

Swing Pricing Policy

Kempen Capital Management



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1. Introduction

Kempen Capital Management (KCM) has a fiduciary duty to protect the interests of the shareholders of our funds, and to thus preserve the performance generated in each of our niche strategies. In the absence of a proper mechanism to prevent it, frequent trading due to subscriptions and redemptions will dilute the performance of our funds, since all trading costs will be borne by the fund itself. These costs will henceforth be borne by *all* investors, even those who did not trade at all. In order to mitigate this effect, KCM has adopted the **swing pricing** method, in which these costs are assigned to the trading investors only, so that the performance of the fund remains unaffected.

In this memo, we elaborate on this mechanism. First, we explain how it works, and why KCM has adopted it. Next, we show how the relevant factors are computed, and how the governance of this process is structured. Finally, we show what the impact of this mechanism is, both on trading and non-trading investors.

► 2. Protecting investors

When investors subscribe to one of our funds, the portfolio manager will normally trade as a result of this inflow (the same of course applies in case of a redemption). The costs associated with this activity will need to be covered by the fund's assets, and the value of the funds will therefore deteriorate ("dilute"). Hence, the cost associated with this inflow is effectively borne by all investors, and this is therefore not in the ongoing interest of the existing shareholders of our funds.

This issue can easily be addressed by the introduction of swing pricing, a method that has over the last decade emerged as the industry standard for dealing with this issue.

2.1 How swing pricing works

In the swing pricing mechanism, the fund's NAV price is adjusted to ensure that the costs of the underlying portfolio activity caused by subscribing and redeeming shareholders is borne by to those investors only, rather than by all investors, including existing shareholders¹.

The amount with which the NAV is adjusted is called the **swing factor**, and it is supposed to cover for the trading costs incurred due to in- an outflows. Applying the swing factor to the NAV of a particular day will henceforth ensure that the performance of the fund will remain unaffected.

There are two standard methods for implementing swing pricing:

- > **Full swing** – The NAV is always adjusted if there is a subscription or redemption. The direction of the swing is determined by the net capital flows of the day.
- > **Partial swing** – In this method, the NAV is only adjusted when the net capital activity of the day exceeds a predefined threshold.

¹ This is how the swing factor is applied for Luxemburg funds. For our Dutch funds, the NAV itself is not adjusted, but the swing factor is just added or deducted as a separate item. This operational detail does not affect the discussion in the rest of this memo, so we will refrain from mentioning this distinction in what follows.

It is important to stress that the swing factor is not an additional service fee. As explained above, it is merely a cost-neutral way of distributing trading costs fairly amongst investors.

2.2 The industry standard

After considering various alternatives, KCM believes that the aforementioned swing pricing mechanism is the fairest and most practical way of dealing with the dilution of performance due to in- and outflows. This is emphasized by the fact that this method has emerged as *the* industry standard for mutual funds.

In a recent comprehensive survey² by ALFI (the Association of the Luxembourg Fund Industry), it is shown that a significant majority of the respondents has adopted this method, and that this number is rapidly increasing. Increasing trading costs associated with the financial crisis is mentioned as one of the main drivers of this transformation. This conclusion holds for various European countries, although asset managers in France, Germany and Italy have so far apparently seemed less inclined to introduce the mechanism.

While the full swing method is considered the basis method, a significant number of the respondents has now chosen to adopt the partial swing approach, either 1) to reduce the frequency of swinging, and therefore reduce NAV volatility, or 2) because they consider their product to have sufficiently liquidity, and are therefore only concerned with larger flows.

► 3. Swing pricing at KCM

KCM has adopted the full swing method for all of its funds. In this section, we will elaborate on the principles underlying this decision, we will list the different elements that constitute the swing factor, and we will describe the internal process that is followed when reviewing swing factors.

3.1 Guiding principles

Below, we list several items that KCM has defined as guiding principles for the swing pricing process:

- > **Protecting investors** – The swing pricing method should be chosen such that it protects existing investors in all circumstances.
- > **Cost neutrality** – Neither the funds, nor KCM should gain profit from the swing pricing method. The swing factors should thus be calibrated to accurately reflect the current trading cost levels.
- > **Full swing** – KCM chooses the full swing as the standard swing pricing method. KCM data shows that a large part (>80%) of the trading costs would not be compensated for when choosing the common threshold of 1% (of the NAV). This would be in conflict with the first principle, because these costs would dilute the performance for existing investors. The only way to prevent this from happening is to apply the full swing. In case a KCM fund is shown to be able to structurally absorb a limited amount of in- or outflow without the immediate need for trading, and thus incurring cost, a partial swing could be considered.
- > **Review periodicity** – Swing factors are reviewed on a periodical basis. However, when market developments so require, KCM will re-evaluate the swing factors on an ad hoc basis in between regular reviews.

² “Swing Pricing”, ALFI, 2011 – http://www.alfi.lu/sites/alfi.lu/files/ALFI_Swing_Pricing.pdf

3.2 Calculation of swing factor

The swing factors are reviewed at least once every year, and the review process takes into consideration the following cost factors:

- > Commission cost (for equity funds),
- > Spread cost (for fixed income/credit funds),
- > Financial transaction tax (where applicable),
- > Transaction fee of custodian,
- > Market impact, and
- > Trading cost for FX trades (where relevant).

The swing factors are rounded to the nearest 5bps multiple. The resulting swing factors should be seen as a proxy for the relevant cost levels, and this factor should therefore cover for trading costs until the next review.

3.3 Governance

The following parties are involved in establishing the appropriate swing factors:

- > The **KCM Risk Management** department is responsible for calculating and combining the different cost factors. This department is independent from portfolio management and client management, and is therefore in the best position to review these factors in an unbiased manner. Trading costs are determined by using various sources and parties, such as portfolio management, the trading desk, etc.
- > The **KCM Risk Committee**³ subsequently scrutinizes the final numbers, and decides on their appropriateness. This committee convenes monthly, but it may do so more frequently when the market conditions require this.
- > This outcome of the KCM Risk Committee will serve as a final advice for the **Management** of the KCM funds (e.g. the Board for the Luxemburg funds), who has the final authority to approve new swing factors.

As soon as the new swing factors have been approved, they will be published on the Kempen website, and they will go 'live' immediately thereafter.

³ The KCM Risk Committee has KCM's CIO and COO as a member, and it is chaired by the KCM Risk Management Director.

► 4. Implications

The swinging pricing mechanism is designed to protect the interests of existing shareholders in the fund. This is true whether there is a net capital inflow or outflow. This is of course advantageous for the existing shareholders, but what does it exactly imply for trading investors?

In this section, we will further elaborate on the exact implications of the swing pricing mechanism for both the trading and non-trading investors.

4.1 Trading investors

The effect for trading investors can be twofold:

- > When an investor is redeeming on a day when there is a net outflow, or subscribing on a day when there is a net inflow, the investor will indeed pay for the associated trading costs via a, respectively, lower or higher (i.e. 'swung') NAV.
- > When an investor is redeeming on a day when there is net inflow, or subscribing on a day when there is net outflow, the investor will benefit from this trade, since the NAV has been swung in their favour. These events are much less likely to occur than those of the first bullet, due to the fact that they are by definition in the opposite direction of the net flow. Our calculations have shown that this will occur for less than 15% of all flows for a typical fund.

This latter effect seems counterintuitive, but it is a direct consequence of the swing pricing mechanism chosen. There are ways to amend this, for example by choosing two NAV's (one with and one without swing factor applied), but the (operational and regulatory) implications of this approach do not outweigh the limited benefit of avoiding this effect.

All things considered, it is safe to say that, in the current swing pricing mechanism, a trading investor is never unduly taxed: he never pays more than the most current estimate of the applicable trading costs when he would have traded outside of the funds.

4.2 Existing shareholders

The swing pricing mechanism was introduced to protect existing shareholders by preventing the dilution of the fund's performance. Indeed, the construction of this mechanism is such that all trading costs are borne by the trading investors, by which the long term return of the fund remains unaffected.

This can be illustrated by examining two funds of KCM, the Kempen Global High Dividend Fund and the Kempen (Lux) Euro Credit Fund. For each of these funds, we have listed in the second column the annualized three-year return (2010-2012) relative to the respective benchmark. In the third column, we have shown the cumulative trading costs over the same period, expressed as a percentage of the NAV. This is therefore a direct proxy for the deterioration of the value of the fund.

Fund	Outperformance* (2010-2012)	Performance impact** without swing pricing
Kempen Global High Dividend Fund	2.5%	-/- 0.10% (= EUR 1.8mio)
Kempen (Lux) Euro Credit Fund	1.0%	-/- 0.15% (= EUR 0.6mio)

* Relative return based on the annualized 3-year performances of fund and benchmark. See also the Kempen website.

** Negative annualized performance impact on 3-year horizon (in percentage and in EUR).

It is evident that, in the absence of swing pricing, the performance of these KCM funds would have deteriorated significantly (up to 0.15%) due to the fact that trading costs would have been covered by the fund's assets. For the Kempen Global High Dividend Fund, for example, EUR 1.8 million of trading costs would be deducted from the fund's asset, each and every year. These numbers are certainly material when comparing them to the outperformances during that same period, and should henceforth not be neglected. It is clear that the swing pricing mechanism indeed protected these KCM funds from undue dilution.

One should also note that the abovementioned negative impact depends on the turnover of the funds. When the size of the daily net flows increases, the performance dilution would be amplified with a similar factor. In the absence of a swing pricing mechanism, trading frequencies and sizes may increase due to a moral hazard effect, leading to higher turnovers, and hence lower performances. We therefore consider the performance impact numbers in the above table as a lower limit of the real effect of having no swing pricing method in place.

► 5. Conclusion

In this memo, we have explained KCM's approach to mitigate the effect of dilution to trading costs.

KCM believes that the swing pricing mechanism is a simple and practical approach to protect the interests of our funds' investors, based on the guiding principles we have laid out in this memo.

This approach may impact investors that are trading, but it never does so unfairly: the swing factor represents the costs of trading of the relevant flows in a cost-neutral way, and it is therefore a proxy of what the investor would have paid when dealing in the individual securities outside of the fund.

This is exemplified by the fact that the performance of our funds would have deteriorated significantly when swing pricing would not have been applied.

We therefore believe that the swing pricing mechanism aligns with KCM's fiduciary duty to generate long term outperformance for all investors, whether they are new to the funds or not.