THE HEDGE FUND FEE CONUNDRUM

By one estimate, the hedge fund industry managed $2.6 trillion in capital at year-end 2013. Many expect growth to accelerate over the coming five years as institutional investors like US pension funds seek alternatives to investing in low yielding fixed income assets. Deutsche Bank, for example, predicts that industry assets will grow by another $400 billion this year alone.

This growth comes in the face of widespread discontent about the cost of investing in hedge funds. In the pre-crisis period, when hedge funds routinely outperformed traditional assets, the cost of investing was largely overlooked. In recent years, though, as the average hedge fund delivered single digit returns, high fees increasingly have come under scrutiny. To put the issue in context, investors paid approximately $95 billion in fees in 2013, or 44% of what their investors took home. By our estimate, this figure is twice what it should be: in other words, investors overpaid by a staggering $47 billion. The same conclusion can be drawn for each year since the financial crisis.

Why is this? In the post-crisis period, institutional investors and their consultants partially brought down the cost of investing by “dis-intermediating” funds of hedge funds – in essence, cutting out the middleman. However, this represented only a small percentage of overall fees. Driven in part by risk aversion (you don't get fired for hiring IBM), those same investors instead steered capital directly to the largest hedge funds – the $10 billion plus firms you read about in the press. By some estimates, 100% of net capital inflows post-crisis went to the top 100 managers. The big have gotten bigger and the small have struggled.

Why is this problematic? Hedge funds charge two types of fees: a management fee and a performance fee (typically 20% of profits). When hedge funds were small, relatively high management fees (1.6% on average) were necessary to cover costs and to enable a manager to expand the research team, hire a head of operations, etc. Performance fees were geared to better align the interests of investors and the manager, something that was sorely lacking in the mutual fund business.

As the industry matured, the fee structure didn’t. A typical manager with $5 billion in assets under management earns $80 million in fees – most of it pure profit. Incremental management fees don’t add to research coverage or a more robust investment process; they simply increase the manager’s take home pay. Further, as funds grow, managers take less risk to preserve the value of the business. Performance fees then no longer provide incentives for stellar returns, but rather become an annual tax on investors. The absence of a hurdle rate on incentive fees meant that the 32% rise in the S&P 500 index last year resulted in 200bps of overpayment across the industry. When you overpay for beta, it is a dollar for dollar reduction in alpha: it’s why fee reduction is the purest form of alpha.[1] Skill should be rewarded handsomely, not luck.

In the rest of the asset management industry, large investors get fee concessions; it’s why retail investors have the odds stacked against them. However, when institutional investors fall over themselves to invest in a name brand fund, the manager has little incentive to cut fees. Counterintuitively, institutionalization has failed to

[1] See Fee Reduction and Alpha Generation

result in real cost savings for most large investors. And as we know, the cost of investing is one of the most important factors in long-term investment performance.

There are four potential solutions. As noted recently by the head of hedge fund allocations for a large pension fund manager, sophisticated investors will migrate to a combination of hedge funds and comparable, but far less expensive, strategies like dynamic and alternative betas, in which investors break down the drivers of hedge fund returns and invest in them directly.[2] What you don't get in manager talent, you save in lower fees.

The second option is for investors to band together to demand a material reduction in fees. A group of investors that constitute half the assets of a $5 billion fund has a much better chance to bring down fees than if each $50 million investor negotiates separately. The two areas of focus should be to bring down management fees (as a percentage of assets under management) as assets increase and to insist that managers only earn performance fees above a specified benchmark.

A third possibility is to steer capital to smaller hedge funds. Interestingly, the have and have-not bifurcation of the industry may be a catalyst for reform. Many smaller hedge funds, facing years of difficulty in raising capital, are much more willing to drop fees today. An institutional investor who can invest $50 million with a $200 million manager can pretty much set its own terms. Importantly, since smaller managers generally outperform larger ones over time[3], investors could see a dual benefit of a pick up in performance and lower fees.

A fourth area garnering attention recently is the alternative mutual fund space, where hedge fund strategies are managed in registered investment funds. These products are in their infancy with short track records and an unproven business model. While some products are offered at roughly half the cost of investing in hedge funds, the fee structure still is double or more that of traditional mutual funds. The elephant in the room is whether the performance of these products will match those of the hedge funds they emulate. Most are marketed off track records of hedge funds, not mutual funds, and the mutual fund structure, by design, has many more constraints. It's a bit like asking a champion boxer to fight with his shoelaces tied. The irony is that the appeal of hedge funds twenty years ago was to take talented investors and free them of the (many) constraints of managing assets in a mutual fund structure; we now appear to have come full circle.[4]

Pension funds, other institutional investors and their advisors need to take a hard look at this issue. As one pension fund trustee reportedly observed, at some point you stop looking at fees as a percentage of assets and focus on the dollars involved. A pension fund with $4 billion invested in hedge funds that overpays by 2% per annum throws away $80 million a year. Over a decade that's $800 million. To paraphrase the famous quote, a million here and a million there and soon you're talking about real money.

---

[2] See Hedge Fund Replication: A Practitioner's Scorecard and Two Unanswered Questions About Alternative Betas

[3] See Performance of Emerging Equity Long/Short Hedge Fund Managers

[4] See Performance Drag of Alternative Multi-Manager Mutual Funds