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Response to the consultation on incorporating performance fees within the charge cap

We, the Association of Real Estate Funds[1] (AREF), responded to the consultations "Investment Innovation and Future Consolidation" and "Improving outcomes for members of defined contribution pension schemes". We support DWP putting in measures to encourage DC schemes to invest in illiquid assets. Pension schemes are investors in many of the property funds that are members of AREF and we want to ensure that DC pension schemes are able to invest in these types of products too.

We welcome the opportunity to respond to this consultation on incorporating performance fees within the charge cap. We have not responded to the questions in the consultation direct as they are mainly addressed at trustees of pension schemes or relate to investment in venture capital and/or growth equity. However, we have given below our views on some areas of the consultation.

Performance Fees

Firstly, we would like to mention that we disagree that performance fees are actually a charge. Performance fees typically arise where a fund or portfolio delivers a return to investors that exceeds a pre-determined benchmark or hurdle. Carried interest, or a performance fee with similar characteristics, is not therefore really a fee at all, but rather a profit share allocated to the manager when a hurdle return for investors is achieved. We believe that carried interest and other performance fees should be reported as a reduction of risk adjusted net returns rather than falling within the charge cap.

Although, the proposed multi-year smoothing option would reduce the occurrences of breaching the charge cap, you are still expecting trustees to keep the average charge to members over the multi-year period within the charge cap limit. There is the possibility of a charge cap breach if an investment performs exceptionally well and the trustee being penalised for choosing a successful investment. If you intend to keep performance fees within the charge cap, we believe that trustees of pension schemes should have the ability to justify any beaches of the charge cap due to strong performance of investments. Trustees should be encouraged to focus on value for money and performance; expecting them to focus on cost without consideration of the value received in return is not to the long-term benefit of pension scheme members.

[1] The Association of Real Estate Funds (AREF) represents the UK real estate funds industry and has 67 member funds with a collective net asset value of more than £70 billion under management on behalf of their investors. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the MSCI/AREF UK Quarterly Property Funds Index and the MSCI/AREF Property Fund Vision Handbook.

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The arguments for removing the look-through requirements for closed-ended vehicles holding Venture Capital (VC) / Growth Equity (GE), we believe are equally valid for some other asset classes. We do not understand why there should be a different treatment of VC/GE relative to other higher returning investment strategies in which performance fees are normal.

As noted in sections 116 and 117 of the consultation, there is the risk of arbitrage if there is a difference in the treatment of costs depending whether the scheme invests direct or through a fund or fund of funds. Also, as in the case of the proposal for the treatment of look-through costs for VC/GE, it could make a difference to whether costs are included in the charge cap if investing in a closed-ended or open-ended fund. Trustees' investment decisions on which type of funds to invest in or even to invest direct in an asset should not be influenced by whether costs would be included in the charge cap or not.

The need for piecemeal carve outs for look through costs for specific asset classes and fund structures and the introduction of complex mechanisms so pension funds can invest in assets with performance fees highlight to us that the charge cap is not appropriate.

A top priority for the joint Bank of England, FCA and HM Treasury's Productive Finance Working Group will be to identify potential fund structures that invest in long-term assets, such as the Long-Term Asset Fund (LTAF), and consider what is required to ensure that they are viable investment options for a range of investors, including default arrangements of DC pension schemes. Some of the long-term assets, that could possibly be held by the LTAF, may be carved out from the cap and others may not, creating the possibility of further complexity.

Physical assets costs

We welcome putting the exclusion of the costs of holding physical assets from the charge cap on a statutory footing. As we mentioned in our response to the consultation last October, in the interest of consistency, we would suggest aligning the costs in the non-exhaustive list of charges with the costs and expenses in the Cost Transparency Initiative's (CTI's) reporting templates. These are an industry standard for making institutional investment cost data more transparent to investors such as pension schemes. They were developed by the Pensions and Lifetime Savings Association, the Investment Association and the Local Government Pension Scheme Advisory Board with the support of ourselves and the British Venture Capital Association.

Also, we would like to point out that in the CTI reporting templates carried interest and performance fees, paid from net asset value (NAV) are not regarded as ongoing management costs but are reported separately to investors.

If you would like to discuss any aspect of our response please contact Jacqui Bungay (jbungay@aref.org.uk), Policy Secretariat at AREF,. Also, as our members invest in real estate and other real assets for various types of open-ended and closed-ended funds we are always willing to assist the DWP by sharing this wealth of knowledge and experience.

Yours sincerely

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