Defining fair hedge fund fees today

During the last six years of strong long-only returns, investors have questioned the value of risk-adjusted performance from hedge funds and their higher relative fee structures. As both a provider of hedge fund solutions and as a hedge fund investor ourselves, we appreciate the frustration investors have with many hedge funds not living up to their performance expectations.

A transformation of the current hedge fund fee structure could help address this issue. It could align the interests between managers and investors better and only pay top fees for top performance.

Hedge funds – Horses for courses

“If you think it’s expensive to hire a professional to do the job, wait until you hire an amateur”

Red Adair (International oil well fire-fighter)

The hedge fund universe contains an extraordinary variety of managers and strategies: there are well over 10,000 hedge funds for investors to choose from. Having been an investor in hedge funds for over 25 years, we can confirm that there are big differences between the top managers and the rest of the universe.

These differences are mostly performance-related, but they also include: operational capability, risk management, idea-generation and research skills, ability to adapt to changing market and regulatory environments, and other non-quantifiable characteristics that in combination can distinguish a great manager from the rest of the pack.

Fees for hedge fund managers come from two main sources: management fees and performance fees. Management fees are earned regardless of performance, while performance fees reward managers based on the returns that they generate. Edmund Truell, Chairman of the London Pensions Fund Authority (LPFA), echoed the sentiment we believe most hedge fund investors have when it comes to paying fees. He said “hedge funds should lower their fees to reflect their true expenses”, but added that he remained “happy to pay for good performance”.

We understand that hedge fund managers have fixed costs and need to charge management fees to cover ongoing expenses, but performance should be the more meaningful driver of overall fees for a hedge fund manager to better align their interests with their investors.

So, the question is what level of fees is considered reasonable and what is not? Unigestion recognises that those who do excel (i.e. meet expectations of return, but also the risk taken) deserve both the best recognition and the best rewards possible in the form of remuneration for their performance. Equally, in a challenging financial arena there should be little reward for managers who are not offering the very best possible returns for their investors.

An investor making an allocation to a hedge fund expects to earn the top range of performance of a chosen hedge fund strategy. Though capacity issues may limit choice for some large institutions (e.g. some managers are simply unable to deploy large amounts of capital and will cap the amount of money they accept – which can be a very good thing for existing investors), no investor is likely to allocate to a manager wishing to only achieve average returns.

Summary

- Hedge fund fees may be high, but the net result can be worth it – it all depends on your objectives.
- The best performing hedge fund managers should earn more as a percentage gross return than their less performing peers, but this is not the case today.
- The alignment of interests with investors is crucial: we recognise the need for management fees to cover on-going costs, but performance fees should be the larger part of manager compensation and should be subject to a hurdle rate.
Therefore, as a starting point for defining what is a reasonable level of fees, we break down the broad universe of recent hedge fund manager performance into four quartiles from best (1st) to worse (4th):

<table>
<thead>
<tr>
<th>Quartile</th>
<th>Average gross return</th>
<th>Average net return</th>
<th>HF manager share of gross return</th>
<th>Investor share of gross return</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st</td>
<td>17.9%</td>
<td>13.2%</td>
<td>26.3%</td>
<td>73.7%</td>
</tr>
<tr>
<td>2nd</td>
<td>9.1%</td>
<td>6.1%</td>
<td>33.0%</td>
<td>67.0%</td>
</tr>
<tr>
<td>3rd</td>
<td>5.1%</td>
<td>2.9%</td>
<td>43.4%</td>
<td>56.6%</td>
</tr>
<tr>
<td>4th</td>
<td>-2.2%</td>
<td>-3.9%</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: eVestment Hedge Fund (HFN). Annualised performance from 01.01.2011 to 31.12.2014. Managers with large outsized and unrepresentative returns both positive and negative have been excluded as have those who did not report sufficient fees information.

As the table above shows, the top quartile hedge fund managers generate an average net return of 13.2%. We believe that this level of return (8%-plus) over a market cycle, is very attractive to investors. Investors would, therefore, be happy to reward these top managers for their results. (However, the return objectives and expectations for managers will and should differ by investment strategy, in the same way that investors would not expect the same return from bonds as they do for equities).

There is an interesting point to take away from ranking manager performance into quartiles along with their slice of the gross return. The table above shows that top quartile hedge fund managers earn approximately 25% of total gross returns as fees – a smaller percentage of gross returns than lower quartile managers.

For example, while third quartile managers have produced gross returns since 2011 of 5.1%, investors have only seen a return of 2.9% from them. This is due to the fee structure that results in these hedge fund managers taking over 43% of the gross return in fees – nearly 20% more of the take of gross returns that the top performing managers earn.

Consequently, the current broad hedge fund fee structure today seems to reward the worst performing managers the most as they get a larger percentage of gross returns. This is something that we do not accept as investors and we believe it should not be acceptable as a general practice.

Defining a fair fee for hedge funds

“…there is no greater inequality than the equal treatment of unequals”
Felix Frankfurter (Former Associate Justice of the US Supreme Court)

According to Deutsche Bank’s 13th annual Alternative Investor Survey (published March 2015), investors remain willing to pay for superior performance: “Investors cited a willingness to pay these (2% and 20%) fees to managers that offer ‘consistent strong performance in absolute terms’ or ‘consistent outperformance of peers’ “.

It added that investors pay an average management fee of 1.65% and an average performance fee of 18.03%.

This survey tells us that there is still a healthy demand for hedge funds and their higher fee structures, provided the objectives of investors can be met, whether the goal is performance (relative or absolute), risk management or other.

We believe that investors will accept paying around 25% of the gross return to top managers in exchange for their results. If this is what investors are willing to pay the best managers, then the worse performing managers should not earn a larger share of the gross return.

1 Net returns. From 01.01.2011 to 31.12.2014. Data from eVestment Hedge Fund (HFN)
In an ideal world a hedge fund manager would only earn performance fees and not charge a management fee. This would provide a very high level of alignment with investors as managers’ earnings would only be based on what they generate in terms of returns.

Stepping back into reality, however, we understand that most hedge fund managers cannot survive on performance fees alone. The ability to generate performance and retain talent requires ongoing management fees. We believe it is right for hedge funds to charge management fees but that these fees should be structured in such a way that the overall fee is around 25% of gross performance.

How can this be achieved? As the table below shows, we advocate including a hurdle rate, where a minimum return must be generated by a hedge fund manager before they start to collect performance fees. This hurdle rate could be for example, based on the level of management fees the manager wishes to charge. Essentially, the higher the management fee, the higher the hurdle rate.

**Total fee comparison – higher returns**

We apply the average fees paid by institutions for their hedge fund investments (shown by Deutsche Bank’s research) to the average performance of top quartile hedge fund managers.

<table>
<thead>
<tr>
<th>Model</th>
<th>Gross HF performance</th>
<th>Management fee</th>
<th>Hurdle rate</th>
<th>Performance fee</th>
<th>Total HF Fee</th>
<th>HF % of gross return</th>
<th>Investor % of gross return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>17.9%</td>
<td>1.65%</td>
<td>0.0%</td>
<td>18.0%</td>
<td>4.6%</td>
<td>25.6%</td>
<td>74.4%</td>
</tr>
<tr>
<td>Proposed</td>
<td>17.9%</td>
<td>1.20%</td>
<td>3.0%</td>
<td>25.0%</td>
<td>4.6%</td>
<td>25.8%</td>
<td>74.2%</td>
</tr>
</tbody>
</table>

**Total fee comparison – lower returns**

The benefit to investors from a Unigestion proposed fee structure can be seen when a manager delivers low returns.

<table>
<thead>
<tr>
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<th>Total HF Fee</th>
<th>HF % of gross return</th>
<th>Investor % of gross return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>5%</td>
<td>1.65%</td>
<td>0.0%</td>
<td>18.0%</td>
<td>2.3%</td>
<td>45.1%</td>
<td>54.9%</td>
</tr>
<tr>
<td>Proposed</td>
<td>5%</td>
<td>1.20%</td>
<td>3.0%</td>
<td>25.0%</td>
<td>1.4%</td>
<td>28.0%</td>
<td>72.0%</td>
</tr>
</tbody>
</table>

**Total fee comparison – exceptional returns**

When a hedge fund manager delivers an exceptional return (say 25% gross), their total fee earned is in fact higher than the current model.

<table>
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<tr>
<td>Current</td>
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<td>5.9%</td>
<td>23.4%</td>
<td>76.6%</td>
</tr>
<tr>
<td>Proposed</td>
<td>25%</td>
<td>1.20%</td>
<td>3.0%</td>
<td>25.0%</td>
<td>6.4%</td>
<td>25.6%</td>
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Source: Unigestion, eVestment Hedge Fund (HFN)

The real difference between the current hedge fund fee model and our proposal model can be seen where managers generate lower gross returns. In this case, under the current model, the manager will take nearly half the gross returns, which in our view is far too high and not aligned with the interests of the investor.

“…we advocate including a hurdle rate, where a minimum return must be generated by a hedge fund manager before they start to collect performance fees.”
What Unigestion is proposing is for managers to adopt a fee structure that gives them top pay, but is better aligned with investor interests. We don’t propose a traditional bargaining approach where we look to pay managers less overall, but instead pay them what they deserve based on performance. This will benefit all investors, big and small.

A number of funds have already chosen to adopt more investor-friendly fee structures as shown by management and performance fees data we collected from eVestment Hedge Fund (HFN) between 2011 and 2014 from the operations of 3,268 hedge funds. This approach is still far from becoming mainstream. However, we believe it should be.

Reward the best

“Price is what you pay, value is what you get” – Warren Buffett

The hedge fund universe has historically attracted very clever investment managers because it offers the possibility of more freedom to fully realise their potential and be well paid for doing so.

As investors in hedge funds ourselves, we want to encourage the very best managers to continue to offer their skills and talent and it is right that these managers are well paid for their superior services. The problem is that for every manager who performs as investors expect and can indeed justify their fees; there are another three or so who do not. Yet these underperformers will still charge investors the same or more, based on the percentage of the gross performance.

Moreover, hedge fund performance is dynamic and the top managers of today may not necessarily be the top managers of tomorrow. We believe the best way to align interests with investors and reward top performing managers when they deliver exceptional returns, is to transform the current hedge fund fee structure into a structure that tips the compensation scale in favour of hedge fund managers who perform well. This can include both a high fixed cost (management fee) and large performance fee.

In simpler terms, this is achieved through a combination of two things. The first is to introduce a hurdle rate, so that the hedge manager only starts to collect performance fees once they deliver a minimum net return to investors. The second is to lower the management fee in exchange for a higher performance fee. By making these two adjustments, managers who deliver good results for their clients will continue to earn top fees, but those who do not, will not enjoy the same level of high fees that many hedge fund earn today.

Moreover, by adopting our proposed fee structure, investors might be more willing to remain invested with a manager who has had a tough year. The cost to for doing so would be less for the investor, while the manager would feel the pain more from lower fee revenue.

We believe this transformation of the fee structure should be implemented across the board for all managers both big and small. Larger managers or those that have recently performed well should not be given a free pass to charge higher fees based on good past performance. Compensation based directly on what managers deliver will create a more level playing field. This is a change that we believe most investors will welcome.

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