

## Investment performance fees too complex and too high?

Performance fees have the potential to be the highest fee paid by retail investors yet they may not even know they are paying them or how much they are paying.

Performance fees can reward fund managers for a job well done. The theory is that when the investor benefits from strong investment performance, the fund manager can also share in their success – a seemingly win-win situation.

However, the NZ managed fund market experience is that not all performance fees are structured fairly or are transparent. Retail investors may be paying too much in performance fees, or even worse, paying a performance fee when comparable market performance has not even been achieved.

To help investors understand performance fees, research house Morningstar released a research paper on performance fees<sup>1</sup>. Whilst based on the Australian experience, Morningstar identified five key criteria when assessing performance fees, they are:

1. Quantum – how much is too much?
2. Benchmark – is it relevant to the asset class invested in?
3. Performance hurdle and cap – has the managed imposed an alpha target to outperform?
4. High water mark – does a manager need to recoup previous losses before charging a performance fee?
5. Crystallisation period – over what time frame is a performance fee assessed?

Harbour Asset Management Limited (Harbour) has conducted a review of performance fees being charged on actual retail Australasian equity mandates offered as unit trusts in the New Zealand market<sup>2</sup>.

The following table summarises the findings:

Fund	Quantum: Reasonable mix of base management fee and performance fee	Benchmark: Appropriate equity benchmark	Hurdle: Hurdle over equity benchmark performance criteria	High Water Mark: Recoup previous losses	Crystallisation period: Payment period assessment time
Harbour Australasian Equity Fund	✓	✓	✓	✓	✓
Fund 2	✗	✗	✗	✓	Unclear

<sup>1</sup> Morningstar: Best Practices in Managed Fund Performance Fees, April 2011.

<sup>2</sup> This research was based on information contained in Australasian equity fund unit trust Investment Statements. The table is a subjective assessment of criteria by Harbour.

Fund 3	✗	✗	✗	✓	✗
Fund 4	✓	✗	✗	✓	✓
Fund 5	✓	✗	✗	✓	✓
Fund 6	✗	✗	✗	✓	✓
Fund 7	✓	✓	✗	✓	unclear
Fund 8	✓	✗	✗	✓	✗
Fund 9	✗	✗	✗	✓	✓
Fund 10	✗	✗	✗	✓	✓

It appears few New Zealand managers are operating at a global best practice level when structuring performance fees.

Most managers reviewed offered performance fees benchmarked against cash or an absolute level of return when investors are exposing themselves to equity risk. Investors have the potential to pay a performance fee for below market performance.

The Financial Markets Authority (FMA) has also expressed concern about the structure of performance fees being charged on KiwiSaver Schemes<sup>3</sup>. In this Guidance Note, the FMA provides guidelines for fees regarded as “not unreasonable” and a framework for reviewing and considering if a KiwiSaver Scheme complies.

Retail managed fund investors who are charged performance fees need to understand the structure of these fees and how they are applied. Failure to do so may result in investors paying more in fees than is reasonably fair or not even being aware that they are paying such fees.

An Authorised Financial Adviser will help investors understand what performance fees apply to any particular managed fund and how those fees are structured.

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<sup>3</sup> Financial Markets Authority Guidance Note: KiwiSaver Performance Fees, November 2011.