

Hedge Fund Fees: Its not the magnitude but the design

Hedge funds have been accused of charging extortionate fees. The typical hedge fund charges what they call 2 and 20 fees by which is meant that there is a 2% management fee charged on the total assets managed and a 20% performance fee in the form of a share of profits. The management fee is to keep the lights on, meet overheads and running costs.

Investors don't really have a problem with this, although, they should to a certain extent. The costs of managing a hedge fund do not vary proportionally with the size of assets under management. Thus, a sliding scale is a fairer compensation. However, this creates all sorts of other considerations driving investors into larger funds in order to benefit from a 'bulk discount'. Lets not go there.

The main complaint that investors have with hedge fund fees is performance fee. While on the surface the 20% performance fee looks like a share of profits, it isn't. Well, not precisely. Performance fees cannot be negative, whereas performance can. Moreover, performance fees ignore the opportunity cost of an investment, and while we can argue about what an appropriate opportunity cost is, a simple candidate would be the return on cash held for matching periods to the redemption frequency of the fund. So 3 month LIBOR would be an appropriate proxy for a quarterly liquidity fund. Basically, what investors are calling for is a Hurdle Rate, over which performance fees are calculated. Why should an investor pay performance fees on cash since a manager could put all their assets in cash and still receive a performance fee on the cash return?

The issue of how to handle losses is a more difficult issue. Rather than complicate the issue, a simple holdback would help to partially address the asymmetrical nature of the current performance fee design. Most funds have a high watermark mechanism, meaning that performance fees are only earned if a fund is making money for their investor. But a high watermark is defeated whenever the performance fee is crystallised and paid away to the manager. As in so many things in life and finance, possession is ten ninths of the law.

A simple 2 period or 3 period holdback could work as follows. Lets for the sake of argument call a period a year. Every year, the performance fee is calculated but only half is crystallized and paid out. The other half is kept in the fund and at risk. Every year, if there fund is profitable, the previous year's held back performance fee is paid out. So every year, the manager receives half of the current year performance fee, and the retained half of last year's performance fee. Here is where the negative performance fee can take effect: If the manager has made a loss, the 20% performance fee is calculated on the loss and is charged against any performance fees held back from previous years.

Until an investment manager can have a negative performance fee, they effectively have a call option on performance and are prone to taking excessive risk.

The time has come to re-assess hedge fund fees, not to limit them or reduce them, but to re-design them in such a way as to incentivize the manager to protect the downside as much as seek upside opportunities.