



Pay for "Play"

Blame it on the hedge funds—the trend to performance-based fees

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Despite competition, money management fees are going up, not down. The root cause, some grouch, is performance-based fees nudging out asset-based fee arrangements.

Hedge fund fees usually are structured to pay a flat expense fee and a performance fee if returns are above a targeted level—e.g., if returns are more than x% annually, the profits are shared: 80% to the investor and 20% to the fund manager.

In time, performance-based fees gravitated from being a strictly hedge fund manager compensation arrangement to one that straight large-cap equity managers may require. While some argue that performance-based fees better align interests, others argue that it amounts to no more than fee inflation.

The California State Teachers' Retirement System (CalSTRS)—the second largest public pension fund in the U.S. with \$171.1 billion in assets as of May 2007—has been experimenting with compensating money managers by using performance-based fees since the early 1990s. We have not adopted it on a consistent basis," says Christopher J. Ailman, Chief Investment Officer of CalSTRS. The end result of that experimentation is a rather lackluster acceptance. "Our experience didn't lead us to be opposed," says Ailman, "nor fully enthusiastic."

Traditionally, money management fees are asset-based, i.e., investors pay a percentage of the portfolio, usually quarterly, says Paul Bracaglia, a partner in the Philadelphia office of PricewaterhouseCoopers LLP.

For example, on a \$100 million portfolio, a fee of 30 basis points would yield \$300,000 in fees annually. Asset-based fees inherently put people on the same side of the table, argues Bracaglia, since money managers can only increase their fees if they increase the portfolio.

Performance-based fees, on the other hand, base fees on portfolio returns. In a pure performance-based fee arrangement, a manager would not receive any income unless there is a return on investment—e.g., if a \$100 million account had a 10% return and the fees were 10% of profits, there would be \$1 million in fees. Pure performance-based fees, however, are actually very rare, says Robert Arnott, a principal at Research Affiliates in Pasadena, California.

Instead, most performance-based fee arrangements give managers a set floor of fees and a percentage of profits. For example, says Arnott, most hedge fund managers get "2 plus 20." This means that the manager gets a guaranteed annual fee of 2% of assets plus 20% of returns. So, if a \$100 million portfolio had a 10% return, the hedge fund would then take \$2 million for a base fee and an additional \$2 million in performance fees—although some managers only charge the performance fee after subtracting the base fee and a hurdle from the performance.

Eating Money Managers' Cake

The main complaint about performance-based fees is that they allow money managers to have their cake and eat it, too. "Why do we need to pay someone an incentive to do their job?" asks Bracaglia. "It's their job to increase the portfolio. Money managers usually charge

30 basis points to 1 1/2%—that's fair compensation for managing money. Why should we then give them an additional incentive to do their job?"

Furthermore, says Bracaglia, often the point at which the manager is owed incentive fees is relatively low. For example, he says, assume the threshold for the incentive fee is a 6% return on investment, and the portfolio earns an 8% return on investment—the manager is owed an incentive fee on 2% of the return. However, if the S&P 500 returned 12%, says Bracaglia, that manager has underperformed the market, but the plan is still required to pay incentive fees.

The other problem, says Ailman, is that, unless the investment has a finite period of time, fees tend to be asymmetrical. Managers share in the profits on the upside, but do not participate 100% on the downside. "If the fund underperforms, they don't rebate fees," he says.

For example, says Ailman, assume a pension fund invests in two different types of performance-based fee investments: a large-cap public equity account and a private equity account. If both accounts perform well in a given year, then both managers will receive incentives. However, if performance trails two years later, a pension fund can offset losses against gains in the private equity account, and if the net result is little or no return, the manager receives no incentive.

However, in the large-cap account, the pension fund pays performance fees in years the account does well, but does not receive rebates of fees in years the account underperforms. "In the end, you can have no profit and you paid out higher fees," he says.

CalSTRS requires managers to aggregate returns in private equity transactions. "I want to aggregate positive and negative alpha over the life of the account. Just because someone makes you money in the beginning, you shouldn't have to pay an extra fee if, in the end, you lost money or broke even," says Ailman.

This leads to the biggest complaint: that performance-based fees can be much larger than asset-based fees for the same return on investment. This can lead to investors believing the fee is too high even though it is what was negotiated. Arnott tells of a client who disputed a performance-based fee. Under the terms of the contract,

Arnott's firm was owed a performance fee of \$250,000. The client, however, only wanted to pay \$195,000. Arnott reports that Research Affiliates accepted the \$195,000 from the client. "The difference was small enough that it wasn't worth fighting over, but we dropped the client," he says.

The question, says Bracaglia, is whether the same returns can be had for lower cost. The question is not out of place, he notes, since 401(k) participants now are suing trustees for not controlling costs. This puts trustees in a tough place, he admits. The industry is moving to incentive fees, but trustees also have to control costs. "I'm damned if I do, damned if I don't," he says.

Performance-based fees are nothing new, but there never was a stampede toward them from either the managerial or fund side. Money managers resisted accepting performance-based management fees because, if performance softened, revenues dried up, says Arnott. However, that has changed.

"You're starting to see increasing use of performance-based fees," says Arnott, "because, if managers do a good job, then they want to be compensated for it."

Plan sponsors' acceptance of performance-based fees has been even more gradual, and is still far from the norm. Fifteen years ago, 5% of assets under management were in performance-based fee arrangements; today, that number is between 15% and 20%, says Arnott.

Jumbo sponsors, those with \$25 billion and more, generally have part of their assets managed under performance-based fee arrangements. Ailman, however, takes a different view, noting that sponsors are not so much insisting on performance-based fees but finding they may be the only option.

"We're seeing more equity managers who don't want to get just asset-based fees," he says. Adding insult to injury, Ailman says that CalSTRS' experience has been that performance-based fees have not helped the performance of those managers.

The new insistence on performance-based fees is leading to fee escalation, say Ailman and Bracaglia, despite growing competition. Competition should be leading to lower fees not higher fees, says Bracaglia. "There are more competitors, but prices are going up," says Ailman. "The market is demanding more, and they are getting it."

"The bottom line," says Ailman, "is that hedge funds are not an asset class, they are a compensation scheme, and it's affecting every part of the investment management industry."

When Performance-Based Fees Work

Private equity and real estate are the best venues for performance-based fees, says Christopher J. Ailman, Chief Investment Officer of CalSTRS. Both private equity and real estate tend to have finite time periods—they have certain beginnings and endings. This makes it easier to aggregate and determine overall returns on which to base those fees, he says. With fixed income and public equity investments, however, the time period is infinite and, because you pay incentives in up years, but do not get rebates in underperforming years, the tendency is to pay out more in fees than what would have been paid under a traditional asset-based arrangement.

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