

Performance Fees Explained

Investment Solutions has recently launched a new fund, the **Select World Equity Fund**, which includes a performance fee as part of its fees and expenses. This fact sheet is designed to explain the key characteristics of a performance fee.

What is a performance fee?

A performance fee is designed to reward a fund manager if the returns of their fund exceed a certain target level. The additional fee earned is generally a percentage of the return above the target level so that the fund manager participates in the returns they generate. A manager will not be paid a performance fee for any period in which the manager underperforms their target.

Certain safeguards are usually built into the design of performance fees. For example, any underperformance may have to be recovered before future performance fees can be earned. This ensures that managers only receive performance fees for sustained outperformance.

A performance fee is usually paid in addition to a flat annual management fee and any other periodic charges that may be payable. Typically, the flat management fee associated with a performance fee is usually less than a flat fee only structure.

Example 1 overleaf provides an illustration how these fees work and provides a comparison with a flat fee structure.

Why use a performance fee and not just pay a flat fee only scale?

It is increasingly difficult to access the world's best managers without paying a performance fee structure. Investment Solutions believes that including these managers and aligning their interests with those of investors, is likely to improve a fund's overall performance.

Investment Solutions researches the manager universe and makes a qualitative assessment of managers using a range of criteria including remuneration. Not all managers will have performance fee structures, and it will not always be beneficial for investors and the fund to invest in managers that do.

There are three key benefits of a performance fee structure compared to a flat fee scale:

- If the manager underperforms the benchmark, a performance fee structure charges lower fees than if the fund had a flat fee only scale. The fund pays a lower overall fee and is better off.
- If the manager performs in line with the benchmark, a performance fee structure charges lower fees than would otherwise be payable. The investor pays a lower overall fee and is better off.

- If the manager is in line with its outperformance target (e.g. benchmark +1%), a performance fee structure charges similar but probably slightly higher fees, and therefore the investor pays a slightly higher fee while benefitting from the outperformance.

Investors therefore benefit from the use of performance fees through both the choice of better managers and the alignment of interests with those managers.

Investment Solutions revenues are unchanged as it does not participate in performance fees, but believes a performance fee structure payable to the underlying asset managers is in investors interests as it aligns the interests of both parties.

How does it work in the Select World Equity Fund?

The Select World Equity Fund is a multi-manager fund and each manager will be rewarded for their performance and are not affected by the performance of other managers or the overall fund.

This means that the fund as a whole could underperform while a performance fee may still be payable. Investment Solutions believe this is fair as when one manager has exceeded their targets they should not be penalised by the performance of the other managers who may not have - Example 2 illustrates this situation.

The targets set for each manager are relative to the overall market and, as such, a performance fee may still be payable in times where the market as a whole declines. Again, we believe that this is fair as the manager's objective is to outperform the market. If the manager outperforms a falling market, they have protected value for investors and should be rewarded – Example 3 illustrates this situation.

Each manager's performance is measured on a daily basis and any performance fees payable are accrued in the valuation of the fund and form part of the unit/share price at which an investor will transact. As an investor, you will never have to write a cheque to pay a fund manager's performance fee. Investment Solutions will not receive any part of the performance fee - this fee is paid in its entirety to the manager.

Working Examples

Example 1: How performance fees work

Typically a remuneration structure with a performance fee will approximately be equal to the flat fee only scale (Management fee only) structure a manager would offer, at the level the outperformance target of that manager is reached. The outperformance target is the objective of the manager and is normally expressed as a return above its benchmark. i.e. benchmark +1%.

The following table illustrates the potential fees payable to an individual manager in a range of scenarios. For purely illustrative purposes and ease of calculation, it is assumed all the managers operate underlying performance fee structures, on the basis of a Management fee of 1.0% p.a. and a performance related fee of 20% of the outperformance above a common benchmark. The flat fee only scale is assumed to be 1.2%p.a.

Relative Performance (A)	Flat Fee Only Scale (B)	Management Fee + Performance Fee (C)	Net Performance for Flat Fee Only Scale (A-B)	Net Performance for Mgmt + Perf Fee (A-C)	Fee Differential
-1.00%	1.20%	1.00%	-2.20%	-2.00%	-0.20%
0.00%	1.20%	1.00%	-1.20%	-1.00%	-0.20%
1.00%	1.20%	1.20%	-0.20%	-0.20%	0.00%
3.00%	1.20%	1.60%	1.80%	1.40%	0.40%
5.00%	1.20%	2.00%	3.80%	3.00%	0.80%

Example 2: The performance fee applicable if one manager outperforms and one underperforms

The following table illustrates the potential performance fee payable if one manager outperforms the benchmark and one underperforms, with the market itself decreasing in value. It is evident that a manager may still earn a performance fee in this example, even though the overall performance has been

negative. The outperforming manager has added value for the investor by outperforming the benchmark and earns a performance fee. The underperforming manager earns a lower fee than would otherwise have been payable.

Split of fund	Fund Performance	Benchmark Performance	Out Performance	Performance Fee Payable	Management + Performance Fee
Manager A 50%	0.00%	4.00%	-4.00%	0.00%	1.00%
Manager B 50%	6.00%	4.00%	2.00%	0.40%	1.40%
Fund	3.00%	4.00%	-1.00%	0.20%	1.20%

Example 3: The performance fee applicable if one or more manager significantly underperforms

The following table illustrates that there could be circumstances where the fund underperforms the benchmark and the investor pays a higher total fee than would otherwise be payable. This

would typically apply in circumstances of extreme underperformance by one or more managers.

Split of fund	Fund Performance	Benchmark Performance	Out Performance	Performance Fee Payable	Management + Performance Fee
Manager A 50%	-20.00%	-6.00%	-14.00%	0.00%	1.00%
Manager B 50%	0.00%	-6.00%	6.00%	1.20%	2.20%
Fund	-10.00%	-6.00%	-4.00%	0.60%	1.60%

Any Further Questions?

If you would like to discuss performance fees in more detail please do not hesitate to contact the Business Development team:

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