

# THE INVESTOR

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## Thought of the Month – Fees for Managing the *Potential* to Manage? What's next?!

As we review a range of traditional and alternative fund investments throughout the world, we can only look on in awe as some managers charge a sundry of fees for their services that independent observers might consider aggressive. Let's first take a look at managers who charge fees based on commitments. According to some sources, and fee schedules of some actual funds, it is "standard industry practice" in the private equity business to charge management fees based on committed capital as opposed to capital under management. In other words, management fees for the *potential* to manage funds. Unfortunately this idea seems to be spreading as we recently noticed a fixed income hedge fund charging similar fees on commitments, even though there was no clear idea if and when capital would ever be called to fill remaining commitments.

Then there are managers who charge performance fees based on outperformance compared to a risky index, as opposed to high-on-high or compared to a near risk free rate such as LIBOR. In other words, if the index goes down 20% and this fund only declines 5%, investors will pay a significantly large performance fee based on the 15% outperformance even though they earned negative returns.

We wonder what other entertaining types of fee arrangements there are, and as time goes by, perhaps we can share some other interesting examples that we encounter. Meanwhile this leaves us with some pending questions: What are investors really paying for? As many fees or bonuses are based on performance, are there any superior, fairer measures of performance than currently used? Should traders be somehow penalized for negative returns? Should the fees/bonuses be a fixed percentage of performance, capped as a percentage of NAV, etc.? And how are economies of scale factored in particularly with passive index-tracking funds? (see more on this below)

## Why is the Sky Blue? – Are Investors Getting a Fair Treatment?

With all due respect to fund managers who work hard to generate decent returns, it is still questionable whether investors are getting a fair treatment with respect to the earnings on their investments and the fees they have to pay. Although the industry has devised measures such as 'outperformance' in determining their fees, is this measure appropriate and fair? As stated above, a manager may brag about outperforming an index while still generating negative returns, which still earns him/her a handsome fee. This is certainly a biased arrangement in favour of the manager and none can claim that it is a fair game for the investor. When we walk into a casino, we all know that the odds are in favour of the house but it is doubtful whether investors are aware that they are facing a similar situation. In the next section we'll explore these points and give reasons why we feel that the current arrangements are not fair to the investor.

## Nourishment – In Search of Fair Compensation

In this section we'll explore beyond where we left off last month and examine alternative compensation arrangements that incorporate risk with performance. Many people's livelihoods depend on the arrangements negotiated with their investors, but can anyone come up with a mechanism that can justify the fees paid and keep everyone happy?

When it comes to compensating fund managers, or traders, two conflicting issues arise: fairness and simplicity. Fees paid need to be based on a formula that is fair to both the manager and investor that is commensurate with the effort put into generating the earnings and not on simple techniques such as cash-leveraging (explained later). Next, the formula needs to be relatively simple to understand and implement across all fund managers in order to keep the fee structures competitive, yet simplicity may also neglect the important ingredients that determine a fair fee. Let's look at these issues one at a time.

Fee asymmetry: Under the current scheme, fees are paid for positive earnings but no penalties are imposed for losses. This scheme encourages managers to take on higher risk (perhaps without the investors' knowledge) because they have nothing to lose. This raises the issue of whether the risk preference of the investor matches that of the manager. More on the topic of being risk averse versus a risk taker in next month's newsletter.

Fixed percentage of performance: How did the magic number of around 20% come about? Our intuition tells us that when hedge funds first started, only a few existed and could demand an unchallenged price as investors did not have many choices. However as the number of fund managers grew, this performance fee has not come down which implies a lack of competition. Therefore the conclusion can only be one of two things: there are still not enough fund managers around to create sufficient competition and force prices down, or some form of invisible cartel exists that allows all managers to demand the same fees. Furthermore, should it be a flat rate or perhaps a variable rate dependent on some measure other than performance?

Passive funds: With today's diversity of derivatives, it takes very little effort to create an index-tracking fund with only a small portion of the capital invested. The rest of the capital can go into a combination of risk-free fixed income investments together with the purchase of downside protection, such as put options, that when all put together, can often generate returns above the risk-free rate or the index itself. In this category, we can also include other types of capital guaranteed funds or guaranteed structured products. Managing such funds does not require market gurus or rocket scientists, and the amount of management time or skills required does not depend on the total capital invested. In other words, since the talent, time, effort and systems required to run such a fund is not a function of the size of the fund, is it fair to investors that they must pay such managers a flat-rate management fee regardless of the amount of capital invested or the generated earnings / losses? Once all the fixed administration costs which do not depend on total capital, plus management / transaction costs including the managers' salaries are covered, the rest is all profit. Very easy way to make money at the expense of the investors, and with market competition virtually non-existent because of the limited number of service providers, we see little hope in any of this changing. Or are these arrangements due to a lack of bargaining power by investors even though there are a large number of providers? Perhaps things may change if investors come together to collectively bargain for change.

Now let's examine some specific issues with regards to current fee compensation mechanisms. Some of the arguments are based on a paper titled "[Compensating Fund Managers for Risk-Adjusted Performance](#)" by [Thomas S. Coleman, Aequilibrium Investments Limited, and Laurence B. Siegel, Ford Foundation](#) that can be found on the AIMA website at [www.aima.org](http://www.aima.org).

Cash-leveraging: A fund manager can easily double the fund returns, and thus his/her fees, by borrowing funds at the riskless rate and investing them in the same original strategy. Thus if the original investment of \$100 million was earning 10%, he/she can borrow another \$100 million and invest it in the same strategy which still earns 10%. However on a portfolio basis,

the performance has now doubled which also doubles the manager's fee without any downside risk on personal fees. Sounds like a simple technique, but what about portfolio risk? Similar leveraging techniques can also be created using derivatives, such as futures, options or other o-t-c products, which require capital amounts equal to only a fraction of the face amount.

**Portfolio risk:** In the cash example above, by doubling the amount of capital invested, the portfolio risk has also doubled due to the leveraging effect, however this is rarely, if ever, taken into consideration when compensating fund managers. It may not be too complicated to incorporate risk in the fee formula by using other popular measures such as the Sharpe ratio, however these can also be far from perfect.

**Sharpe ratio:** Continuing with the example, since the fund's excess return (portfolio return less risk free rate) has doubled while the portfolio risk as measured by the standard deviation of the portfolio returns has also doubled, then the Sharpe ratio remains unchanged. (Sharpe ratio is defined as the excess return divided by the standard deviation of the portfolio returns.) Leveraging through borrowed funds at the risk free rate will not change the Sharpe ratio. Therefore the Sharpe ratio is not offering a good-enough indicator of performance versus risk as it does not factor-in leverage risk. One more point - since these measures are usually based on historical discrete observations of monthly returns, it is possible to 'smooth' them over time using off-market derivatives to reduce the fluctuation in returns (the standard deviation of returns) thereby increasing the Sharpe ratio of the fund.

**Other performance measures:** In the paper mentioned above, the authors suggest an alternate performance measure (risk-adjusted return) that is a transformation of the Sharpe ratio. The attractive features are that it expresses the performance measure as a return while also taking risk and leverage into account. Yet all risk measurements explored thus far focus solely on historical fluctuations in the fund's performance. It is perhaps time that fund managers start taking a closer look at value-at-risk (VaR) which provides a better indicator of risk as it assesses the current portfolio rather than a fund's past holdings. When VaR is combined with NAV, it factors-in the portfolio leverage together with risk. Perhaps with some further modifications to incorporate variables found in the Sharpe ratio, it can also be used as a better tool for measuring performance.

However as performance models become more sophisticated, they can also become more complicated, which we presume most fund managers and investors would rather avoid. There are also transparency and disclosure issues that need to be addressed, as perhaps some managers that offer disclosure of VAR, leverage, and other risk figures on an on-going basis might feel at a disadvantage to their non-disclosing peers. Thus finding the right balance between an easy-to-implement model and a fair measure to both investor and manager will undoubtedly remain unresolved until perhaps a regulatory body, association, or the collective efforts of investors forces fund managers to disclose a particular measure as already happened within the banking industry following the capital adequacy requirements of the BIS. Yet this is only one part of the problem. The other parts deals with finding the appropriate rate or sliding rate used in determining the manager's fee. This would not be for the regulators to tell us but based purely on market competition within the funds industry.

## Feedback

As always, we greatly appreciate your comments and feedback. We realize that our ideas and information might be cutting edge, futuristic kind of stuff or mysterious in some ways. E-mail us anytime at [help@financialcontrollimited.com](mailto:help@financialcontrollimited.com) if you would like a) for us to clarify anything, b) to recommend improvements to us, or c) to just debate with us – we like philosophy especially as it relates to financial services!