ALEXANDERFORBES
INVESTMENTS

Performance-based Fees

Paid to investment managers in the Alexander Forbes Investments life pooled portfolios

Introduction

Clients invested in portfolios unitised and managed on the Alexander Forbes Investments life licence (for example, the AF Investments Balanced range) pay the company a set policy fee. This fee may vary based on a range of factors such as the client's asset size or the services he or she requires. The policy fee is always expressed as a percentage of the assets invested in the portfolio. From this fee, we pay the underlying managers their fixed fees earned for managing the portfolios.

In addition to earning fixed fees, the underlying managers in certain portfolios may also earn performance-based fees if they outperform a relevant benchmark. Performance fees can be defined as additional fees above the fixed fee that reward a manager for outperforming a predefined benchmark. They are therefore designed to reward an active manager's skill in generating outperformance.

Like fixed fees, performance fees are paid as a percentage of the assets under management, with the percentage determined as a share of the outperformance generated. They are designed to align the interests of investment managers and clients. Performance fees are paid to the underlying investment managers by Alexander Forbes Investments' clients in addition to the policy fees paid. As investment managers share in outperformance along with clients by retaining a portion of the outperformance received in the portfolio, clients will not see an explicit deduction from their assets regarding performance fees as the unit prices are calculated after the deduction of any performance fees earned.

Alexander Forbes Investments does not participate in, charge or earn any performance fees other than in the hedge fund portfolios.

Alexander Forbes Investments portfolios where underlying investment managers may earn performance fees

Not all our underlying managers (and therefore portfolios) participate in performance-based fee arrangements. Generally, performance-based fees are only paid in mandates with longer time horizons where the asset class is broad enough to warrant a manager's skill being rewarded. Appendix 1 summarises some of the larger/more widely utilised Alexander Forbes Investments portfolios and indicates what percentage of these portfolios are subject to performance-based fees. These fees are charged at a manager-mandate level, so if any building block where performance fees may become payable is used to construct a risk-profiled Alexander Forbes Investments portfolio, by default this portfolio will have an underlying element on which performance fees may be earned.

Performance fees have recently become topical among clients, regulators and industry bodies. In its retirement-reform papers, National Treasury has specifically highlighted these fees as an area for attention This is largely as a result of them being poorly designed in instances and too complex for clients to understand (particularly individual investors). Disclosure has also been highlighted as a pitfall.

Alexander Forbes Investments was one of the first local unit trust management companies to remove performance fees from its unit trust funds. This process began over three years ago and was completed in 2014.

Although performance fees provide a good tool to align the interests of the manager and the client, if structured correctly, we have taken a strategic decision to continue removing them in our Life Pooled portfolios and phase out performance-fee arrangements in our underlying mandates in these portfolios in a measured manner over the short to medium term. Wherever possible, we will seek to do this in a way that incurs no additional policy fees for clients. We began this process in June 2014. Appendix 1 also provides a short summary of the significant progress made in this regard. Importantly, this has so far been achieved at no additional policy-fee cost to clients, and will result in better returns net of fees for clients.

Structure of underlying manager performance fees (where these are still applicable)

Alexander Forbes Investments has sought to standardise the basis for investment-manager remuneration. Performance-based fees are set at levels that reward investment managers for desired outperformance without encouraging undue risk-taking. In determining a fair and equitable performance-based fee, we consider the mandate of each portfolio to devise a basis that is consistent with the desired investment return and expected risk of the portfolio. We structure our underlying investment-manager performance fees with a number of key elements to ensure fair treatment of all parties and alignment of interest.

These are the common definitions and terminology that applies to performance-fee elements and the principles of what constitutes best practice.

1. Performance-fee benchmark

This is the performance benchmark against which performance is measured to determine whether the manager is entitled to earn a performance fee.

The objectives of the specific mandate and the performance-fee benchmark should always align. The fees should be paid for manager skill, not luck, nor market "beta", which is what the market has done with no manager intervention.

2. Hurdle

The amount by which a manager needs to beat the performance-fee benchmark before earning performance fees.

3. Participation rate or sharing rate

The percentage of the performance above the performance-fee hurdle that the manager shares in.

A 15% participation rate implies a manager earns (retains) 15% of all performance above the performance-fee hurdle.

Example: A manager that has a R100 million SA bond mandate with a benchmark of the ALBI plus a hurdle of 1% a year delivers 2% of outperformance over the measurement period with a participation rate of 15%. In this instance, the manager would earn:

2% outperformance minus 1% hurdle x 15% participation rate x mandate size = R150 000

This leaves R850 000 of the outperformance generated through the manager's skill for the client.

4. Cap

The outperformance of the hurdle after which no further performance fees are paid.

Caps are instituted purely to limit fees to an acceptable level. Uncapped by definition can result in limitless fees paid presuming, of course, outperformance is limitless. In the prudential environment of pension-fund management where a combination of capital growth and preservation is often required, an argument can be made for capped fees to limit needless risk-taking in the pursuit of performance fees.

5. Measurement period

The period over which the manager's performance is measured against the hurdle to determine if a performance fee is payable.

Investing and skill should be measured over extended periods. There is no correlation between a manager's skill and performance against the hurdle over the short term (at least a year). Market cycles and investment time horizons are longer as the riskiness of the asset class increases. Measurement periods should align with the investment time horizon (longer for equity/capital-growth strategies, and shorter for capital-preservation strategies). Ideally, measurement periods should be cumulative from inception of the mandate as rolling periods can forgive a manager for underperformance.

6. The concept of the high-watermark

High-watermarks ensure a manager does not earn performance fees unless it is generating new outperformance above the highest previous watermark. This prevents clients paying for performance more than once where managers go through out- and underperformance cycles.

7. Crystallisation periods and clawbacks.

A crystallisation period is when any performance fees payable are physically paid to the underlying investment manager. Clawbacks are a mechanism that ensures the performance fees paid to a manager are kept current. If managers outperform, a portion of assets is set aside for them. If they underperform, these fees that have been set aside (but not yet paid or "crystallised") are "clawed back" to the client. At the end of the crystallisation period, whatever performance fees earned are then paid to the manager.

Alexander Forbes Investments strives to have similar bases for performance-based fees within each portfolio, but these can vary slightly from manager to manager. Appendix 2 sets out the parameters for the above performance-fee elements in our main portfolios. Where managers in a portfolio may have differing parameters, the range of highest and lowest is shown.

Frequently asked questions

Q1: Where does Alexander Forbes Investments show performance fees paid to underlying investment managers?

They are shown (if applicable) on the monthly fund fact sheets for each portfolio. Performance fees are expressed as the percentage of the total portfolio paid to underlying investment managers over the past 12 months.

Q2: Why does Alexander Forbes Investments not show each specific underlying manager's performance fee?

To negotiate the best possible fee arrangements on behalf of our portfolios, we enter into a confidentiality agreement with investment managers and are thus unable to disclose the individual underlying fees.

Q3: Can some of the underlying investment managers in a portfolio earn performance fees when the overall portfolio does not beat the benchmark?

Yes. It is possible in a multi-managed portfolio that some managers outperform and earn performance fees while others underperform, causing the portfolio as a whole to underperform the benchmark. This is, however, no different from the scenario where a client appoints managers individually on a segregated or even pooled basis. Importantly, though, the converse is also true in that a portfolio may outperform the benchmark with some managers earning no performance fees.

Q4: Who calculates if performance fees are payable, how often is this done, and how are these verified?

We calculate performance fees monthly as soon after month-end as possible. These calculations are sent to each investment manager for verification. If agreed between us and the investment manager, these fees are deducted from the portfolio and held in the performance-fee account until the crystallisation date, when the balance outstanding in the account is paid to the investment manager. Performance-fee calculations are independently verified on an on-going basis by our internal and external auditors.

Q5: Do all clients pay the same performance fees?

Yes. As all performance fees are paid by the portfolio and reflected in the unit price. All clients share proportionately in the payment of these fees.