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Effective from: 1 March 2019

ASISA PERFORMANCE FEE STANDARD FOR RETIREMENT FUNDS

INTRODUCTION

The purpose of this Standard is to create an environment of transparency and disclosure in the retirement fund industry when performance fees are charged by an investment manager.

The Explanatory Memorandum published by National Treasury during December 2016 in respect of the revised draft regulations 37, 38 and 39 issued in terms of section 36(1)(c) of the Pension Funds Act, 1956, clarifies that investments that have a performance fee element will be allowed in the default investment portfolio - “subject to, in the interim, compliance with an industry standard that should simplify methodology and disclosure, and funds motivating their use to the FSB as part of their compliance with the default regulations and Regulation 28. The standard could ultimately be supplemented or replaced by an FSB regulatory standard. The appropriateness of performance fees will be monitored during both the industry and FSB sanctioned standard, to enable review of the policy decision if necessary.”

ASISA members have therefore agreed to this Standard, which amongst other desirable outcomes, will constitute an industry standard as contemplated in the Explanatory Memorandum.

The Standard will assist retirement fund trustees to make an informed decision as to the desirability of different performance fee and fixed fee options, and understand the financial implications thereof. To this end, the Standard aims to:

- Align investors’ interests in terms of investment outcomes with that of the Manager’s interest in terms of revenue.
- Establish minimum performance fee disclosure standards for fund managers who charge performance fees on retirement fund investment mandates.
- Ensure that fund managers use standardised terminology when explaining performance fee structures

This Standard aims to embody the following principles in the design, calculation and disclosure of performance fees:

- Fairness
- Consistency
- Transparency
- Accuracy
- Completeness
- Appropriateness

It is noted that this standard does not cover private equity or infrastructure investments. A separate standard will need to be provided in respect of these investments due to their differing nature.

Fund management fees charged by investment managers are structured in a way that covers and provides for various costs involved with managing and administering funds by the manager.

Performance fees are a form of fund management fees expressed in variable terms, as opposed to a flat fee. This variable charging structure, when well-constructed, should align the interest of both clients and managers at all times.

Performance fee structures are widely used and some of the main reasons and advantages of these structures are:

- Ensures that investors pay lower fees if managers do not out-perform their hurdles or benchmarks.
- A well-structured performance fee can shift the emphasis of the manager’s remuneration toward the delivery of superior long term returns rather than concentrating on accumulating assets under management.
- Closer alignment between the size of the investment management fee and the level of outperformance/underperformance of the fund manager. This alignment has the benefit of discouraging unnecessary switching of retirement fund assets during periods of cyclical underperformance.
- Demand from investors and advisors/consultants to have more options in terms of fee structures used;
- A properly structured performance fee structure helps align the fee structures between active and passive managers in situations where active managers underperform their benchmark.

GLOSSARY

A Manager may not refer to the concepts below by any other name, nor may he attribute different meanings to the terms in any circumstances. In all internal and external communications, whether for the purposes of marketing or not, terminology will be standardised by the industry as follows:

Performance Fee Benchmark: This is the yardstick that the client's performance is measured against for performance fee calculation purposes.

Fee Hurdle: This is the level of performance the fund must achieve, prior to a fee higher than the Minimum Fee being charged. Fee Hurdles refers to the absolute hurdle (e.g. ALSI + 2% per annum) and not only the threshold (e.g. 2% per annum) and should be linked to the Performance Fee Benchmark. A fee hurdle can also be created using a notional portfolio which allows for client cash flows based on the performance fee benchmark.

Performance Fee Measurement Period: The period for which the fund performance is compared to the Fee Hurdle, each time the fee is accrued.

Sharing Ratio: The percentage of performance, relative to the Fee Hurdle, that the Manager is entitled to receive as a fee.

Since Inception High Water Mark: The highest level of relative outperformance of the fund over the Fee Hurdle since inception of the fund.

High Water Mark: The highest level of relative outperformance of the portfolio over the Fee Hurdle since inception of the fee or reset. High water marks are designed to ensure that investors don't pay for given outperformance more than once. There can be other mechanisms which track the performance or value of the client's portfolio relative to the Performance Fee Benchmark to ensure that no performance fees are paid until previous underperformance has been recouped, thus having the same function as a high water mark, referred to as a high water mark principle

Reset: In performance fee structures with a traditional high water mark, the reset of the high water mark occurs when a performance fee is triggered.

Performance Fee Payment Frequency: This is the frequency at which the amounts provided in the fund in respect of fees in excess of the Minimum Fee are transferred from the fund to the Manager.

Base Fee: This is the portion of the annual management fee charged before any performance is taken into account.

Fee at Benchmark: This is the annual management fee that will be charged when the fund's performance is equal to the Performance Fee Benchmark over the Performance Fee Measurement Period.

Minimum Fee: This is the minimum annual management fee that may be recovered from the fund by the Manager.

Maximum Fee: This is the maximum annual management fee that may in any instance be paid by the client to the Manager. This fee includes the Base Fee and all performance fee elements.

Investment Management Agreement: the legal contract between a segregated client and the investment manager.

PERFORMANCE FEES: CONSIDERATIONS FOR METHODOLOGY

There are a number of methodologies for performance fees with numerous possible variations in the detailed operation of even seemingly similar methodologies. No single method can be deemed to be universally superior and it is for the client, their advisor and manager to select, design and agree on the most appropriate for their particular circumstances and mandate of the portfolio. This Standard illustrates the issues that managers should consider when designing their methodology. Please note that any total fee agreed between client and manager is fully negotiated, disclosed and documented in the investment management agreement that both parties sign.

1. Performance Fee Benchmark appropriateness

The Performance Fee Benchmark is a key component of a performance fee structure. Managers should ensure that the Performance Fee Benchmarks offered to the client are relevant to the client's investment mandate.

Benchmarks can generally be grouped into investable and non-investable. Examples of investable benchmarks are indices published by exchanges. Non-investable benchmark examples are inflation rates and peer groups.

Generally accepted characteristics of a benchmark are:

Investable Benchmark	Non-Investable Benchmark
Must be appropriately chosen for the type of fund and represent the relevant risk and return drivers of the product (see below).	Must be appropriately chosen for the type of fund and represent the relevant risk and return drivers of the product (see below).
Must be verifiable by an independent party i.e. prices verifiable through independent sources.	Must be verifiable by an independent party i.e. levels/values verifiable through independent sources.
Must be gross of fees.	Must be gross of fees, where possible.
Must be calculated on a total return basis and include reinvested income or dividends.	
Must be tradable.	

Performance Fee Benchmarks must be disclosed in the investment management agreement. Furthermore, guidelines as described below for Performance Fee Benchmarks will ensure appropriateness.

Acceptable performance fee benchmarks and behaviour include:

a. Equity and Fixed Income portfolios should use the appropriate Total Return Indices or an appropriate sector/asset peer group benchmark.

b. Multi-asset class portfolios can use the appropriate Total Return Composite Indices, sector peer or real return benchmarks ("Inflation plus" type benchmarks):
   - Peer group benchmarks for performance fees allow portfolios to only pay performance fees should the manager do better than the average (or median) of their peers.
   - Where the manager is targeting an absolute or real return the use of an inflation benchmark aligns the interest of investors through a full market cycle and may be the appropriate benchmark to use. Real return benchmarks should be congruent with the risks associated with the portfolio.

c. Should an appropriate single asset class index or peer group not exist, it may be necessary to utilise an alternative benchmark until such time that an appropriate index or peer group benchmark becomes available.

The list below, whilst not exhaustive, includes examples of inappropriate Performance Fee Benchmarks, hurdles and behaviour:

a. Hurdles not relative to the stated benchmark of the portfolio. For example an equity portfolio should not have an ALSI benchmark with a cash +x% Performance Fee Benchmark and hurdle.
b. Money market portfolios should not have performance fees.
c. Equity portfolios should not use an inflation benchmark.
d. Index benchmarks for single asset class portfolios that do not reflect the investment universe of the portfolio, unless (c) in the previous paragraph applies.
e. Fees earned for benchmark performance should not be at a fee hurdle lower than the Performance Fee Benchmark.

2. Convexity

The performance fee structure should in no way alter the way in which the investment manager manages the portfolio in terms of the risk being taken. There are sufficient levels of regulatory controls built into CISCA, Regulation 28 and mandate guidelines to prevent managers from acting irresponsibly and taking excessive risk. Performance fees should be earned in a linear manner, unless the client instructs otherwise. Performance fee structures should be appropriately designed to take into account the manner in which the portfolio is managed and performance should be seen through a full market cycle. It is also important that the fee structure should either apply a cap or a form of since inception high watermark.

3. Symmetry

The principle of performance fee symmetry is accepted as an important concept and is best achieved over a full market cycle. It should also be viewed in context of the total fee structure to ensure that the individual levels used are not inappropriate. There are various ways that symmetry can be achieved in terms of the entire fee including, but not limited to, the examples below:

a. The effect of asymmetry can be reduced by setting a lower base fee for performance at Performance Fee Benchmark than a comparable fixed fee. All other things equal, this would result in the client paying a lower fee for benchmark performance.
b. Participation for the investment manager in over and under performance if used. If there is a limit to the participation of the portfolio manager when the portfolio underperforms (i.e. the minimum total fee payable under the very worst circumstances is greater than zero), there should be a cap on the upside and/or a form of since inception high water mark.
c. Fee Rebate structures for failure to meet certain criteria on portfolio performance or risk parameters.
d. Using a high water mark principle is a good way to ensure a degree of symmetry, as the portfolio does not pay the performance fee while the portfolio underperforms, and it is only levied once the high water mark has been surpassed.

4. Base fee

Generally the base fee of a portfolio with a performance fee structure should be lower than a corresponding flat fee for a similar product. However, the base fee should not be looked at in isolation, but rather as a component of the total fee package.

5. Key performance fee components

The ideal performance fee structure is one which is specific to each portfolio and the investment horizon of the portfolio. As such the standardisation of the various performance fee components is critical to ensure fair application to the portfolio. Not every performance fee structure will necessarily comprise all of these components. All the components that are used in a performance fee structure should be looked at in terms of the total fee package and the nature of the particular portfolio or mandate.

a. Period of performance measurement

   Unlike collective investment schemes, segregated clients can tailor their performance measurement period. If the performance measurement period is too short then the fee could reward the manager for luck rather than skill. A longer

measurement period better allows for the skill of the manager to be rewarded, and should achieve closer alignment of interest between the portfolio and the manager. It should also result in a lower level of volatility in performance fees and a smoother incidence in the payment of performance fees. Since inception performance measurement periods can also be used as the performance fees are bespoke to each client. Where a rolling measurement period is used the measurement period should be at least 1 year and furthermore should be suitable for the particular type of portfolio or mandate, unless otherwise agreed with the client.

b. Method of calculation of outperformance

Performance fee calculation should occur as specified within the investment management agreement and can be daily, monthly, quarterly or annually or as agreed between the client and the Manager. The outperformance can be calculated either using the actual portfolio performance in Rand terms relative to the Fee Hurdle or Performance Fee Benchmark in Rand terms (Portfolio-based calculation), or by comparing the investment performance rate of the portfolio with the hurdle rate (Rate-based calculation).

For a rate-based calculation the return of the portfolio is calculated as per the industry accepted performance calculation processes and procedures (e.g. GIPS Standards). This number is then compared with the appropriate gross performance fee hurdle or benchmark (refer section 1 and section 5(d)). The rate-based outperformance can be calculated using one of the following methodologies:

i. Arithmetic outperformance = $Return_F$ – $Return_{BM}$
ii. Geometric outperformance = $(1+ Return_F)/(1+ Return_{BM})-1$

c. High Water marks (when used)

A traditional high water mark should not reset until previous underperformance has been recouped. If a performance fee has no cap, it should be required to have a form of since inception high water mark.

d. Caps (when used)

Performance fee structures without a high watermark should have a cap, providing for a maximum overall fee that a portfolio can expect to pay per annum. The cap should be disclosed as the maximum fee payable by the portfolio including the performance fee component. If a performance fee has no cap, it should be required to have some form of a since inception high water mark.

The role of the cap is to counter excessive risk taking and to reduce the impact of extreme market movements on the performance fee. The cap should be considered within the context of the entire fee structure.

e. Sharing Ratio

Sharing Ratios above 30% of the annualised relative performance could generally be considered excessive. However, the sharing Ratio needs to be considered in conjunction with the Base Fee and the Performance Fee Benchmark and the entire performance fee design. In general, the more demanding the Performance Fee Benchmark and the lower the Base Fee, the higher the Sharing Ratio could be and vice versa.

DISCLOSURE

There should be full disclosure of fees and investment managers should refer to requirements set out in the Investment Management Agreement (mandate) to calculate, accrue, communicate and deduct the performance fee. This should include any fees levied by any underlying managers within the portfolio. Furthermore, it is noted that all fees charged must be included (in a transparent manner) in the monthly and quarterly statements received by the client.

When disclosing the performance fee methodology to clients, the investment manager should use the terminology as defined in the “Glossary” section of this document.

The investment manager must ensure that invoices setting out the performance fee calculations are sent to retirement fund clients in accordance with the terms of their contract.

EFFECTIVE DATE

The effective date for the Standard on a prospective basis is **1 March 2019** or on redraft/review of existing Investment Management Agreements (IMAs).