Why learn about performance fees?

> "Never, ever, think about something else when you should be thinking about the power of incentives.
>
> Charles T. Munger

The fee structures that we have in place are the incentive structures that our industry operates under. These have the capacity to influence how firm owners and managers think and operate.

Why learn about performance fees?

1. The question of fees is growing in importance as the market cycle changes

2. Status quo of weak price competition means managers are not significantly impacted by poor performance of their funds

3. Advisers will need to understand the fee structure in order to identify funds that offer value for money over the long-term future

1. The question of fees is growing in importance

Many factors used to choose funds are backward looking:

- Past performance
- Total costs, including annual management fees charged
- Investment manager's approach to security selection

Performance

- Affected by market cycles
- There is little evidence of persistence in outperformance
- Fluctuates, with long downturns

Fees

- Biggest component of costs and charges reducing return
- Felt less during periods of strong performance
- Higher impact during times of weak performance.

Approach

- Often inconsistent
- Affected by performance
- Influenced by fees

As the decade long bull-run turns, **advisers' value add** will be understanding the interplay between these factors to select the funds that offer best value for money on a ***forward-looking*** basis.

2. Status quo: Market forces are not squeezing low value options out

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> We find weak price competition in a number of areas of the asset management industry
>
> FCA Asset Management Market Study

FCA Asset Management Study, CFA Value for money Positioning Paper, Morningstar (*How Long Can a Good Fund Underperform its Benchmark?*, March 2018)

2. Status quo: Market forces are not squeezing low value options out

- Favourable market cycles make less skilled managers look skilled
- Poor performance does not always lead to fund closure
    - Weak performance isn't always painful to the fund manager
    - Worse performing funds may be merged with better performing funds
- Investors do not tend to leave underperforming funds easily
    - May not be aware of underperformance – obscured by complex reporting
    - Not compared to a benchmark – absolute performance in a bull market may look good

FCA Asset Management Study, CFA Value for money Positioning Paper, Morningstar (*How Long Can a Good Fund Underperform its Benchmark?*, March 2018)

3. Understand the fee structure to identify value for money

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> It is important not to equate Value For Money with lowest cost in isolation
>
> CFA UK Value for money Position Paper

3. Understand the fee structure to identify value for money

- Fee levels and performance are not correlated:
    - Many active funds deliver disappointing performance but charge high fees
    - Conversely, in a poor-performing fund, low fees do not mean higher return
- Understanding the fee *structure* can help you work out likely future value for money
- There are 3 types:
    1. Flat percentage: manager paid based on fund size
    2. Performance-based: manager paid based on **benefit delivered**
    3. Combination

What do you need to understand about the different fee structures?

Fees matter for more than one reason: they reduce return and influence manager's behavior.

1. Flat fees have advantages, but there are also potential negative consequences
2. Ideally investors should pay fees based on the total value delivered over their investment period.
3. Performance-based fees can be the closest practical solution – *if* they are structured fairly.

1. Flat percentage: manager paid based on fund size

Advantages of a specified percentage

- Simple to explain
- Easy to calculate
- Easy to compare
- Predictable

> "[the fund provider] took a charging structure that was fairly simple and straightforward to explain to investors, even if it wasn't entirely fair, and made it complicated and hard to explain"
>
> Adrian Lowcock, as quoted in the Financial Times*

*Riding, Siobhan. "Fidelity and Allianz performance-fee funds struggle to pull in money". The Financial Times. 11 Feb 2019

1. Flat percentage: manager paid based on fund size

Potential negative consequences:

- Performance clustering or closet tracking to avoid losing clients through very different return to others, or the index.
- Growing assets above the ‘capacity threshold’ beyond which performance suffers.
- Investors suffer downturns disproportionately to managers.

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> The prevailing [flat] fee model incentivises firms to grow assets under management, which is not necessarily aligned with investors’ best interests.
>
> FCA Asset Management Market Study Final Report

Flat fees do not align managers interests with investors

	Manager adds value	Manager destroys value	Manager delivers market return
Cumulative outperformance generated by the manager	1	2	3
Fees charged as a flat % of client's assets	Little reward	Little penalty	Fee is stable
Value for money	✓	✗	✗

Flat fees do not align managers interests with investors

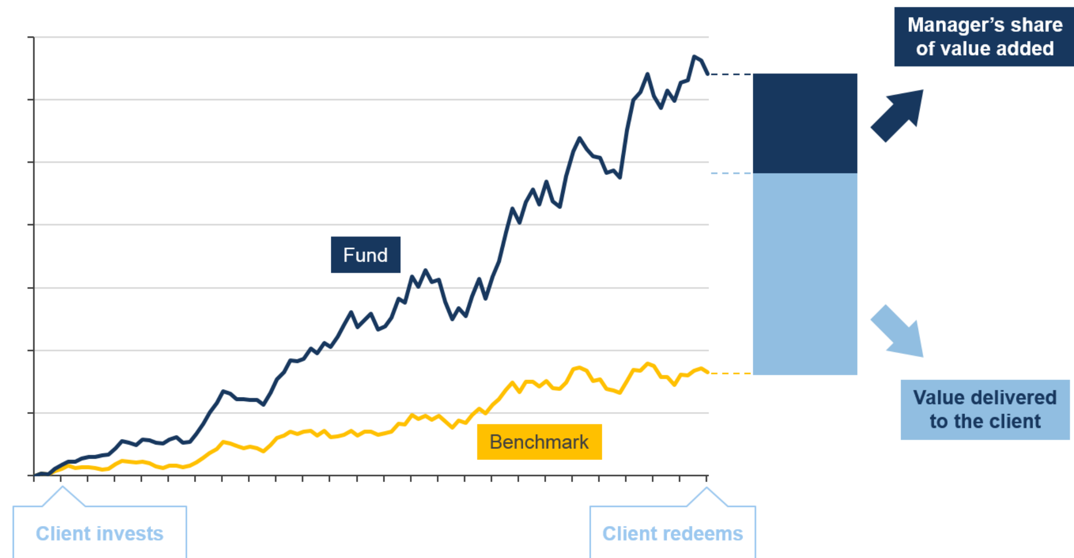
Results:

1. No incentive to outperform
2. Gather assets
3. Avoid underperformance

Ideal: Pay for value delivered at the end of the investment period

In a perfect world, investors would pay nothing until they redeem their money at the end of their investment horizon. At that point, both parties would know precisely how much value was added by the manager and fees could be calculated based on a pre-agreed sharing ratio.

- In a pay-for-performance world, underperforming managers would feel their share of the pain.
- Managers who consistently fail to deliver value would go out of business



2. Performance-based fees could be the most practical solution

The manager takes a percentage of outperformance

- Often poorly disclosed and not well understood
- Not all performance fees truly reward based on benefit delivered
- Should be symmetric

Managers share return *and* risk with symmetrical performance fees

Results:

1. Incentivised to outperform
2. No incentive to grow too much
3. Managers are mindful of client's risk
4. Managers assume some risk

Topics covered

- Defining performance
- Base fees and hurdle rates
- Percentage of outperformance
- Fee symmetry

Defining performance

1. Start with the **fund's objective**
   - The fund's objective states the fundamental benefit the manager aims to deliver to investors.
   - A performance fee should therefore be paid if the manager delivers *this* benefit.
2. Pay careful attention to the **benchmark, or return target**
   - Look for a benchmark if one is not clearly disclosed – fund performance should be assessed against a relevant benchmark to determine the value the manager has added.
   - Any calculation of performance for fee purposes should use a benchmark aligned with the fund's objectives and strategy and *not* an easier or unrelated one.

Defining performance – examples of what to watch out for

Fund objective: long-term capital growth by investing in global equities

- Performance should be assessed, and the fee calculated, based on performance relative to a global equity benchmark, *not* relative to, for example, UK equities, bonds, cash or headline inflation. Even a peer group benchmark may not be appropriate for calculating fees since the peer group may have underperformed overall.

Fund objective: Absolute return through different markets, targeting cash (3-month GBP LIBOR-0.125%) + 4%

- A performance fee calculated relative to, for example, just the 3-month GBP LIBOR does not measure delivery of the benefit clients would expect – i.e. the stated return target, which is almost 4% higher.

Base fees and hurdle rates

1. Is there a base fee?
    - This is the fee paid even when there is no outperformance
    - The lower the better. If a base fee is charged, it should ideally be in line with the fee charged by a passive alternative to the actively managed fund*.
    - A base fee of zero would mean the fund is even cheaper than an index tracker fund if it delivers similar performance.
2. Hurdle rates
    - This is the performance above which a performance fee starts being charged.
    - It should be the point from which a manager can be said to be adding value.
    - The hurdle rate should therefore ideally be the same as the benchmark.

*This is the structure used in Japan's Government Pension Investment Fund (GPIF), the largest pool of retirement savings in the world.

Base fees and hurdle rates – examples of what to watch out for

Fund objective: long-term capital growth by investing in global equities

- Index tracker fees typically charge approximately 0.1% per annum. Any base fee should not be higher than that for providing performance equal to the benchmark.

Fund objective: Capital growth from UK and global equities

- A cash-equivalent hurdle rate, GBP LIBOR for example, is inappropriate. It is not aligned with the fund's objective and is too low a bar to use to measure the value added by the manager.

Percentage of outperformance

1. What proportion of outperformance goes to the manager?
    - Also known as the ‘manager sharing rate’, this can vary from 10% to 50%
    - If there is a base fee, the sharing rate should be lower.
    - A higher base fee should come with a lower performance component.
    - Managers charging no base fee could have a higher share of performance.

2. Look at the sharing rate in the context of the hurdle rate
    - A high sharing rate against a low hurdle rate means managers are rewarded despite not achieving what the investor would consider to be the target return.

Percentage of outperformance – examples of what to watch out for

Fund objective: long-term capital growth by investing in global equities, measured against the FTSE All Share Index

- A 10-20% sharing rate for performance above a *cash* target would inappropriately reward the manager for delivering return that is not aligned with investor expectations.

Fund objective: Absolute return through different markets, targeting cash (3-month GBP LIBOR-0.125%) + 4%

- A sharing rate of 10% for performance above a hurdle rate that is lower than the targeted return (e.g. the 3-month GBP LIBOR) charged *in addition* to a base fee of 1.5% would result in excessive total fees being charged, and which are not reflective of the benefit delivered.

Fee symmetry

1. Does the manager share in outperformance *and* underperformance?
    - A symmetrical fee has a mechanism that results in the manager's profits being negatively impacted by underperformance, usually through reducing the base fee.
    - The manager should be 'penalized' for poor return to the same extent that as being rewarded for good return.

2. Pay attention to the specifics:
    - **A high watermark**: A high watermark is the fund value that must be regained after underperformance, before performance fees can be charged again.
    - **A fulcrum fee**: There is no sharing rate: managers charge a base fee for performance equal to the benchmark, which then increases or decreases by a specified percentage for out- or underperformance.
    - **Fee refunds**: A manager applying a truly symmetrical sharing rate may actually refund fees.

Fee symmetry – examples of what to watch out for

Asymmetric fee: Base fee of 1.5% plus 15% performance fee for performance above a hurdle rate of 12% measured over a 1-year period. On any day that performance is more than 12%, a performance fee is charged.

- If the fund's benchmark return is more than 12%, the performance fee would still be charged when the fund underperforms. There is also no penalty for subsequent periods of performance lower than 12%. The fee is not based on benefit delivered over time.

Asymmetric fee with a high watermark: Base fee of 1.5%. 10% performance fee for performance above the benchmark, with a high watermark.

- The manager is rewarded for outperformance and after underperformance, investors won't be charged for gains made as the fund recuperates losses.
- However, the 'pain' of any underperformance is actually borne by the investor alone as the manager still earns the base fee.
- Research* suggests this type of fee unduly influences managers' approach to investment risk, which may not be in investors' best interests.

****Heads we win, tails you lose.*** Why don't more fund managers offer symmetric performance fees?**, Clare et al, Cass Business School, October 2014**

Asymmetric fees with a high watermark provide *upside* alignment

	1	2
Cumulative outperformance generated by the manager	Manager adds value	Manager outperforms, then underperforms
Fees charged as a % of client's assets	Reward	Also reward!
Value for money	✓	✗

Fee symmetry – examples of what to watch out for

Fulcrum fee: Base fee of 0.65% for performance equal to the benchmark. A symmetric fixed performance fee of 0.20%.

- This means that the manager is rewarded for outperformance by earning a fixed fee of 0.85%, and is penalised for underperformance by a reduction in the base fee to 0.45%. While the fee is symmetrical, continued underperformance is not further penalised. This means that a long-term underperforming fund would still make a profit.

Fee refund: Zero base fee. 50% sharing rate for performance above or below the benchmark, which means fees are charged for performance and refunded during underperformance.

- The manager is equally rewarded or penalised for out- or underperformance.
- Research* suggests this type of structure aligns managers interests with investors, giving managers a strong incentive to maintain performance, and finds a positive relationship between the level of the performance fee and fund alpha.
- However, the choice of benchmark and/hurdle rate is even more important for the measurement of this fee to be fair to investors.

*Starks (1987), Holmstrom and Milgrom (1987), Ou-Yang (2003), Kyle et al (2011), Dybvig et al (2010), Golec (1992) as quoted in *Heads we win, tails you lose*, Cass Business School, October 2014

Hallmarks of good performance fees

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Of course that does not mean that every form of performance charge is okay - they have to have the right characteristics to be justified. I think funds that charge a performance fee need to have a low base fee. So if these funds under-perform, managers won't be awarded a performance fee and investors will pay a base fee that is lower than the market average.

James de Sausmarez
Director, Henderson Global Investors

Hallmarks of good performance fees

- ✓ Net of costs performance measurements
- ✓ No cash benchmarks. Performance measured against a relevant benchmark.
- ✓ Low or no base fees
- ✓ Hurdle rate lower than the benchmark *only* if the base fee is lower than a passive alternative
- ✓ High watermark
- ✓ Symmetric – managers are penalized for underperformance
- ✓ Factsheets and marketing documents clearly set out the structure, when performance fees are triggered and what happens during underperformance.