AREF

The Association of Real Estate Funds
Camomile Court, 23 Camomile Street,
London, EC3A 7LL
+44 (0)20 7269 4677
info@aref.org.uk

Sinead Donnelly & David Farrar
Department for Work and Pensions
Policy Group
Private Pensions and Arm's Length Bodies Directorate
Third Floor South
Quarry House
Leeds
LD2 7UA

By email: pensions.investment@dwp.gsi.gov.uk

29 March 2019

Dear Sinead & David

Response to the Consultation on the Consideration of Illiquid Assets and the Development of Scale in Occupational Defined Contribution schemes

We, the Association of Real Estate Funds[1] (AREF), would like to show our support for encouraging occupational DC schemes to invest in illiquid assets. We have not provided a response to the specific questions within the consultation as occupational DC schemes are not within our area of expertise. However, pension schemes are investors in many of the property funds that are members of AREF. Also, we have knowledge on performance fees within our membership so we feel we can make a valuable contribution to this consultation.

We note that this consultation is part of the Government's wider work on patient capital. We responded to both the FCA's CP18/40 Consultation on proposed amendment of COBS 21.3 permitted links rules and DP18/10 Patient Capital and Authorised Funds. In both, we have been firm supporters of encouraging and facilitating access to patient capital to a wider range of investors. We believe for long-term investment strategies, it is appropriate to include patient capital as part of a diversified portfolio.

We were delighted to see the clarification from the FCA in CP18/40 that the requirement for regular publication of pricing by underlying funds does not limit unit-linked funds to invest in 'permitted scheme interests' which are priced daily. There appears to be a general practice for DC schemes to require daily dealing; we would expect these type of schemes to consider investing in funds that do not price daily too. In our responses to CP18/40, DP18/10 and FCA CP18/27 Consultation on illiquid assets and open-ended funds, we asked the FCA to enter into

[1] The Association of Real Estate Funds represents the UK real estate funds industry and has around 60 member funds with a collective net asset value of more than £72 billion under management on behalf of their investors, including £18 billion on behalf of retail investors in the UK. The Association is committed to promoting transparency in performance measurement and fund reporting through the AREF Code of Practice, the AREF/IPD UK Quarterly Property Funds Index and the AREF/IPD Property Fund Vision Handbook.

Registered Address
The Association of Real Estate Funds
Camomile Court, 23 Camomile Street,
London, EC3A 7LL
Registered in England & Wales No: 04601584

AREF

dialogue with DC schemes and also, distributors that only offer daily dealing funds on their platforms. We would like the FCA to explain to them the importance of giving investors the choice to invest in funds that do not deal daily so they can invest in a wider range of assets. By insisting that funds deal daily they are preventing investors the ability to further diversify their portfolios and in some cases match their investments more closely to their investment strategy.

Also, in our responses to CP18/27, CP18/40 and DP18/10 we have asked the FCA to permit in COLL deferral of redemptions for a period of time which matches the expected period to sell the underlying assets held by the fund. Currently under COLL, authorised funds can only defer redemptions for one valuation point which usually equates to one business day. We believe that funds investing in illiquid assets should be able to defer redemptions up to 6 months. If they wish, they should be able to provide daily pricing and daily subscriptions without daily redemptions. Currently, if funds are low on liquidity they have to consider undertaking rapid sales and possibly suspending dealing in the fund. We do not believe that this is beneficial to investors, such as pension schemes, that invest in these funds for the long-term.

Currently, 20% of a unit-linked fund can be invested in Qualified Investor Scheme (QIS) and Unregulated Collective Investment Scheme (UCIS) assets. In CP18/40, the FCA proposed removing the current 20% limit and investments in this category would instead be limited by the overall amalgamated percentage limit across all illiquid assets of 50%. We agree that the 20% limit should be removed to enable increased investment in illiquid assets.

Further measures to facilitate investment into illiquid investments

- **Reporting on the scheme investment approach**

  We are advocates for greater transparency in our industry. The MSCI/AREF UK Quarterly Property Fund Index provides an independent view of current market performance and the performance of our member funds active within it. In addition, the quarterly MSCI/AREF Property Fund Vision Handbook gives detailed information on our member funds and can be used to gain an understanding into the key drivers of performance.

  We agree that members of pension schemes should be made aware of the trustees' investment strategies and how these are being followed. To encourage diversification of DC scheme portfolios, the current requirements could be expanded to include in the Statement of Investment Principles (SIP) the type of assets the trustees have considered investing in to achieve the scheme's investment strategy. This could include their reasoning for investing in, or not, a wide range of asset including illiquid assets. As mentioned in the consultation, this would seek to prompt schemes to document their consideration of assets classes which might deliver sustainable and competitive long-term returns. Annually, in the Implementation Statement, the trustees could provide data on how each of the asset classes they considered have performed.

- **Encouraging consolidation**

  Investments in illiquid assets usually have to be of a significant size; therefore, unless smaller schemes invest via pooled funds, they would not be able to include illiquid assets as part of a balanced portfolio. We agree that a higher standard of governance may be more readily achievable by larger schemes that have significant resources they can dedicate to governance. Therefore, we support the proposal for small DC schemes to consider formally every three years their position on consolidation.

Illiquid investments, performance fees and the default charge cap

- **The default fund charge cap**

  We would like to highlight that to invest in infrastructure, schemes would probably have to invest in closed-ended funds. As management fees for these types of funds are usually between 1% and 1.5% it may be challenging to meet the charge cap.

- **Accommodating performance fees within the charge cap**

  In paragraph 31 of Chapter 4 of the consultation it is suggested that schemes of sufficient size may be able to negotiate a fixed fee with managers of funds who usually charge performance fees. This may not be an option as some funds do not offer fixed fees and only charge performance fees. We would like to clarify whether this refers to the practice of some funds offering different share classes where some share classes have performance fees and others just fixed fees.

  We feel that performance fees can assist in ensuring the investment manager provides the best returns for investors in a fund. We totally understand that a function of the charge cap is to ensure investors do not pay high fees for poor fund performance. However, where structured properly, performance fees can improve the alignment of interests between DC schemes investing in funds and the investment managers. We would argue that that it could be beneficial for DC schemes to invest in funds with performance fees that reward good performance appropriately. However, the charge cap can be a barrier to this so we would ask that well-structured performance fees are not included in the charge cap. We would suggest that the DWP issue guidance on what constitutes a performance fee that would qualify to be outside the charge cap. This could include the requirements expected of hurdle rates, high-water marks and clawback provisions.

  - A hurdle rate is the minimum amount of profit or returns a fund must earn before it can charge an incentive fee. The DWP could mandate that performance fees must have a hurdle rate of, say, at least 3% in order to qualify for the charge cap exemption.

  - A high water mark is the highest value that an investment fund has ever reached. DWP guidance could stipulate that a performance fee except from the charge cap should include a high water mark clause.

  - The DWP may require a performance fee exempted from the charge cap to be subject to clawback provisions. For example, the performance fees may be required to be crystallised over the course of several years. In the years where fund returns turn negative the investment manager would not receive their performance fee.

- **Considering the use of performance fees in defined contribution schemes.**

  In the consultation paper it is acknowledged that it is a challenge to ensure that any performance fees are shared fairly amongst members of the DC scheme where members can join and leave at any time. Accruing for performance fees is a possible solution to this problem. However, it should be pointed out that it is not always known if performance fees will be applied and the amount of performance fee may not be known until the end of a fund’s life.

- **Additional method of charge cap compliance**

  Unlike the existing prospective assessment which gives assurance about ongoing charge cap compliance, the additional assessment does not give such assurance; the cap could be exceeded by a higher than expected outperformance or a significant shift in value of the assets held by the scheme in favour of the assets with performance fees cap.

- **Performance fee guidance for DC schemes**

  We support DWP publishing guidance on appropriate performance fees structures for trustees. As mentioned above these could include the structure of performance fees that would be exempt from the charge cap.

Updated charge cap guidance

We welcome the additional clarity that has been provided around the costs and charges in scope and those excluded from the default fund charge cap.

You are welcome to contact Jacqui Bungay (jbungay@aref.org.uk), Policy Secretariat at AREF, to discuss any aspect of our response. 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

John Cartwright
Chief Executive, The Association of Real Estate Funds