

PAYING FOR PAIN OR PLEASURE?

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INTRODUCTION

Are performance fees a panacea or Pandora's box? The alignment of interests between managers and investors¹ would seem to be a powerful argument in favour of funds using performance fees. But questions remain as to exactly how such fees are structured and, as they are appearing more frequently in the European mutual funds world, this report will look at both hedge funds and mutual funds in order to provide new insights and better understanding.

This report is presented in two sections. The first covers mutual funds in the UK (OEICs and unit trusts) where performance fees have only been allowed in recent years, so developments from a 'clean slate' can be clearly seen. This also serves as an introduction to the basic concepts involved in structuring such a fee. The second section covers hedge funds, where not only are performance fees the norm, but clients are primarily institutional and high net worth investors. The second section builds on the analysis presented in the first half of the report. Together, the different perspectives in both sections will have relevance for the wider industry.

REPORT HIGHLIGHTS

- Lipper has identified 81 open-ended funds in the UK with performance fees in place, a rise of 138% from the 34 funds identified at the end of 2007 — still less than 5% of the industry's total number of funds.
- Two thirds of UK funds (66%) can charge a performance fee even when the fund out-performs a falling index. Also, among those funds that must beat an index to earn a performance fee, fewer than a quarter (22%) use a cash-like index (such as Libor), indicating that far more funds than just those seeking absolute returns use performance fees
- Lipper unveils its 10-point list of fee standards for hedge funds, which can be used as guidelines for disclosing fees and expenses by fund companies, as well as a 'checklist' for investors' due diligence.
- Among hedge funds where Lipper has calculated Total Expense Ratios (TERs), the asset-weighted average is 1.82% and the mean is 2.48% — before the impact of performance fees, which can often double the level of annual expenses incurred. Clearer disclosure of such costs would certainly help hedge fund investors.

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¹ AIMA written evidence to the House of Commons Treasury Committee (27 Jan 2009)



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UK MUTUAL FUNDS

“Consumers unfamiliar with this charging structure [performance fees] may not be able to make appropriate comparisons or understand their impact on net returns in the absence of a significant improvement in standards of disclosure or literature.”²

This comment from the UK financial regulator highlighting the need to improve standards prompts an examination of both the current guidelines and the performance fee structures currently being used.

The FSA lifted the ban on open-ended funds charging performance-related fees in April 2004 (Policy Statement 04/7). The main factors to be considered when constructing a performance fee were suggested by the FSA, although they are quite loose: “it may be based on performance above a defined positive rate of return”, accrual and crystallisation “should be reasonable”, and “disclosure should be given in plain language together with examples of the operation of the performance fee.”

One of the more constructive factors that was presented as a requirement, not just a suggestion, was that the “benchmark must be reasonable given the investment objectives of the authorised fund”. With an increasing number of funds seeking absolute returns, the appeal of using a cash-like benchmark (such as Libor or the Bank of England base rate) is apparent. Nevertheless the use of such benchmarks by equity-based funds should surely give pause for thought — and not a little concern.

Interestingly the FSA dropped two other requirements during its consultation process. The first was the requirement for a High Water Mark and the second was the prevention of funds charging performance fees when investors lost money.

The FSA’s guidelines also come close to requiring a cap on the cost to the fund that a performance fee can incur, stating that “the prospectus should contain the maximum amount or percentage of scheme property that the performance fee might represent in an annual accounting period.” But this does not mean there is a requirement to cap performance fee payments, and when the Financial Services Consumer Panel expressed concern about fee caps, the FSA responded by saying that this issue would instead be covered by its conduct of business rules (COB 5.6) that prohibited excessive fees.



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Sadly, in May 2007 the FSA removed its rules on excessive charges (Policy Statement 07/6). Indeed the regulator went further and stated “we do not act as a price regulator, and we do not consider it appropriate for us to take such a role in these circumstances.”

² FSA Financial Risk Outlook (2008)

PERFORMANCE FEES IN PRACTICE

At the time of writing Lipper has been able to identify 81 open-ended funds in the UK with performance fees in place, a rise of 138% from the 34 funds identified at the end of 2007³ – still less than 5% of the industry's total number of funds.

Once the use of a performance fee has been identified, the fun starts and an investor can begin to decipher how the fee will work in practice. In summarising a fund's performance fee structure, two questions need to be asked. Firstly, when will the performance fee be charged? Secondly, how much will be charged?

For the first question, a performance fee will normally be charged if one or more of the following are reached:

- a fund's return exceeds a specified absolute percentage level (which may be zero), or what can be referred to as an 'absolute' condition
- a fund's return exceeds a relevant index, or what can be referred to as a 'relative' condition
- a fund's current return exceeds its previous high level, i.e. a High Water Mark. (This mechanism aims to ensure that investors do not pay twice for the same absolute increase.)

For the second question – how much will be charged – the typical hedge fund fee rate is 20% and, sure enough, this is reflected among funds with such fees in the UK, although a significant minority have opted for 15%. Inextricably linked to this rate is whether such a fee is applied to all returns achieved ('raw' performance) or only returns above a specified benchmark ('net' performance).

Also on this second question, watch out to see whether the fund caps the amount charged in any given year. In other words, if the fund charges 20% on all performance and its 1-year performance is 40%, will the fund charge the full 8%, or does the fund cap such a fee at, say, twice its management fee (typically this would then be 3%)? In recent years UK funds charging performance fees have ranged widely in what they have charged in practice, from 0.01% to over 5%, so the issue of the cap is certainly relevant.

Lipper's detailed research into performance fee structures, carried out each year since 2000⁴, can add flesh to the bones of performance fees in the UK.



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Using the first question above, a detailed analysis of 50 funds with performance fees in the UK reveals that among those funds that must beat an index to earn a performance-related fee, fewer than a quarter (22%) use a cash-like index (such as Libor), indicating that far more funds than just those seeking absolute returns use performance fees. Around one third (32%) have a High Water Mark, suggesting that most of the industry agrees with the FSA's decision to drop this requirement.

Pulling together different aspects of these fee structures, the research reveals that two thirds of funds (66%) can charge a performance fee if the fund out-performs a falling index, i.e. when investors are losing money. While there may be cases where paying a performance fee relative to an index only is acceptable (and no 'absolute' condition), this is a good example of retail investors really needing to be aware of what they might be letting themselves in for.

As to the level of performance fees being charged, the average performance fee is 18.2%. Just four funds analysed (fewer than 10%) have a cap in place to limit the amount that will actually be charged in any given year.

A minority of funds with performance fees charge less than the typical 1.5% management fee, but the vast majority charge 1.5% or more, suggesting that there is, in principle, no financial downside for fund companies implementing a performance fee structure.

³ Four funds with performance fees in 2007 have since closed. Also, for the purpose of this analysis, three institutional real estate funds with performance fees have been excluded.

⁴ For detailed analysis of performance fee structures across Europe and the UK, please ask for more information on Lipper's Benchmarking Performance Fees study.

THE IMPACT OF PERFORMANCE FEES

An indication of the level of fees incurred when a performance fee is charged have already been given, but for a larger fund sample the net needs to be cast wider and capture European funds.

Over the past decade, of the funds where fund expenses have been analysed and a performance fee is in place, the average performance fee charged is just over 0.4% of fund assets, although the median (or middle value) is zero. The latter finding highlights that in the majority of cases funds with performance fees do not achieve the performance fee targets set. If one excludes such instances where no performance fees are earned, then the average fee rises to 1% and the median to 0.5%.

Drawing together the two sections of this report, funds of hedge funds can be used as an example of how the layering of different fees and expenses can add up for the investor. To illustrate the combination of performance fees and operating expenses, two hypothetical scenarios are presented below, using reasonable assumptions.

Fund of hedge funds 'A' has a top level performance fee structure in place (10% of all returns), while fund of hedge funds 'B' does not have a top level performance fee structure, has lower operating expenses (1.25% versus 1.80% for 'A'), and the underlying fund investments have operating expenses at the lower end of the scale (1.25% versus 2.00% for 'A').

In addition, there are two performance scenarios, where returns are lower (up by 5% after expenses) and where they are higher (up by 15% after expenses). Again, these examples are hypothetical as each underlying hedge fund will obviously perform differently and have a different performance fee structure and operating expenses, but the overall figures are reasonable, assuming a fee of 20%.

In the lower performance scenario, fund 'A' bears annual charges of 5.02%, while fund 'B' bears 3.5%. Meanwhile in the higher performance scenario, fund 'A' bears charges of 7.82% and fund 'B' bears 5.5%. This highlights just how well fund of hedge funds managers have to perform in order to generate returns for their investors.



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HEDGE FUNDS

Context is crucial, although often overlooked, when getting to grips with hedge funds' fee structures. The first aspect to appreciate is the hedge fund industry's conception of their fee structures relative to those for mutual funds.

One senior hedge fund executive's summary serves as a useful starting point. On the one hand, mutual funds can be seen as "marketing institutions and their single, most important aspect in terms of their profitability is what their assets under management are." By way of contrast, "the most important driver of profitability for a hedge fund is performance, say 1 and 20 or 2 and 20... there's very little profit, if any, in the management fee."⁵

Increasing assets under management is certainly the most obvious means for a mutual fund to increase revenue. However, this viewpoint resounds most loudly when in a US environment, while in Europe mutual funds are much smaller on average and are more likely to be of a similar size to hedge funds. Similarly the historical trend for mutual fund fee levels in the US is downward, but it is generally upward in Europe, again altering the context depending on which side of the Atlantic one sits.

Picking apart the different approach to fee-setting between hedge and mutual funds also prompts closer scrutiny of the management, or fixed, element of a fee structure. European cross-border mutual funds open to retail investors were analysed and annual back office costs (the difference between a fund's management fee and its Total Expense Ratio, or TER) average 41 basis points, falling to 34 basis points when the average is weighted by fund assets. So one would expect equivalent costs for hedge funds to be at least this level.

Sure enough, for those offshore-domiciled funds where Lipper has been able to calculate TERs from single manager hedge fund accounts, the back office expenses are shown to be an asset-weighted average 31 basis points (although hitting a hefty 87 bp's when a simple average is used). The average management fee is slightly over 1.5% for both averages, which results in an asset-weighted average TER of 1.82% and a mean of 2.48% — before the impact of performance fees, which can often double the level of annual fees and expenses incurred.



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These broad figures have been used to highlight the principle of why operating expenses beyond the management fee matter, rather than a comparison of management fees per se. For specific fee comparisons, a breakdown by investment strategy would enable more relevant analysis to deal with key differences such as the fund management process or alpha potential.

This analysis raises both a disclosure issue and the prospect of greater scrutiny of the fixed costs for hedge funds (is there really no profit in the management fee?). While this research bears out the view that "2 and 20" may well be nearer to "1.5 and 20" on average, this crucially excludes the impact of other operating costs that together form the TER. The commercial terms disclosure outlined by the Hedge Funds Standards Board could usefully be more robust than the current suggestion that "managers might also consider disclosure of a total expense ratio or gross vs. net return."⁶ Certainly hedge fund managers launching Ucits will have to address this issue.

⁵ CEO, Clinton Group, SEC Hedge Fund Roundtable, May 2003

⁶ Hedge Fund Standards final report (January 2008) — www.hfsb.org

PERFORMANCE FEE STANDARDS

Turning to the more distinctive side of a hedge fund fee structure, the performance fee, there is room for many fee structures to be tightened up considerably in order to ensure fairness for investors. In other words, going beyond the assertion that a performance fee innately aligns the interests of a fund manager and his/her investors, which is sometimes taken on trust.

And it is to this debate that CalPERS brought its considerable weight to bear in a memorandum to its hedge fund partners.⁷ This memorandum provides invaluable insights into an institutional investor's view on the details of how performance fees are structured, touching on hurdle rates, clawbacks, crystallisation frequency and relative fee rates. A not dissimilar approach was outlined by Utah Retirement Systems (in January 2009). The important element here is that these comments were not trying to drive fees down per se, but for hedge funds to justify their fees and address specific elements of the fee structure.

Embracing these sentiments, together with ten years of experience researching performance fee structures, Lipper presents a set of fee standards for hedge funds. While not intended to be comprehensive, these standards go further than those previously in the public domain, although the Report of the Investor's Committee to the President's Working Group on Financial Markets⁸ approaches this, as does CalPERS' memorandum.

By way of contrast, the Alternative Investment Fund Managers Directive (AIFMD) does not relate its guidelines on remuneration to these issues at all.¹⁰ One comment that is sensible and worth mentioning from this draft directive is that "the assessment of performance is set in a multi-year framework ... in order to ensure that the assessment process is based on longer term performance." This could usefully be linked to the sixth fee standard that Lipper has put forward.



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FEE STANDARDS FOR HEDGE FUNDS⁹

Elements to be considered when assessing or negotiating a fee structure

1. What is the performance fee rate? Is this applied to the fund's 'raw' (all returns) or 'net' (above a benchmark) performance?
2. Is there a fixed hurdle rate, or other benchmark, above which performance fees are achieved?
3. Is there a High Water Mark? If so, what is its duration?
4. Is there an equalisation system?
5. Is there a claw back (or loss carryover) mechanism?
6. How often is the performance fee 'crystallised' for payment?
7. Is there a fee cap?
8. Is there a penalty for under-performance?
9. Is there a quid pro quo for any 'lock-up' arrangements, e.g. downward adjustments on management or performance fees?
10. Is there a redemption penalty and what is the redemption notice period?

⁷ CalPERS' Memorandum to hedge fund partners, March 2009.

⁸ Principles and best practices for hedge fund investors, 15 April 2008

⁹ For further details on structuring performance fees, please see Lipper's 'Benchmarking Performance Fees' study.

Lipper's guidelines address the complementary issues of fairness and transparency. They do not specify what level fees should be, although they do include the proposition that fees should be reduced in the case of under-performance, so that a fund's fee structure becomes more than a one-way bet for the fund company.

For a fund company to go beyond this and lower performance fee rates — as some fund managers have proposed in media reports — surely undermines the very concept of paying substantially higher fees in return for receiving absolute returns. Either a fund manager is worth such fees, or he/she has to admit that they cannot be justified. Lowering the performance fee rate can surely only be justified if the company also re-pays the excessive fees that were previously achieved.

A related topic is whether performance fees increase the level of risk that fund managers take. While this topic largely lies outside the scope of this current report, it is worth noting that a fund's High Water Mark (that aims to ensure that investors do not pay twice for the same absolute increase in fund performance) may result in unintended fund manager behaviour, be it leaving the fund altogether¹¹ or taking greater risks.¹² Having said this, much of the finger-pointing aimed at High Water Marks relates only to those that are permanent (i.e. not reset after a certain number of years). The presence, or lack, of a High Water Mark is just the first step — this is why Lipper's fee standards specifically refer to the duration of such a structure.

Only by addressing these issues can hedge funds clearly demonstrate both the alignment of their interests with those of investors and that the incentives to deliver absolute returns are appropriate. Of course, after considering these factors investors may well take the view that the weight of such fees is a price worth paying, but they will have had the opportunity to compare fee structures with an appropriate level of detail.

¹⁰ See Article 9a and Annex II of AIFMD (March 2010), <http://register.consilium.europa.eu/pdf/en/10/st07/st07377.en10.pdf>

¹¹ R. Barry, Hedge funds: a walk through the graveyard (Macquarie, 2003)

¹² AIRC, The gross truth about hedge fund performance and risk (2008)

CONCLUDING COMMENTS

In preparing this report, the aim has been to bring some different perspectives that have relevance for the wider funds industry when considering performance-related fees. Among other findings, three themes have emerged:

- 1. Alignment of interests.** Fund companies should demonstrate they are doing more than just assuming that a performance fee intrinsically aligns the interests of a fund manager and their investors.
- 2. Clarity of information.** There are a range of factors that contribute to the performance fee structure and each of these should be clearly addressed by a fund company, together with accompanying information on management fees and TERs.
- 3. Fiduciary responsibility.** Investors who struggle to understand the impact of annual fund expenses will certainly struggle to comprehend how a performance fee works — companies should not open themselves to allegations that they are taking advantage of this situation.

“I am always happiest investing when I know the manager has a sizable stake in the fund alongside my own.”¹³ As a final thought, James Montier’s words make it tempting to suggest that one very effective way for a manager to align his/her interests with those of investors is to invest in his/her own fund, which would also directly reward the fund manager in relation to how well they have performed.



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ABOUT LIPPER

Lipper, a Thomson Reuters company, is a global leader in supplying fund information, analytical tools and commentary. Lipper has advised key organisations on fee-related issues, including the European Commission’s UCITS Contact Committee, IOSCO’s Committee on Investment Management, the OECD’s Committee on Financial Markets and CESR’s KID drafting group. Lipper also co-authored INREV’s Fee Metrics Guidelines.

¹³ James Montier, Société Générale, The tao of investing, 24 February 2009