

WITH-PROFIT ANNUITIES

Bonus Declaration
2015



Employee Benefits: Investments



Contents

Page

Introduction	2
Summary of Bonus Declaration	2
Economic Overview	4
With-profit annuity overview	6
Investments	8
Funding level	9
Glossary	10
Further Information	11



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 decreased slightly from 8.1% p.a. (at 31 December 2013) to 7.96% p.a. (at 31 December 2014).

Funding level

The with-profit annuity portfolio was fully funded on 31 December 2014.

Bonus declared

At a funding level of 100%, the product can afford to declare a bonus equal to the long-term expected return of 7.96% - since the funding level was over 100% a higher bonus could be afforded.

Sanlam's board of directors declared a bonus of 12% to be used in the calculation of Bonus Pension increases occurring from 1 March 2015 to 29 February 2016 and Quantum Pension increases occurring from 1 May 2015 to 30 April 2016.

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:

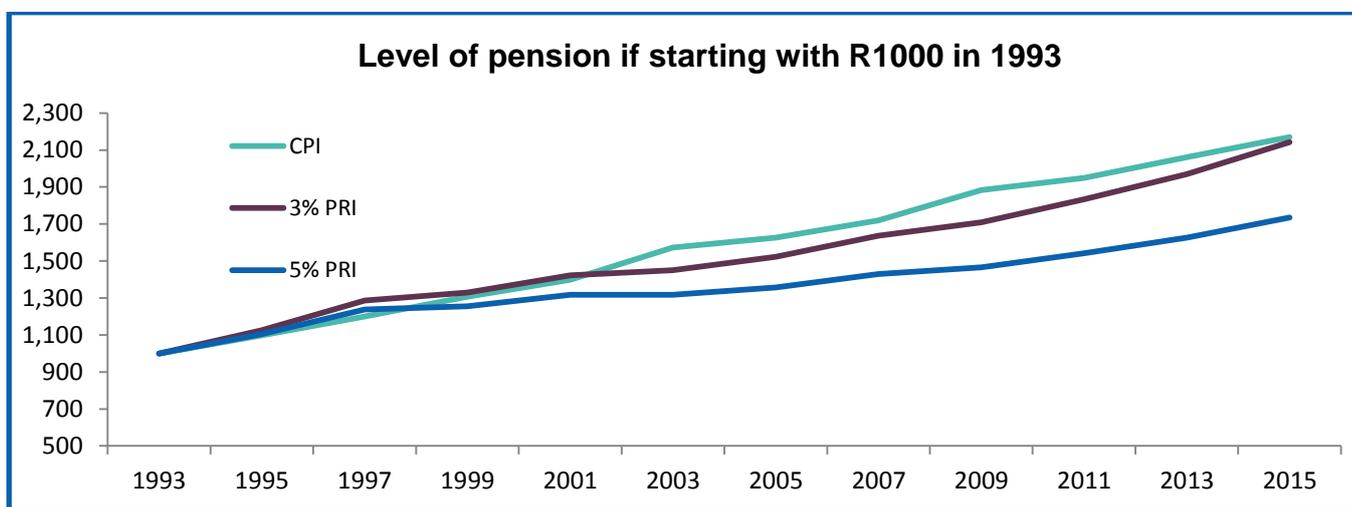
$$\text{Pension increase percentage} = \frac{1 + \text{bonus rate}}{1 + \text{purchase rate}} - 1$$



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

Purchase rate	Increase
3.00%	8.70%
3.50%	8.20%
4.00%	7.70%
4.20%	7.50%
4.50%	7.20%
5.00%	6.70%
5.50%	6.20%
6.00%	5.70%
6.50%	5.20%
7.00%	4.70%
7.50%	4.20%
8.00%	3.70%

The graph below illustrates the different growth rates based on the same starting pension of R1000 from 1993 until 2015. 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

Adverse supply side shocks, including work stoppages and electricity supply disruptions, constrained real economic activity in 2014. Against this unfavourable background, the total gross operating surplus (a proxy for profits) of South African companies increased only 6.6 per cent in the year to the third quarter of 2014.

Final demand has been especially weak. Reserve Bank data shows an outright decline in real domestic final demand in the first quarter of 2014, followed by a limited improvement in the following two quarters. In the third quarter of 2014, domestic final demand increased at just 1.5 per cent annualised.

Following a relatively firm increase of 8.1 per cent in 2013, real private sector investment turned sharply lower. This must partly reflect the one-off impact of lumpy investment by independent power producers last year, which has now faded from the data. But, that is not the only explanation, or even the most important one. It is also clear the marginal rate of return on fixed investment has been too low to entice private businesses to lift their fixed investment spending.

Not surprisingly, employment growth was also constrained in 2014 and soft real personal disposable income growth dampened final consumption expenditure by households. Households have continued deleveraging. Reserve Bank data shows household debt peaked at close to 90 per cent of personal disposable income in 2008. Latest available data shows 78.3 per cent in the third quarter of 2014. At least, the nascent decline in fuel prices implies households should “save” around R24bn on an annualised basis (1.1 per cent of personal disposable income) which should lift real household spending to a degree in 2015.

Also, against the backdrop of the sharp depreciation of the trade weighted Rand since late 2010, data from the Reserve Bank indicates import volume growth is trending weaker, while export volumes have improved, partly reflecting the expansion of exports to the rest of Africa, where income growth has held up relatively well. If global income growth holds up an improvement in real net exports should help underpin real economic activity. Hence, we expect GDP growth to lift in 2015, although the expected growth rate of 2.25 per cent for 2015, following 1.3 per cent in 2014, is still moderate.

The Rand remained soft against the robust US\$ through 2014, although we believe the currency is materially undervalued. On a related topic, South Africa’s large current account deficit has attracted much attention. But the plunge in oil prices, which suggests a marked improvement in the country’s terms of trade, should help reduce this deficit materially from the 6.0 per cent of GDP recorded in the third quarter of 2014. Specifically, the fall in oil prices, all else being equal, should reduce the oil import bill by around 2 per cent of GDP provided the spike in the number of barrels of oil imported late in 2014 proves to be temporary.



Headline consumer price inflation peaked at 6.6 per cent in June 2014, before slowing through the latter half of the year. Despite the weak Rand, the sharp fall in oil prices in the latter half of 2014 should cause inflation to slow substantially, possibly towards 4 per cent year-on-year by the second quarter of 2015. In any event, the trade-weighted Rand has been relatively stable over the past year. Core inflation is, nonetheless, likely to remain sticky and headline inflation is expected to drift higher in the latter half of the year, ending 2015 at above 5 per cent - still below the upper limit of the Reserve Bank's inflation target range of 3 to 6 per cent.

Firm core consumer price inflation and rand volatility prompted the South African Reserve Bank to increase its repo rate by 50bp in January 2014 and by a further 25bp in July 2014. The magnitude and timing of potential further repo rate increases is uncertain. But, if inflation slows in markedly in the first half of 2015 and the current account deficit shrinks significantly, this should give pause for thought. However, the Reserve Bank's real repo rate remains below its historic average and core CPI remains uncomfortably high, relatively close to the upper limit of the Bank's inflation target range. Hence, the Bank has warned that its policy rate will need to "normalize" over time. Even so, we expect the domestic real policy rate to remain low relative to its long-term average for an extended period.



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.



② 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

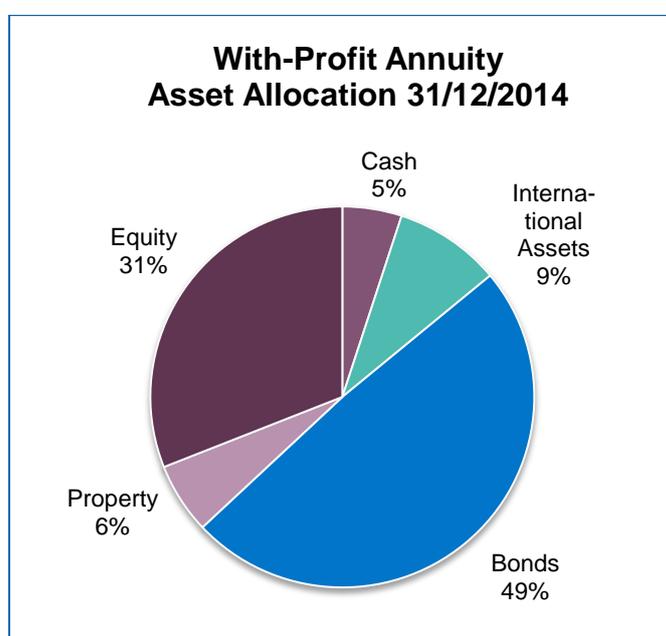
Investment strategy: 2014

Over 2014, 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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