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PERFORMANCE-BASED FEES

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ABSTRACT

Asset-based fees, under which managers are compensated with a percentage of assets under management, have been the dominant compensation structure used in the investment management industry. Although there is little evidence that suggests institutional investors will dramatically alter their standard asset-based fee arrangements, the industry has seen growth in the area of performance-based fees. This paper discusses performance-based fees as they relate to traditional long-only managers and shows that, if structured properly, they can be an attractive alternative to asset-based fees.

INTRODUCTION

Performance-based fees are more common than one might think. A recent survey found that 56% of institutional clients surveyed used performance-based fees for at least one manager in 2016[1]. However, that number is highly skewed towards alternative investments. This is up from 35% of investors responding to the 2011 survey, but down from the 59% of respondents to the 2009 survey. For traditional long-only managers, U.S. Mid Cap Equity, Emerging Markets Equity, and U.S. Large Cap Equity were the traditional long-only asset classes with the highest utilization of performance-based fees, at 8% of respondents each.

Performance-based fees attempt to better align the economic interests of managers and institutional investors by creating a relationship between what investors pay and the performance they actually receive. That is, over longer periods, fees paid under a performance-based fee structure should roughly track the outperformance, or "alpha," that the manager has been able to provide.

ASSET-BASED FEES

Asset-based fees compensate investment managers by paying them a percentage of assets under management. Even though this arrangement is widespread, valid arguments can be made against asset-based fees. For example, a manager who simply matched the calendar year returns of the S&P 500 from 1996 through 2018 received a 524% increase in their asset-based fee, while adding no excess return over the period (see Exhibit 1). This increase in dollar fees was directly the result of asset price increases driven by market forces—not alpha. That is, the manager's total compensation increased through their beta (market) exposure rather than through their ability to add incremental value over their stated benchmark.[2]

Additionally, asset-based fees create an incentive for investment managers to gather assets beyond what might be considered optimal levels. In asset classes with perceived inefficiencies and relative illiquidity, such as small and micro-cap stocks and emerging markets, studies have shown that increased asset levels can erode a manager's ability to add value.[3] Coupled

[1] For a review, see: Blanton, Shane. "Callan 2017 Investment Management Fee Survey", 2017.
[2] The flat fee component of a performance-based fee would see the same increase.
[3] For a review, see: Vangelisti, Marco. "The Capacity of an Equity Strategy." *Journal of Portfolio Management*. (32) Winter 2006.

with the fact that managers are often not fired for mediocre or slightly trailing performance over the medium-term, managers have great incentive to gather assets above what might be considered an optimal level—to the detriment of investors. This mindset for investors to keep managers, despite mediocre or poor performance over the medium-term, may stem from headwinds for the particular mandate, high transition costs, or having implemented a structured "watch list" policy, amongst other reasons.

Exhibit 1

Year	S&P 500 Index Return	Growth of $100 mm	Annual Fees mm (1.00%)	Cumulative % Fee Increase
1996	23.0%	$123.1	$1.2	
1997	33.4	164.2	1.4	
1998	28.6	211.1	1.9	
1999	21.0	255.5	2.3	
2000	-9.1	232.2	2.4	198%
2001	-11.9	204.6	2.2	
2002	-22.1	159.4	1.8	
2003	28.7	205.2	1.8	
2004	10.9	227.5	2.2	
2005	4.9	238.6	2.3	189%
2006	15.8	276.3	2.6	
2007	5.5	291.5	2.8	
2008	-37.0	183.7	2.4	
2009	26.5	232.3	2.1	
2010	15.1	267.2	2.5	203%
2011	2.1	272.9	2.7	
2012	16.0	316.5	2.9	
2013	32.4	419.1	3.7	
2014	13.7	476.4	4.5	
2015	1.4	483.0	4.8	390%
2016	12.0	540.8	5.1	
2017	21.8	658.8	6.0	
2018	-4.4	630.0	6.4	524%

PERFORMANCE-BASED FEES

Performance-based fees compensate managers on their relative performance: if they perform well relative to their benchmark they receive higher fees, whereas if they perform poorly relative to their benchmark they receive minimal (or potentially no) fees.

The concept of performance-based fees is not new. Under rule 205-3 of the Investment Advisers Act of 1940, investors may charge performance-based fees to investors provided they have at least $1,000,000 under management with the advisor (up from $750,000 prior to 2012), have more than $2,000,000 of net worth (up from $1,500,000), or if they are considered "qualified purchasers" under section 2(a)(51)(A) of the Advisers Act. Additionally, a "fulcrum fee" structure is required under the Advisers Act.[4] Fulcrum fees create a symmetrical payoff that creates a more equitable fee structure between investment advisors and their investors.

In addition to the requirements laid out by the Investment Advisers Act, the Department of Labor has issued opinions on the use of performance-based fees on ERISA accounts. For plans that fall under ERISA, performance-based fees should be limited to securities with readily available market quotations, the fee formula needs to include both realized and unrealized gains and losses, the advisor must be registered under the U.S. Advisers Act, and the plan must be of substantial size (i.e., assets of at least $50 million).[5]

Performance-based fees may have either "symmetrical" or "asymmetrical" fee structures. Asymmetrical fee structures, which we discuss first, are prevalent in the area of alternative asset classes such as hedge funds, real estate, and private equity. Symmetrical fee structures are more likely to be utilized by traditional, long-only asset managers.

Asymmetrical Fee Structures

Typically, asymmetrical fee structures provide managers with a standard asset-based fee and a percentage of the profits (or carry). In some instances (mostly for closed-end private market funds), a manager may have to clear a hurdle rate (or preferred return) prior to collecting their percentage of the profits. In other cases (more common among hedge funds), the fee structure includes a high water mark that prohibit the manager from collecting a percentage of the profits until losses from previous high points are recovered. Clawback provisions (again, mostly for closed-end private market funds) can protect investors by providing an avenue to reclaim a portion of fees paid in the early life of an investment should the strategy subsequently return less than the stated hurdle rate.

Although asymmetrical fees provide some favorable elements to the investor, such as clawback provisions, the structure tends to favor investment managers by allowing them to share in the upside potential while not penalizing their asset-based fee revenue should they underperform. Essentially, asymmetrical structures give managers a "free call option" while they control the underlying volatility. Since an option's value increases with higher volatility, a manager who raises the risk of a portfolio increases their potential payoff. As a result, underperforming managers may be encouraged to increase the volatility of the portfolio to reach performance hurdles, while outperforming managers may reduce risk in an attempt to "lock in" profits. Still, at least one study of hedge funds showed that "increased volatility is driven by peer performance and tempered by the strong relationship between volatility and manager termination."[6] That is to say that a manager's manipulation of volatility tends to be a relative game, as managers fear termination due to underperformance versus their peer group.

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[4] SEC Website: http://www.sec.gov/rules/final/ia-1731.htm.

[5] Performance Fees: Some Lesser Known Concepts and Why You Should Know Them, Norberg John D., September/October 1999, Vol. 4, No. 5: pp. 9-10.

[6] Brown, Goetzmann, & Park; Careers and Survival: Competition and Risk in the Hedge Fund and CTA Industry, 2000.

Symmetrical ("Fulcrum") Fee Structures

The Investment Advisers Act of 1940 specifically identifies a fulcrum fee approach as the required structure for the performance-based fees for traditional long-only managers. The fulcrum structure creates a symmetrical arrangement whereby managers' and investors' interests should be more closely aligned.

Under a fulcrum fee structure, manager fees increase for performance above that of the benchmark and decrease for performance below that of the benchmark. Initially, a flat (base) fee is determined, which is generally equivalent to a manager's standard asset-based fee. A minimum fee is established that is roughly equivalent to similar passive index strategies, while a maximum fee ensures a manager is not compensated for taking on unwanted levels of risk.

Performance-based fees arguably do a better job at matching manager compensation with investor performance. Investors pay lower fees over periods of underperformance and managers receive additional revenue during periods of outperformance. Additionally, performance-based fees reduce the principal-agent conflict whereby agents (i.e., managers) seek to maximize profits with little regard to the principals' overall wealth. Performance-based fees may be more likely to encourage managers to run strategies at optimal asset levels in areas where large base levels can impair their ability to add alpha due to liquidity constraints. Finally, if performance-based fees can be structured with a base fee below a manager's normal asset-based fee, the arrangement may result in lower fees for the investor over the long term. This will likely be the case if the manager matches or underperforms its benchmark.

CAVEATS

Performance-based fees are not without some downsides. First, if structured improperly (as is arguably the case for many hedge funds), performance-based fees can encourage managers to take on excessive risk in their portfolios.

Even with fulcrum-based fee structures, there remains a negative skew. Since the manager's downside is capped, they are symmetrical around the fulcrum point. Managers never lose money; they just do not make as much as they could have. Arguably, true alignment of interest requires sharing in the downside as well as the upside. Hence, performance-based fees can be viewed as call options (even under fulcrum constructs) for the managers.

The use of performance-based fees for long-only managers may indicate an investor's lack of confidence in their ability to select top performing managers. If an investor has conviction in a manager, they would expect them to outperform. If this is the case, they are entering the agreement expecting to pay a higher fee than they would under a flat fee structure. If the investor does not have conviction in a manager, it begs the question of why they would hire that manager in the first place.

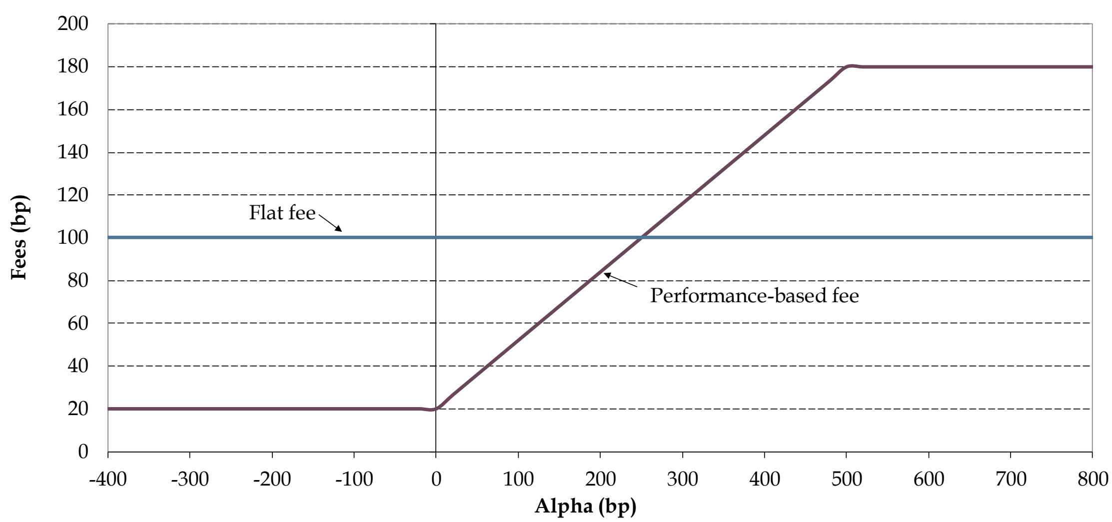
Additionally, performance-based fees create uncertain cash flows for investment managers and can create business risks for poorly capitalized firms, though this is less of a problem for larger management firms.

IMPLEMENTATION

Ensuring a symmetrical fee structure that discourages excessive risk taking behavior is essential when implementing performance-based fees. Initially, a flat fee —or fulcrum— should be established along with an associated required rate of excess return (i.e., alpha). The fulcrum should be set so that the level of outperformance that is expected of the manager yields a fee that is typical for active managers in that asset class. The manager will receive this flat fee if they outperform their benchmark by the required rate of excess return. Performance above (below) the required rate of excess return will increase (decrease) the management fee until the maximum (minimum) fee is reached.

Ideally, the excess return calculation should be adjusted for all risk factors (e.g., value, carry, quality, momentum, etc.) that the investor could achieve on their own at a lower cost. In other words, the investor should pay for alpha, not betas.

The use of a maximum fee discourages managers from taking imprudent risk in order to increase fees. The minimum (or base) fee should be roughly equivalent to the fee for a related passive index strategy,[7] and it should be associated with a zero value for alpha. The maximum fee will be the same distance from the flat fee as the minimum fee. The minimum fee, flat fee, and required rate of excess return will define a slope that can be used—along with the maximum fee—to calculate the value of alpha at which the maximum fee will be realized. Using these rules, the resulting fee structure will resemble that of the figure and table below.



[7] The benchmark index should be highly correlated to the manager's strategy in an effort to award superior active management instead of idiosyncratic style or capitalization differences between a manager's strategy and that of any given benchmark.

Excess Returns (bp)	Base Fee (bp)		Performance Fee (bp)		Total Fee (bp)	
< 0	20	+	0	=	20	Minimum
100	20	+	32	=	52	
200	20	+	64	=	84	
250	**20**	**+**	**80**	**=**	**100**	**Fulcrum**
300	20	+	96	=	116	
400	20	+	128	=	148	
> 500	20	+	160	=	180	Maximum

Typically, a negotiated base fee will be charged for the first twelve months of the strategy, given that this is too short a time-frame to make a fair assessment of performance in most cases. Following the twelve-month period, a since-inception performance fee is calculated until a pre-determined longer-term rolling period is established. The rolling period should be at least three years in duration (preferably longer) to discourage managers from jeopardizing long-term performance for potential short–term revenue generation. Such constructs can have the inherent effect of compelling investors to stick with a manager for a longer period of time. This may be a good thing, as it reduces performance-chasing behavior (e.g., terminating a manager after they have underperformed and replacing them with a manager who just outperformed).

If a performance-based fee arrangement is entered into, Meketa Investment Group recommends the fees be calculated by a third party, such as the investor's custodial bank, to prevent conflicts of interest.

RISK-LINKED FEES

Some managers have begun to offer risk-based performance fees. To potentially mitigate the chances that managers are adding unnecessary risk into their portfolio, a fee structure based on the information ratio may be practical. The information ratio measures the consistency of a portfolio's performance relative to a benchmark. A positive number indicates outperformance versus the benchmark, and the higher the number represents higher consistency. Investors choosing a risk-based performance fee anticipate that utilizing the information ratio will discourage excess risk taking by managers. In addition, the consistency aspect of the information ratio may help the manager focus on achieving solid returns over a full market cycle.

SUMMARY

Meketa Investment Group believes that asset-based fees will remain the industry standard, but we recognize that in some situations performance-based fees may arguably better align the economic interests of investment managers and their investors. In other words, fees paid under a performance-based fee structure should roughly track the level of alpha that the manager delivers. In addition, it may help reduce an asset-gathering mindset by managers.

Ensuring a symmetrical fee structure that discourages excessive risk taking behavior is essential when implementing performance-based fees. We recommend structuring performance-based fees such that the base fee is below a manager's normal asset-based fee (if possible, in line with the management fee for the equivalent passive strategy), and that the excess return calculation should be adjusted for all risk factors (i.e., the investor should pay for alpha, not betas).

If structured improperly, a performance based fee structure may actually encourage excessive risk-taking. Adding risk-linked metrics to the fee structure may help mitigate that potential risk. In addition, during the due diligence process, investors should confirm that managers run portfolios similarly regardless of whether the fee schedule is asset-based or performance-based.

Recent fee negotiations for clients have shown that managers are almost always willing to decrease fees, especially if they have recently underperformed. For top-tier, hard-to-access managers, performance fees probably make sense and may be the only means of accessing them. Otherwise, we recommend that in most cases investors should - with the help of their consultant - negotiate as low a flat fee as possible.

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