With-Profit Annuities
Annual Bonus Declaration
2024/2025

Sanlam Corporate Investments

Contents

Introduction

Following the letter sent to pensioners informing them of the annual increases for Sanlam's with-profit annuities, this document aims to illuminate the various factors taken into consideration in the declaration of the increases. Sanlam's with-profit annuities include Bonus Pensions and Quantum Pensions in which pensioners are invested.

The aim with bonus declarations is to declare as high a bonus as possible, without risking the future financial stability and security of the with-profit annuity portfolio (this would jeopardise future bonuses), also taking Sanlam's smoothing policy into account.

This document is not restricted to providing an overview of the with-profit annuity portfolio and background information to the bonuses being declared - general information is also provided regarding the operation of with-profit annuities.

Summary of Bonus Declaration

Long-term expected returns

The net long-term rate of return was 11.58% p.a. at 31 December 2023.

Funding level

The with-profit annuity portfolio was fully funded on 31 December 2023.

Bonus declared

Sanlam's board of directors declared a bonus of 10.70% to be used in the calculation of increases occurring from 1 March 2024 to 28 February 2025.

Increases in pension

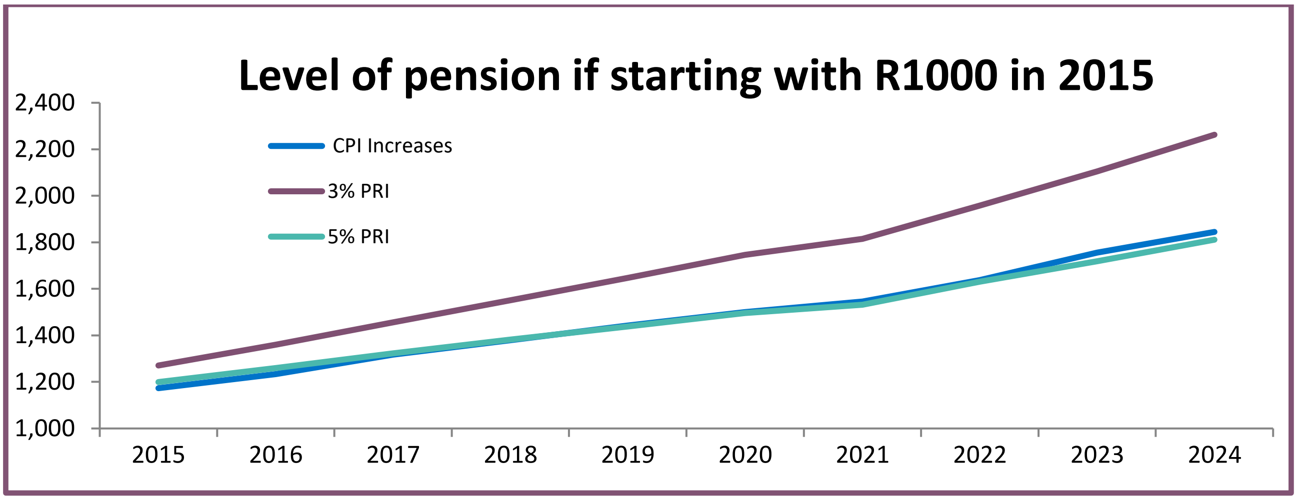
The increase in your pension depends on the purchase rate at which your Retirement Fund trustees elected to purchase your pension. It is calculated according to the following formula:

$$\text{Pension increase percentage} = \frac{1+\text{bonus rate}}{1+\text{purchase rate}} - 1$$

For your convenience, the following table lists the resultant increases for various purchase rates.

Purchase rate	Increase
3.00%	7.50%
3.50%	7.00%
4.00%	6.40%
4.20%	6.20%
4.50%	5.90%
5.00%	5.40%
5.50%	4.90%
6.00%	4.40%
6.50%	3.90%
7.00%	3.50%
7.50%	3.00%
8.00%	2.50%

The graph below illustrates the different growth rates based on the same starting pension of R1000 from 2015 until 2024. Note that for the same starting pension, a lower purchase rate category pension will cost more upfront than a higher purchase rate category pension, but will offer better prospects for future increases. CPI is the inflation rate in for the given year.



Economic Overview

General economic conditions for 2023

Given a downward revision to the second-quarter growth estimate in addition to the 0.99% annualised decrease in real GDP in Quarter 3, it seems growth for the calendar year 2023, overall, is likely to be restricted to 0.6%.

The key development reflected in the Quarter 3 real GDP release was the outright falls in household consumption expenditure (-1.2% saar[i]) and gross fixed-capital formation (-13% saar). Including government consumption total consumption fell 0.6% saar in the quarter.

This is consistent with the decrease in South Africa's current account deficit from 2.3% of GDP in the second quarter of 2023 to 0.3% of GDP in Quarter 3. Less consumption implies more savings. Together, more savings and less investment (fixed investment plus the change in inventories) are consistent with an improvement in the current account balance.

At the same time, the current account deficit is the mirror image of the net capital inflows required to fund it. Hence, the shrinking current account deficit implies less net capital inflows were available to support domestic expenditure.

Viewed from one perspective, the vulnerability of the rand exchange rate over the past two years reflects the impact of tightening US monetary policy, electricity loadshedding (which constrains potential GDP growth), lower export commodity prices in 2023 and, probably, South Africa's Financial Action Task Force (FATF) greylisting in February 2023. Indeed, after factoring in these factors the rand is arguably trading where it should.

Meanwhile, since South Africa is a small, open economy, currency weakness has contributed to inflation pressures and higher inflation expectations in recent years. This prompted the South African Reserve Bank (SARB) to hike its policy interest rate by a cumulative 125 bps to 8.25% in 2023, although it left the policy interest rate unchanged in the latter half of 2023. In turn, restrictive monetary policy has constrained domestic demand. Simultaneously, higher interest rates have been necessary to dampen imports and limit the deterioration in the current account balance.

Headline CPI increased from 5.4% in September 2023 to 5.9% in October 2023, before slowing to 5.5% in November 2023. Apart from relatively firm increases in food and non-alcoholic beverages over October and November, an interesting development was the 9.7% monthly surge in hotel prices in October 2023, followed by a further increase of 0.1% in November 2023 – a surprising outcome since hotel occupancy rates have not yet fully recovered to their pre-pandemic level. Still, given the low weight of just 1.05% for this sub-index the jump did little damage to the advance in total CPI. At the same time, encouragingly, core CPI increased by 4.5% in the year to November 2023, in line with the mid-point of the SARB's inflation target range.

In a further important development on the inflation front, the producer price index (PPI) for intermediate manufactured goods decreased 2.3% in the year to November 2023, while the PPI for final manufactured goods increased 4.6% over the same period, suggesting contained pipeline goods price pressures.

The November 2023 Medium-Term Budget Policy Statement (MTBPS) reflected a familiar outcome as the trajectory of the government's debt ratio was revised higher by National Treasury. Gross loan debt is now expected to peak at 77.7% of GDP in 2025/26, before moderating according to National Treasury's projections. This compares with the expected peak of 73.6% of GDP in 2025/26 published in the February 2023 Budget Review.

Given modest real GDP growth, Treasury projected an expected net revenue shortfall of R44.4 billion in the current fiscal year, while projecting a larger Main Budget deficit of 4.7% of GDP in 2023/24, relative to the initial projection of 3.9% of GDP published in February 2023. This excludes support for Eskom, amounting to R78 billion (1.1% of GDP) in the current fiscal year.

Tax revenue is forecast to grow faster than nominal GDP over the next three fiscal years. In part, this reflects expected revenue raising measures amounting to R15 billion in 2024/25 (read possible tax increases).

Treasury is still intent on following through on its fiscal consolidation promise but this is becoming increasingly difficult as high interest payments on the government's large debt stock absorb an ever-increasing share of available resources. In 2008/09, debt servicing cost amounted to 8.8% of Main Budget revenue. Treasury projected this will increase to an estimated 20.7% of revenue in 2023/24 (or R354.5 billion).

With-profit annuity overview

What is a with-profit annuity?

Sanlam has two with-profit annuity products, namely Bonus Pensions and Quantum Pensions. With-profit annuities enable pensioners to share in the "surpluses" or "deficits" (explanation follows) made on the underlying annuity portfolio by way of annual increases to their pensions (deficits would therefore imply no or low increases). These surpluses/deficits are mainly based on investment returns (but also include surpluses and deficits arising from the mortality experience).

With-profit annuities may be bought at various "purchase rates" (explained below). Only net investment returns in excess of the purchase rate leads to surpluses, which are then available to provide increases in pensions. For example, the net return (gross returns less fees) is 7% and the purchase rate is 5%. After applying the increase formula on page 4, only about 1.9%, will be available for increases to pensions.

Pension increases are not constant and can vary from year to year. This depends on investment performance (both past and future expectations), mortality experience and the smoothing methodology applied by Sanlam.

What is meant by a "purchase rate"?

Understanding the concept of a "purchase rate" is central to understanding how with-profit annuities work. The purchase rate of your pension was chosen by your Retirement Fund Trustees. The purchase price concept is explained in a series of examples. Please note that these examples are simplified for ease of understanding (for instance, they ignore the impact of smoothing and mortality experience).

- 0% purchase rate:

Consider a 65-year-old retiree who purchases a with-profit annuity of R100 a year. Let's assume that he is expected to live another 20 years. A total purchase price of R2 000 (R100 x 20) may be charged to cover the future pension payments. This R2 000 is invested, and any future investment return is available to finance pension increases (the purchase price covers the basic pension payments). In this example, the full future investment return (it is decreased by 0%) is available to finance pension increases, so it is defined as a "0% purchase rate" annuity. For example, if future net investment returns were 7% p.a., the full 7% (7% - 0%) is available to increase future pensions.

- 3% purchase rate:

As in the above example, the retiree has R2 000 to spend on a with-profit annuity but he prefers a higher initial pension (greater than R100) in exchange for lower future pension increases. He is willing to accept 3% p.a. lower future pension increases in exchange for a higher initial pension. As only future investment returns in excess of 3% are used to finance future pension increases, it is defined as a “3% purchase rate” annuity. For example, if future net investment returns were 7% p.a., then, after applying the pension increase formula, only 3.9% of it is available to increase future pensions.

- 5% purchase rate:

Again, the retiree has R2 000 to spend on a with-profit annuity. The retiree wants an initial pension that is even higher than that purchased at a 3% purchase rate, in exchange for even lower future pension increases. He is willing to accept 5% p.a. lower future pension increases in exchange for a higher initial pension. As only future investment returns in excess of 5% are used to finance future pension increases, it is defined as a “5% purchase rate” annuity. For example, if future net investment returns were 7% p.a., then, after applying the pension increase formula, only 1.9% of it is available to increase future pensions.

What is a “surplus” or “deficit”?

A surplus refers to money that becomes available to finance pension increases. The major source of surpluses is the investment return earned on the portfolio. If the investment return earned is greater than the purchase rate then there is a “surplus” of assets that are available to finance pension increases.

A deficit refers to a shortfall in the money becoming available to finance pension increases. The major source of deficits is the investment return earned on the portfolio. If the investment return earned is less than the purchase rate then there is a “deficit” of assets that are available to finance pension increases and this will translate into lower, or no increases.

Mortality experience also leads to surpluses and deficits. For instance, if fewer pensioners die than expected, then there are more pensions that need to be paid out which leads to a deficit. Alternatively, if more pensioners die than expected, then fewer pensions need to be paid out, resulting in a surplus of assets to be shared amongst surviving pensioners (in the form of higher increases).

Note that the full impact of surpluses and deficits isn’t always immediately seen in the form of higher or lower increases, as Sanlam’s policy is to smooth out their impact over time.

What is guaranteed?

Sanlam guarantees to pay the current level of pension for the rest of the pensioner’s life. Therefore the current level of pension will not be reduced during the lifetime of the pensioner. Sanlam provides no guarantee of future increases. However, once the pension has been increased, Sanlam guarantees that the pension will not reduce from the new level.

Investments

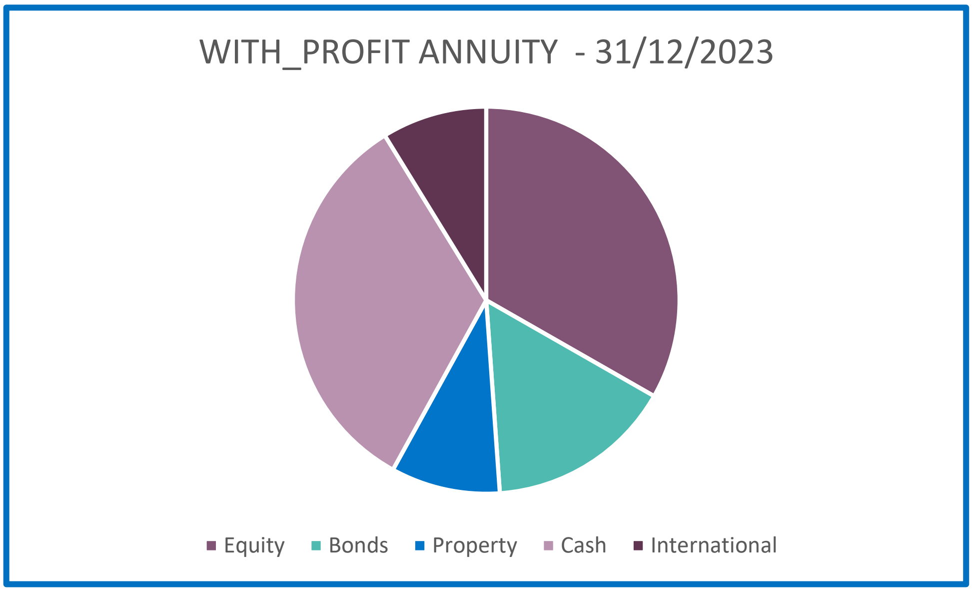
Investment strategy: 2023

Over 2023, there were two separate sub portfolios of assets in which the with-profit annuity portfolio is invested:

- A matched sub portfolio of assets
- An active sub portfolio of assets

The matched sub portfolio of assets was invested so as to meet a portion of the guaranteed pensions. These assets were invested mainly in long-term interest-bearing bonds, enabling Sanlam to guarantee that pensions will not be decreased throughout the lifetime of pensioners.

The active sub portfolio of assets attempted to outperform a fixed benchmark and will be used to finance future bonuses. These assets were invested mainly in equities.



Funding level

What is the funding level?

The funding level gives an indication of the financial soundness of the with-profit annuity portfolio. Importantly, the funding level has an impact on the bonus which is declared.

Funding level	Meaning
More than 100%	The value of the assets is sufficient to declare a bonus in excess of the net LTRR.
100%	The value of the assets is sufficient to declare a bonus equal to the net LTRR.
Less than 100%	The value of the assets is insufficient to declare a bonus equal to the net LTRR.

In technical terms, the funding level is defined as the total value of the assets divided by the present value of future pensions (assuming that future bonuses equal the net LTRR).

What factors affect the funding level?

Anything that affects the value of the assets or the expected future stream of pension payments will affect the funding level:

- The value of the assets increase if there is a positive investment return and decreases if there is a negative investment return. However, funding level increases or decreases depend, inter alia, on the investment return achieved relative to the investment return expected (the LTRR).
- The assumed net LTRR affects the expected future pension increases (see previous table).
- If fewer pensioners than expected die, then pensions are payable to more people than expected (if more pensioners than expected die then the opposite is true). This may further result in the life expectancy assumptions for pensioners being revised upward, meaning pensions are expected to be paid out over a longer period.
- Investment returns earned that are not immediately used to declare bonuses will improve the funding level.
- Bonuses declared in excess of earned investment returns will reduce the funding level.

Glossary

Annuity	An agreement by an insurer to pay a sum of money on a regular basis for a number of years.
Purchase Rate	The purchase rate represents the minimum smoothed return that the portfolio underlying Bonus- and Quantum Pensions has to achieve, to continue paying the current level of pension. The higher the purchase rate selected, the higher the starting income, but the lower the expected increase each year. The lower the purchase rate selected, the lower the starting income, but the higher the expected increase each year.
Actuary	A specialist, usually employed by insurance companies, who is trained in mathematics, statistics and accounting. The actuary is responsible for various calculations used in the development of insurance products.
Bonus (of With Profit Annuity)	Pension increase.
CPI	This stands for Consumer Price Index and is a calculation for determining inflation.
Inflation	The process of steadily rising prices resulting in the diminishing purchasing power of money.
Insurer / insurance company	Usually a company which agrees to pay an amount or amounts of money should an event take place which is specified in the agreement.
Joint and survivorship annuity	An annuity which is payable to the named beneficiaries (for instance, a husband and wife) during the period of their joint lives which will continue to the survivor when the first beneficiary dies.
Mortality experience	The number of deaths in a group of people, usually expressed as deaths per thousand. It can be the rate for the total population, or it can be refined by factors such as age groupings or causes of death. These figures help the actuaries of an insurance company to do the necessary calculations when a product of insurance is developed.
Real return	The return above inflation. For example, if inflation is 4% and the return is 7%, the real return will be 3%.
Return (investment return)	The money which has been made from an investment. Investment return can consist of interest or dividends paid to the investor of the money.
Smoothing principle	In terms of the smoothing principle, pension increases are adjusted by the insurer so that, in years of poor market performance, higher pension increases than actual returns can be declared. In years of good market performance, increases are lower than actual returns. In this way, pension increases tend not to vary much so that clients are protected from extreme ups and downs of the market. Smoothing is an important mechanism for reducing volatility in investment returns.
Trustee	A person appointed to manage the property or money of another, or of a group of persons.
With-profit annuities	These annuities enable pensioners to share in the profits made on the underlying investment portfolio by way of annual increases (“bonuses”) to their pensions.

Further Information

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