With-Profit Annuities
Annual Bonus Declaration
2023/2024

Sanlam Corporate Investments

Insurance | Financial Planning | Retirement | Investments | Wealth

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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 11.48% p.a. at 31 December 2022.

Funding level

The with-profit annuity portfolio was fully funded on 31 December 2022.

Bonus declared

Sanlam's board of directors declared a bonus of 10.70% to be used in the calculation of Bonus Pension increases occurring from 1 March 2023 to 28 February 2024 and Quantum Pension increases occurring from 1 May 2023 to 30 April 2024.

Increases in pension

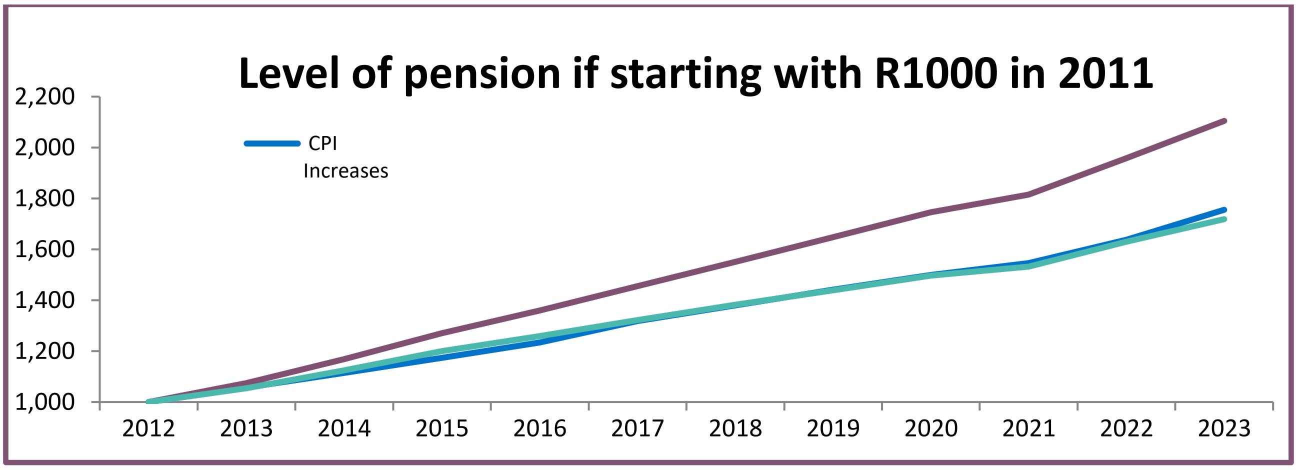
The increase in your pension depends on the purchase rate at which your Retirement Fund trustees elected to purchase your pension. It is calculated according to the following formula:

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

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 2012 until 2023. 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 2022

The first quarter of 2022 was full of unpleasant surprises, starting with high levels of financial market volatility as January uncertainty over global inflation and interest rate policies, and risk-off investor sentiment, were reflected in broad weakness across both global equities and bonds. Then, in the final week of February, a tragic and destructive Russian invasion of Ukraine and the unprecedented level of sanctions placed on Russia led to even more uncertainty, skyrocketing commodity prices, and inflation worries. Due to a confluence of events, many global asset returns—including those from traditional secure havens like US Treasuries—were severely negative. The US Federal Reserve (Fed) increased its base rate by 25 bps at its March meeting because of the US February CPI rising to 7.9% y/y, the highest rate since 1982. In the UK, the Bank of England raised interest rates by 25 basis points for the third time in a run in March and issued a warning that inflation would hit 8.0% y/y in April. South Africa was one of the few countries to profit from the increases in the price of rare metals and other commodities. In contrast to most other nations, the rand significantly strengthened against the main international currencies, and the local equity and nominal bond markets both reported respectable returns for the quarter. However, this was somewhat offset in March by widespread pessimism among investors and weakness in Naspers/Prosus shares because of a further sell-off in Tencent amid a renewed regulatory crackdown by the Chinese government.

Investors were concerned about a significant slowdown in global development in the second quarter of 2024, which led to an increase in corporate earnings during the second quarter (Q2) of 2022, particularly in June. This occurred at a time when downward revisions to economic growth projections for the world's largest economies were made as a result of steep interest rate increases in the US, stringent Covid-19 lockdowns in China, as well as the ongoing destructive Russia-Ukraine war. Even as other product prices fell, speculation about prolonged inflationary pressures, stagflation, and/or recession increased in response to further increases in the prices of food and energy. Most financial markets experienced losses because of this confluence of variables, including those for equities, nominal bonds, and inflation-linked bonds.

South African markets were less insulated from the global inflation and growth concerns than in the previous quarter. This was due to the fall in commodity prices, accelerating inflation, and forecasts for more aggressive local interest rate hikes in July, plus even slower growth ahead. South Africa's fragile economic recovery came under increasing pressure in Q2: growth prospects took a downturn due to the renewal of national Stage 4-6 loadshedding, severe flooding in KwaZulu Natal, rising inflation and higher-than-expected interest rate hikes, as well as the retreat in commodity prices. The South African Reserve Bank (SARB) lowered its GDP growth forecast for 2022 to 1.7% from 2.0% previously. In the UK, the Bank of England implemented another interest rate hike in June, taking its main bank rate to 1.25%, the highest level in 13 years. This came against inflation of 9.1% y/y in May. Compared to the previous quarter, South African markets were less protected from worries about inflation and development abroad. Commodity price declines, accelerating inflation, anticipated aggressive local interest rate increases in July, and future predictions of even weaker growth were all to blame for this. The unstable economic recovery in South Africa came under increasing strain in Q2 as a result of the national Stage 4-6 load shedding renewal, severe flooding in KwaZulu Natal, rising inflation, higher-than-expected interest rate hikes, and a decline in commodity prices. The SARB revised its prior estimate of 2022 GDP growth from 2.0% to 1.7%.

Global central banks, led by the US Fed, largely crushed any residual optimism about economic growth for the year and into 2023 during the third quarter. The US Fed's tenacious battle against persistent inflation led to unexpectedly aggressive interest rate increases, forcing markets to repeatedly revise their predictions for interest rates to be much higher. Bond prices were affected by these events, which increased scepticism about corporate earnings growth and sent most markets into negative territory, especially emerging market equities. The ongoing conflict between Russia and Ukraine, the European energy crisis, and China's ongoing economic slowdown as a result of constrained financial conditions all made the situation worse. South African markets were not spared in the sell-off; growth prospects deteriorated amid rising prices, higher borrowing costs and the high frequency of electricity outages, all of which weighed on economic activity. When Liz Truss, the new prime minister of the UK, unveiled a budget plan that heavily relied on deficit spending and tax cuts to spur development, the financial markets and the public reacted negatively. A swift sell-off of government assets and the British pound followed. While this was happening, annual inflation in the Euro Area shot up to 10% (from 9.1% in August), the first-time inflation reached double digits on record, prompting the European Central Bank to increase interest rates by a record-breaking 75bps. As China experienced its worst Covid-19 outbreak since the pandemic's peak in early 2020, activity there was severely hampered by the government's anti-virus campaigns.

Global financial markets made up some of the ground lost over the previous three quarters, which were dominated by bearish mood and bad news, in the fourth quarter of 2022. Despite the bleak prediction, there were some encouraging signs in October and November, when buyers were drawn in by lower asset valuations, slightly better clarity regarding company earnings prospects, and declining fuel and food prices. By the middle of December, the pattern of interest rate hikes had slowed down, which contributed to the renewed optimism. The severity of the anticipated 2023 global growth slowdown, the effect of the massive new Covid wave in China, the ongoing tragedies of the Ukraine-Russia conflict, and the stickiness of inflation in advanced economies were all factors that prompted caution once again in December. As a result, markets in December partially reversed some of their early gains. Major central banks increased interest rates. The SARB also raised interest rates by 75 basis points in November, matching the Fed. Local equities and bonds benefited from the more upbeat investor sentiment, outperforming the main global indices, despite ongoing loadshedding and an increase in political risk in early December due to reports that President Cyril Ramaphosa could resign. The FTSE/JSE All Share Index returned 3.6% for the year ended 31 December 2022, the All-Bond Index returned 4.3%, the SA Listed Property (SAPY) returned a pedestrian return of 0.5%, and SA Cash (STeFI Composite Index) continued to fare well with a return of 5.2%. On the global front, the MSCI World Index was down 12.7% (in ZAR), global bond (Bloomberg Global Aggregate Index) was down at 10.7% (in ZAR), and global property (FTSE EPRA/NAREIT Developed Dividend) was also down 19.2%.

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

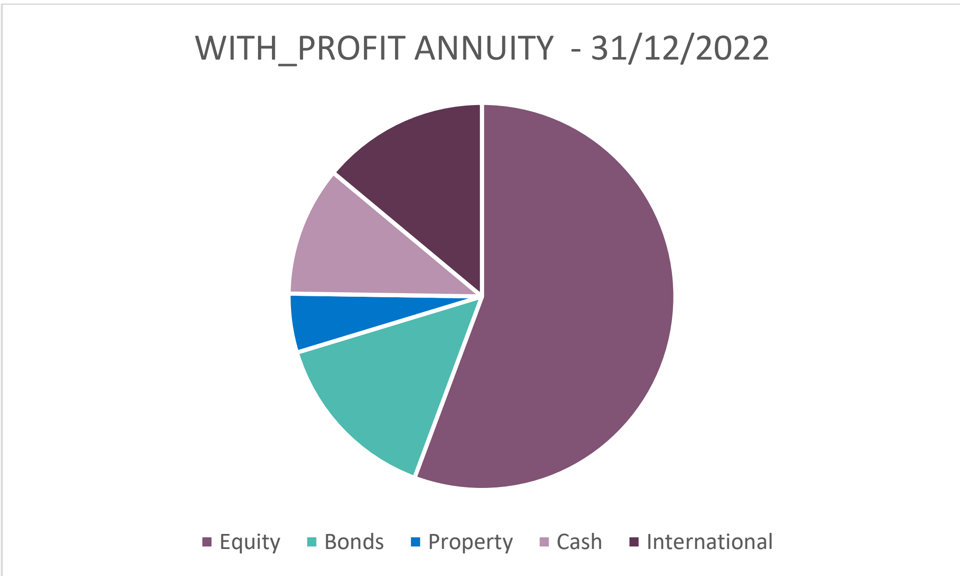
Investment strategy: 2022

Over 2022, 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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