FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

Guidance Note: KiwiSaver Performance Fees

November 2011

About this guidance note

This guidance note is designed to provide the Managers and Trustees of KiwiSaver schemes with a basis on which they can determine whether any performance fees that are proposed to be charged, or are charged, either directly or indirectly to a member's investment in the Scheme can be considered "not unreasonable".

The Guidance Note builds upon the three characteristics that the Government Actuary identified in his Guidance Note KSGN2 issued in March 2008, and will be the basis upon which FMA will assess whether a performance fee is "not unreasonable".

Background

Recently FMA has received an increasing number of enquiries regarding the reasonableness of performance-based fees. Performance-based fees are variable in nature, dependent on the delivery of specified investment returns. Generally these are paid in addition to a fixed base rate that is not directly linked to investment returns.

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 and determine whether a KiwiSaver scheme complies with Clause 2.

General objectives and underlying principles

FMA believes performance fees need to be assessed to ensure they are not unreasonable 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 objectives and principles:

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

Consistent with this:

- It can be appropriate to recognise special skills, resources and outcomes delivered by the manager in agreed performance fee arrangements.

- 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 fixed fee in relation to the 'standard' or base investment asset mix and the performance fee must take account of effective allowance already in that base fee for an element of active management (the Beta portion). It is our expectation that the higher the fixed fee the lower the expected level of performance fee.

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

Accordingly:

- Performance fee structures should be aligned with investor's 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 that the return was achieved by putting the investor's capital at risk.

- Fee structures should be based on an appropriate extended time frame. They should avoid situations where large fees are paid for a single year immediately preceding or following periods of low returns.

- Fee structures should share the 'downside' of performance between manager and investor as well as the 'upside'.

- 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.

Performance fee elements

In applying the principles, FMA's expectation is that performance fees will contain the following key elements detailed below. Where any of these elements are not present in any performance fee arrangement then we would expect that this will be reflected in other terms or in any fixed fee payable.

- The performance fee should be expressed as a percentage of assets under management. It must be based on returns in excess of a 'Hurdle Rate of Return'. The returns should be calculated after deduction of all fixed base fees already paid by the investor.

- 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 <u>before</u> 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.
- If appropriate, an allowance in the minimum Hurdle Rate of Return where there are active management fees already implicit in any fixed base fee.

- The application of a 'High Water Mark' where past underperformance is recovered prior to the accrual of any future performance fee. The relevant Net Asset Value or unit price should be based on the same methodology as the calculation of any performance fee.

- An appropriate multi-year assessment period. This might include either deferred payment or claw-back provisions in the event that good performance reverses within that period (with corresponding adjustments to any High Water Marks if appropriate). While performance fee calculations are normally fixed annually (and accrued within that period), longer multi-year assessment periods may be appropriate to mitigate the impact of strong performance periods being immediately followed by poor outcomes.

- An annual cap on the performance fee. This will ensure a fair and reasonable total investment fee is payable for the services provided.

- "Reset" provisions, where the investment manager has the opportunity to re-establish either the Hurdle Rate of Return or High Water Mark, should be approached with caution and shouldn't be considered where the investment manager can make such adjustments without approval by investors or someone charged to act in their best interests. (Note: any such change would, in any event, need to be referred to the FMA on the basis of a change in fee arrangement).

Assessment of performance fee arrangements

In testing the reasonableness of fees FMA will have regard amongst other things, for:

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

Disclosure of Performance Fees

Performance Fees by primary KiwiSaver Manager

Where the performance fee payable to the Manager (or an investment manager affiliate), is in respect of a material proportion of the assets of the Fund, or may have a material impact on the total fee payable by the investor, then the Manager will be expected to clearly articulate the basis, rationale and reasonableness for each element listed above for performance fee structures in disclosure material. This would include an explanation as to why an element may not be present.

Performance Fee at asset class or sub-manager level within KiwiSaver funds

Where a performance fee is payable to a third party investment manager unrelated to the Manager, and:

- Has been entered into on an arm's length basis,
- Has none of the fee payable to the Manager,
- Is in respect of only a portion of the investments of the Fund,

then, disclosure of the key elements of the performance arrangements will be required. Such disclosure should demonstrate that any performance fee is not expected to be a material element (generally less than 10%) of any total fee payable by the investor.

Glossary of terms:

Annual Cap:	The total combined fixed and performance annual fee that can be payable
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 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

A Financial Markets Authority (FMA) guidance note describes FMA's interpretation of the law and how we will apply and enforce it.

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.