



# The Focus On Fees

## A guide to preparing your funds

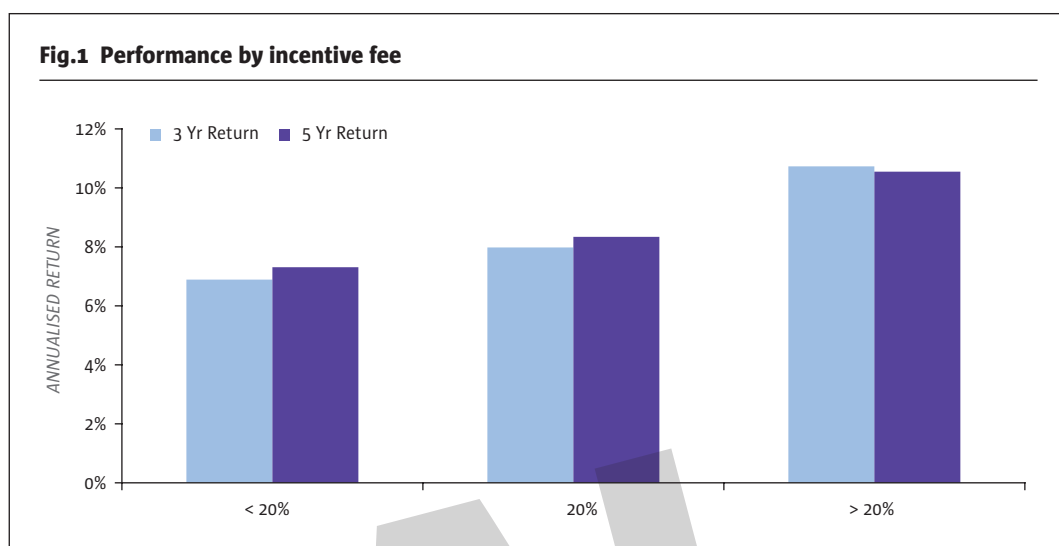
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Over the last several years, hedge fund investors have increasingly focused on the fees they have been paying to their hedge fund managers, and rightfully so. Few would argue that the current hedge fund model, while certainly successful for many limited partners, has not been more successful on average for the general partners. It is with this reality foremost in mind that fiduciaries of large institutional investors in hedge funds have aggressively negotiated for fee discounts. And the evidence suggests that they have been successful.<sup>1</sup> Research indicates that the average fees paid by hedge fund LPs are now approximately a 1.6% management fee and 18% profit incentive.

Nevertheless, I've long argued that many investors have taken a rather un-nuanced approach to reducing fees, one fraught with its own set of adverse selection biases and unintended consequences. Some investors I have spoken to have a hard and fast rule of simply refusing to pay 2% and 20% ever, for any manager, let alone anything higher. Should the manager not budge, they will simply pass on the opportunity. While this may eliminate some of the best hedge funds ipso facto, worse still are the practices of some LPs who screen the universe of managers looking for those whose rack rate is already below the "standard" 2% and 20%, only beginning due diligence with a list of discounters. This behaviour is puzzling.

In theory, any service provider must compete on either quality or price, and in some instances both. Taken to the logical extreme, in any highly competitive industry with thousands of participants and few barriers to entry, a buyer who screens the universe of providers solely for the lowest cost competitor will almost assuredly have also identified a seller amongst the lowest quality providers. Investment management is certainly a highly competitive industry and searching for the lowest cost provider may be perfectly rational in the commoditised world of beta returns. In this highly efficient market, the difference in quality between high-cost and low-cost is extremely low, as evidenced by the tight dispersion of returns between top and bottom quartile managers and indeed, the lack of persistence of performance in returns across quartiles.<sup>2</sup>

However, this same decision is counterintuitive at best, outright counterproductive at worst, when searching for alpha generators. Unlike beta managers, evidence<sup>3</sup> suggests that hedge funds do exhibit persistence of returns over time, as well as significant dispersion between top and bottom quartile managers. Now, if the reader accepts that alpha may in fact exist, the author concedes it is admittedly a rare find; but one can hardly expect a manager that truly possesses an alpha edge



to give it away cheaply. It is a high-quality, high-value service. Rather, one should question any firm purportedly selling true alpha at a significant discount to the competition. It's perfectly *irrational* to expect the highest-quality provider (true alpha generator) to also be a discounter (beta provider/asset gatherer). Not surprisingly, recent research from Prequin<sup>4</sup> indicates that the managers who generate the strongest returns net of fees charge some of the highest fees.

Prequin has found a direct monotonic relationship between the annualised returns over several time periods and the performance fees of hedge fund managers. Those firms generating the strongest net of fee returns do in fact charge the highest performance allocations. More interestingly, when discounted for volatility the results are the same. Managers with a performance fee above 20% generated Sharpe ratios of 2.11, those charging 20% or less just 1.18.

While simply searching for the lowest-cost manager clearly makes sense in commoditised beta space, knowingly taking a portfolio tilt away from the highest alpha generators when seeking alpha does not. Now this is not to say that investors should not seek to reduce fees and access the highest-quality managers at the best possible price point. Instead, investors should take a more nuanced approach to seeking access to the most desirable return streams as efficiently and cheaply as possible. A quick thought exercise illustrates how one could apply a more effective paradigm towards reducing hedge fund fees. While the discussion below may seem overly simplistic to some or patently unrealistic to others, it is in fact based on direct due diligence.

Certain hedge funds (global macro or CTA, typically) often offer the opportunity to invest in the exact same investment strategy (indeed, often the exact

same fund via different share classes) at different exposure levels. In the scenario below, we have one fund offered in two share classes – Class A and Class B. Class B simply uses twice as much leverage as Class A.

For example, if Class A were to have equity of \$100, it would invest \$20 in margin for an interest rate futures contract (to make it simple, let us state this results in notional value of \$1,000) and the remaining \$80 in cash. Class A is then 10 x levered, or notional of \$1,000/equity of \$100. Class B would take the same \$100 and invest \$40 in futures margin on the same interest rate product, controlling notional value of \$2,000, and invest the remaining \$60 in cash, preferably outside the prime broker. This is 20x leverage, or notional of \$2,000 over equity of \$100. The result is a perfect 1:2 ratio between gross performance and volatility for both funds, and (nearly) identical Sharpe ratios.

	CLASS A	CLASS B
Mgmt fee	2.00%	2.00%
Incentive Fee	20%	20%
Exposure	1 x	2 x
Gross Return	5%	10%
Volatility	10%	20%
Risk Free	0.15%	
Sharpe Ratio	0.49	0.50

It follows then that an equity investment of \$100 in both funds results in the same management fees, but very different returns, assuming a 5% gross return for the low exposure share class for the full year.

**Table 2. Equal equity invested**

	CLASS A	CLASS B
<b>Investment</b>	\$ 100.00	\$ 100.00
<b>Gains</b>	\$ 5.00	\$ 10.00
<b>Mgmt fee</b>	\$ 2.00	\$ 2.00
<b>Incentive Fee</b>	\$ 0.60	\$ 1.60
<b>Ending Value</b>	\$ 102.40	\$ 106.40
<b>Net Return</b>	2.40%	6.40%

It is apparent that although the limited partner pays the same management fees on either investment, Class B generates higher returns and higher incentive fees, albeit via simple leverage and clearly not alpha. More importantly though, Class B shares generate higher returns per unit of management fees paid. Intuitively, most would likely agree that Class A appears rich relative to class B, but this can be taken one step further and quantified precisely.

To that end, in order to put these two classes on equal footing from an exposure basis rather than a naïve equity-invested perspective, an investor would have to allocate \$50 to Class B and place another \$50 into T bills. The result would be margin of \$20 (or 40% of \$50), and a total of \$80 in cash (60% of \$50, or \$30, and the additional \$50). These portfolios are now exactly identical with a notional exposure of \$1,000, but Class B, which is nominally the same management fee, is now clearly cheaper than Class A. To equalise the cost of the separate share classes, Class B should have a management fee exactly twice that of Class A, and this would result in precisely the same net of fees performance.

**Table 3. Equal exposures**

	CLASS A	T bills	CLASS B
<b>Investment</b>	\$ 100.00		\$ 50.00
<b>Gains</b>	\$ 5.00		\$ 5.00
<b>Mgmt fee</b>	\$ 2.00		\$ 1.00
<b>Incentive Fee</b>	\$ 0.60		\$ 0.80
<b>Ending Value</b>	\$ 102.40		\$ 103.20
<b>Net Return</b>	2.40%		3.20%

This is actually quite common in macro or managed futures, where exposures can easily be adjusted by utilising more or less of the equity as futures margin. The pricing on these funds is often confusing to investors, and they may select the more expensive share class simply because they are unwilling or unable to accept the higher volatility level, or worse perhaps believing they are

getting a discount. Sometimes managers will offer a nominal discount on the low leverage version, say 1.5%, versus 2.0% on the double class. In this instance, the 2.0% class is still only two-thirds the true cost of the 1.5% version when equalised for exposures. Avoiding the 2.0% share class simply by policy could actually result in higher costs. In fact when confronted with this analysis on pricing, I've had managers confess the only reason they don't equalise the fees is because many big-ticket investors are "too stupid" to realise they are overpaying for the low exposure version! While this type of response may be surprising to some, investors should realise hedge funds literally try to hit the highest bid wherever possible.

Whereas the relative cheapness or richness of individual share classes within one strategy is mathematically and definitively measurable as discussed above, the same process and concepts should be applied to vetting the fees of distinct hedge fund managers. Since the purpose of hedge funds is ostensibly to access a unique or differentiated return profile unavailable via traditional investment products, the key to valuing a hedge fund manager's cost rests in the investor's ability to identify unique return streams to begin with. This necessarily requires the specialised skill set of assessing the ex ante probability for a hedge fund manager to generate alpha or high risk-adjusted returns.

The tool set necessary to do this is beyond the scope of this article, and clearly if an investor is not able to identify alpha, then that investor should focus on accessing the lowest-cost betas available. But if you want alpha, find it first and foremost, and then secondly get it at the most attractive price possible. Frankly, if a hedge fund portfolio is not singularly committed to finding the best risk-adjusted net of fee returns possible, then don't have one.

In the end, nominal fees are irrelevant, but fees relative to the leverage utilised or notional amount of assets controlled per unit of equity are important. Fees relative to the levels of risk-adjusted return and alpha generated are important. Disentangling alpha and beta is admittedly difficult, so fees relative to net of fee total returns are also important. In the end, you don't eat alpha; you eat total return. A process that attempts to identify the most attractive return profiles from both an alpha and total return perspective, and then focuses on ensuring the limited partner retains an acceptable percentage of both alpha (perhaps 50% to 60%) as well as gross return (70% to 80%) across expected probability distributions is more likely to result in a better net return outcome for the portfolio as a whole than one which naively zeroes in on reducing nominal costs. **THFJ**

**FOOTNOTES**

1. See Beales & Unmack (2012). The trend down has been documented for some time (Whitehouse 2010). Further, this trend is confirmed through numerous other sources including prime brokers such as J.P. Morgan and Goldman Sachs, consultants such as Albourne and direct interaction with hedge fund managers and other LPs (for instance, see Dumlao [2013]).
2. Fund Evaluation Group (2013) has quite nicely summarised into a client-ready presentation a great deal of research from Fama & French, William Sharpe, among others that details the lack of alpha (negative alpha?) present in public equity managers on the average. The underlying academic research is available on SSRN for those wishing to do further reading.
3. Boyson (2008) found that a portfolio of funds with strong prior performance outperformed a portfolio with poor prior performance by 9.6% per year. Ammann et al. (2010) found statistically significant performance persistence for up to 36 months.
4. See Preqin (2013), and Williamson (2013).

**SOURCES**

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