Special Report
Fees

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Just rewards

Unfairness, high levels, perverse incentives: fees are always guaranteed to raise temperatures. Martin Steward considers some imaginative proposals for alignment of interests

In October Norway's auditor general rapped Norges Bank Investment Management (NBIM) on the knuckles over external asset management costs incurred by the Government Pension Fund Global. We are used to hearing about the pain of paying asset-based management fees to underperforming active managers, but in this case concern was focused on performance-based fees – NOK1.4bn (€117m) out of a total fees burden of NOK1.8bn. The auditor noted that one contract had no upper limit on performance fee payable, leaving the Fund shelling out NOK500m to a single manager in 2009.

State secretary in the ministry of finance Hilde Singsaas insisted the fund's costs would be kept "low and within clear limits", but she also observed that, "If the external managers have earned a lot of money, this means that the fund has earned even more."

And with performance fees we can underline that riposte, can't we? After all, a manager can grow fat on management fees while his performance goes nowhere – or even down. This was the logic applied by our December 'Strategically Speaking' guests, Winton Capital Management: coming from the 2-and-20 hedge fund world, it offers its new long-only global equities strategy at 0.2-and-20. "If we don't do well, we don't get paid," as head of equities research Mark Precious put it.

Should investors haggle for this kind of thing? Todd Ruppert, CEO at T Rowe Price Global Investment Services, thinks not. He considers lowering asset-based fees and trying to claw them back through performance fees reckless and misaligned with investors, citing "many occasions" when his firm walked away from prospective clients insisting on that kind of compensation.

"If I buy my wife a pendant and she really likes it, I don't go back to the store to offer them more money, because I pick what I think is going to work in the first place," he says. "If there is confidence the manager can add value over time the client is better off paying a flat fee and reaping 100% of the outperformance. If we underperform paying us less is not an efficient response - the client should terminate us." It is worth noting that T Rowe Price's revenues exhibited the most sensitivity to market movements of all the asset managers in a recent study by EDHEC's Bernd Scherer discussed on pages 52-53.

In case you are tempted to assume that this is lily-livered long-only managers refusing to 'eat their own cooking' like hedge fund managers do, take it from Thomas Wehlen, founder of Coburn Barrett, whose Global Leveraged Index fund, a macro strategy, has returned 14% annualised since inception 13 years ago – charging nothing but a flat 2% management fee. "We simply feel that, with a flat management fee, the better the fund performs the greater share the investor gets," he says.

The extent of that greater share is not widely understood, and challenges State Secretary Sigsaas' statement about alignment. Even if an investor is happy to share the traditional 20% of steadily rising gains with its manager, it needs to think again about the classic 'annual banking' model – because as soon as the investment period extends beyond the 'banking' of the first performance charge that investor is doomed to receive less than 80% of the cumulative return.

Figure 1 shows how this profit share would have worked out on the Dow Jones Credit Suisse Long/Short Equity index, with a 20% performance fee banked and reinvested annually. After the losses of 2008 the managers' share of the profits had grown to a whopping 36%, but even after a 78% cumulative return to 2007 with no down years it had already reached 24%.

"Pension funds really have a lightbulb moment when they see those charts," says Thom Young, president of Optcapital, a consultancy specialising in option and stock-appreciation right (SAR) fee structures to help the industry overcome this misalignment, which have been enthusiastically supported by US pension fund managers such as deputy-CIO of the Utah Retirement Systems, Larry Powell. "They always knew they were getting nibbled, even in up markets," Young adds.

Getting nibbled is bad enough, but getting an arm and a leg bitten off, 2008 style, is much worse – which makes the perverse incentives embedded in performance fees that much more problematic. "They encourage maximum short-term risk taking," says Wehlen. "When a bet is won managers get very well paid, but when it isn't the investor alone carries the loss."

As Wehlen implies, a performance fee is a free call option on your fund's return. As every trader knows, the most valuable options are on the most volatile underlying securities: there is an incentive either to increase the fund's volatility (because the manager is only exposed to the upside) or to increase tail risk, banking annual fees on low-volatility returns, before those returns are wiped out by the tail event. "The present model provides the possibility of a hedge fund manager realizing a 20% performance fee at the end of a bonanza year," observed CalPERS in its 2009 re-think of its hedge fund relationships. "If the fund suffers a significant decline the next year, the manager could still have a large net gain at the end of the two years, but the investor may break even or even lose money."

Ben Funk, head of research at fund of funds manager Liongate Capital, says he sees pressure on managers to lower management fees in favour of performance fees, but that investors also want to avoid "encouraging people to manage their own revenue risk with clients' capital" – in other words, increasing volatility to get their free call in-the-money. Liongate's solution is to insist that a significant proportion of managers' personal wealth depends on their long-term performance.

But Funk also sees a general move away from the "almost universal" 2-and-20 towards more diverse structures that reflect liquidity, fund size, operational complexity, the alpha/beta share of return streams and, especially, strategy time horizon. Hilltop Fund Management, a UK-based fund of funds, is working with Optcapital to launch a SAR fund next year. Philippe Gougenheim, head of hedge funds at Unigestion, reveals that one of its recent fund of funds mandates not only defers performance fees for three years, but makes them dependent on returns crossing a certain threshold after two years. Similarly, Hermes BPK, the fund of funds partnership part-owned by the UK's BT Pension Scheme, has just introduced a three-year 'clawback' performance fee structure, which refunds in cash rather than the usual fund units: "This unique structure provides greater alignment with clients who take a long-term view," says co-CIO Mark Barker.

The recent EU Alternative Investment Fund Managers Directive (AIFMD) will no doubt accelerate these processes, with its requirement that at least 50% of "variable remuneration" should be paid in the form of shares in the manager's fund and at least 40% should be "deferred over a period which is appropriate in view of the life cycle and redemption policy", which it considers to be at least three to five years. Optcapital certainly senses an opportunity and is working to raise awareness of its options and SAR structures with European regulators.

The idea is simple. Whereas the traditional model sees the manager 'bank' 20% of each year's profit, Optcapital's model starts by dividing invested capital into the client's share and the manager's share, with the manager bearing all the investment risk of his share and having an option to bank it at a certain point in time. Split that 80/20 and, when he exercises his option, the manager will receive exactly 20% of the accumulated profit since subscription. Meanwhile his share of the profits remains at risk symmetrically with the client's (figure 2). Manager and client can negotiate the terms of the option - for example, the client might allow an option to be exercised on a certain percentage of realised profits after certain time periods – but if the bulk can only be exercised at final redemption, the longer the client stays invested the better the deal is for him relative to the 'annual-banking' model, particularly in terms of downside volatility. Optcapital claims the structure can increase hedge fund returns by 6% over a five-year period, without any improvement in alpha, making a €1bn allocation better-off by around €12m per year.

"We are working with a state pension fund right now that is thinking of allowing its manager to exercise about 20% of the option spread each year between years two, three and four, in return for the ability to rebalance 20% of their capital away from the fund in the event of outperformance," says Young. "The point is, this can be tailored and surgical. We've seen proposals for compensation suggest deferring for three years. But 52% of institutional investors remain with a manager for six years and 31% for 10 years or longer. Why force managers take their skin out of the game after three years, when you can design options that meet investors' horizons perfectly?"

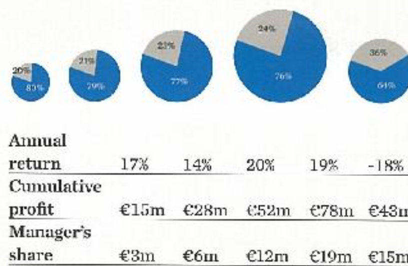
Kirill Ilinski, co-founder and CIO of Fusion Asset Management, agrees. But he wants to see managers go further than sharing downside risk proportionately with their clients. His firm's solution, 'Shock Absorber Fees' (SAFe), would see performance fees paid into a separate 'SAFe Account' each year; the manager can only get his hands on it when the client redeems (or when a pre-determined level has been attained) and in the meantime the entire amount remains at risk to cover losses. The manager, not the client, always takes the first loss as long as there is cash left in the SAFe Account.

"This asymmetry transfers some of the volatility of the strategy back to the manager," Ilinski observes. The result is a dramatic reduction in the client's downside risk for the same return – Sortino ratios double, and for many strategies client drawdowns become non-existent.

Ilinski believes this has big implications for the broader economy. "As the SAFe Account cushion grows the client will want to increase risk – otherwise the manager is only risking the top layer of the cushion he's built up for himself," he reasons. "By de-risking risky investments, pension funds can rebalance away from low-yielding assets into more economically-productive investments. And it's not a small number."

Taking the £1.6trn (€1.9trn) FTSE350 as an example and assuming that 20% of this market-cap is held by funds with SAFe Accounts with an average leverage factor of 1.5-times, Ilinski reckons the UK economy could benefit from £160bn of new equity investment. Removing the incentive to herd into hot, yield-enhancing markets could also reduce systemic risk, he suggests. His vision is of a regulated industry-owned trust company setting-up SAFe Accounts for all asset management funds and bank trading desks that pay performance-based fees and bonuses. During early AIFMD discussions he took the idea to UK Conservative MEP and shadow rapporteur Syed Kamall, who has raised the idea with the UK Treasury. On 7 December he presented it to a gathering of European industry, regulatory and government figures convened by the ▶

1. Not the 80/20 rule

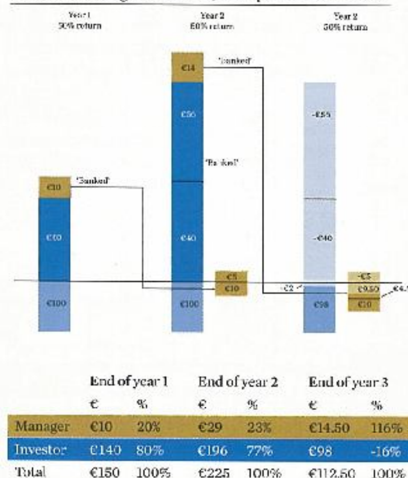


Annual return	17%	14%	20%	19%	-18%
Cumulative profit	€15m	€28m	€52m	€78m	€43m
Manager's share	€3m	€6m	€12m	€19m	€15m

The illustration shows cumulative profit sharing with a 20% 'annual banking' performance fee on $100 tracking the Dow Jones Credit Suisse Long/Short Equity index, in 2004, 2005, 2006, 2007 and 2008
Source: Optcapital; Dow Jones Credit Suisse Hedge Fund index

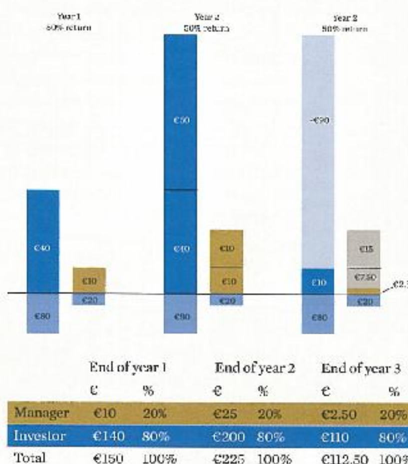
2. Annual-banking versus option-based 'clawback' performance fees

Annual banking mechanics, 20% performance fee



	End of year 1		End of year 2		End of year 3	
	€	%	€	%	€	%
Manager	€10	20%	€29	23%	€14.50	116%
Investor	€140	80%	€196	77%	€98	-16%
Total	€150	100%	€225	100%	€112.50	100%

Option/SAR mechanics, 20% performance fee



	End of year 1		End of year 2		End of year 3	
	€	%	€	%	€	%
Manager	€10	20%	€25	20%	€2.50	20%
Investor	€140	80%	€200	80%	€110	80%
Total	€150	100%	€225	100%	€112.50	100%

Source: Optcapital

International Centre for Financial Regulation (ICFR). "We believe this simple solution could change the way our industry works," says Ilinski.

It is worth recounting how Fusion arrived at this idea, because it tells us something important about the alignment of compensation structures with risk-taking strategies. Before co-founding the firm in 2004, Ilinski's job was trading equity index volatility-based protection for JPMorgan Chase's convertibles market-making book (he helped develop Credit Risk Reversal, the industry-standard model for pricing this kind of insurance). Similarly, until the financial crisis Fusion specialized solely in a range of 'insurance'-style investment products and hedging services, led by its flagship Long Volatility Fund. Ticking away innocuously and then delivering extremely high returns when market volatility spikes, this right-tail risk profile is precisely the opposite of the left-tail risk that sits most uncomfortably with the 'annual-banking' performance fee structure.

So what drew Fusion away from that structure? The Long Volatility fund was one of the best hedge funds to be in during 2008, and cash-strapped clients redeemed to make other parts of their portfolio whole again. Fusion recognised that this was not a sustainable business, and rolled-out new products, including an absolute return version of Long Volatility fund that contained some short-vol positions, and a pure short-vol cash management service called Fusion Libor+, which uses an 'intelligent carry' strategy in G10 currencies. 'SAFe' was about dealing with these left-tail, short-vol risks.

"The whole mentality of Fusion is to be very, very protective of downside," says Ilinski. "We always cut the tail, we always know how much we can lose, so when we moved beyond our initial range of short-risk products – which have very clearly defined downside – this fee structure was a natural progression to maintain that."

Ultimately, Fusion decided to move the intelligent carry strategy into a UCITS vehicle when it became clear that clients "preferred daily liquidity rather than monthly liquidity with downside protection", but Ilinski says the firm will use SAFe if it ever launches long-risk strategies. "It would work for anything that tries to extract a systematic risk premium over time, which is 99% of investment."

The fact that Fusion specialises in the 1% of strategies that are not long-risk has perhaps given it a non-biased perspective on the fee structure best-suited to long-risk portfolios. "If a manager doesn't want this arrangement, he doesn't want to put his money at risk first," as Ilinski says. "I'd say that that was a signal."

Well, sure – but it may simply signal that the manager is better off under the broadly accepted status quo. It is clear what is in it for clients, but what is in it for managers?

First, if the manager is prepared to risk 100% of his performance fee, he may be justified in raising that fee. Second, there is the marketing argument: under Optcapital's model, because performance fees are not banked each year the manager can report net returns that are not reduced by those fees; and both the Optcapital and SAFe models lead to lower reported strategy volatility. "Imagine how much easier your marketing guys' lives are going to be," says Young. "Managers down 20% in 2008 would have made up some of that with unclaimed fees, reporting 14-15% losses instead."

Third, a fee structure better-aligned with longer-term investment is likely to attract stickier money, making it easier to negotiate longer lock-ups (or obviating the need for lock-ups at all) and creating a more stable environment for capital expenditure and retaining talent.

And finally, there is a tax incentive. Since 2008, US managers have had to pay tax on their accrued performance fees: under basic deferred-fee systems, that means paying tax on unrealized income; neither Optcapital's options nor shares in a SAFe Account are subject to this tax. These are also tax-efficient ways to fund multi-year employee retention programmes.

When IPE surveyed its readers on the subject last month, 64% of those who did not invest in hedge funds cited fees as the reason. And as the Norway fund episode shows, even those who do not think fees are too high come under pressure from those who do. The incentive to align interests more clearly with those potential clients is clear. The structures outlined here suggest some ways in which that might be achieved.

No RESTing on laurels

REST Superannuation (The Retail Employees Superannuation Trust) is Australia's biggest in terms of membership, managing more than AUD18bn (€13.4bn) for almost 2m people. IPE caught up with CEO Damian Hill at its 10th Anniversary Awards in December to talk about how the fund structures – and compensates – its internal and external investment risk-taking capabilities.

Damian Hill, CEO, REST Supperannuation

IPE: REST has a formidable in-house investment management team. How does that affect what you do with external managers?

Hill: "We use both internal and external managers, and we deliberately employ, or potentially employ, both across the same asset classes. This is to make sure that we do not cut ourselves off from opportunities to exploit good eternal management. We like our internal team, not least because they have only one client – so we can be sure that they are not going to turn into asset gatherers."

IPE: Is there a performance-related element to your internal teams' compensation?

Hill: "Yes, we have a performance-based bonus system. It's pretty simple: they have to beat the market."

IPE: And how does that change the way you think about external managers and the way they should be compensated?

Hill: "We like to allocate to boutiques in order that we can be a cornerstone client. Indeed, we have been day-one investors with some managers. We usually start them off with a fixed fee, to help them fund themselves through the start-up phase, with a view to moving them onto a more performance-oriented fee structure."

IPE: So you clearly believe in the incentives that performance fees can introduce. What about the claims that are made about inducement to take irresponsible risk, and the problems surrounding the 'annual banking' fees?

Hill: "You certainly have to be sure that the managers you use are not simply gearing up to generate performance-fee revenue – but that's all part of the due diligence process, as well as having trust. There has been a debate about deferred fees and clawback structures across the Australian industry in general, and at REST in particular. In fact, the two largest Australian consultants – Frontier Investment Consulting and JANA Investment Advisers – recently put out some recommendations that covered these questions for consideration."

Beta-zero fees

Bernd Scherer tells Martin Steward that asset managers should take a good look at – and possibly hedge – the market risk embedded in their fees. How might that change the relationship with clients?

Many asset management companies went bust thanks to the financial crisis. No wonder many more are now taking a closer look at their key business risks.

"Sometimes it takes a catalyst to create awareness – and P&L is an excellent teacher," says Bernd Scherer, professor of finance at the EDHEC Business School and former Morgan Stanley managing director.

Scherer's attention is particularly focused on the pure market exposure risk that asset managers run via the asset-based fees that generate the bulk of their revenues. He feels this is massively overlooked by the industry, which assumes that its key risks are operational. But if an asset manager charges fees as a percentage of assets under management, and if those assets fall in line with the market, it stands to reason that revenues will fall in line with the market. A manager running €10bn and charging a fee of 0.50% immediately has a directional long market exposure of €50m before he even starts – a hugely variable income stream in a business with very high fixed costs. "What has been called scaleability is really just operating leverage," Scherer observes.

It took 2008 and the need to "fight post-bonus depression" to spur him into writing a series of papers that are now appearing in academic and