

Guidance Note: KiwiSaver Performance Fees

May 2012

About this guidance note

This guidance note is intended for the managers and trustees of KiwiSaver schemes. It sets out the criteria against which FMA will assess the reasonableness of performance fees.

Issuing guidance is just one of the ways we can be transparent and share our intended approach with the market. Guidance helps market participants be confident they understand our approach and how we interpret, and intend to apply, the law relating to their responsibilities.

It is FMA's intention to update guidance given to the market in the event of legislative changes, where market norms evolve, where new information is available to it or where there are changes in market conduct requiring guidance. Accordingly, the market should expect further guidance on performance fees over time.

KiwiSaver is a regulatory priority for FMA and it also intends to provide further guidance to the market on a number of issues pertinent to KiwiSaver, for example investment risk disclosure (particularly in the context of investment returns and fees).

Introduction

Under Clause 2 of Schedule 1 of the KiwiSaver Act 2006 (the 'Act'), KiwiSaver fees must not be unreasonable. KiwiSaver Regulations (the 'Regulations') 10 to 12 provide the framework for the Financial Markets Authority (FMA) to consider whether in its view a KiwiSaver scheme complies with Clause 2.

This guidance note sets out the criteria against which FMA will assess whether any performance fees that are proposed to be charged, or are charged by a manager to a member's investment in the Scheme can be considered 'not unreasonable'.

It builds upon the three characteristics the Government Actuary identified in his Guidance Note KSGN2 issued in March 2008.

KiwiSaver managers and trustees should note the requirement for fees to be 'not unreasonable' is an implied term in a KiwiSaver trust deed. FMA expects the trustees of KiwiSaver schemes to monitor the KiwiSaver schemes they supervise for compliance with their obligations under their trust arrangements, including that fees charged are 'not

unreasonable'. In undertaking this monitoring trustees should be guided by the principles set out in this guidance note.

FMA does not expect to see a significant increase in performance fees in the KiwiSaver market.

General principles

FMA believes performance fees need to be assessed on a case-by-case basis. In undertaking our assessment on whether a fee is not unreasonable FMA will be guided by the following general principles:

Principle 1: It is reasonable to offer fair reward for the application of investment manager skill.

Consistent with this:

- It can be appropriate to recognise special skills, resources and outcomes delivered by the manager in agreed performance fee arrangements.
- FMA considers performance fees on KiwiSaver schemes should only be charged in certain, limited circumstances, for example actively-managed growth funds.
- Performance rewards should be built on special skill based factors added by the manager over and above those generally available through investing 'in the market' i.e. recognising alpha not beta.
- When considering what 'in the market' means, we will consider the usual investment mix and inherent market return and risk characteristics of the 'standard' or base investment position of the fund concerned in normal market conditions.
- Investors should not pay twice for the same return. Therefore the relativity between any on-going base fee in relation to the 'standard' or base investment asset mix and the performance fee must take account of the effective allowance already in that base fee for an element of active management (the Beta portion). We expect the higher the base fee the lower the expected level of performance fee.

Principle 2: Performance fees should adequately reflect the risks taken by both the investment manager and the investor.

Accordingly:

- Performance fee structures should be aligned with investors' objectives. The fee structure should not reward managers by giving the manager an undue share of the return that might result from active management. This recognises the return was achieved by putting the investors' capital at risk.
- Performance fee structures should not have the potential to encourage inappropriate or undue risk taking by the manager. For example, they should not have increased portfolio gearing or semi-permanent higher risk tilts away from the 'standard' investment position.

- It is important that investors are given sufficient information on the risks being taken with their capital to generate the excess returns driving performance fees. It is difficult for investors to judge the appropriateness of performance fees without understanding the investment risks being taken to deliver them.

Performance fee elements

In applying the principles, FMA's expectation is that performance fees will contain the following key elements:

- Hurdle Rate of Return with an appropriate benchmark;
- High Water Mark (with no resets);
- Crystallisation periods of not less than a year; and
- Performance fee cap (in most circumstances).

The performance fee should be expressed as a percentage of the return that is in excess of the Hurdle Rate of Return. The returns should be calculated after deduction of all base fees already paid by the investor.

Hurdle Rate of Return

The Hurdle Rate of Return should reflect:

- The long term objectives and inherent risk characteristics for the fund concerned (in general the higher the risk then the higher the required hurdle).
- An appropriate return benchmark, generally the expected return from the standard fund asset mix under normal expected market conditions before allowance for 'added value' from active management. The benchmark should be based on a suitable market-related index, adjusted where necessary for the inherent risks and potential returns within the fund concerned. FMA accepts that, for a true 'absolute return' investment fund, a cash-based benchmark (e.g. 90 day bank bill rate (BKBM)) may, in certain circumstances, be an appropriate benchmark. In these circumstances FMA would expect the fund's track record over time to reflect the 'absolute investment style'.
- If appropriate, an allowance in the minimum Hurdle Rate of Return where there are active management fees already implicit in any base fee.

High Water Mark

- A 'High Water Mark' is to apply so that past underperformance is recovered prior to the accrual of any future performance fee. The High Water Mark cannot be reset. The relevant Net Asset Value or unit price should be based on the same methodology as the calculation of any performance fee.

No resets

- FMA does not expect to see any 'reset' provisions i.e. where the manager has the opportunity to re-establish either the Hurdle Rate of Return or High Water Mark. Note that any such change would, in any event, need to be referred to FMA on the basis of a change in fee arrangement.

Crystallisation periods

- The performance fee should be 'crystallised', or paid to the manager, at intervals of not less than once per year (accrued daily within that period) and, where practical, calculated at the KiwiSaver scheme's balance date. If a date other than the balance date is chosen, then the calculation data should be reviewed by an appropriately qualified independent third party, preferably an auditor.

Performance fee cap

- FMA would expect to see an annual cap on the performance fee in almost all circumstances. This will ensure a fair and reasonable total investment fee is payable for the services provided. However, it will consider individual performance fee arrangements which do not include a cap if the fee arrangements are otherwise sufficiently robust in all other respects e.g. high Hurdle Rate of Return and lower (or preferably capped) base fees.

Assessment of performance fee arrangements

In testing the reasonableness of fees FMA will also consider:

- total investment fees and expenses (on a TER basis) payable under various performance scenarios;
- the relativity between any base fee and performance fee;
- any cap on total fees;
- the sharing of outcomes between investor and manager; and
- how the performance fee arrangement (including any base fee elements) compares for reasonableness against alternative equivalent fund structures with only base fees.

Disclosure of performance fees

In general, fees on KiwiSaver schemes should be disclosed in accordance with the guidelines set out in FMA's Guidance Note on Effective Disclosure. The following sections are particularly relevant:

- **Section D: Material information - Risks**

Note statement that customised risk disclosures are *"necessary even where your offer involves a generic business proposition such as, for example, a managed fund that invests in a particular class of equities. Specific risks may still arise. For example, your investment philosophy, current hedging policy or approach to leverage may give rise to specific risks that need to be disclosed"*.

- **Table VII: Examples of risk topics to consider**
- **Table X: Examples of factors to consider on past financial information**

This includes the statement: *“If you have a high risk strategy that could potentially result in a higher return, and you choose to mention the higher return, the high risk strategy should be mentioned so the return information is taken in context”*.

High risk strategies which could result in higher returns (including excess returns generating performance fees) should be adequately disclosed as it is important for investors to be made aware of the potential risks that may be taken to deliver performance fees e.g. use of leverage or derivatives.

- **Section F: Sector specific issues - managed funds – investment performance and costs disclosure**

Particular attention is drawn to the sections which highlight:

- that the nature of fees and their effect on investment performance should be disclosed; and
- that *“disclosure should enable potential investors to identify the nature of the fund, the risks and the returns”*. Risks include investment risks.

Refer to www.fma.govt.nz for further details on this guidance note.

Note the Periodic Reporting Regulations for Retail KiwiSaver Schemes are likely to result in further fee disclosure requirements.

Disclosure elements of performance fees

The table below outlines the disclosures we would expect to be made for performance fees charged in connection with a fund that forms part of a KiwiSaver scheme.

Element	Amount (example only)	Description
Return objective	Absolute returns above cash after all fees	This describes what the fund is trying to achieve.
Hurdle Rate of Return	BKBM + [x]% p.a.; or MSCI	The return that must be achieved before a fee applies.
Fee on excess return	[x]%	The amount of the return above the Hurdle Rate of Return that is paid to the manager.
Performance Fee capped	Yes, at [x]% of Average Net Asset Value p.a.	
High Water Mark	Yes	Where the portfolio value goes up and then down over multiple periods, this ensures no fee is payable if the manager has previously been rewarded for that performance.
Fee frequency	[annual]	How often the fee is paid
Fee payable to	Manager’s name	Who ultimately receives the reward?

Glossary of terms:

Annual Cap:	The total annual fee that can be payable in respect of either a performance fee or a base fee (or both).
High Water Mark:	The highest unit price or Net Asset Value per share achieved at the end of any performance fee calculation period. No future performance fee is payable until the High Water Mark has been exceeded.
Hurdle Rate of Return:	The minimum rate of return that must be earned in the relevant calculation period before a performance fee is payable, with the fee payable on the excess return above the Hurdle Rate of Return.
Manager:	As defined in section 4 of the KiwiSaver Act 2006.
Net Asset Value:	Market value of assets less the net present value of liabilities including allowance for all management fees.
TER:	Until the KiwiSaver Fees Disclosure Regulations become law the Total Expense Ratio as set out in guidelines issued by The Financial Services Council (formerly known as The Investment Savings and Insurance Association of New Zealand).

Related information

- KiwiSaver Guideline No KSGN1: Unreasonable fees
- KiwiSaver Guideline No KSGN2: Performance Fees and Ethical Fund Fees
- KiwiSaver Act 2006
- KiwiSaver Regulations 2006

Disclaimer

This guidance note explains the approach FMA intends to take when considering performance fees in the context of the 'not unreasonable' fee requirements in the Act.

It does not constitute legal advice. We encourage you to seek your own professional advice to find out how the legislation discussed and any other applicable laws apply to you, as it is your responsibility to determine your obligations.

Examples are provided purely for illustration. They are not exhaustive and are not intended to impose or imply particular rules or requirements.