities have responded, a couple of times, by tightening fiscal and monetary policy respectively, which has, to some extent hurt other sectors of the economy. It thus becomes necessary to understand the implications of this economic turmoil on pension funds and extend the attention to what may appear to be best strategies to counter the effects.

Economic slowdowns and instability puts downward pressure on returns of financial assets and in turn pension fund returns. This is because pension funds typically invest in assets that are correlated with stable, economic growth. For example, stocks and bonds tend to generate positive alpha returns when the economy is growing steadily amidst low inflation levels. Thus, when the economic growth is slow, these assets tend to perform poorly, which can lead to lower returns for our local pension funds. Similarly, in an inflationary environment, the returns from such assets may fail to match the rising inflation levels. The stock market recorded a poor run in 2022 when the economy was hard hit by inflation, largely due to the policy measures introduced by the government to manage inflation and exchange rate spirals. Also, the USD bourse (VFEX) is still illiquid and generating negative returns – typical of an emerging exchange. To this end, inflation and currency depreciation continue to weigh down overall economic growth and consequently investment returns.

Inflationary pressures tend to erode the net asset value of pension funds. The price of assets can rise and fall with inflation. For an investment portfolio to maintain its value in an inflationary environment such as ours, the rate of return on the pension assets should at least equate the rate of inflation. Historically, the local stock exchange has been known for generating above-inflation returns or at least re-price with inflation. However, in response to policy measures introduced on the bourse in 2022 – i.e. capital gains tax of 4% for shares sold before a vesting period of 270 days, the market became illiquid and took a tumble- performed sub-inflation. Given that the majority of pension funds were (still are) heavily invested in stock market (ZSE), the pension value was eroded. Emerging markets such as ours are highly inefficient, hence, most investment assets may trail the rate of inflation. Further, whilst assets such as equities and property may track inflation, if inflation gets out of hand to hyper-inflation levels, it is possible for such asset classes to underperform as the effect of hyperinflation on the general economy also adversely affects the underlying performance of companies and tenants.

On the other hand, the currency depreciation is also having devastating impacts on pension fund business. Local pension funds' portfolios have been predominantly Zimbabwean dollar denominated with the major asset classes providing investment securities in ZWL. The ZWL has been on an incessant depreciation trend against the USD on the auction system, from ZWL108.6660/US$ in Jan 2021 to ZWL5,739.7961/US$ in June 2023. This means that for a portfolio to preserve its real value, it would also have grown at least at the same rate(s). It is difficult to register such growth on ZWL assets given such accelerated levels of currency depreciation and as a result, the real value of the portfolio also declines as the currency continues to depreciate.

Further, the macroeconomic stability has limited the universe of available asset classes. There are some asset classes that are less attractive during inflationary periods. These include money market instruments and bonds yet in stable markets pension funds should have higher exposures to such asset classes as they mimic the liability structure of pension funds and provide the needed liquidity. These fixed income instruments traditionally tend to have a fixed rate of return –i.e. interest or coupon. With inflation rising above this fixed rate of return, the asset value is eroded in real terms. Thus, the Zimbabwean dollar (ZWL) denominated money market instruments and bonds have become less attractive to investors. This creates a balancing problem on the asset portfolio as the pension fund end up with higher concentration to illiquid and volatile asset classes. At a time when the stock market was declining in 2022 such that any exit was without a notable loss and the fixed income space was shrinking, liquidity risk became inevitable. However, USD denominated fixed income instruments are now coming to market – these are more attractive. Still, there are, however, twin limitations; the tenor is restricted to 2025 as there are currency uncertainties beyond then, and some pensions funds do not have USD contributions to take positions in these assets.

When inflation is rising at a rate faster than the rate of return on financial assets e.g. shares and bonds, portfolio value is eroded at a rate which is equal to the difference between inflation rate and portfolio rate of return. This implies a loss of value to pension fund's members. It is against this background that pension funds with significant quantum of maturing obligations may fail to settle pension benefits in part or in full. The Justice Smith Commission- which was appointed to investigate the loss of pension value during the hyperinflationary period (2008-9) recommended that pensioners should be compensated for the evident loss of value and both the authorities and pension funds themselves were found culpable. Whilst the compensation framework was put forward for implementation by IPEC recently, we may need another compensation framework again if the current economic instability worsens. The reality is that, in an unstable economic environment, the risk of making sub-optimal investment decisions and losing money becomes inevitable.

In addition, the cost of providing pension care escalates under such conditions. The cost of living is directly proportional to inflation. For example, the month-on-month inflation for June was 74.5%, i.e. the cost of living also increases by at least the same rate. This means that, in order to maintain the standard of living of the retirees, the sponsor needs to increase pension contributions by at least the same rate. It is however difficult to equally match the rate of inflation because the rate of salary adjustment may also trail inflation.

Also, the environment has made it difficult for pension funds to comply with IPEC regulations. For instance, IPEC introduced maximum exposure guidelines per asset class to adhered to by Pension Funds for which compliance in this exceedingly unstable economy is not only difficult, but also nearly impossible- at least in the short term. Why? Asset Managers may see it fit to trim down exposures into asset classes which are susceptible to currency and inflation risk e.g. listed equities (ZSE) and fixed income instruments. On the other hand, increasing exposures to real assets such as real estate and commodities, or even offshore investments (though not insulated from currency risk) may see the Fund having extended exposure in real estate and offshore investments, above the statutory limit of 40% and 15% respectively. Alternative investments are also becoming topical due to their ability to mitigate both inflation and currency risk, but with only a 15% exposure limit. The Fund Trustees are faced with a dilemma; should we remain compliant and subject the Fund to value erosion (detrimental to investors) or de-risk temporarily and preserve value and even generate more value by increasing exposure to real assets (may expose the fund to concentration and liquidity risk).

Consequently, the traditional investment strategies may not work well in an unstable macroeconomic environment. This is especially true when the usual strategy used to include a significant exposure to

asset classes that do not provide a cushion against inflation. The stock market used to be the readily available and dominant haven for pension contributions. However, with the observed turbulences on the local bourse at the back of the twin effects of inflation and currency depreciation, its dominance is fast replaced by other asset classes. Traditionally, pension funds globally tried to avoid commodities on account of their relatively marginal and volatile path of returns. With the global economy becoming gloomy and geo-political tensions escalating, commodities have begun to attract interest from pension funds as they bring the much need stability and inflation cushion.

At this point, it is now unequivocal that the current happenings are detrimental to the pension business. There are a couple of strategies that Trustees can consider in order to preserve value, these include;

- ensuring portfolio diversification by extending exposure in asset classes that hedges against inflation and currency risk e.g. real estate, commodities (gold coins, grain, etc), private equity;
- taking advantage of the 15% allocation for offshore investments to mitigate country specific risks,
- striking an optimum blend of short-term and long term alternative investments,
- revisiting the strategic and tactical asset allocation
- the goal is to harden the portfolio, or at least a large portion of the portfolio.
- Considering USD-linked fixed income investment instruments

Pensions by nature are tailored for a stable environment given the need for predictable payment obligations. As such, inflation remains the biggest enemy of the pensioner and pension funds. Unfortunately, pensions are still necessary to avoid old-age poverty hence the need to be innovative and ensure pension funds continue to deliver value despite an unstable economic environment. It is against the above backdrop that the inflationary pressures and currency issues are weighing heavily on the performance of pension funds. It however remains important for Fund Trustees, Investment Consultants and Asset Managers to devise plans that ensure value preservation for the greater good of the pension fund members. Statutory requirements should, bearing in mind the difficulties, be adhered to and where necessary, seek regulatory guidance from the pensions regulator-IPEC.

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