Hedge Fund Fees. Suggestions for the Future

I have argued before that hedge fund fees were poorly designed, and in that article had suggested a possible design for performance fees. Here I provide more detail into what I think is a practical solution which addresses some but not all of the problems with current fee structures.

Management fees:

This is the simpler issue to deal with. First of all, one has to question what is the purpose of management fees. In traditional long only mutual funds, management fees are the compensation for the manager for managing the fund. With the rise of absolute return funds, and their performance fees, management fees were no longer intended to be the primary compensation for managing of assets. The industry generally represents that management fees are compensation for overheads and the costs of running the asset management business.

If this is in fact the case, then the current flat percentage of assets management fee does not do as represented. The costs and overheads of running an asset management business are not linear in the size of assets under management. There are economies of scale. By charging a flat percentage of assets under management, these economies of scale accrue to the investment manager and not to the investor.

If management fees are indeed intended to cover overheads and costs, then a sliding scale is closer to the intended purpose. One can envisage management fees being charged as follows: 2% of assets as long as assets under management in the fund are under a certain amount, 1.5% when assets rise to a certain level, and 1% whenever assets are over a certain amount. This is just an example of course and there are other ways management fees can be designed to reflect the represented purpose.

A further finessing of management fees which is useful is to waive management fees for side pocketed investments. This encourages the manager to think carefully about side pocketing any assets. Certainly investors would not appreciate management fees being charged on assets that have been 'gated' or suspended.

Performance Fees:

Hedge funds fees typically include a profit share by the manager. This can range from 15% to 30% but for the vast majority of funds is 20% of profits. Pre-2005 there were a significant minority of funds which had a hurdle rate (strictly positive). That is, performance fees were only applied once the fund's returns were higher than some positive return. In the later years, this practice had mostly disappeared as demand outstripped supply and hedge fund managers were able to increase their prices. Almost all hedge funds still operate a 'High Watermark' by which is meant that the investor pays fees only if the fund's NAV is above the previous high. Should the fund's value fall, performance fees are not collected until the previous high NAV is exceeded again.

This all sounds fair except that there are timing issues. Fees are accrued and at some point crystallized. This usually happens annually. A situation can arise therefore where performance fees are paid out at the end of the year or quarter, the NAV falls thereafter. Even if there is a recovery but the high watermark is not re-attained, fees paid out are not reclaimed.

A simple solution is as follows:

- Fees are accrued semi-annually.
- 50% of the performance fee is paid out semi-annually.
- 50% of the performance fee is retained in Escrow (not to be invested in the fund.)
- Each retained performance fee vests and is paid out 30 months later (for example, the delay can be made equal to the lock up for example).
- All retained fees in Escrow are subject to negative performance fees = 20% of loss from the NAV of last performance fee cal
culation period.
- When redemptions are paid in full, fees held back are released to the manager.

This design has the following features:

- The investor pays performance fees on the net performance for their holding period, unless the performance is negative over the entire holding period. Unfortunately the manager cannot be expected to pay a negative performance fee over the entire holding period if the performance turned out to be negative over the holding period.
- The manager is incentivized to make money over the long term instead of making money only in a given year.
- The manager has 50% of their performance fee at risk on a rolling basis. On a cumulative basis, the manager may have a whole year’s performance fee at risk.
- It has the same kind of incentive as a private equity clawback fee structure.
- The above fee structure can be adjusted for the length of the holdback. The longer the holdback, the more

performance fee is at risk.

- A manager who is confident in generating returns over the length of their lock up should not object to such a fee schedule.
- It incentivizes a manager to force redeem investors if they do not expect to be able to make money.

The Future:

Customers are the ultimate regulator of an industry, so it is investors who ultimately regulate the hedge fund industry. As long as investors are small and numerous, there may not be the aggregation of bargaining power to negotiate with fund managers. The huge concentration of assets under control in the fund of funds industry afforded funds of funds the opportunity to negotiate, not harshly but fairly with hedge fund managers. Not just on fees but on liquidity terms, transparency and controls. This was an opportunity that was missed. The battering taken by funds of funds in 2008 has greatly impaired their powers. We can only hope that investors find some way of communicating their needs to fund managers. And we can only hope that fund managers are enlightened enough to see that investors are not deliberately antagonistic, although it may seem so today.