FINANCIAL REVIEW

Fund managers' benchmark for performance fees 'should be lowered'

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Reporter

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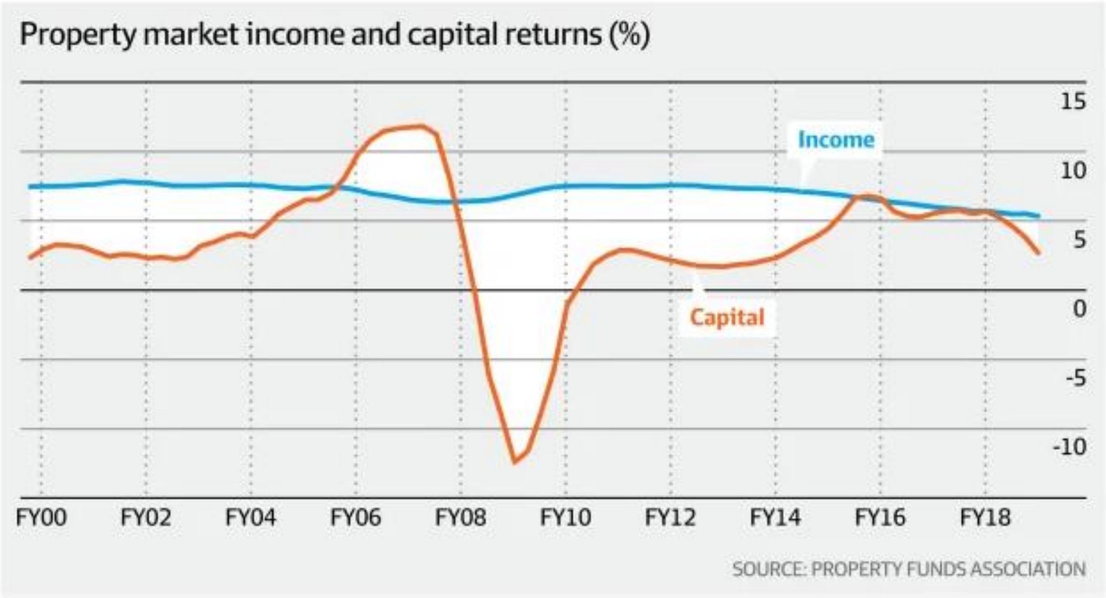
Property fund managers should lower the return benchmarks or hurdle rates that earn them lucrative performance fees, given the low interest rates and yields, a new report commissioned by the Property Funds Association (PFA) says.

A survey of 55 property funds by Atchison Consultants for the PFA found that 45 of them had a performance fee structure, with the most common hurdle rate being able to achieve a 10 per cent absolute or internal rate of return.



Other minimum benchmarks ranged from returns of 8 to 12 per cent or were based on outperforming an index.

Fund managers typically earn a base fee related to gross asset value, and extra payment if the fund outperforms and adds value for investors.

The current typical 10 per cent hurdle rate is based on the property market generating an average total return of 10.5 per cent per annum over the past 20 years.

But looking ahead, Atchison Consultants forecast much lower absolute total returns from commercial property – of 5.5 to 6.5 per cent – with income returns (or yields) expected to drop to 4.75 per cent compared with an average of 7 per cent over the past 20 years.

Much of this yield compression has come about through access to cheap debt, which has fuelled a global investment push into commercial property from listed and unlisted funds.

In Australia, yields on premium CBD office towers have fallen to 4 per cent or lower while in some cases prime industrial assets are selling on yields below 5 per cent.

Also supporting this view of a lower absolute return, the report said, were the lower yields on 10-year government bonds, which averaged 4.6 per cent between 1997 and 2007 but were now forecast to return 2.5 per cent.

This means there is still a healthy premium on a 5.5 or 6.5 per cent return generated by a property fund compared with the "risk-free rate".

"In the current and forecast property market conditions, it is clear that a performance fee based on a benchmark of 10 per cent is inappropriate," the report said.

"A maximum 6.75 per cent benchmark or lower is a more acceptable rate going forward," it concluded.