HOW TO CUT HEDGE FUND FEES IN HALF

PART ONE: THE INVESTOR AGGREGATION MODEL

There is a strong argument that, on average, hedge fund fees today are double what they should be. Over the past five years, the typical hedge fund generated 2.3% alpha relative to a 60/40 portfolio *before* fees, yet negative alpha *after* fees.[1] The difference is roughly the 300 bps or so that were paid in management and incentive fees. Granted, a 60/40 portfolio generated unusually high returns over the same period and many hedge funds did much better. However, when most investors are willing to pay 50% of true alpha generation, the notion of paying away more than 100% seems unjust.

The issue is that the fee structure of the industry has not evolved with institutionalization and asset growth. As veterans of the industry know, the 2/20 fee structure was designed to provide small hedge funds with an incentive to outperform. A high management fee would cover costs, while performance fees would align interests with investors – an inducement to attract confident, talented managers to deliver exceptional returns.

How times have changed. Take a representative $10 billion equity long/short hedge fund. A 2% management fee generates $150 million or more in pure profits; often, the founder gets paid $100 million or more to walk in the door in January. Similarly, performance fees almost invariably are paid with no hurdle rate. The same manager – assuming he's consistently net long 30-40% – was paid an extra $200 million or more in 2013 simply because equities were up 30% plus. To paraphrase a private equity titan, performance fees with no hurdle are, "after the wheel, God's greatest invention" – for the managers.

As discussed below, a more equitable solution would be for management fees to decline as assets grow and for performance fees to be paid above a hurdle. These two changes could save investors 100-150 bps per annum, improve net of fee performance, and better align incentives.

There are two ways to approach this: a direct and indirect approach. As discussed below, investors can pursue a model to negotiate as a group and extract lower fees from the 100 or so large funds that have attracted most capital post-crisis. An alternative solution, discussed in a forthcoming note, is to migrate to a core-satellite model akin to the traditional asset management business – a lower cost core can reduce costs without diminishing overall performance.

[1] HFRI Fund Weighted Composite index vs a 60/40 portfolio consisting of the MSCI ACWI and ten year Treasury Note over 2010-14. For caveats on the use of alpha as a measure of outperformance, see Lies, Damned Lies and Alpha.

The Investor Aggregation Model

Throughout the business world, firms purchase in bulk at reduced costs and pass much of those savings along to consumers. Think of the impact of Walmart on consumer retail. Consumers benefit from lower costs, the firm keeps a spread, and suppliers get scale orders. Efficiency works.

The structure of the hedge fund industry today is not conducive to this: buyers (investors) are highly fragmented and hence purchase services from (make investments in) suppliers (hedge funds) on a piecemeal basis. Post-crisis, as institutional investors steered most capital to the 100 or so largest hedge funds, there's much more concentration on the supplier side. Investors tend to make new allocations to funds that are doing particularly well, where demand is highest and the track record of delivering excess returns, net of fees, is strongest.

The end result is that large managers have all the leverage in fee discussions. Perhaps this is why even small discounts are treated as wins. The largest investors, like sovereign wealth funds, reportedly will write $250 million checks and expect a 25 bps management fee discount – 5-10% of all-in fees. At a conference last year, a consulting firm acknowledged that $40 billion of (largely nondiscretionary) client capital resulted in fee savings of 10-15 basis points – or 2-4% of the total. Taking a different approach, some investors opt to invest in lower cost, but less liquid, share classes – those discounts are generally in the range of 15-20%. However, when you give up valuable liquidity, you take on added risk: if the fund runs into trouble, more liquid investors might leave you holding the bag.

In this context, even small discounts are treated as wins – paying $90 certainly is better than paying $100. But what if "fair" is really $50? The solution, in theory, is for investors to band together to negotiate fees downward. This would shed light on what is an achievable, and hopefully equitable, fee level.

Where is the Most Bang for the Buck?

The first goal should be for management fees to decline with asset growth – this would benefit both early and new investors. Excessive management fees, in a sense, are "pure alpha" – the manager gets a check every month regardless of whether the market is going up or down; conversely, when investors overpay, alpha is reduced dollar for dollar. Performance should improve as well: excessive management fees can lead to risk aversion since preservation of firm value trumps risk taking. (Note that some emerging managers now offer a "founders" share class where management fees decline for early investors as assets grow; although later investors will still pay full management fees, this is an excellent step in the right direction.)

Likewise, the second goal should be for performance fees to be paid above a relevant hurdle rate. For most equity long/short funds, a hurdle of 30-40% of the appropriate equity index is reasonable. Over 2010-14, this might have saved 100 bps per annum: in rising equity markets, investors don't overpay. On the other hand, in a severe market decline, the manager can be rewarded disproportionately: 200-250 bps extra if he's flat when the S&P is down 30%. Good for investors, good for managers. For lower beta funds, an alternative hurdle like LIBOR plus 400 bps seems reasonable: after all, do the managers really think they can't consistently beat this over time?

What are the Obstacles?

As discussed above, the first is industry structure. Fragmented buyers have little leverage, but a $1 trillion aggregator could dictate terms. When Walmart places a $1 billion order, no one questions its ability to perform. Here we have a chicken and egg issue: no investor or consulting firm controls enough capital to truly shift leverage. It's worth noting that there have been several failed attempts at this, such as investable indices, where the absence of capital up front raised credibility issues and led to adverse selection.

A parallel obstacle is the incentive structure for most allocators:

- Banding together requires ceding some autonomy which most allocators are loathe to do – if investors break ranks, leverage is lost.
- Current investors have the most leverage -- fifty $50 million investors ready to redeem need be taken seriously by even the largest firms. However, disappointed allocators are much more likely to fire an underperforming manager rather than press for changes in the current fee structure. It's simply easier to allocate to a new manager who has been performing well, and hence has justified prior fees.
- Allocators would have to acknowledge that, in many cases, fees are inequitable. For a current manager, this raises thorny questions about why the fund was recommended in the first place. For new allocations, it requires a determination of what is and is not justified – not easy to do given the cyclicality of performance.
- In order to negotiate effectively, allocators need to be prepared walk away and, hence, be excluded from certain managers – difficult to do when access to star managers is an important selling point.

The result is that many funds fail to justify the fee structure, yet the only practical recourse for investors is to redeem and try a different fund. Since performance is often frustratingly cyclical, high fees paid in one year won't be recouped if performance suffers the next. As we know, it's also very difficult to predict which managers will do better going forward. Both these points argue for a more aggressive push for lower fees irrespective of recent performance. The obstacles to this, as noted, are significant.

Conclusion

In a sense, there already are aggregators, if not on the scale described above. Large funds of funds appear to have meaningfully evolved their models post-crisis to better align incentives. Some now rarely allocate to flagship funds, preferring instead to negotiate special feeders that concentrate on specific strategies and investment teams. Reportedly, incentive fees for less liquid strategies are paid over several years rather than annually. This adds credence to the notion that an investor with real buying power – say, a $500 million feeder to start – can make meaningful progress. It may also explain why some of those funds of funds have performed much better than industry averages in recent years.

Another alternative is for very large institutions to concentrate their investments. A typical portfolio might contain five large multi-strategy funds whose portfolios substantially overlap. Rather than spread the investments – say, $200 million to each – would the investor be better off asking each manager to bid on the whole $1 billion? This would increase concentration risk, but given how diversified the funds are, probably not as much as many would fear. It would also shed light on how allocators rank the managers: maybe Manager A is worth it at full fees, but Manager B is equally attractive at half the fees. A counterargument is adverse selection; however, it's hard to see how this would be an issue with the largest funds, where there already is an institutional stamp of approval.

Institutional consulting firms are another option. They serve as gatekeepers for tens, and in some cases hundreds, of billions of dollars of investment capital. Most mandates, though, are non-discretionary, so it's not clear how they would wield their allocation authority. Presumably, they could remove a recommendation on a manager solely due to fees, but it's much more likely that such a decision would be based on performance (which, of course, is tied to whether the fees make sense).

Given the industry structure and agency issues described above, real progress on this front is unlikely in the near term. A more realistic alternative, as discussed in a forthcoming note, is a shift to a core-satellite model.