How performance-based fees should be disclosed

This information sheet outlines how we expect fund managers to disclose performance-based fees to investors.

Performance-based fee disclosure

1. Schedule 4 of the Financial Markets Conduct Regulations 2013 (the Regulations) requires the PDS of every fund to show how any performance-based fee is charged.[1] The PDS must at least disclose:
    a. the hurdle rate of return
    b. what fee is charged for returns above the hurdle rate
    c. whether the fee has a maximum limit and if so, what that is, and
    d. how frequent the fees are calculated, and how often investors are paying the fee.[2]
2. When applicable, the Regulations require the PDS to tell investors the fund does not need to achieve a hurdle rate (or minimum rate of return) before a performance fee applies.[3] The PDS also needs to say if a fee can be charged when the return of the market index is not achieved.[4]
3. Managers of KiwiSaver schemes must also ensure any performance-based fees are reasonable.[5] We have previously provided guidance on KiwiSaver performance-based fees. We encourage managers of non-KiwiSaver schemes to also take note of this guidance. Whether the schemes are KiwiSaver or not, the Regulations require managers to provide an example of how fees apply to investors. Within the example, managers must disclose how any applicable performance fee affects an investor's returns.[6]

The effect of having no high water mark

4. The term 'high water mark' means the highest value that a fund has achieved on previous performance fee calculation dates. Performance-based fees are often only payable if a fund's performance exceeds the high water mark. A high water mark ensures that if a manager loses money over a period, they must achieve investment returns above the high water mark before receiving a performance-based fee.

[1] Clause 33(1) of schedule 4 of the Regulations
[2] Clause 33(2)(d) of schedule 4 of the Regulations
[3] Clause 33(3) of schedule 4 of the Regulations
[4] Clause 33(4) of schedule 4 of the Regulations
[5] Clause 2 of schedule 1 of the KiwiSaver Act 2006
[6] Clause 38(1) of schedule 4 of the Regulations

5. The FMC Act does not require the use of a high water mark. Investors however, will be affected by the absence of one, or by a high water mark that works differently to the one described above (for example where the high water mark can be reset).[7]

6. The absence of a high water mark means the fund manager may be rewarded for the same performance, and this must be clearly explained to investors in the PDS. Failure to do so would most likely result in a fee description that is misleading.

7. The next page contains an example of wording a manager could use in the PDS to explain the absence of a high water mark:

Sample disclosure when there is no high water mark

The fund does not apply a high water mark, which may be applied by other funds. A 'high water mark' is the value the fund must reach before the manager can charge a performance fee.

Managers who apply a high water mark must ensure the fund's value is at least equal to the high water mark the last time they charged performance fees. If a fund loses value, the manager must ensure the value of the fund increases above the high water mark before being able to charge further performance fees.

The impact of this fund not applying a high water mark is that if this fund drops in value and then recovers, you may be paying a performance fee twice for the same return, once for the recovered growth, as well as the original growth.

Performance-based fees calculated using a different market index

8. Under the Regulations, all managed funds are required to report their performance as part of the fund update. This performance must be measured against the returns of an appropriate market index.[8] The market index used must appropriately reflect market movements in the types of assets that the fund invests in (comparative index). Although not a legal requirement, it is reasonable to link the hurdle rate for any performance-based fee to the returns of the comparative index.

9. Some funds currently base their performance fee on a hurdle rate of return linked to a market index that does not reflect the asset class and risks of the underlying investments. An example is equity-based funds that use a 90-day bank bill index as the hurdle rate of return. The impact of this is a fund may still be paid a performance-based fee although it has underperformed against the fund's comparative index.

[7] Note that for KiwiSaver funds, when assessing whether a performance-based fee is reasonable, we would expect the fee to contain a high water mark which cannot be reset.
[8] Clause 61 of schedule 4 of the Regulations

10. Where a fund's hurdle rate of return is linked to the performance of a market index different to the comparative index, this should be clearly disclosed in the PDS so that prospective investors understand the implication. The following is an example of language that a manager could use for this purpose:

Sample disclosure when a fund uses a different market index

Our performance fees are based on a hurdle rate of return. The 'hurdle rate' is the minimum return the fund must achieve before being able to charge a performance fee, and is determined by a market index.

In our fund update, we compare the fund's performance against the [insert market index]. Our view is this index provides the best comparison of how the fund should perform.

However the hurdle rate of return for the performance fee payable to us is based on [insert market index]. This means you may be paying a performance fee even if the fund's performance does not match or beat the market index which has more comparable assets.

11. The wording above is not prescribed. Managers may use alternative language which they feel better suits the nature of their fund and the basis on which performance-based fees are charged. It is important, however, that any alternative wording makes it clear to investors that two different market indices are used, and the consequences this has for investors.