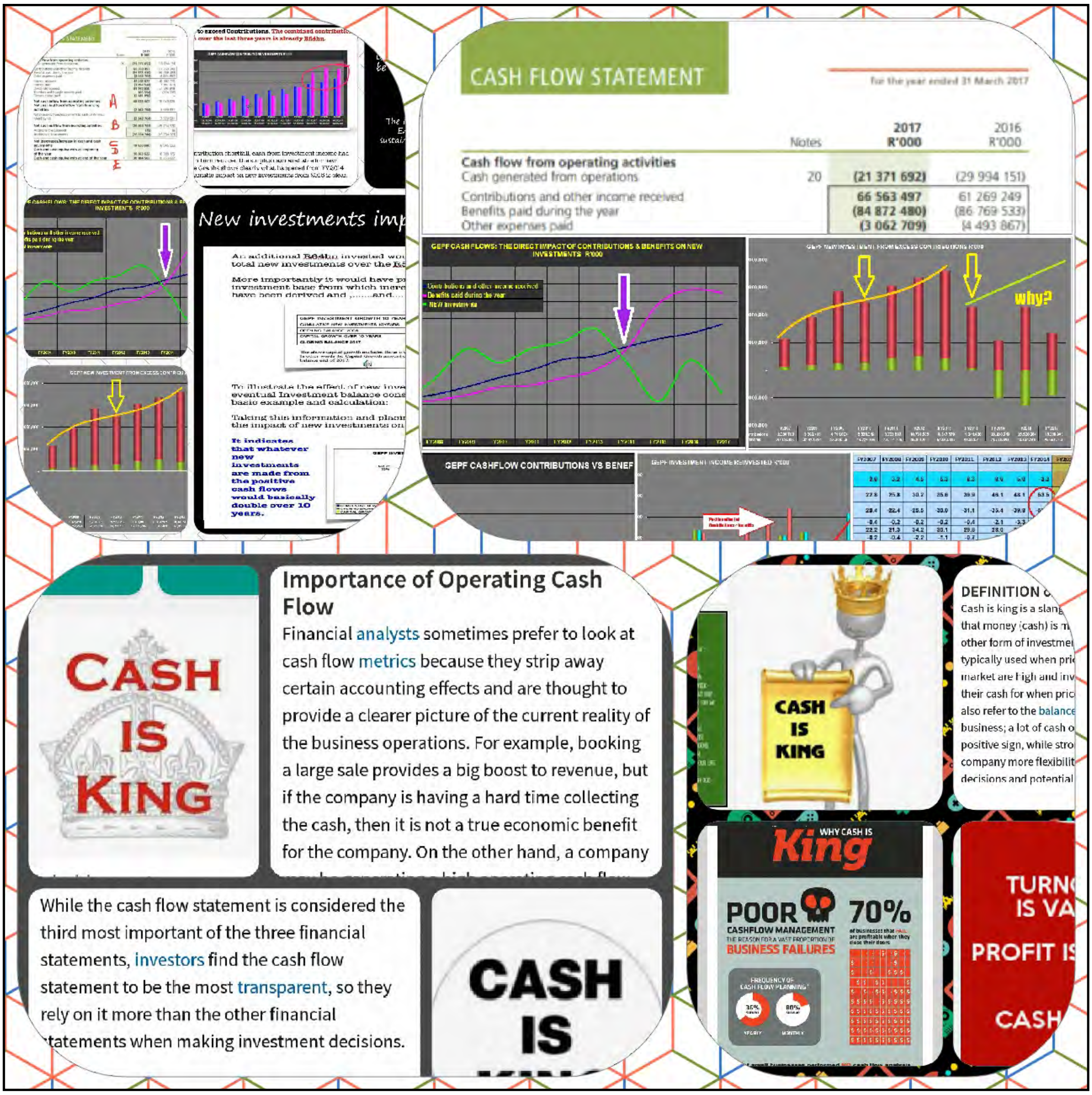
GEPF CASH FLOW STATEMENT ANALYSIS FOR THE FINANCIAL YEARS 2007 to 2017

(Compiled: March 2018)



INTRODUCTION

The following extract from an article Cash Flow Statement: Reviewing The Cash Flow From Operations By Michael Schmidt refers: (https://www.investopedia.com/articles/investing/102413/cash-flow-statement-reviewing-cash-flow-operations.asp)

“Operating cash flow is cash that is generated from the normal operating processes of a business. A company's ability to consistently generate positive cash flows from its daily business operations is highly valued by investors. In particular, operating cash flow can uncover a company's true profitability. It’s one of the purest measures of cash sources and uses.
The purpose of drawing up a cash flow statement is to see a company's sources of cash and uses of cash, over a specified time period. The cash flow statement is traditionally considered to be less important than the income statement and the balance sheet, but it can be used to understand the trends of a company's performance that can't be understood through the other two financial statements.

While the cash flow statement is considered the third most important of the three financial statements, investors find the cash flow statement to be the most transparent, so they rely on it more than the other financial statements when making investment decisions.”

After doing some research on the situation at pension funds in general and at the GEPF specifically, the comments that the cash flow statement is considered less important appears to be true. The focus at the GEPF appears to be on the escalating Assets under management (Aum), the adherence to the Minimum funding level and to pay pension increases matching inflation. If these three conditions are met the assumption is that everything is fine with the FUND.

However, any cashflow statement that shows cash from operations is negative, should immediately raise alarm bells. If this continues over a number of successive years, something seriously is amiss for no business can expect to keep on functioning where your operations becomes a user of cash.

Comparing the GEPF cashflow statement information since 2007 provided for interesting reading. The analysis performed is very basic, ie. a comparison of similar line items over 11 years.
Herewith the cashflow statement taken from the most recent Annual report (2017) from where the information was obtained. The Annual reports since 2007 was used. http://www.gepf.gov.za/index.php/annual_reports

CASH FLOW STATEMENT

for the year ended 31 March 2017

	Notes	2017 R'000	2016 R'000
Cash flow from operating activities			
Cash generated from operations	20	**(21 371 692)**	(29 994 151)
Contributions and other income received		**66 563 497**	61 269 249
Benefits paid during the year		**(84 872 480)**	(86 769 533)
Other expenses paid		**(3 062 709)**	(4 493 867)
Interest received		**43 261 671**	40 602 310
Interest paid		**(1 894 538)**	(1 851 873)
Dividends received		**31 140 650**	27 516 948
Transfers and bought services paid		**(66 594)**	(224 208)
Divorce claims paid		**(2 141 090)**	–
Net cash inflow from operating activities		**48 928 407**	36 049 026
Net cash (outflow)/inflow from financing activities		**(2 342 764)**	3 639 991
Net proceeds from/(repayment) to Bank of America Merrill Lynch		**(2 342 764)**	3 639 991
Net cash outflow from investing activities		**(26 664 763)**	(45 734 570)
Additions to equipment		**(19)**	(9)
Additions to investments		**(26 664 744)**	(45 734 561)
Net (decrease)/increase in cash and cash equivalents		**19 920 880**	(6 045 553)
Cash and cash equivalents at beginning of the year		**10 263 622**	16 309 175
Cash and cash equivalents at end of the year	7	**30 184 502**	10 263 622

IN A NUTSHELL, WHAT THE ANALYSIS REVEALS:

- Enough cash needs to flow INTO the Fund to cover benefits payable.
- In addition, enough cash needs to be available to build up investments to cover future benefits.
- Through the Funds operations cash are generated mainly from contributions and the return on investments.
- The use of this cash is dominated by the payment of benefits.
- The cash that remains after benefits are paid are then channeled towards investments.
- A review of the last 11 years cash flow statements reveals that up to 2013/4 the Fund did reasonably well in generating through its operations enough cash to pay benefits and to set aside amounts for new investments.
- **However, from 2014 onwards,** the excess cash that should be invested have reduced significantly. This is as a result of Contributions not being sufficient to cover the Benefits. In all the years prior to 2014 this was the case so this relationship has inverted.
- A second source of cash is investment income. Interest and dividends are used to defray administrative cost as well as the expenses to invest. In the past, whatever cash was left over could immediately be reinvested.
- Since 2014 however, cash generated through **investments also had to be used** to cover a portion of Benefits. This obviously reduces the available cash to be channeled to the investment managers for new investments.
- The reduced level of new investments **in turn has a negative effect on the Funding level as well as the quantum of investment income in future years.**

The bottom line ….

In making a determination as to whether the Trustees are taking reasonable steps to protect the best interest of 400000 pensioners pertaining to the safeguarding of inflation based increases, the following should be considered. From the reports of the independent experts involved with the FUND we see the following:

- the actuary determined that the actual contribution levels is less than required,
- the independent auditor confirmed that there was a shortfall in the contributions
- the auditor went further to confirm what the impact (consequence) will be on the funding level because of the contribution shortfall.

The cash flow information herewith indicates that the inaction of the Trustees basically reduces the amount of investments held. This in turn reduce the quantum of investment income. Both these factors negatively impact the FUNDING level. In addition, all of this INCREASES the investment risk for current pensioners and the next generation of beneficiaries.

This analysis provides an alternative viewpoint to what the Chairperson of the Board stated in her 2017 review. In short this analysis indicates that:

- **the FUNDING levels is ALREADY negatively impacted AND will deteriorate FURTHER,**
- **the GROWTH in investments is negatively impacted NOT ONLY because of the weak economy BUT as a result of the decisions taken by the BOARD,**

- **One such decision relates to the increase of the Contribution rate**

A comparison between the combined cashflows between the different Boards of Trustees revealed the following in respect of the current Board:

- **With 3/4 of the Mokate/de Wit term of office gone, the combined negative cashflows from operations ALREADY amounts to R89,3bn. Contrast this with the two previous Boards who over 8 years managed a positive result totaling R33.7bn.**
- **The level of the negative cashflow from operations is alarming when considering that the negative cashflow in one year, namely 2015, was on par with the combined positive cashflows of the 7 years prior (2007 to 2013),**

========================. END OF SUMMARY ======================

THE RESULTS OF THE CASH FLOW STATEMENT ANALYSIS

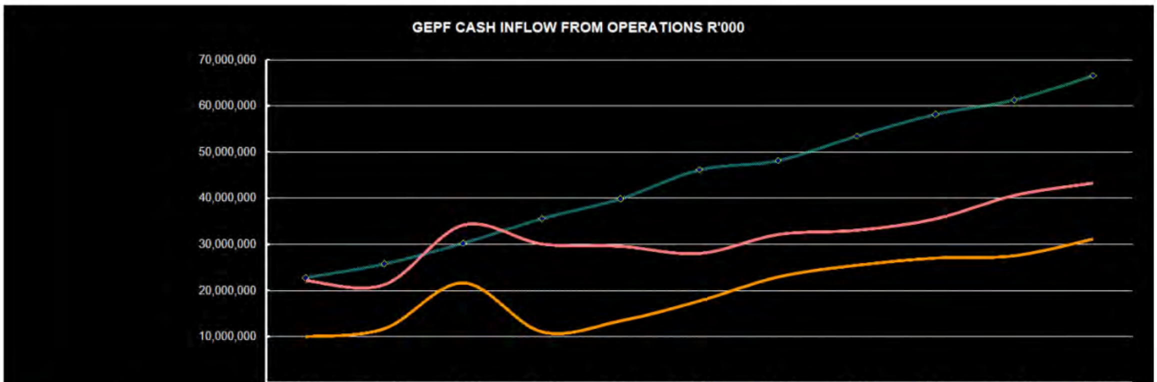
SOURCES OF CASH

The cashflow statement indicates that the inflows (or sources) of cash comes primarily from Contributions and Investment income*. The main cash inflows from operating activities indicated:

- Contributions
- Interest
- Dividends

*Profit with the Sale of investments, although significant, is not a line item in the main cash flow statement.

A look at the trend lines for all three sources shows a steady incline over the 11 years. However the gradient is markedly different between contributions and interest.



	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
Contributions and other income received	22,752,804	25,759,965	30,223,240	35,566,690	39,857,896	46,132,222	48,117,481	53,459,588	58,143,847	61,269,249	66,563,497
Interest received	22,166,254	21,257,188	34,167,885	30,060,343	29,569,137	28,006,234	32,122,996	33,033,165	35,507,949	40,602,310	43,261,671
Dividends received	9,969,553	11,723,190	21,639,942	11,032,054	13,416,104	17,714,803	22,912,160	25,458,009	27,033,433	27,516,948	31,140,650

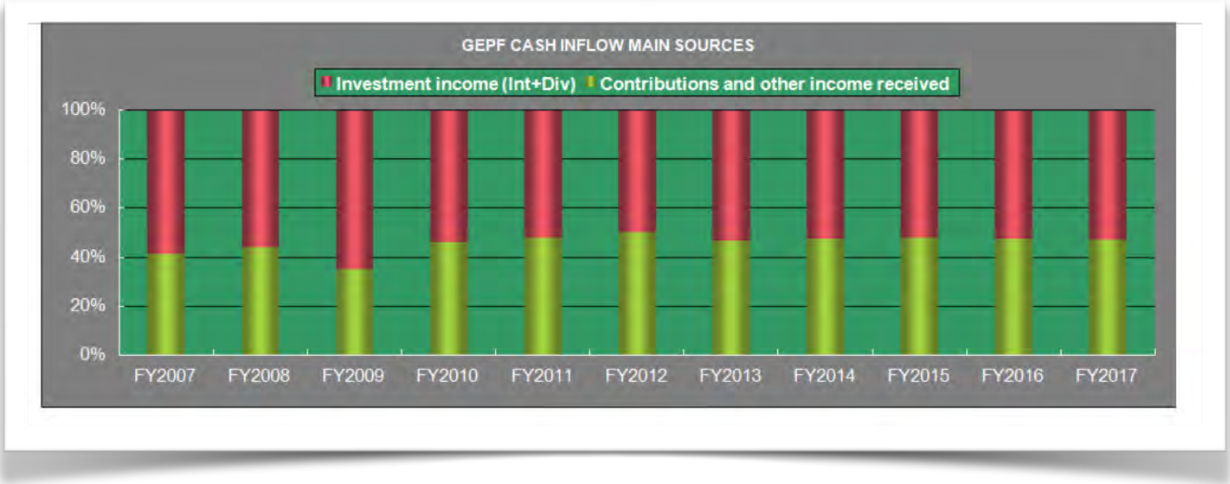
Over 11 years the Contributions as well as Dividends basically increased threefold but Interest in comparison, only doubled.

Its uncertain why Interest has not kept pace with the growth of Contributions over the 11 years.

CASH FLOWS FROM OPERATIONS inflows	FY2007	FY2017	11 Years
Contributions and other income received	22 752 804	66 563 497	292,6%
Interest received	22 166 254	43 261 671	195,2%
Dividends received	9 969 553	31 140 650	312,4%

When we compare the cash inflows based on the underlying cause (asset), we see that cash coming from investment income exceeds the level of contributions from members/employers consistently over the 11 years.

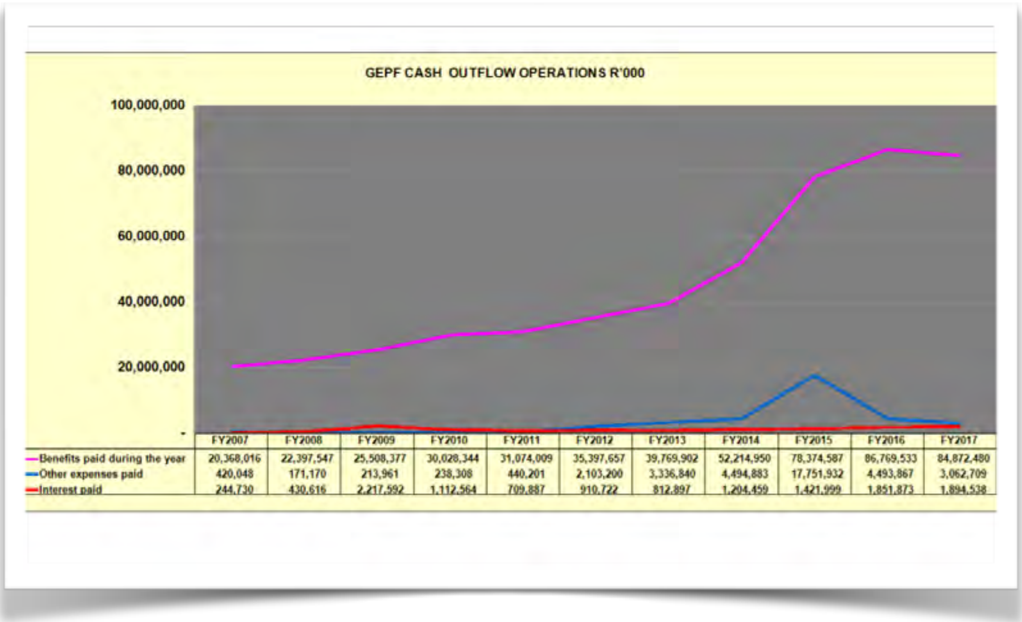
So, proportionally, the proceeds from investments has a marginally bigger impact on



the eventual investment balance than contributions. **THIS IS ONE OF THE REASONS WHY THE FOCUS SHOULD REMAIN ON THE TYPE OF INVESTMENTS MADE ON BEHALF OF MEMBERS.**

USES OF CASH

The main outflow of cash with operational activities is the payment of Benefits. "Other Expenses*" as well as interest paid are also indicated BUT in comparison with benefits, are



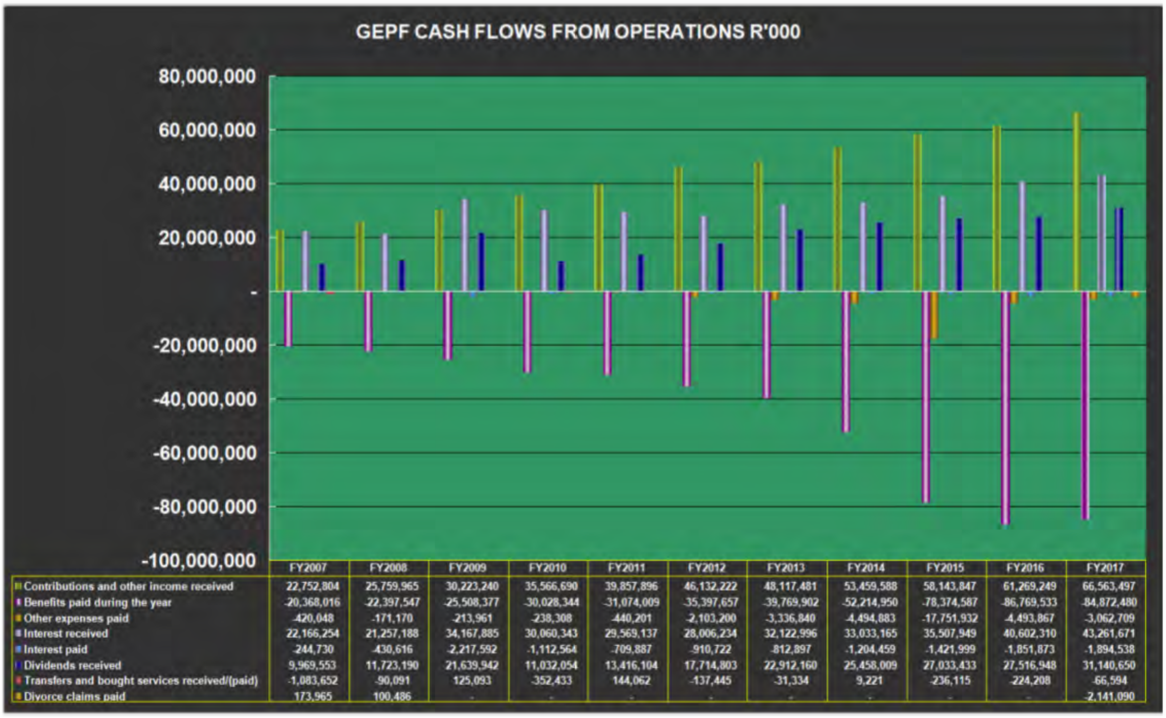
	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
Benefits paid during the year	20,368,016	22,397,547	25,508,377	30,028,344	31,074,009	35,397,657	39,769,902	52,214,950	78,374,587	86,769,533	84,872,480
Other expenses paid	420,048	171,170	213,961	238,308	440,201	2,103,200	3,336,840	4,494,883	17,751,932	4,493,867	3,062,709
Interest paid	244,730	430,616	2,217,592	1,112,564	709,887	910,722	812,897	1,204,459	1,421,999	1,851,873	1,894,538

insignificant users of operational cash. The trend of benefit payment was a steady incline up to 2013. Between the end of 2013 and 2015 (two years) the benefits basically doubled ie. from R39bn to R78bn. In 2017, the benefit level at least showed signs of flattening out on the R84bn mark.

Other expenses jumped five fold between 2011 and 2012 to R2bn and then basically doubled again to R4bn by the end of 2014, barely two years later. In 2015 these expenses ballooned to R17bn. Considering the fluctuations and the growth since 2007, the budget control over these expenses does not appear to be effective.

CASH FLOWS FROM OPERATIONS

Placing the all the above on one graphic, provides the context as to the dominant sources and uses of cash from operational activities.



	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
Contributions and other income received	22,752,804	25,759,965	30,223,240	35,566,690	39,857,896	46,132,222	48,117,481	53,459,588	58,143,847	61,269,249	66,563,497
Benefits paid during the year	-20,368,016	-22,397,547	-25,508,377	-30,028,344	-31,074,009	-35,397,657	-39,769,902	-52,214,950	-78,374,587	-86,769,533	-84,872,480
Other expenses paid	-420,048	-171,170	-213,961	-238,308	-440,201	-2,103,200	-3,336,840	-4,494,883	-17,751,932	-4,493,867	-3,062,709
Interest received	22,166,254	21,257,188	34,167,885	30,060,343	29,569,137	28,006,234	32,122,996	33,033,165	35,507,949	40,602,310	43,261,671
Interest paid	-244,730	-430,616	-2,217,592	-1,112,564	-709,887	-910,722	-812,897	-1,204,459	-1,421,999	-1,851,873	-1,894,538
Dividends received	9,969,553	11,723,190	21,639,942	11,032,054	13,416,104	17,714,803	22,912,160	25,458,009	27,033,433	27,516,948	31,140,650
Transfers and bought services received/(paid)	-1,083,652	-90,091	125,093	-352,433	144,062	-137,445	-31,334	9,221	-236,115	-224,208	-66,594
Divorce claims paid	173,965	100,486	-	-	-	-	-	-	-	-	-2,141,090

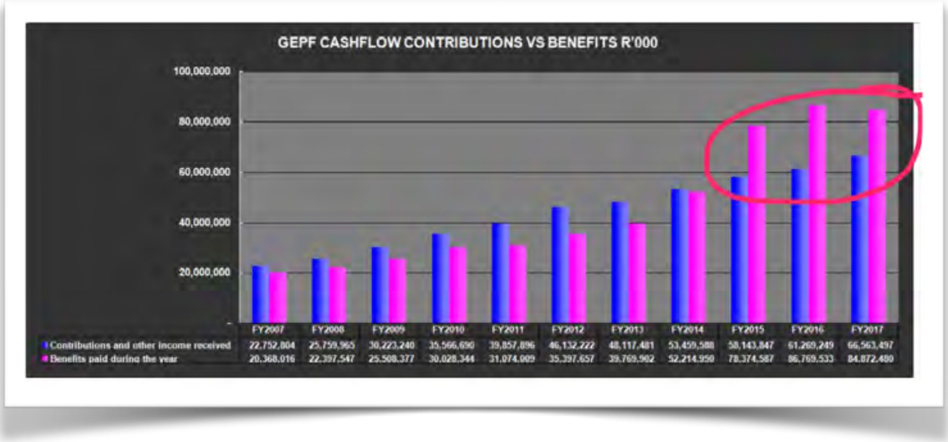
The top half (cash inflows) of the Graph shows the Contributions, interest and dividends.

The lower half of the graph (cash outflows) is dominated by the benefits paid. In 2015, there was a significant spike in respect of "other expenses paid" for some unknown reason.

At this point, the higher growth of benefits relative to contributions from 2015 onwards can already be seen.

CONTRIBUTIONS VS BENEFITS

Narrowing the focus on the Contributions and Benefits relationship provides us with the following graph. It can clearly be seen that during the period 2007 to 2013 the cash inflows from contributions exceeded the outflows related to the payment of benefits.



In 2014 we almost had a break even situation. From 2015 onwards the benefits exceeds contributions significantly! From the trend lines its clear that since 2014 the Benefits grew out of proportion with the trends of prior years. The cause of this has been attributed to an increased number of members resigning from the FUND for various reasons.

The 2017 Annual report indicates for instance:

"Benefits paid increased by R5 billion in the current year, mainly due to a slight increase in resignations from the Fund."

As the shortfall between Benefits and Contributions in 2017 was R25bn (R86bn - R61bn) , this leaves a shortfall balance of R20bn which the increased resignations on its own, does not explain.

Notwithstanding, members are entitled to their benefits as and when they choose. The FUND should be able to absorb these choices.

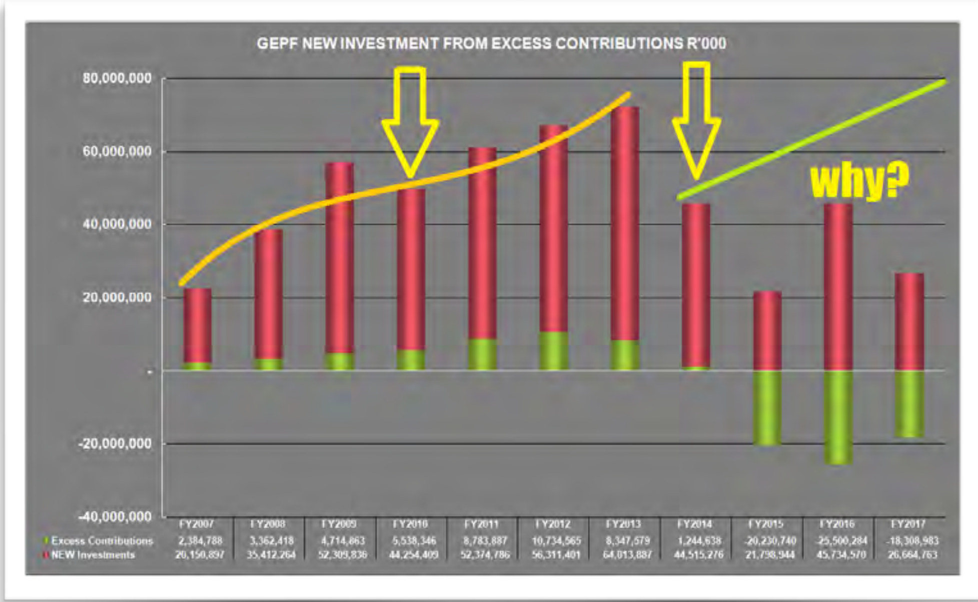
The one reason thats within the control of the Board, lies with the Contributions.

IMPACT ON NEW INVESTMENTS

As the cash that remains after payment of benefits are normally channeled towards investments, it follows that a first requirement would be for contributions to exceed benefits.

As such, the Contributions vs Benefit relationship directly impacts new investments as the graph above illustrates.

Before 2014, the cash left over after benefit payments (excess contributions) could flow to the investment manager to add as new investments. It did not form the bulk of new investments but, it made a positive impact nonetheless.

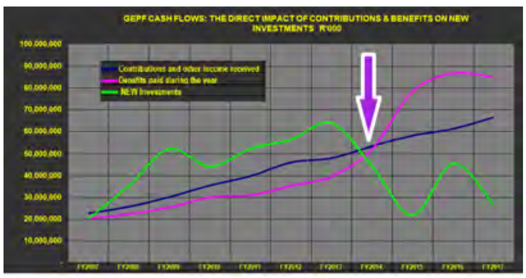


Since 2014 the turnaround as well as the degree thereof can be clearly seen in the graph. The new investment levels is markedly lower and especially visible when we compare with the high levels of new investments between 2011 to 2013.

Nb!.The investment levels during 2015 to 2017 is even lower than in 2009/2010 when there was a global market crisis, hence the question WHY? as indicated on the graph.

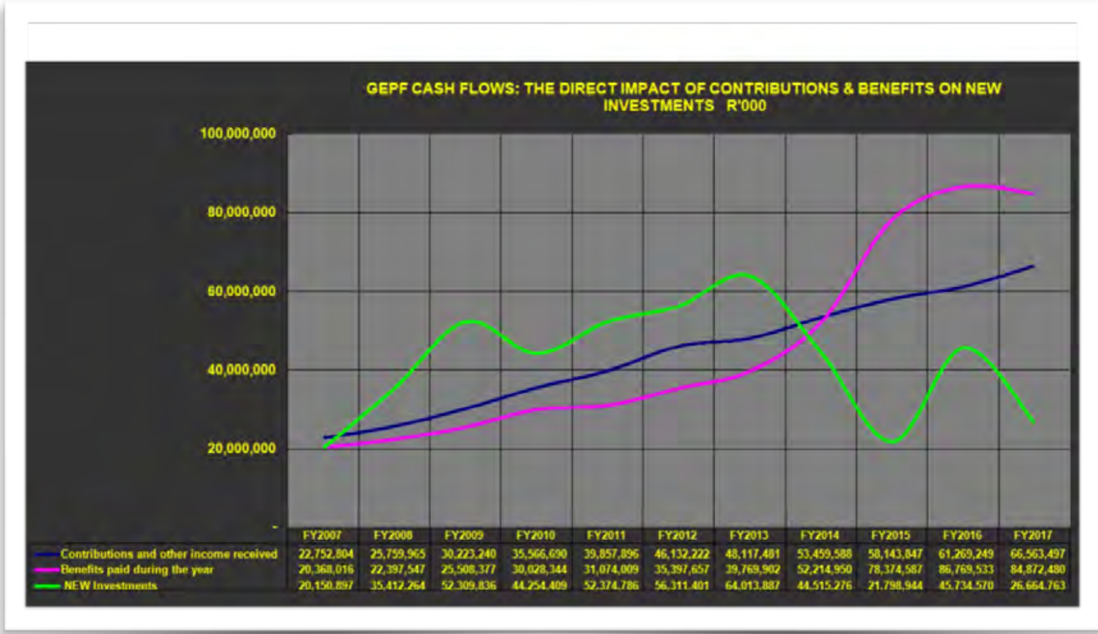
THE DIRECT IMPACT THE LOW CONTRIBUTION RATE HAS ON NEW INVESTMENTS

This graph clearly indicates the significant impact that the Contribution vs Benefit relationship have on new investments.



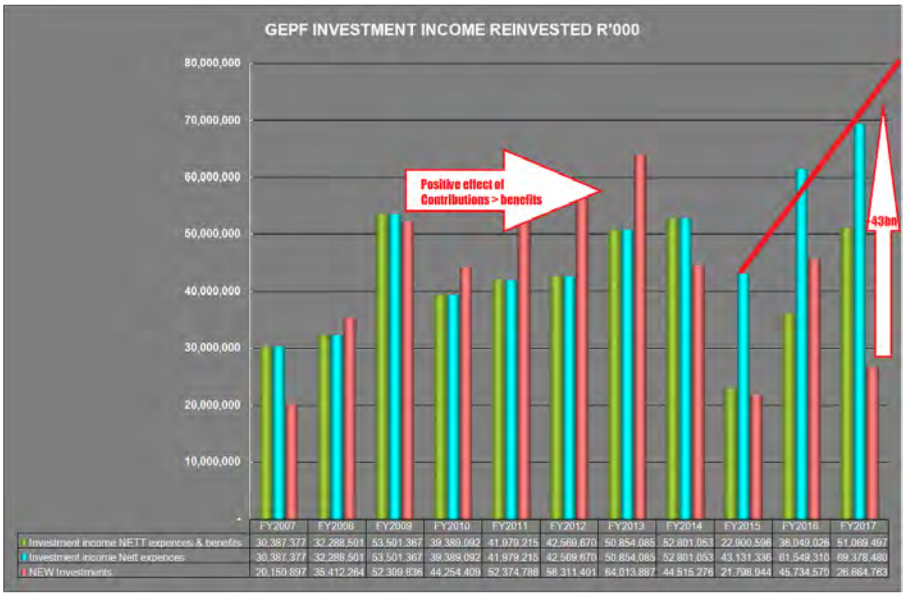
As long as Contributions exceeded Benefits, new investments are actually on a level higher than Contributions itself.
This comes about as a result of the excess cash generated from investment activities which can immediately be re-invested.

However, as soon as the Contribution shortfall arose, this in itself has a knock on effect on the other sources of cash ie. Investment income.



The start of a downward spiral? In short, the cash left over after the payment of administration and investment costs from the cash received via interest and dividends, now have to be diverted to cover the Contribution Shortfall, this happened in 2015 for the first time. (The first year of the term of office of the Mokate/de Wit Board)

To further illustrate the dramatic impact on the available investment income for investment purposes two calculations were done.



The first one **where the contribution shortfall is settled** with investment income and **the second one where the shortfall is not covered by investment income.** The difference between the **actual new investments** made and **what could have been made if contributions covered the benefits,** is clearly visible on the graph between 2015 and 2017. As indicated on the graph itself, the lost investment opportunity for 2017 alone was R43bn (R69bn less R26bn).

Over these three years the Contribution shortfall amounts to +- R64bn calculated as follows =>

Cashflow Contributions<Benefits	Contributions	Benefits	Shortfall R'Bn
FY2015	58,1	78,3	-20,2
FY2016	61,2	86,7	-25,5
FY2017	66,5	84,8	-18,3
TOTALS	**185,8**	**249,8**	**-64**

To place this amount in context lets look at the total new investments made over the 10 year period between 2008 and 2017:

Source: Cash flow statements. Net cash outflow from investing activities	NEW INVESTMENTS R'000
FY2008	35,412,264
FY2009	52,309,836
FY2010	44,254,409
FY2011	52,374,786
FY2012	56,311,401
FY2013	64,013,887
FY2014	44,515,276
FY2015	21,798,944
FY2016	45,734,570
FY2017	26,664,763
TOTAL	**443,390,136**

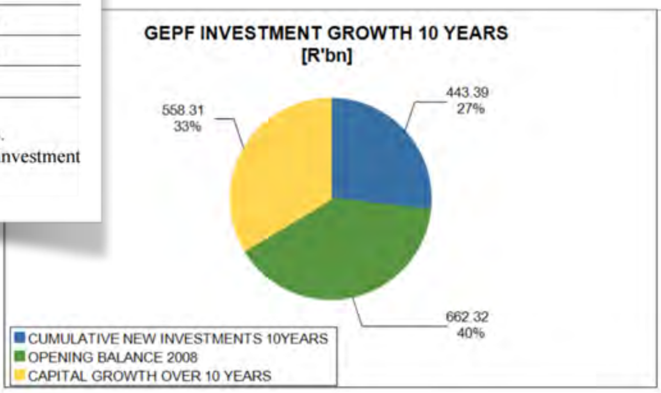
An additional R64bn invested would have pushed the total new investments for the 10 years over the R500bn mark.

More importantly it would have provided an increased investment base from which increased returns could have been derived in perpetuity. An increased funding level supports the consideration for benefit improvements. Something which ALL members benefit from.

To illustrate the effect of new investments on the eventual Investment balance consider the following basic example and calculation.

GEPF INVESTMENT GROWTH 10 YEARS	R'BN	%
CUMULATIVE NEW INVESTMENTS 10YEARS	443.39	27%
OPENING BALANCE 2008	662.32	40%
CAPITAL GROWTH OVER 10 YEARS	558.31	34%
CLOSING BALANCE 2017	**1,664.02**	

The above capital growth excludes those investments sold during the 10 years. In other words the Capital Growth amount of R'bn558 is what remains in the investment balance end of 2017.



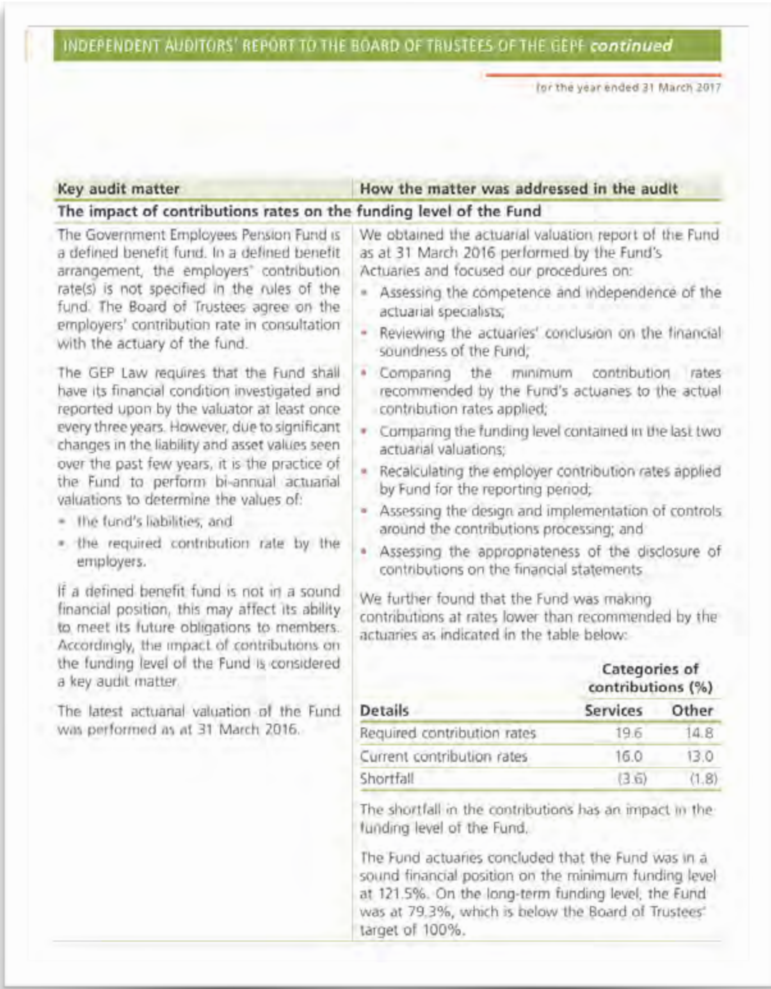
Taking this information and placing it in a graph shows the impact of new investments on capital growth.

It indicates that whatever new investments are made from the positive cash flows would basically double over 10 years.

SO THEN, WHY NO INCREASE IN THE CONTRIBUTION LEVELS?

The above is a question that should actually be answered by the Board. There is no voluntary disclosure in the most recent annual report on this issue.

Regarding the contributions we see the following from the extracted reports from the 2017 Annual Report of the independent experts involved with the FUND.



INDEPENDENT AUDITORS' REPORT TO THE BOARD OF TRUSTEES OF THE GEPF *continued*

for the year ended 31 March 2017

Key audit matter | **How the matter was addressed in the audit**

The impact of contributions rates on the funding level of the Fund

The Government Employees Pension Fund is a defined benefit fund. In a defined benefit arrangement, the employers' contribution rate(s) is not specified in the rules of the fund. The Board of Trustees agree on the employers' contribution rate in consultation with the actuary of the fund.

The GEP Law requires that the Fund shall have its financial condition investigated and reported upon by the valuator at least once every three years. However, due to significant changes in the liability and asset values seen over the past few years, it is the practice of the Fund to perform bi-annual actuarial valuations to determine the values of:

- the fund's liabilities, and
- the required contribution rate by the employers.

If a defined benefit fund is not in a sound financial position, this may affect its ability to meet its future obligations to members. Accordingly, the impact of contributions on the funding level of the Fund is considered a key audit matter.

The latest actuarial valuation of the Fund was performed as at 31 March 2016.

We obtained the actuarial valuation report of the Fund as at 31 March 2016 performed by the Fund's Actuaries and focused our procedures on:

- Assessing the competence and independence of the actuarial specialists;
- Reviewing the actuaries' conclusion on the financial soundness of the Fund;
- Comparing the minimum contribution rates recommended by the Fund's actuaries to the actual contribution rates applied;
- Comparing the funding level contained in the last two actuarial valuations;
- Recalculating the employer contribution rates applied by Fund for the reporting period;
- Assessing the design and implementation of controls around the contributions processing; and
- Assessing the appropriateness of the disclosure of contributions on the financial statements

We further found that the Fund was making contributions at rates lower than recommended by the actuaries as indicated in the table below:

	Categories of contributions (%)	
Details	**Services**	**Other**
Required contribution rates	19.6	14.8
Current contribution rates	16.0	13.0
Shortfall	(3.6)	(1.8)

The shortfall in the contributions has an impact in the funding level of the Fund.

The Fund actuaries concluded that the Fund was in a sound financial position on the minimum funding level at 121.5%. On the long-term funding level, the Fund was at 79.3%, which is below the Board of Trustees' target of 100%.

The Actuary determined that the actual contribution levels is less than required.

The independent auditors confirmed the shortfall in the contributions AND they confirmed what the impact (consequence) will be on the funding level because of the contribution shortfall.

Perhaps the reason for the Board's inaction lies in the comment by the actuary that the continued below calculated contribution levels can be "afforded from the excess of assets over the best estimate liabilities" .

The excess assets referred to by the actuary amounted to R222bn at the end of March 2016.

Its unlikely that the actuary with this comment meant for the Board **not to increase** the Contribution rates. Its more likely the actuary calculated the impact on the minimum funding level. **Unfortunately the actuary has not gone one step further and calculated the impact and affordability on the long term funding level.**

However, in the absence of the Board acting on the information (ie. Increase the Contribution rate) it does appear there is a belief that they can continue with this course of action as it is legal and acceptable.

BUT IS THIS ACTION IN THE BEST INTEREST OF THE FUND?

Rule 7.2 indicates that the contribution rate shall be determined… with due regard to the recommendations of the actuary.

The auditors articulated their interpretation of the actuary's report ie. the actuary **recommended** higher contribution rates.

In addition, Rule 7.2 further states that the fund must meet its obligations **at all times**. All times implies in future as well ie. the long term funding level.

Based on the above, is the Board acting in compliance with the GEPlaw by not insisting on higher contribution rates?

Valuation results as at 31 March 2016

The results of GEPF actuarial valuation as at 31 March 2016 are shown in the table below.

Financial position	31 March 2016 (R million)	31 March 2014 (R million)
Contributing member liability	1 029 889	878 721
S-case and exits in progress	12 063	18 155
Pensioner and deferred pensioner liability	349 805	263 558
Data and past discriminatory practice reserves	15 419	13 082
Total best-estimate liabilities	1 407 176	1 173 516
Net assets	1 629 923	1 425 719
Excess of assets over liabilities	222 747	252 203
Funding level of liabilities	115.8%	121.5%
Recommended reserves*	647 049	541 375
Total best-estimate liabilities and reserves	2 054 225	1 714 891
Net assets	1 629 923	1 425 719
Excess of assets over liabilities and reserves	(424 302)	(289 172)
Funding level of liabilities and reserves	79.3%	83.1%

* For the 31 March 2016 valuation, this consists of a solvency reserve [illegible] million), 100% CPI pension increase reserve [illegible] and a mortality [illegible]

The 2016 actuarial valuation results show that the funding level has deteriorated when compared with the 2014 actuarial valuation.

In terms of the policies adopted by the trustees, the reserves established as at 31 March 2016 are limited to the amount affordable by the Fund, namely R222 747 million. On this basis 34.4% of the recommended reserves could be held. As at 31 March 2014, a reserve of R252 203 million (or some 46.6% of the recommended reserves) was affordable.

Employer contribution rate for the year from 1 April 2016 to 31 March 2017

Based on the best-estimate actuarial valuation basis, and ignoring the excess of the assets over the best-estimate liabilities, the required employer contribution rate is 19.6% of pensionable salary in respect of "services" members and 14.8% of pensionable salary in respect of "other" members, reflecting the differences in the benefit structure of these two categories of members.

The employer currently contributes at a rate of 16% of pensionable salary in respect of "services" members and 13% in respect of "other" members. All members of the Fund contribute at a rate of 7.5% of their pensionable salary.

The shortfall in the required contribution rate is expected to amount to some R6 000 million over the next year and can be afforded from the excess of the assets over the best-estimate liabilities.

Valuation as at 31 March 2018

The next valuation of the Fund will be undertaken effective 31 March 2018.

H. Buck

Howard Buck
Valuator to the Fund

16 October 2017

THE TRUSTEES DUTY TO PROTECT THE INTEREST OF MEMBERS

Even if the Board has a legal opinion to cover themselves by not increasing the contribution rates, is this action protecting the interest of members?

Rule 4.1.19(a)- Trustees or their substitutes must take reasonable steps to ensure that the **interests of members are protected.**

What are those interests?
The Board's own investment policy statement indicates the following ==>

11. Members are not exposed to investment risks prior to their retirement because of the defined benefit nature of the fund. Once they are in receipt of a pension, pensioners, or survivors enjoying dependants' pensions after the death of a member, are exposed to investment risks to the extent that such risks may adversely impact the Fund's ability to afford pension increases above the minimum set out in the pension increase policy.

In the 2017 annual report the PEO has stated that:

"Investment returns below the inflation rate could impact negatively on the Fund's objective of granting full inflationary increases to pensioners."

However, what we have here is a case where the inaction of the Trustees basically reduces the amount of investments held.

This in turn reduce the quantum of investment income.

PRINCIPAL EXECUTIVE OFFICER'S REPORT

During the period under review, the Office of the Principal Executive Officer (PEO) continued to support the Board of Trustees, ensuring that the Government Employees Pension Fund (GEPF) acted in the best interests of its members, pensioners and beneficiaries. It also endeavoured to ensure that the Fund's strategy and specific deliverables were implemented in conjunction with the Government Pensions Administration Agency (GPAA) and the Public Investment Corporation (PIC).

The GEPF commenced with the implementation of its balanced scorecard on 1 April 2016 based on the Board's strategy, incorporating outstanding items from the previous year and recorded a significant improvement on its performance.

Financial highlights

At the end of the period under review, the market value of the Fund reached R1.67 trillion, which is an increase of 2.6% on the value at 31 March 2016. During this period, the Fund produced a return of 4.3%, outperforming its strategic benchmark return of 3.7%. This investment performance was achieved in a period of low economic growth, volatile financial markets, and with inflation (at 6.3% year-on-year) slightly higher than the South African Reserve Bank's Consumer Price Index (CPI) target range of 3% to 6%. Investment returns below the inflation rate could impact negatively on the Fund's objective of granting full inflationary increases to pensioners.

The Fund recorded several financial highlights during the period under review. Its accumulated funds increased from R1.63 trillion in 2016 to R1.67 trillion in 2017. Its investment portfolio increased from R1.64 trillion in 2016 to R1.67 trillion in 2017. Contributions received and

Based on the above, it does appear that the Trustees are NOT taking reasonable steps to protect the best interest of +|- 400000 pensioners pertaining to the safeguarding of inflation based increases.

The Board's action on the contribution rates are unnecessarily **INCREASING** the investment risk of pensioners specifically.

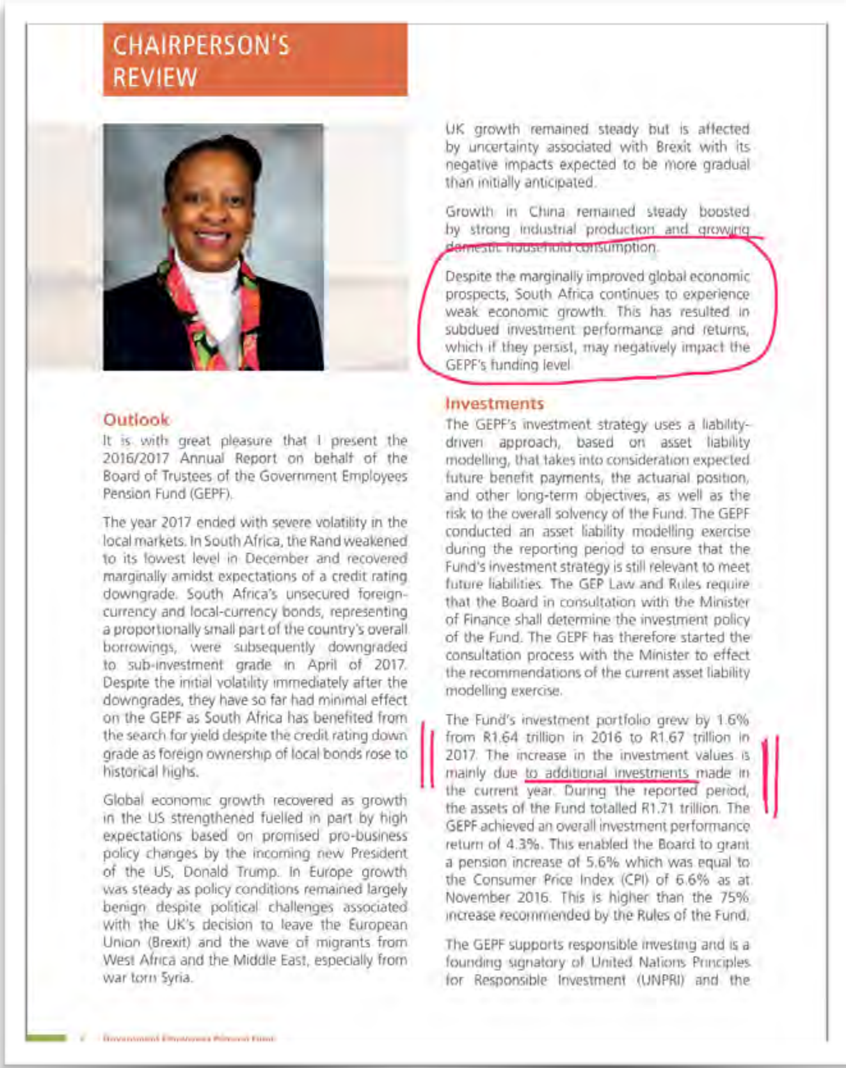
But it is not only current pensioners that are at risk. The contributions also directly affect the long term funding level as the auditors indicated.

The Fund actuaries concluded that the Fund was in a sound financial position on the minimum funding level at 121.5%. On the long-term funding level, the Fund was at 79.3%, which is below the Board of Trustees' target of 100%.

In summary, not raising the contribution rates also negatively impacts the funding levels, especially the achievement of the long-term funding level which the Board themselves has targeted at 100%.

The most recent pronouncement on the Funding level is in the 2017 Annual Report.

THE CHAIRPERSONS TAKE ON THE FUNDING LEVEL AND INVESTMENTS (Source: 2017 Annual Report)



CHAIRPERSON'S REVIEW

Outlook

It is with great pleasure that I present the 2016/2017 Annual Report on behalf of the Board of Trustees of the Government Employees Pension Fund (GEPF).

The year 2017 ended with severe volatility in the local markets. In South Africa, the Rand weakened to its lowest level in December and recovered marginally amidst expectations of a credit rating downgrade. South Africa's unsecured foreign-currency and local-currency bonds, representing a proportionally small part of the country's overall borrowings, were subsequently downgraded to sub-investment grade in April of 2017. Despite the initial volatility immediately after the downgrades, they have so far had minimal effect on the GEPF as South Africa has benefited from the search for yield despite the credit rating down grade as foreign ownership of local bonds rose to historical highs.

Global economic growth recovered as growth in the US strengthened fuelled in part by high expectations based on promised pro-business policy changes by the incoming new President of the US, Donald Trump. In Europe growth was steady as policy conditions remained largely benign despite political challenges associated with the UK's decision to leave the European Union (Brexit) and the wave of migrants from West Africa and the Middle East, especially from war torn Syria.

UK growth remained steady but is affected by uncertainty associated with Brexit with its negative impacts expected to be more gradual than initially anticipated.

Growth in China remained steady boosted by strong industrial production and growing domestic household consumption.

Despite the marginally improved global economic prospects, South Africa continues to experience weak economic growth. This has resulted in subdued investment performance and returns, which if they persist, may negatively impact the GEPF's funding level.

Investments

The GEPF's investment strategy uses a liability-driven approach, based on asset liability modelling, that takes into consideration expected future benefit payments, the actuarial position, and other long-term objectives, as well as the risk to the overall solvency of the Fund. The GEPF conducted an asset liability modelling exercise during the reporting period to ensure that the Fund's investment strategy is still relevant to meet future liabilities. The GEP Law and Rules require that the Board in consultation with the Minister of Finance shall determine the investment policy of the Fund. The GEPF has therefore started the consultation process with the Minister to effect the recommendations of the current asset liability modelling exercise.

The Fund's investment portfolio grew by 1.6% from R1.64 trillion in 2016 to R1.67 trillion in 2017. The increase in the investment values is mainly due to additional investments made in the current year. During the reported period, the assets of the Fund totalled R1.71 trillion. The GEPF achieved an overall investment performance return of 4.3%. This enabled the Board to grant a pension increase of 5.6% which was equal to the Consumer Price Index (CPI) of 6.6% as at November 2016. This is higher than the 75% increase recommended by the Rules of the Fund.

The GEPF supports responsible investing and is a founding signatory of United Nations Principles for Responsible Investment (UNPRI) and the

Weak economic growth is indicated as the cause of subdued investment performance and returns and may impact the GEPF's funding level.

The increase in investment values is mainly due to additional investments.

Testing the validity of the Chairpersons comments against the Cashflow Analysis performed.

Regarding the Funding level comment, the 2016 Actuarial report contradicts this because the funding levels **has already deteriorated** since 2014. The Auditors also clearly indicated that the Contribution shortfall impacts the funding levels. Contributions and its impact on the funding level is regarded as a KEY AUDIT MATTER.

Subdued investment performance is NOT ONLY the result of the weak economy BUT relates also to the Fund investing all its resources in the highest yielding secure financial instruments. NEW investments is less than expected because of the knock on effect of the Contribution shortfall as already highlighted by this analysis.

The Chairperson’s comment about the increase in investment values remains **silent** as to the root cause of **WHY New investments in 2017 is at its lowest level since 2008. This, notwithstanding the indication that more cash was available in view that R30bn was retained in the Cash & cash equivalent balance at FYE 2017. (The Average balance over 10 years was R10bn)**

Finally, it should be noted that the Funding levels deteriorated since 2014 with the affordability of the Contingency Reserves, as calculated by the Actuary, dropping by R135bn between 2014 and 2016.

R’000	2 010	2 012	2 014	2 016
Recommended reserves	344 877 000	464 181 000	541 375 000	647 049 000
ACTUAL CONTINGENCY RESERVE	64 282 112	27 330 197	252 202 686	222 747 371
RESERVE SHORTFALL	280 594 888	436 850 803	289 172 314	424 301 629
				289 172 314
Negative movement 2014 to 2016				135 129 315

To compound this issue, its uncertain what the multiyear plan of the GEPF is to achieve the 100% Long-term funding level. We have no idea of what the interim targets are and the time horizon envisaged to achieve this target. Is it by the year 2040, is it 2030?

What is for sure, is that an deteriorating funding rate (from 83% to 79% between 2014 and 2016) is indicative that strategically the Funding levels are moving in the WRONG DIRECTION! This is not surprising when considering the Chairpersons views on the actual status and causes of the deteriorating Funding levels at the end of 2017.

The longterm-funding level and its achievement impacts ALL members virtue of the scope it allows further improvements of benefits.

WORKSHEET WITH DATA GROUPED BY BOARD OF TRUSTEES (Chair/Vice Chair indicated)

FUND GOVERNANCE

Overview of the Board of Trustees

The Board governs the Fund and is accountable for its administrative and investment performance. According to the Government Employees Pension (GEP) Law, fiduciary responsibility for the Fund rests with the Board of Trustees. The Law requires that the Board be appointed for a four-year term, after which it must make way for a new Board. The Minister of Finance inaugurated the current Board on 17 April 2014 for a period of four years.

The information is grouped by the term of office of the last three Board's of Trustees. Once the 4th year data for the current Board (Mokate/de Wit) is received, more detailed comparisons and analysis will be done.

R'bn	FY2007	FY2008	FY2009	FY2010
BoT KUSKUS/BAIT				
Cash generated from operations	**2,0**	**3,2**	**4,5**	**5,3**
Contributions and other income received	22,8	25,8	30,2	35,6
Benefits paid during the year	-20,4	-22,4	-25,5	-30,0
Other expenses paid	-0,4	-0,2	-0,2	-0,2
Interest received	22,2	21,3	34,2	30,1
Interest paid	-0,2	-0,4	-2,2	-1,1
Dividends received	10,0	11,7	21,6	11,0
Transfers and bought services received/(paid)	-1,1	-0,1	0,1	-0,4
Divorce claims paid	0,2	0,1	- ,0	- ,0
Net cash inflow from operating activities	**32,9**	**35,8**	**58,2**	**44,9**
Net cash outflow from investing activities	**-20,2**	**-35,4**	**-52,3**	**-44,3**
Additions to equipment	-0,0	-0,0	-0,0	-0,0
Additions to investments	-20,1	-35,4	-52,3	-44,2
Net increase in cash and cash equivalents	**-0,1**	**0,3**	**5,9**	**0,7**
Cash and cash equivalents at beginning of the year	1,1	0,9	8,5	14,4
Cash and cash equivalents at end of the year	0,9	1,3	14,4	15,1

R'bn	FY2011	FY2012	FY2013	FY2014
BoT: MOLOTO/BADAL				
Cash generated from operations	**8,3**	**8,6**	**5,0**	**-3,3**
Contributions and other income received	39,9	46,1	48,1	53,5
Benefits paid during the year	-31,1	-35,4	-39,8	-52,2
Other expenses paid	-0,4	-2,1	-3,3	-4,5
Interest received	29,6	28,0	32,1	33,0
Interest paid	-0,7	-0,9	-0,8	-1,2
Dividends received	13,4	17,7	22,9	25,5
Transfers and bought services received/(paid)	0,1	-0,1	-0,0	0,0
Divorce claims paid	- ,0	- ,0	- ,0	- ,0
Net cash inflow from operating activities	**50,8**	**53,3**	**59,2**	**54,0**
Net cash outflow from investing activities	**-52,4**	**-56,3**	**-64,0**	**-44,5**
Additions to equipment	-0,0	-0,0	-0,0	-0,0
Additions to investments	-52,4	-56,3	-64,0	-44,5
Net increase in cash and cash equivalents	**-1,6**	**-3,0**	**-4,8**	**9,5**
Cash and cash equivalents at beginning of the year	15,1	13,5	10,5	5,7
Cash and cash equivalents at end of the year	13,5	10,5	5,7	15,2

R'bn	FY2015	FY2016	FY2017	
BoT: MOKATE/DE WIT				
Cash generated from operations	**-38,0**	**-30,0**	**-21,4**	
Contributions and other income received	58,1	61,3	66,6	
Benefits paid during the year	-78,4	-86,8	-84,9	
Other expenses paid	-17,8	-4,5	-3,1	
Interest received	35,5	40,6	43,3	
Interest paid	-1,4	-1,9	-1,9	
Dividends received	27,0	27,5	31,1	
Transfers and bought services received/(paid)	-0,2	-0,2	-0,1	
Divorce claims paid	- ,0	- ,0	-2,1	
Net cash inflow from operating activities	**22,9**	**36,0**	**48,9**	
Net cash outflow from investing activities	**-21,8**	**-45,7**	**-26,7**	
Additions to equipment	-0,0	-0,0	-0,0	
Additions to investments	-21,8	-45,7	-26,7	
Net increase in cash and cash equivalents	**1,1**	**-6,0**	**19,9**	
Cash and cash equivalents at beginning of the year	15,2	16,3	10,3	
Cash and cash equivalents at end of the year	16,3	10,3	30,2	

MULTIYEAR DATA ON ONE WORKSHEET

The combined totals per BoT per the available data is as follows.
NB! The Mokate/de Wit board data is ONLY for 3 years.

CASHFLOW COMBINED PER BOARD OF TRUSTEE [BoT]			
R'bn	4 YEAR	4 YEAR	3 YEAR
	BoT KUSKUS/ BAIT	BoT: MOLOTO/ BADAL	BoT: MOKATE/DE WIT
Cash generated from operations	15,0	18,7	-89,3
Contributions and other income received	114,3	187,6	186,0
Benefits paid during the year	-98,3	-158,5	-250,0
Other expenses paid	-1,0	-10,4	-25,3
Interest received (1)	107,7	122,7	119,4
Interest paid	-4,0	-3,6	-5,2
Dividends received (1)	54,4	79,5	85,7
Transfers and bought services received/(paid)	-1,4	-0,0	-0,5
Divorce claims paid	0,3	- ,0	-2,1
Net cash inflow from operating activities	171,8	217,3	107,9
Net cash outflow from investing activities	-152,1	-217,2	-94,2
Additions to equipment	-0,1	-0,0	-0,0
Additions to investments	-152,1	-217,2	-94,2
Net increase in cash and cash equivalents	6,8	0,1	15,0

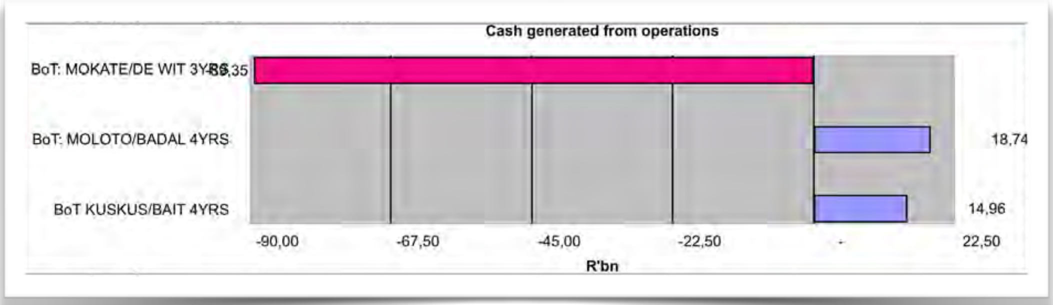
MULTIYEAR CASH FLOW STATEMENT: FLAGGED LINE ITEMS FOR THE CURRENT BOARD

The information of the 4th year of the current Board, will only be available in October 2018. However, as can be seen from the extract of the worksheet herewith, some trends can already be observed. These will be subject to detailed analysis at a later stage.

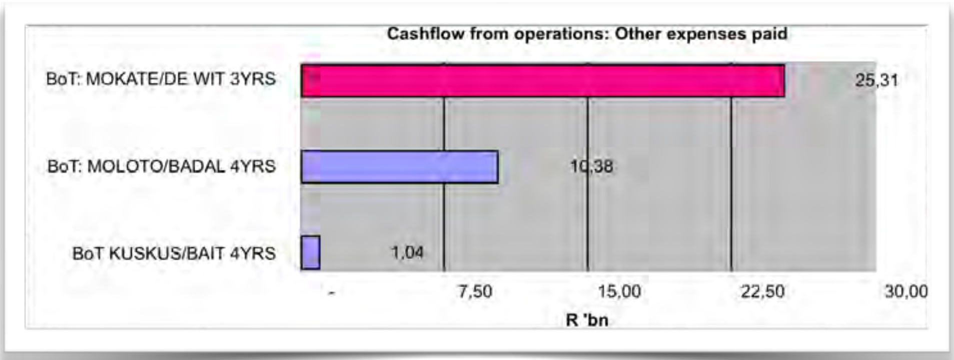
?

R'bn	FY2015	FY2016	FY2017
BoT: MOKATE/DE WIT			
Cash generated from operations	-38,0	-30,0	-21,4
Contributions and other income received	58,1	61,3	66,6
Benefits paid during the year	-78,4	-86,8	-84,9
Other expenses paid	-17,8	-4,5	-3,1
Interest received	35,5	40,6	43,3
Interest paid	-1,4	-1,9	-1,9
Dividends received	27,0	27,5	31,1
Transfers and bought services received/(paid)	-0,2	-0,2	-0,1
Divorce claims paid	- ,0	- ,0	-2,1
Net cash inflow from operating activities	22,9	36,0	48,9
Net cash outflow from investing activities	-21,8	-45,7	-26,7
Additions to equipment	-0,0	-0,0	-0,0
Additions to investments	-21,8	-45,7	-26,7
Net increase in cash and cash equivalents	1,1	-6,0	19,9
Cash and cash equivalents at beginning of the year	15,2	16,3	10,3
Cash and cash equivalents at end of the year	16,3	10,3	30,2

- **Cash generated from operations has always been positive. However, from 2014 onwards, its been negative as a result of the contributions shortfall,**
- **The level of the negative cashflow from operations is alarming when considering that the negative cashflow in one year, namely 2015, was on par with the combined positive cashflows of the 7 years prior (2007 to 2013),**
- **With 3/4 of the Mokate/de Wit term of office gone, the combined negative cashflows from operations ALREADY amounts to R89,3bn.**



- **Other expenses paid has escalated significantly since 2007 but alarmingly so under the stewardship of the MOKATE/DE WIT board. The total over the last 3 years is already R25.3bn. This is more than double the combined amount (R11.4bn) paid out in the previous 8 years!**
- **Interest received since 2007 has not kept pace with the growth of other sources of cash,**
- **Additions to investments has decreased to the lowest levels since 2008,**



- **Cash & cash equivalents retained in 2017 appears excessive when compared to the averages of prior years and considering the below expected additions to investments.**

CONCLUDING REMARKS

The GEPF is a fund with 1.67 trillion rands in assets at the end of 2017. The sheer size of the fund, combined with the so called government guarantee, creates the illusion of invincibility, this fund is too big to fail. History is full of lessons and examples of where this prophesy was proved wrong. From biblical times when David took care of Goliath and onwards to the most famous sinking of the Titanic. In the USA there have been banks that was too big to fail, ie. Bear Stearns.

It is hoped that this analysis has succeeded in bringing home the message that the KEY INGREDIENT to ensure the current size of the Fund (Aum speak), is because of the cumulative effect of the positive cashflows from operations over a number of years. The key factor in this is the Contributions that exceeds Benefits.

For the last three year, THIS SITUATION is no more!

A number of other concerns were highlighted in this document. These needs to be properly ventilated in public and addressed by the BoT.

For the cash flow from operations to change over from a positive to a negative result, is a fundamental matter that warrants far more scrutiny by those charged with external oversight.

Last mentioned actually represents a change in the funding model and as such, requires increased transparency and disclosures to members and pensioners.

The analysis indicates that external oversight mechanisms need to dig a bit deeper, ask more searching questions about the cash flows at the GEPF.

Lets hope this will happen in 2018.

Comments? Email them to x2vandyk@gmail.com

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