Date: 28th March 2012

VERITÉ RESEARCH

Employees Provident Fund (EPF)

Issue

The Mission of the Employee's Provident Fund (EPF) is: '*To provide maximum retirement benefits and an efficient service to our members through prudent and innovative management of the fund.*'

The EPF's management of equity investments are seriously at odds with its mission. It has hugely underperformed the All Share Price Index (ASPI), and earned only one fourth of what it would have earned if the same investment had been placed with the usual no-risk-low-return government securities, where 95% of the EPF funds are placed. Additionally, in 2010, the Employee's Trust Fund's (ETF) investments in equity performed 6 times better than the EPF's investments in equity.

Overview

EPF was established under the EPF Act No.15 of 1958. The employees contribute 8% of their wages and the employer contributes a further 12% of the member's gross earnings. Individual accounts are maintained which are credited in accordance with the investment returns from the Fund.

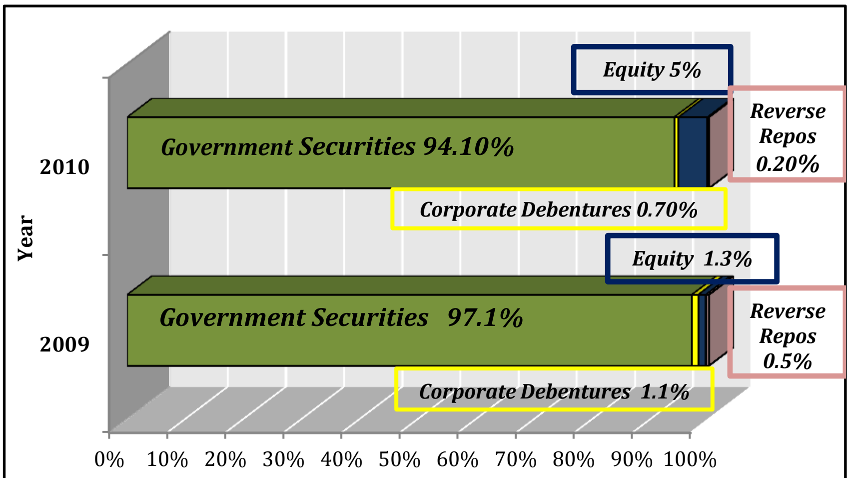

Figure 1

The Monetary Board of the Central Bank being responsible for the financial management of the Fund has to make suitable investments so as to earn a reasonable rate of return.

The total value of the Fund, at the end of 2010, stood at Rs. 899, 650,351,013.

The key areas of investment of the Fund are Government Securities (Treasury Bills/Bonds & Rupee Loans to the Government), Corporate Debentures, Equity and Reverse Repos.

Returns from EPF Investments in the Stock Market vs. All Share Price Index

In 2009, post civil war, the Sri Lankan stock exchange boomed, and in 2010 it became the best performing stock exchange in the world. The percentage increase of the ASPI in these two years was 125% and 96% respectively[1].

[1] http://www.cse.lk/270808/pdf/CSE_Annual_Report_2010.pdf

In contrast, the EPF Investments in the Stock Market gained only 3.73% and 4.20%, respectively. (This calculation includes the Marked to Market Gain/Loss on equities)[2].

Performance of EPF Investments in the Stock Market

	EPF Investment in Equities (Rs. Bn)	*EPF Gains from Equity Investments*	*ASPI Gains*	*EPF Gains -Rupee Amount (Rs. Bn)*	*Gains if investment had tracked the ASPI (Rs. Bn)*
2009	9.8	3.73%	125%	0.36	12.25
2010	43.7	4.20%	96%	1.83	41.95

The stream investment and recorded returns in 2009 and 2010 calculate to an internal rate of return of 4.11%. However, if the investments had performed as well as the ASPI, the internal rate of return would have been 103.66%. Where the quantum of investment had an expected market return of 54 billion, based on the ASPI of the stock exchange during this these two years, the EPF earned only a combined total of 2.2 billion. In 2010 alone, the loss as a result of not investing in the ASPI amounts to 40 billion.

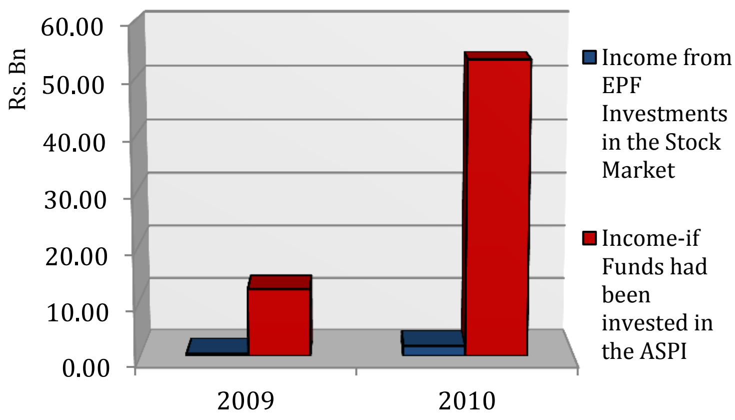

Figure 2

The scale of the loss is cause for even greater concern than the absolute amount. Its investment is such that, in 2009, the adverse ratio of actual to expected gains is 1:33. If the extra returns were then added to the equities, the expected gain in 2010 would have been 29 times that which was actually recorded by the EPF -- even after including the marked to market gains recorded.[3]

(That is, if EPF had simply distributed its investment proportionately across all shares in the stock market without any thought or analysis, it would have earned 33 times and 29 times more than it actually earned with its expert investment decisions, respectively in 2009 and 2010).

Returns from EPF Investments in Equity vs. Returns from ETF Investments in Equity

The Employees Trust Fund (ETF), which is managed by the Commissioner of Labour, has, however, managed to garner much greater returns in their stock market investments.

In contrast to the EPF's gain of 3.73% in 2009, the ETF made a gain of 11.9%.

In 2010, the ETF made a gain of 26% which is almost 6 times greater than the gain of 4.20% made by the EPF's investments in the stock market.

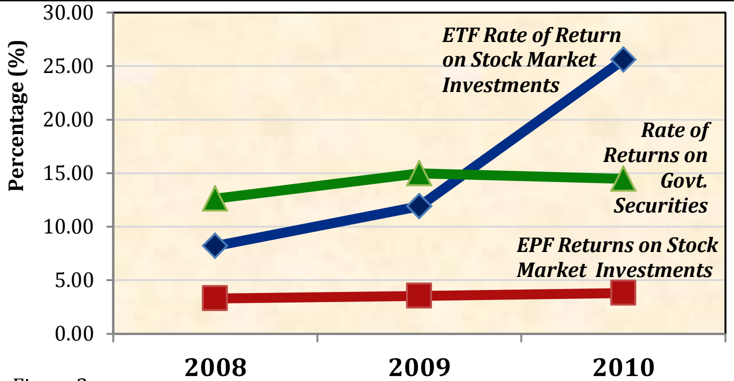

Figure 3

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[2] The return to workers from EPF Investments in equities are 3.53% and 3.81%, in 2009 and 2010, respectively, when calculated without utilizing the Gain/Loss Marked to Market on equities.

[3] These calculations include the marked to market gains from the EPF, which have not been included in previous results released by VR with regard to assessing the performance of the EPF.

Returns of EPF Investments to Equity vs. Returns to EPF Investments in Government Securities

Historically, the main investment of the Fund is in Government Securities as it is considered to be a safe investment. In 2009, the Monetary Board invested 97.1% of the EPF Fund in Government Securities, with a rate of return of 15.70%, while in 2010 it invested 94.1% with a return of 14.60%.

From 2009 to 2010, there was a fourfold increase in the percentage of the Fund being invested in equities, with 5% of the Fund (Rs.43.7 billion) being invested in equities, in comparison to the 1.3% of the Fund (Rs.9.8 billion) in 2009. The Central Bank's explanation for this increase was that there was a need to diversify investments, as returns to government securities were on the decline.

Performance of EPF investments in Government Securities

	EPF Investment in Equities (Rs. Bn)	*EPF Gains from Equity Investments*	*Govt. Securities Gains*	*Amount EPF Gained from Equity Investments (Rs. Bn)*	*Amount if investment had been in Govt. Securities (Rs. Bn)*
2009	9.8	3.73%	15.70%	0.36	1.54
2010	43.7	4.20%	14.60%	1.83	6.38

The explanation, however, is contradicted by the outcome, as the return to workers from the EPF's investment in equities in 2009 and 2010, were only 3.73% and 4.20% respectively. Figure 3 shows that the returns from Government Securities has consecutively been higher than the returns to workers from EPF investments in the stock market.

In 2010, if the same investments had been kept in short and long term government securities at the average yield, the EPF would have earned almost 4 times as much as it did by investing in the stock market.

Other Issues- Conflict of Interest

Section 113 of the Monetary Law Act provides that the public debt management function is entrusted to the Central Bank of Sri Lanka. As a result, it handles all matters relating to servicing of domestic and foreign debt of the Government. At the same time, the Monetary Board is required to manage and ensure the best possible rate of return for EPF members.

Therefore a potential conflict of interest arises with regard to these conflicting roles of the Monetary Board of the Central Bank, where on one side it is responsible for debt management of the Government and ensure that the government's financing needs are met at the lowest possible cost, and on the other is required to invest in sources so as to get the highest returns for the EPF fund.

Conclusion

The management of the EPF had continuously stated in its Annual Reports that it seeks to ensure reasonable rates of returns and to provide the maximum retirement benefits to its members. However, the investment decisions made indicate otherwise.

The stock market is what economists call a "constant sum game". That is, the total long term benefits available from the stock market are equal to the actual increase in dividends from the underlying stocks. All deviations from this underlying increase in value are "zero sum": that is, one person's loss is another person's gain. Therefore, the huge underperformance of the EFP investment is not without beneficiaries

To date, there has been no admission by the Central Bank of a professional failure with regard to its foray into the stock exchange. The various business Chambers and COPE have also failed to speak up on this issue. Recently amendments to the EPF Act were passed in Parliament concerning higher penalties on employers with regard to due diligence on EPF payments. Based on the analysis, what is now needed is some mechanism to hold those responsible for the Fund accountable for its prudent management.