Research Review: Paying for performance

Compiled by PortfolioConstruction Forum | 28 October 2013

We asked the research houses: For what types of funds are performance fees warranted, and what is a reasonable performance fee structure?

Morningstar

The question of whether a performance fee is warranted or not really comes down to the fee structure that's in place, rather than the type of fund on which it's used. Performance fees can be acceptable, even beneficial, on any actively managed strategy as long as they are in-keeping with a product's aims.

In a perfect world, we would like to see fulcrum fees adopted in Australia. A fulcrum fee is a perfectly symmetrical fee structure that rewards fund managers on the upside but equally penalises them on the downside by reducing the size of the base fee. This relatively simple fee structure is fair to both fund managers and investors, and does away with many of the complicated facets of existing performance fee structures. Unfortunately, current methods of charging fees are generally considerably more profitable for the fund manager, so we don't expect to see the adoption of fulcrum fees unless the regulator gets involved.

In the meantime, we believe that there are a number of key areas to consider when selecting a fund with a performance fee:

- Make sure that the fund's performance fee is benchmarked to an appropriate index. This is especially important if you expect the market to rise. In such a scenario, funds with absolute fee structures can take advantage of the rising tide and charge fees for relative underperformance.
- Ensure that the fee structure has a high watermark that cannot be reset. This stops investors being charged a fee when a fund manager is merely making up previous underperformance.
- A decent hurdle is a must. The amount of outperformance the manager needs to post before it begins taking fees is significant. The bigger the hurdle, the better – but it should at least cover the base fee. If it doesn't, the fund manager can take a fee even if it underperforms.
- Take note of the actual performance fee quantum, as all else being equal, the higher the fee, the more you pay. However, you may be better off paying a higher performance fee to ensure that the overall structure has an equities-relative benchmark, a high watermark, and a satisfactory hurdle, as the omission of any of

© PortfolioConstruction Forum 2013

these can prove even more costly.

- Favour longer crystallisation periods. This is the frequency over which the fund manager accrues the performance fee. Managers with quarterly crystallisation periods may, for example, be tempted to focus on shorter-term performance-chasing, while those which only take accumulated performance fees annually will need to generate more consistent returns.

Even if you happen across a fund manager which ticks all of these boxes, you still need to weigh up the total expected costs of owning a fund. In most scenarios, the base fee that a manager charges will be by far the most significant cost to the investor. The base fee has to be paid rain or shine, so if you really want value for money, look for a manager with a low base fee and therefore a real incentive to outperform. In our view, all funds with performance fees should also have lower base fees, but this is seldom the case.

Zenith Investment Partners

Performance fees are designed to align fund manager and investor interests. That is, the fund manager is incentivised to deliver strong performance or outperformance, which is also the desired outcome being sort by the investor. On the other hand, management fees are typically charged as a percentage of assets managed and incentivise the gathering of assets rather than a performance outcome. To this extent, it could be argued a properly structured performance fee is in the investor's best interest and therefore warranted or justified across most funds. However, they are almost exclusively only seen within funds operating in growth asset classes and remain a minority group, sitting behind the majority of funds which charge management fees only.

The other issue with the performance fee structures typically seen in Australia is they normally operate as an additional layer of fees. In Zenith's view, there should be a trade-off between management fees and performance fees. If a fund manager charges a performance fee which typically delivers greater fee upside, then the manager should be prepared to take a haircut on their management fee.

The key elements of any performance fee are size, frequency, hurdle rate, benchmark, high water mark and reset.

In Zenith's opinion, the two non-negotiables are the existence of a high water mark and no reset.

A high water mark ensures a fund manager must recover previous underperformance before being eligible for a performance fee. High water marks are generally well accepted and industry best practice.

Resets enable a manager to start over when the high water market is heavily underwater. Unfortunately, the investor doesn't have the same luxury and, for this reason, Zenith believes

a fund manager should not have the ability to wipe the slate clean and walk away from their underperformance.

The third critical element is that of benchmark. In the majority of cases, Zenith believes a market relative benchmark should be used to determine outperformance and hence the applicability of a performance fee. That is, Zenith prefers to see fund managers rewarded for outperformance above the market rather than occurring as a result of a rising tide lifting all boats. While a fund seeking to deliver an absolute return (i.e. positive performance in all market conditions) or with a market neutral composition can argue for the use of an absolute benchmark such as cash, these cases remain the exception rather than the rule.

Zenith also does not believe a fund manager should be paid a performance fee on outperformance above zero – that is, they should at a minimum be required to deliver a cash return (i.e. the risk free rate).

The three key elements of high water mark, resets and benchmark are the critical drivers of any performance fee and will have the largest impact on its magnitude. Investors should study these components carefully and should a fund contain any of the negative attributes detailed above, Zenith would recommend they seek an alternative fund with a more investor-friendly performance fee structure.

The size of the performance fee rate is another element to consider. Typically, this falls between 10% and 30%, with the most commonly seen being either 15% or 20%.

A performance fee can also have a hurdle rate in place – that is, a rate above a benchmark which must be achieved before a performance fee is applied. Zenith believes this hurdle rate should match a fund manager's desired return objective (e.g. 2% above the S&P/ASX 300 Accumulation Index).

Best practice also has a performance fee applied net of management fees.

The frequency of the performance fee charge can also have a bearing on the fund manager's attitude to investing and, while it is impractical to have this match the recommended investment timeframe (e.g. 7 years+ for equities), Zenith believes performance fees shouldn't be charged any more frequent than annually.

Overall, Zenith believes performance fees within a fund have a role to play provided they are balanced and equitable. However, performances fees can't be look at in isolated and need to be considered in the context of the overall fee structure.

van Eyk Research

Performance fees are warranted for all types of managed funds. However, they should only be paid on the generation of true alpha by the manager, or an excess return above an appropriate benchmark for the asset class in question.

The existence of performance fees should be accompanied by low base fees on the level of funds under management. This means that the manager is practising risk reversal – that is, the seller bears most of the risk rather than the buyer. In the context of managed funds, this means the fund manager bears the risk of outperformance or underperformance against the benchmark and only asks the investor for a nominal base fee. In return for bearing this risk, the manager can then justify charging a more substantial performance fee, but only based on the size of the excess returns generated. In other words, if the manager doesn't outperform, it doesn't get paid (or paid very much).

An example fee structure might be a base fee of 0.2% of funds under management and a performance fee of 20% of alpha or excess return. Of course, the benchmark against which the performance of the fund is measured must be suitable one. For example, a long-only equities manager should only earn a performance fee on the alpha component above an equity index benchmark. A market neutral manager might charge its performance fee above a cash hurdle, such that they bear the opportunity cost of investing in cash.

The benefit of such performance fee structures is that they self-regulate the behaviour of fund managers. Managers will not grow assets just for the sake of earning more from the base fee, at the expense of performance. The size of a fund can affect performance and, under this structure, the manager would be incentivised to keep assets under management at a level where it could still deliver meaningful outperformance. It would also force the manager to only undertake research activities that will enhance the outperformance potential of the fund. Rather than chase new mandates to grow funds under management, the manager would chase higher levels of alpha, as this approach would enhance its ability to earn a higher dollar amount of fees via the higher performance fee.

To summarise, performance fees are a good thing – but only if structured correctly and accompanied by a low base fee. This includes what is known as a perpetual high water mark for performance fees, which ensures that any underperformance of the fund is recouped before a performance fee is charged to investors.

Lonsec Research

Lonsec believes that fees structures should take into account the performance objectives, mandate restrictions, asset classes invested in, quality of the investment manager and capacity restrictions of each individual fund. Appropriately structured investment management fees should assist in aligning investors, investment teams, and funds management organisations alike and also include the consideration of the relationship between the base (management) fee and the performance fee where one exists. The below provides more detail on each component of a fee structure and Lonsec's view on those key criteria.

- Base (management) fee – this should be commensurate with the performance objectives and mandate restrictions of the fund. If the fund is unlikely (or not able) to

take large active positions and/or is tracking error constrained, the fee should reflect this benchmark relative design (i.e. not be significantly more expensive than index funds in the asset class). Further, fees for funds with wide mandate limits should be commensurate with the manager's use of the mandate flexibility.

- Base fee with performance fee attached – the base fee should ordinarily be lower than similar funds without performance fee. Instances where the manager has simply applied a performance fee on top of an existing, appropriately structured, base fee are not as well regarded.
- Hurdle rate – performance fee is applied only after the fund achieves an appropriate rate of return, the Hurdle. The Hurdle should be a level of return over an appropriate benchmark given the opportunity set of the fund manager, relevant to the investment style/philosophy of the fund, and the fund's performance objectives. Furthermore, Lonsec prefers to see managers rewarded (via performance fees) for a fund achieving its objective, not merely meeting an arbitrary benchmark return.
- Application – performance fees should be applied only after the base fee has been accounted for. For example, a fund with a base fee of 1% should not charge any performance fee when the pre-fee outperformance is less than 1%. Performance fees should be linked to the performance objectives of the fund, for both quantum and duration of performance targets. Any misalignment of performance objectives and performance fee application is a structural disadvantage.
- Quantum – a percentage rate in line with industry standard. A hurdle rate should be in place. However, where no hurdle rate is in place, performance fee and base fee should not exceed a relevant total fee level for achieving fund objectives.
- High water mark – Lonsec considers that, ideally, performance fees should be subject to a high water mark. That is, before any performance fees are charged, the fund's unit price should be above previous highs. This includes instances where a fund may provide excess performance but absolute negative returns.
- Reset period – resetting of high watermarks should not be undertaken.

In practice, the heterogeneity of available fee structuring strategies and the number of moving parts in a performance fee structure means that an apples to apples comparison of fees between competing funds may be difficult to achieve. Simply removing an element of a fee structure from the table above does not ensure a competitive fee structure, as the multitude of machinations can result in poorly aligned outcomes.

Looking forward, Lonsec believes the advent of more products using trade-off fee structures, whereby fees are adjusted according to the fund's performance outcomes will prove to be more popular with investors and force many existing fee structures to be re-evaluated.

© PortfolioConstruction Forum 2013

Mercer

An appropriate fee structure is one that is aligned with the long-term objectives of the investor, truly reflects manager skill, fosters sustainable alpha and is conducive to a long and cost controlled relationship between manager and investor. But no one size fits all. The ideal fee structure will be specific to the investor and the situation and the engagement of a fund manager should be based on strategy first, fee structure second.

Funds that warrant a performance based fee are ones that have an alignment with an investor's long-term objective but are also targeting a valid benchmark or return target.

So it is ideal in setting a fee structure to avoid the need to assess investment managers on the basis of short-term performance as this amplifies the risk of them making decisions that are not in the long-term best interest of the investors. It's an inconvenient truth that performance data contains high levels of statistical noise making it very difficult to distinguish between luck and skill. The shorter the period under review, the less useful the information deduced. Skilled managers can struggle with their performance for material periods, and the reverse applies for unskilled managers who experience a run of better fortune.

So, while on the one hand, managers generally seek (and rightly so) to be judged over a full market cycle, as that is the period over which skill can materialise, on the other hand, fees structure often stipulate payment of a performance fee over a much shorter period. One year is the most common period. It is fair to ask - is this logical and is it compatible with aligning investor interests?

A flow-on effect of investors using relatively short time periods for assessing and rewarding manager performance is that it encourages portfolio managers to focus on similar timeframes when evaluating market opportunities. This is likely to be detrimental to maximising long-term returns.

In summary, performance fee models should reflect payment based on:

- Outcomes reflecting skill, not luck
- Encouraging alignment with long-term objectives
- Rewarding business practices that foster sustainable alpha; and
- Promoting an enduring partnership and control total costs.

Focusing on the above factors offers several benefits including signalling the investor is serious about focusing on longer term goals, which encourages the manager to develop and maintain a long term mindset. We believe there should be a set maximum on the fee so as the manager is rewarded for alpha but not incentivised to risk-up and go for broke in

portfolio construction forum

pursuit of high revenue.

This approach also fosters a partnership approach that can benefit both parties and avoid manager switching costs. It places the emphasis less on rewarding noise/luck (shorter periods) and more on skill (longer periods) and achievement of the primary goal. Finally, it can promote moderate manager trading activity/portfolio turnover and hence lower transaction costs.

Research Review is compiled by PortfolioConstruction Forum in association with Money Management, to help practitioners assess the robustness and disclosure of each funds research house – especially given the transparency they expect of the funds they rate.

© PortfolioConstruction Forum 2013