Peltz International

White Paper Series:

Rethinking the Fee Paradigm

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I. Rethinking the Fee Paradigm

One of the main culprits behind downward fee pressure in the hedge fund community has been mediocre hedge fund alpha over the past eight years. If managers were generating strong double-digit returns, fewer investors would be concerned about fees charged. But performance has been mediocre, causing many managers to cut fees to keep investors from redeeming.

Relationships, accessibility, and other non-quantifiable factors will always matter, but in an environment where the probability of lower returns is high, and competition doesn't go away, fees will matter.[1]

Some well-established highly respected managers have reduced management fees over the past two years including:

- **Brevan Howard** announced in September 2016 that it was cutting its management fee to zero on new capital committed by existing clients in its flagship Master Fund and its multi-strategy fund.
- **Caxton Associates** cut the management fee on its global fund from 2.6% to between 2.2% and 2.5% while keeping the incentive fee at 27.5%, effective January 2017. Caxton also introduced a new institutional investor share class with a 2% management fee which requires investors to keep assets in for three years.
- **Moore Capital** cut the management fee on its Macro Managers Fund to 2.5% from 3%, effective January 2017.
- **Och-Ziff** cuts its multi-strategy fund management fee by 25 basis points with fees ranging between 1% and 2.5%, effective October 2016.
- **Aurelius Capital** cut its management fee to 1.25% from 1.5%, effective 2017.

Fewer managers have made changes to the performance fee. One example is **Pershing Square** which, in October 2016, provided investors with an option to pay zero performance fees on gains under 5% but 30% on gains above 5%.

Tudor Investment Corp cut fees for the second time in eight months on its flagship fund.[2] The management fee/incentive fee was cut to 1.75/20 from 2.25/25 in July 2016 and 2.75/27 in January 2016.

Investors and consultants feel the recent trimming of fees and the dialogue are a great step forward but further improvement is needed.

In a recent survey, 69% of investors interviewed at the end of 2016 felt their interests were not aligned with their fund manager. Nevertheless, 58% said they have seen favorable changes in fund terms in 2016.[3]

Historical overview of fees

In the 1980s, a 1/10 fee structure was common. Fees rose as more assets came into the space. By the mid to late 1990s, the average traditional hedge funds had a 1/20 fee structure. As institutional assets flooded into hedge funds in the late 1990s/early 2000s, the average fee climbed higher to the 2/20 range.

Since 2007, hedge fund fees have been pressured lower due to the low interest rate environment, the increase of passive and lower cost alternatives, and performance pressure.[4]

While most US pension funds target 7-8% returns, the HFRI Fund weighted composite index gained 5.5% in 2016, dipped 1.1% in 2015 and inched up 3.0% in 2014. Since 2010, on an annual basis, the hedge fund index has trailed the pension target return for five years.

Annual Hedge Fund Returns

Year	(%)
1993	30.9
1994	4.1
1995	21.5
1996	21.1
1997	16.8
1998	2.6
1999	31.3
2000	5.0
2001	4.6
2002	-1.5
2003	19.5
2004	9.0
2005	3.5
2006	12.9
2007	10.0
2008	-19.0
2009	20.0
2010	10.2
2011	-5.3
2012	6.4
2013	9.1
2014	3.0
2015	-1.1
2016	5.5

Source: Hedge Fund Research,
HFRI Fund Weighted Index

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Over the past few years, a steady stream of institutional investors have redeemed from their hedge fund investments in order to avoid the higher fees. California Public Employees' Retirement System led the way in September 2014, announcing plans to liquidate its $4 billion hedge fund program. Other pensions remain committed to hedge funds but are pushing for lower fees and better alignment with their portfolio needs.

The days of 2/20 and quarterly liquidity have long been over. Since 2007, the average management fee for funds launched that year has been gradually decreasing from 1.66% to 1.51% in 2016.[5]

Mean management fee (%)

Year	(%)
2007	1.66
2008	1.65
2009	1.62
2010	1.65
2011	1.62
2012	1.60
2013	1.59
2014	1.57
2015	1.57
2016	1.51

Source: Preqin

Warren Buffett ripped into active managers and hedge funds in his recent annual shareholder letter. He pointed to high fees charged by active managers and performance falling short of the S&P 500. He claimed that active managers cost investors $100 billion in wasted fees over the past 10 years. He advised that investors should stick with low-cost index funds.

Buffett's infamous $1 million bet with Protégé Partners ends later this year. The bet was to determine whether active or passive investment would perform better over a ten-year period. Protégé selected five undisclosed funds of funds while Buffett selected a Vanguard S&P index fund. The Vanguard index fund's compound annual return has been 7.1% compared with an average gain of 2.2% for the funds of funds.

One million dollars invested in the Vanguard fund would have generated $854,000 while the funds of funds would have resulted in $220,000.[6]

II. Snapshot of Current Fees

As shown on the prior page, the average management fee has been declining. Various data providers' statistics show the current average management fee ranging from 1.33% to 1.59% while the average performance fee ranges from 17.40% to 20.00%.

Summary Table of Estimated Fees

	Management Fee (%)	Performance Fee (%)
HFR (All Funds) (12/31/16)	1.48	17.40
HFR (New launches) (12/31/16)	1.33	17.71
Deutsche Bank (all funds)	1.59	17.69
Deutsche Bank (institutional)	1.51	17.52
Seward & Kissel (new launches)	1.48	20.00
Preqin (all launches)	1.56	19.30
Preqin (new launches)	1.51	19.39

Source: HFR, Deutsche Bank, Seward & Kissel, Preqin

Despite these averages, some institutional investors say they see management fees as low as 70 basis points and performance fees in the low teens and even as low as 10%.[7]

Preqin found that only 17% of active single hedge fund managers actually have a 2/20 structure. [8]

Managers' willingness to negotiate

Various surveys reflect managers' willingness to negotiate fees.

A recent Barclay survey found that two-thirds of funds offer a fee discount of some type.[9] Citco Fund Services/HFM survey found that 72% of surveyed managers are creating new fee structures.[10]

In a Preqin survey, the largest percentage of managers said they were likely to offer fee concessions for larger mandates. Seed investors were also likely to receive a fee concession for early stage investing.

Reasons why managers have offered fee concessions

	%
Large mandates	60
Seed capital/founders share	46
Early stage investment	40
Longer lock-ups	36
Separate account of Fund of One structure	23
Limitation on redemptions	5

Source: Preqin

Deutsche Bank's survey found that one-third of investors negotiate for every potential allocation compared with 29% last year. The percentage of pension funds negotiating fees for every investment increased to 72% from 55% last year.[11]

60% of investors said they would not allocate to managers with fees in excess of 2/20 compared with 58% last year. About 74% of institutional investors would not consider such a fee structure.

For new allocations, would you consider allocating to managers with fees in excess of 2/20?

	2017(%)	2016 (%)
Yes	40	42
No	60	58

Deutsche Bank 2017 survey

Fee Differential by Length of Track Record, Strategy, Investor Type and Location

The fee picture varies based on length of track record, manager strategy, investor type and location.

Length of track record

Most of those we interviewed for this white paper feel the next generation of larger managers are more innovative and flexible than established larger managers.

Newer managers are more flexible in trying to align interests with investors. They view it as a competitive advantage.[12]

One recent example is **Rokos Capital Management** offering investors a choice of 2/20 or 1/30 with the latter providing more incentive to generate better returns.[13]

Many hedge funds starting out have already been giving concessions through founders' shares. Since some emerging hedge funds know it has the funding to sustain itself for three or four years, they might also be willing to take on additional capital on similar terms or favorable terms to other investors because it is adding to assets under management and moving the business forward in the medium term.[14]

For established managers and their teams that are used to a certain structure, it may be harder for them to change their fees while managers at early stages in building their business may be more aggressive to raise assets. Some endowments and family offices have a leaning toward newer funds.[15]

Strategy

The management fee i.e. what is required to run the management company, is different and has a different cost structure [based on the fund's strategy].[16]

For example, a long/short equity fund doesn't have the same infrastructure requirements as a quant or global macro fund that has a lot of technology and research build-out. A hybrid credit fund is also a bit more complicated.[17]

Equity hedge funds have seen the most fee erosion as they have been in less demand over the past few years while the universe of equity hedge funds remains large.[18]

Meanwhile, quant equity, fixed income relative value and multi-strategy funds have lowered their fees the least over the past two years. This is likely due in part to the capacity constraints and relatively better supply/demand dynamics for managers in quant equity and fixed income relative value, and the higher costs that multi-strategy funds generally face often due to their business complexity and exposure to netting risk.[19]

How have fees on new hedge fund allocations changed over the past 24 months?

		Meaningfully Lower (%)	**Somewhat Lower (%)**	**Same (%)**	**Higher (%)**
Little change	Quant equity	6	27	64	3
	Fixed income relative value	2	32	66	
	Multi-strategy	3	37	59	1
Some change	Credit	3	43	54	
	CTA/managed futures	13	36	51	
	Global macro	7	43	50	
	Event driven	6	44	50	
More change	Equities	8	61	30	1

Source: Barclays Turning the Tide

According to one data provider, the mean management and performance fees by strategy are:

Single Manager Hedge Fund Fees By Strategy

Strategy	**Mean Mgt Fee (%)**	**Mean Performance Fee (%)**
All single manager hedge funds	1.57	19.29
Macro strategies	1.70	19.47
Multi-strategy	1.63	19.21
Event driven strategies	1.60	19.72
Relative value strategies	1.58	20.04
Credit strategies	1.54	18.30
Equity strategies	1.53	19.30
Niche strategies	1.50	17.76

Source: Preqin Hedge Fund Online

Investor type

Large investors e.g. pensions, endowments, foundations and funds of funds receive the most discounts as well as those investors with more than $5 billion allocated to hedge funds. Private banks and family offices generally see less discounting since they generally have less buying power.[20]

The most traditional items – reduced fees for longer locks and/or larger tickets – have been most commonly negotiated.[21]

Location

Significant fee differences exist based on manager location. North American managers have lower fees than European managers possibly due to greater competition or greater maturity of its hedge fund market. Hedge funds in Asia tend to have lower fees than funds in Europe and North America perhaps to attract skeptical investors.[22]

A few Asian managers are now offering a zero management fee. **Ortus Capital Management** started a fund in the summer of 2016, Ortus FX Fund, which takes 33% of profits without a management fee.[23]

Singapore-based **Noviscient** plans to start a fund with a zero management fee and absorb the first 5% of annual investment losses. It will charge 20% of gains on the first 10% of profits. After that, there is a 50-50 share on profits. [24]

Some Asian managers are using a hurdle on their performance fee. Singapore-based **Gordian Capital**'s Quadratus Fund will charge 1.25/15 for returns exceeding a benchmark.[25]

Other funds are offering the investor a choice. For example, **Myriad Asset Management**, which manages about $4.1 billion, added a new share class that charges the greater of a 30% incentive fee or 1% of assets under management.[26] The performance fee is charged on total return instead of outperformance relative to a benchmark. [27]

Kit Trading, which offers a 1/15 fee structure, gives investors the choice between two share classes – one with lower risk/lower return and one with less downside protection/higher participation in growth.[28]

III. Various Approaches to Aligning Interests

The management fee

More pressure exists on the management fee than the performance fee.

The original concept was that the management fee would allow the firm to run its business and cover operating expenses. The fee is paid regardless of fund performance.

Over time, however, the management fee became a profit center for some firms as they grew in asset size. As Warren Buffett pointed out, when you have $20 billion in assets, you get $400 million just from management fees so the 20% incentive fee becomes less important.

Another problem is that in an environment of lower returns, management fees take a larger proportion of gross alpha generated by managers. In the past few years with lower hedge fund returns, estimates are that 50-75% of the gross alpha has been going to the manager whereas when the manager generates 8-10% net annual returns, the split is 70% to the investor and 30% to the manager. [29]

Investors need to re-think what the management fee is paying for, and ensure that whatever fee arrangements are agreed upon, a fair, transparent, and appropriate alignment of interests is established.[31]

While 55% of respondents saw an improvement in management fees in 2016, 76% see room for further reduction in management fees in 2017. This is 30 percentage points higher than the proportion of investors seeking improved management fees in the year earlier survey.[32]

Terms and conditions that have changed over the past 12 months and need further improvement in 2017

	Have seen change (%)	Need to Improve Further (%)
Management fees	55	76
More transparency at fund level	39	57
Performance fee – amount	30	48
Manager commitment to a fund	18	39
Performance fees – how they are changed	18	57
Hurdle rate	15	59
Lock up period	15	30

Source: Preqin- Alternative Assets, Investor Outlook H1 2017

Performance fee with high water mark

Investors are willing to pay for returns. As a result, performance fees have held up better than management fees.

The high water mark is the historic peak of the fund's net asset value. The performance fee paid is only on the portion of the gain that exceeds the high water mark. Previous losses must be regained before a manager is eligible for a performance fee.

To attract new capital, managers have been negotiating around the high water mark. For example, if the investor puts in new money, the manager may let the investor carry over the old water mark for the new investment.[33]

All the new funds in the Seward & Kissel study had some type of incentive allocation and high water mark provision. None had a modified high water mark while a small percentage had an incentive allocation measured over a rolling multi-year period and an equally small number had a hurdle rate.

One criticism of the high water mark is that it could lead to managers doubling-down on positions and taking extreme risks when the incentive compensation is out-of-the-money. The high water mark provision also increases the likelihood that a fund may close and create a new fund when it is out-of-the-money in terms of incentive compensation.[34] We have seen many examples of both scenarios.

Hurdles

There is increasing talk about performance fees with hurdle rates.

With a hurdle, the performance fee is paid only after a certain return is reached over a pre-agreed benchmark. It aligns interest with investors since the performance fee is paid only for true alpha.[35]

Only about 10% of hedge funds currently have a hurdle.[36] One example is **KAM**, a new fund, which has a 5% hurdle in its Class A share. There is no incentive fee when returns are less than 5%. When returns are more than 5%, there is a 15% incentive fee. Class B has a 17.5% performance fee. Another example is Bernard Melkman's **LightSky Macro** which has a performance fee of 18% per year after the fund makes 4% net.[37]

While 48% of all investors want to see a reduction in performance fees charged, a larger percentage want to see changes in how performance fees are charged e.g. hurdle rates, clawbacks etc.[38]

Hurdle rates can be viewed as a "cost of capital." In the alternative investment space, depending on the strategy, style, objectives, etc. the hurdle could be Libor + a spread (i.e. +400-600 basis points) or the S&P, or a net-adjusted S&P which would take into account the fund's average or typical net exposure over the determinant period.[39]

"As a large institutional investor, I would be delighted to pay premium fees - if I receive superior outcomes. I would not be happy providing my investment managers a free option on my stakeholders' capital, which is the situation we have when there is no mutually agreed-upon hurdle rate appropriately aligned with a given managers style, strategy, and objectives."[40]

One attorney says he has seen the performance fee tied not solely to profit but to the extent to which the performance of the fund exceeds a particular benchmark e.g. an energy-focused fund might have an energy index as its benchmark. “If it outperforms the energy index, the manager would receive a percentage of that outperformance. I’ve seen it in a couple of instances with newer funds for an existing manager or emerging managers.”[41]

Another variant is having a ratchet with performance fees. For example, the manager will pay 10% on the first portion, another 10% on another threshold as opposed to just 20% flat. It is similar to having a benchmark. [42]

Another suggestion is to have a hurdle rate of 8% to 10%. The management fee plus incentive allocation are disproportionate for gross returns in the single digits or even low double digits. With a gross return of 10%, minus the 2% management fee and 20% performance fee, the result is 3.6% for the manager and 6.4% for the investor.[43]

Whatever approach is used for the hurdle, the strategy and the investor’s risk profile need to be considered. If the investor wants a 5-6% return, the hurdle should then be 5-6%. Those that want a higher return should have a higher hurdle.[44]

“A lower management fee, like 1%, plus a performance fee with a hurdle rate of 8% would remove much of the valid criticism of current prevailing hedge fund fees. A 2% management fee works better with a capacity-constrained strategy,” suggests one consultant.[45]

Pensions funds have been able to secure preferential terms. Pensions and funds of funds appear to secure almost twice as many of these terms as their smaller counterparts in the private wealth channel. However, even the smallest investors and smallest tickets have a high occurrence of preferential terms being successfully negotiated.[46]

Channel	**% of Respondents Successfully Negotiating at Least 1 Preferential Term**
Public pension	96
Fund of fund	87
Private pension	82
Advisor/consultant	78
Endowment/foundation	73
Private bank	69
Family office	68
Insurance	60

Source: Barclays Turning the Tide

About 22% of investors in the Barclays survey said that most of the time, they have successfully negotiated hurdle terms while another 23% said they were able to do so some of the time.

Frequency with which investors successfully negotiated the following terms

	Most of the time (%)	Some of the time (%)
Reduced fees for longer lock	40	20
Reduced fees for larger ticket	43	17
Mgt fees decreased as AUM increases	21	29
Hurdle rate	22	23
HWM for a new allocation based off of different allocation	20	21
Performance fee crystallization aligns with lockup period	22	17
Limits on pass-through expenses	23	14
Performance fees increase as returns increase	10	18

Source: Barclays Turning the Tide

	By Hedge Fund Portfolio Size (%)
<$500M	69
$500M-$1B	70
$1B-$5B	89
$5B-10B	95
>10B	100

Source: Barclays Turning the Tide

	By Average Ticket Size (%)
<$25M	65
$26M-$100M	83
$101M-$200M	89
>$201M	100

Source: Barclays Turning the Tide

Crystallization

With crystallization, performance fees are calculated over longer term periods e.g. three years rather than 12 months. This alleviates a situation where investors pay high fees in one year and then have poor performance the next year, having already paid fees.[47]

The preferred structure is for the crystallization of a fund's fees for the underlying investment of the fund to match the duration of it investment. The strategy, expected liquidity, targeted performance time horizon for the strategy and the fund's risk parameters need to be considered.[48]

Certain strategies such as CTA and managed futures can liquidate the underlying positions in the fund daily while other strategies with a high frequency of trading don't need fees to be crystallized. More illiquid strategies don't need to crystallize on an annual basis either.[49]

Claw backs

Generally, when hedge funds experience losses, there are no claw backs. Managers don't have to give anything back.

One approach being considered is that in year one, an investor would pay only a portion of the performance fee if there was a gain. If losses occur in later years, the investor would claw back the withheld compensation. [50]

While some alternative managers are starting to offer claw backs, none of the larger managers have done so.[51]

Other approaches to align interests

Various other approaches are being discussed to better align interests between investors and managers involving fees and terms.

It is not a one-way street for investors. Hedge funds and investors are negotiating.[52] Hedge fund managers gain benefits as well.

Different performance fees based on return generated

Different performance fees are charged based on the return generated i.e. investors pay according to performance. For example, gross performance of 0-5% earns 10% performance fee, 5-10% return earns 15% performance fee, 10%+ return earns 20% performance fee etc.

One criticism of this approach is that it may encourage managers to take excessive risk as they try to generate higher returns.[53]

Rolling multi-year period to measure performance fees

One approach is to spread performance fees over three years with 50% of the fee payable at the end of the first year and 25% payments in the subsequent two years.

Ratcheting down management fees as assets grow

One approach is to gradually decrease management fees as fund assets under management grow, reflecting the economies of scale in operating costs of business.[54]

The benefit is that investors get a fee break as assets under management increase and managers are still able to handle their operating costs.[55]

According to one study, three-quarters of hedge funds offer or are considering offering a sliding-scale fee where management fees decline as the fund's assets increase.[56]

One example is **LightSky Macro**'s management fee which starts at 1.5% and decreases to 1.25% when assets reach $1 billion, and then decreases to 1% if assets hit $2 billion.[57]

One risk with this approach is that the manager can't ask investors to pay a higher management fee down the road if performance slips. If a large multi-billion fund experiences bad performance, has redemptions and assets drop sharply, it can't make do with the 25 basis point management fee that it charged when it had much higher asset level. It already lowered its management fee and is losing money.

Longer term lock-ups

Hedge funds want longer term lock-ups. They want more permanent capital. That's offset by investors wanting an exit strategy in times of stress. For instance, if the general partner is permitted to take a percentage of its own capital out, then investors should also be able to redeem early. Maybe there could be a slight penalty for early redemptions. Maybe they get 98% of their money immediately or they can get 75% right away and wait for the other 25% pending other conditions.[58]

A three-year or five-year lock-up may lead to a lower management fee e.g. a 1/20 fee rather than 2/20.

What is the most persuasive argument for a reduction in hedge fund fees?

	Institutional Investor (%)
Willingness to lock up capital	21
Fund is not meeting returns	19
Ability to write larger tickets	18
Fund has a strong beta element	12
Willingness to invest day 1	9
Your brand as a high quality institutional investor	8
Increasing AUM	4
Fund's risk exposure is too low	2
Downward pressure from local regulators/government	0
Other	3
No argument- focus is on net returns	5

2017 Deutsche Bank survey

Founders' share class

Over 61% of new funds offer founders' share classes. Typically, the founders' class has a management fee rate that is 50 basis points less than the management fee charged in the standard class for such funds and an average incentive allocation of 14.5% for equity funds and 17% for non-equity funds.[59]

Increasingly, fees are tiered in the founders' share class i.e. the rate goes down as assets levels increase. In 2016, 40% of the equity funds issuing founders' classes and 25% of non-equity funds issued founders classes had tiered management fees in the founders' class while 20% of the equity funds issuing founders' share classes had a tiered incentive allocation.[60]

Management fees charged to standard class members fell from last year to 1.43% for non-equity funds and 1.51% for equity funds. About 25% of the single non-equity-based funds offered tiered management fees in their founders' share class in 2016 compared with none doing so in 2015, Tiered management fees were offered by 40% of equity funds in 2016, up 5% from the prior year.[61]

Investors are starting to extract concessions from non-equity based funds similar to those they had previously won from equity-based funds. The percentage of non-equity funds offering special founders' terms to investors jumped from 29% in 2015 to 36% in 2016 while the percentage of equity funds with founders' share classes dropped from 82% to 75% over the same time period.[62]

20% of equity funds with founders' classes used a tiered incentive allocation in 2016 while only one fund did in 2015.

Discount for loyalty

In some instances, investors get discounts on fees the longer they are in the fund. The benefit is that investors are unlikely to redeem from a lower fee fund to reinvest in a 2/20 substitute.[63]

Discounts when investors add more assets during a down period.

Existing investors can invest during a drawdown period in return for lower fees and/or add more capital in their existing high water mark.[64]

Investors can receive discounts on fees while building longer term relationship with their managers. Managers are able to stabilize or even grow their asset base during periods of poor performance.[65]

Other items

Scrutiny on fees sometimes results in negotiation of other terms. While it may not change the fees per sé, it might result in better transparency, establishment of a leverage threshold, or a different type of structure that allows better monitoring e.g. a managed account or fund of one.[66]

IV. Specific Packages

Albourne's "1 or 30" fee structure

In working with various pensions, Albourne Partners analyzed various fee approaches to determine what worked best, why, when it broke down, and how to fix it. In most of those cases, the "1 or 30" approach presented itself as the best option. The consulting firm found it the most negotiable and fair to the manager over a full cycle.[67]

Over the long term and always year-by year, the share of profits will be in a 70:30 split for the investor/manager [i.e. 70% of the split goes to the investor and 30% goes to the manager].[68]

"There have been cases where 30 is not the right number e.g with CTAs and long vol managers, the share of profits has been more like 80:20 [i.e. 80% goes to the investor and 20% goes to the manager]. In that case, it is "1 or 20" instead of "1 or 30." We also don't suggest 1 is universally applicable," says Jonathan Koerner, partner and head of implementation at Albourne Partners.[69]

Managers can't operate on zero. So there has to be some ongoing guaranteed revenue. Some managers may legitimately need 2% to keep their business running. In that case, it would be "2 or 30." If it's an equity long/short manager that operates on 75 basis points, maybe it is "75 basis points or 30." The key is: any time the performance fee is paid, it is paid as required to get to the cumulated 70:30 split.[70]

The three independent concepts to the package are:

1) Reframing away from the traditional 2/20 structure.
2) Novel and most significant is the concept of OR versus AND ["1 or 30" versus "1 and 30"].
3) The beta hurdle

<u>Identifying/calculating the beta</u>

The model works perfectly and achieves what you tell it to achieve but you have to plug in assumptions of or a definition of what beta is.[71]

The hedge fund manager's beta exposure has to be identified. The investor only pays for performance greater than this level. Beta levels will be discussed and agreed by investors and managers during the fee structure negotiations.

Something is needed that can be calculated independently so there is little room for disagreement when the fee calculation comes due.

To arrive at beta substitute calculations, historical data is analyzed such as since inception, 10 years, and the average of the rolling three-year betas. If there is a highly correlated beta to the S&P 500 of 0.2, then often times, managers and investors agree to that as the beta.[72]

Year by year, as the observed beta changes, it might be adjusted over time.

Some are using a simplistic beta or single index as the beta. In other cases, such as global macro, relative value or market neutral, an index is not being used. There might be a "risk-free rate plus" e.g. T-bills plus 1% as the beta substitute. That presents a cleaner option for some investors since they won't be faced with paying a performance fee in a down year but it takes some of the academic purity away from it.[73]

Management fee

The 1% management fee is paid back through a discount in the performance fee. The 1% management fee can be described as an advance against the next eventual performance fee so that the otherwise payable performance fee is reduced by the exact dollar amount of the current year management fees paid, as well as the prior year management fees not previously deducted from a prior year performance fee.[74]

To ensure the long-term alpha share between the investor and manager tracks the targeted 70:30 split, this secondary hurdle must carry forward to subsequent years to the extent any prior years' performance does not offset it.[75]

The result is that the manager always receives a predictable and guaranteed management fee revenue stream and the investor achieves an exact 70% retention of alpha in most cases.

Reaction

Koerner says a number of managers are implementing the approach. He lost count when the managers on the list hit 40. The list is not limited to managers that TRS is talking to and not all managers that Albourne has been working on for other clients. "Momentum is unprecedented. We've seen hurdles and tiered management fees but never before something with so much promise to rival the standard terminology of 2/20. It is the concept of "or" versus "and," says Koerner.[76]

Concerns and criticisms

Koerner points out that some managers may misunderstand that if there is flat year and the management fee has been paid, it can't be forgiven. It needs to be carried forward to the next eventual performance fee as a reduction or the 70:30 split will never be achieved again.[77]

One criticism is the same as with any hard hurdle i.e. if the manager has a flat year and has to make up that year's management fee and the next year's management fee, the manager is incentivized to take greater risk so he can get out of the drawdown. That criticism is inherent with any performance fee where a drawdown will cause that scenario.[78]

Koerner counters that an incentive exists not to get into that situation in the first place so excessive risk-taking doesn't take place. If it causes the performance not to be paid for two or three years, it's because the manager hasn't generated any real return for the investor. Investors, most likely, won't stick around without three years of return.[79]

The "1 or 30" concept is not being applied to managers that pass through traders' fees at a high level. The "1 or 30" works on gross profits. To achieve the perfect 70:30 split, one calculates performance fees based on gross performance. Higher amounts of fees passed through hide from gross performance. Albourne says it is not yet comfortable at this point applying "1 or 30" to managers that pass through traders' fees at any high level.[80]

Others in the industry are not convinced that the "1 or 30" approach will be the new standard. "The approach is new and hasn't been mass adopted yet. A lot of existing fee structures are being negotiated with other parameters. It's possible "1 or 30" will be more prevalent for newer allocations," says one industry veteran.[81]

One issue is defining the hedge fund's beta exposure which can be complicated. A manager negotiating this structure needs to make sure the beta hurdle is really reflective of his strategy. An S&P 500 hurdle may not work for every manager.[82]

From an operational standpoint, a manager needs to understand the year-over-year carryover if he under performs.[83]

The proposed management fee tax treatment also needs to be checked by outside experts before a manager signs on the dotted line.[84]

Protégé's 1/10/20

Protégé Partners is offering a 10/20 incentive fee structure with a 1.0% management fee. The managers receive only a 10% incentive fee if they generate below a 10% net return. If they generate more than a 10% return, then the managers get a 20% performance fee.[85]

Protégé is using this fee structure on the founders' share class of Protégé's newest seed.

"By creating a tiered performance fee, [this approach] ensures investors are getting an appropriate percentage of returns when performance is low but keeps in place the incentive for managers to receive substantial profits if they outperform. It motivates managers to strive for double-digit returns….and by shifting the focus to the performance fee, it reduces the incentive for a manager to raise assets to levels that degrade performance."[86]

Caldwell's SRAP Approach

Ted Caldwell of Lookout Mountain Capital says his Superior Risk Adjusted Performance Model (SRAP) pays managers only for outperformance against a defined benchmark on a risk-adjusted basis. He pays up to a 20% performance fee to managers with the performance measure on a risk-adjusted basis against the benchmark hurdle.

If he chooses to, he may pay managers an upfront performance fee or what he calls a draw of up to 2% which they have to pay back through the performance fee. If a manager is large enough to not need the money upfront, there is no such fee.[87]

New platform: Willis Towers Watson Asset Management Exchange

In a somewhat related move, Willis Towers Watson introduced its Asset Management Exchange in late February. The platform is designed for institutional investors and offers centralized access to managers, standardized fund infrastructure and centralized back office services. Back office providers, lawyers, custodians, auditors and counterparties are in the exchange's domain. By providing the infrastructure, managers can concentrate on investments rather than operations. The intended results are better governance, more transparency and reduced costs.[88]

Hedge fund managers were the first added to the platform with other strategies and asset classes to follow. The exchange has been seeded with $750 million of WTW's delegated hedge fund assets. WTW's internally managed funds of funds will invest with managers on AMX.

V. Outlook

While changes have been made on reducing fees and terms, further changes are still needed.

Institutional pressure is likely to continue as allocations will go to those managers that are flexible on fees. The next generation of larger managers is more innovative and flexible than established larger managers who are used to a certain structure and find it harder to change their fees.

More discussion will focus on hurdle rates where performance fees are contingent on exceeding a benchmark. Claw back provisions may also become more common.
Albourne's "1 or 30" approach will be the basis for further discussion as momentum appears to building for the model.

It is also important to keep the investor's objective in mind. Fees can be based on achieving whatever objectives the investor is seeking to solve for, it doesn't necessarily have to be on raw returns. An investor may not be buying hedge funds to necessarily beat "the market." An investor may be seeking a higher Sharpe ratio, or lower correlation, etc.[89]

A one-size-fits-all fee regime should be re-considered. For strategies with plenty of supply i.e. competition, the case could be made that experience and results should lead to more differentiated pricing. Strategies that are niche and idiosyncratic, where there is less competition, should have different fees. [90]

One growing area of contention is pass-through fees which are charged on top of the existing management and performance fees. Fees related to the fund such as audit and directors' fees, administration, custody or legal changes can be expensed but other areas are less clear such as research-related travel.

While managers claim they need to keep top talent and have the latest technology, investors argue that only the manager benefits and it is not in the spirit of partnership.

The fee discussion should continue even if general hedge fund performance improves. "Not caring as long as performance is good is not the answer. Fees are facts, returns are hope."[91]

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VII. About Peltz International

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