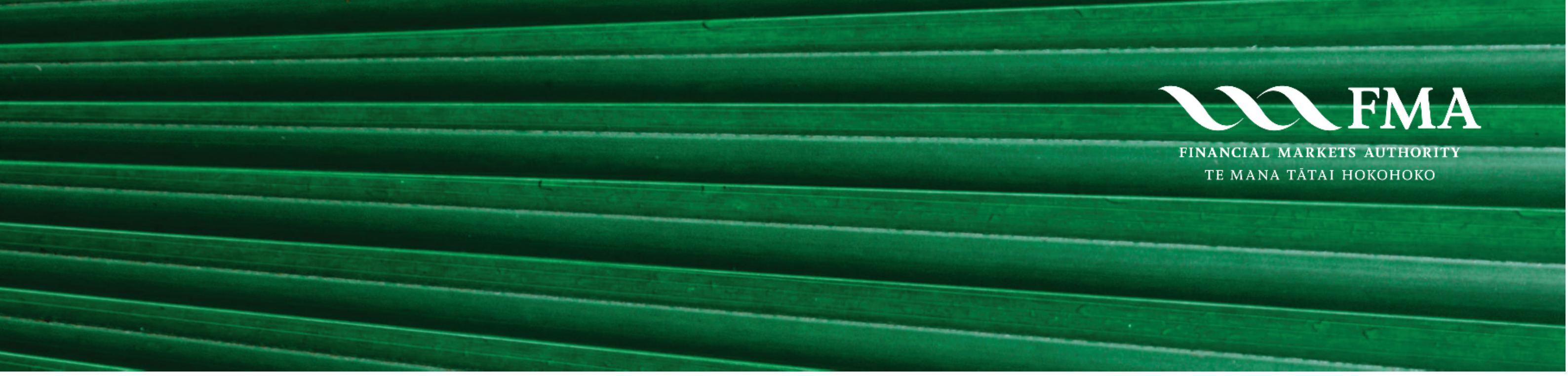

APRIL 2021 (FIRST PUBLISHED MAY 2012)

Guidance note: KiwiSaver Performance Fees

About this guidance note

This guidance note is intended for the managers and supervisors of KiwiSaver schemes. It sets out the criteria against which the Financial Markets Authority (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 our intention to update guidance given to the market in the event of legislative changes, where market norms evolve, where new information is available or where there are changes in market conduct requiring guidance. Accordingly, the market should expect further guidance on performance fees over time.

This guidance note should be read alongside our guidance on managed fund fees and value for money.

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 us with the framework to consider whether in our view a KiwiSaver scheme complies with Clause 2.

This guidance note sets out the criteria against which we 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'.

KiwiSaver managers and supervisors should note the requirement for fees to be 'not unreasonable' is an implied term in a KiwiSaver trust deed. We expect the supervisors 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, supervisors should be guided by the principles set out in this guidance note.

We do not expect to see a significant increase in performance fees in the KiwiSaver market.

General principles

We believe performance fees need to be assessed on a case-by-case basis. In undertaking our assessment on whether a fee is not unreasonable we 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.
- We consider 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 ongoing 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-based fees should be aligned with investors’ objectives. Fees 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-based fees 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, our 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 one 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, 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. We accept 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 we 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

- We do 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 the 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

- We 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, we 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 we will also consider:

- total investment fees and expenses (on a synthetic total expense ratio 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.

Glossary of terms

Term	Explanation
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 return that must be achieved before a performance-based fee applies (as defined in clause 33(2)(a) of Schedule 4 of the Financial Markets Conduct Regulations 2014).
Manager	As defined in section 6 of the Financial Markets Conduct Act 2013.
Net Asset Value	The residual value of the fund's assets after all liabilities, other than net assets attributable to investors, have been deducted (as defined in regulation 5 of the Financial Markets Conduct Regulations 2014).
Synthetic total expense ratio	The ratio of the total charges charged for the operations of the fund and its underlying funds to the fund's average Net Asset Value (as defined in clause 53(1)(c)(v) of Schedule 4 of the Financial Markets Conduct Regulations 2014).

Related information

- Managed fund fees and value for money guidance note
- KiwiSaver Act 2006
- KiwiSaver Regulations 2006

Disclaimer

This guidance note explains the approach the 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.