UNDER PRESSURE: THE CHANGING LANDSCAPE OF INVESTMENT MANAGEMENT FEES

As investors continue to increase their demands on fund managers, both sides are focused on the level and structure of fees. Philip Dickie and Christopher Bodden from Harbour examine the pressures and how fund managers are adjusting to them.

Many hedge fund managers would agree that raising and retaining capital in the current environment is extremely challenging. New managers are struggling to attract capital on viable terms so that they can support their fledgling businesses, and many existing managers have faced redemptions from investors dissatisfied with the relative underperformance of the asset class in recent years.

As the demand for investor capital exceeds the supply, proactive (and reactive) managers have revisited their fund terms in an attempt to make them more competitive. Along with a fund's strategy and historical performance, commercial terms are one of the key areas that investors consider in their allocation process.

One primary area that managers and investors have both focused on is investment management fees. Fees are observable, measurable, and are within the control of the parties to change. There has been a lot of discussion of fees from both sides, as the parties try to find an equilibrium that aligns their competing interests.

This discussion has been taking place for a number of years now with reasonable success, but continues to evolve. In a December 2016 investor survey (Prequin Investor Outlook: Alternative Assets, H1 2017), 58 percent of investors reported an improvement in fund terms over the course of 2016, with 55 percent of them reporting reduced management fees. However, 76 percent of these same investors also see room for further reductions in management fees over 2017. Similarly, 48 percent of these investors are seeking reductions in performance fees charged, and 57 percent are looking for changes in how they are charged.

Investors, under their own pressures to reduce costs and improve returns, want to ensure that fees are commensurate with the product and the alpha it is generating for them. A management fee is intended to cover the cost of running the manager's business, so investors do not want to see this fee being a profit centre for the manager at their expense.

Similarly, they want performance fees that are based on the alpha that has been generated on their behalf. Most investors are reasonable in their expectations—they have nothing to gain from driving their underlying managers out of business—but at the same time, they demand value-accretion and are not going to pay managers a profit on non-alpha-generating activities.

Managers, on the other hand, must carefully weigh a number of factors when setting their fees. Too high and investors may walk away, but if they set them too low it may impede their ability to run their business, especially in years where there is no performance fee

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earned or when the assets under management (AUM) figure is low. Managers thinking about reducing their fees to attract or retain capital should also keep in mind that fee changes are unidirectional—once they go down, it is very unlikely that they will ever go back up.

Better ways to reward

Investors are more interested in new fee models that better measure and reward alpha than they are in simply wanting performance fees to go down. The means to do this vary—from simple to highly creative.

Managers can introduce hurdle rates to their performance fee calculations, either as fixed amounts or as variable hurdles, such as a benchmark index. The hurdle is a proxy for the fund’s beta, so that only the excess alpha is rewarded. The difficulty is finding a hurdle that is relevant to each fund, and which truly represents the beta component of the fund’s returns.

Managers can also introduce tiered performance fees whereby the performance fee percentage increases as the amount of the annual return goes up, or multi-year performance periods whereby the performance fee is paid only on total alpha generated over time.

The latter is particularly appealing to investors who have committed to a longer lock-up period, or for strategies that are more illiquid in nature. Managers are also more likely now to allow investors to retain their high water marks when switching between the manager’s funds.

Management fee arrangements are also under review. Investors recognise that managers, especially emerging managers, rely on these fees to support their business so they do not want to unfairly restrict them, but they also do not want to overpay.

This has led some to implement a tiered management fee structure, whereby the fund pays the manager a higher percentage fee when AUM is low, with a declining percentage paid as AUM grows. In this way, the dollar amount of the fee remains relatively constant, and approximates the operating cost of the fund at its current size.

Managers are also using management fee changes to make their funds more attractive to investors, by reducing fees or giving fee waivers under certain conditions.

It would be remiss not to mention the well-publicised ‘1 or 30’ model developed by the Teacher Retirement System of Texas, and its consultant, Albourne Partners. Under this model, the manager receives only one fee each year: the greater of a 1 percent management fee or 30 percent of performance in excess of a benchmark.

In years when the fund underperforms its benchmark, management fees are paid but then deducted from the following year’s performance fee. The management fee is effectively an advance of future performance fees, meant to ensure that the manager has sufficient working capital to run the business at all times.

As with hurdle rates, however, the model is difficult to implement where there are no relevant benchmarks, and alpha and beta are not so easily distinguished. Possibly because of this, relatively few managers and/or investors have actually implemented the ‘1 or 30’ model.

Structuring fees

This highlights an important point when considering how to structure fees: the fee mechanics need to be transparent, measurable, and easily understood. Overly complicated fees may annoy or confuse investors, or cause them to spend an unnecessary amount of time to work through what they will actually be paying under a variety of scenarios.

Complicated fee structures that do not fit easily into fund accounting systems also increase the risk of human error in calculating the fees and the possibility of net asset value (NAV) restatements. We believe this is why, despite all the new models that are being discussed, the vast majority of managers who have made changes to their fee structures have decided to keep the traditional fee mechanics and simply reduce the percentages charged.

When amending fees, managers must also consider the delivery method that they will use to offer the new fees, or an assortment of fees, to their investors. Although investors continue to access preferential fee terms through exclusive funds-of-one and managed accounts, or pursuant to a side letter, many managers today are choosing to make a variety of terms available to all investors through multiple share classes. These share classes are simple to set up and administer, and give investors the ability to select the combination of terms that appeals most to them.

Managers are often willing to trade a portion of their fees for a more stable capital base. Thus, it is common to see fee breaks offered to investors in exchange for a longer lock-up on their shares. Investors with a long-term investment horizon are comfortable committing to stay with good managers over a longer period if they are getting something in return.

Founders’ classes have been common for some time to help emerging managers attract longer-term capital to get them off the ground. These classes typically offer reduced fees in exchange for a longer lock-up period. They often come with capacity guarantees as well, allowing the investors to top-up their investment on the same preferable terms as the fund grows. These ‘limited time’ offers are usually available only for an initial period or until the fund reaches a certain AUM, whichever comes first.

There has also been an increase in the use of Institutional share classes, where fee breaks are given when invested capital exceeds certain thresholds. These classes are often initiated for a single, large investor, but once established they can be offered to any other investors who are also willing to invest similar levels of capital.

There are countless ways to modify fee structures to make them more appealing to investors. It is less important which approach is used, as long as fees are periodically reviewed and updated to ensure that they are appropriate for the fund and create a fair balance between the interests of managers and investors alike. ■

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