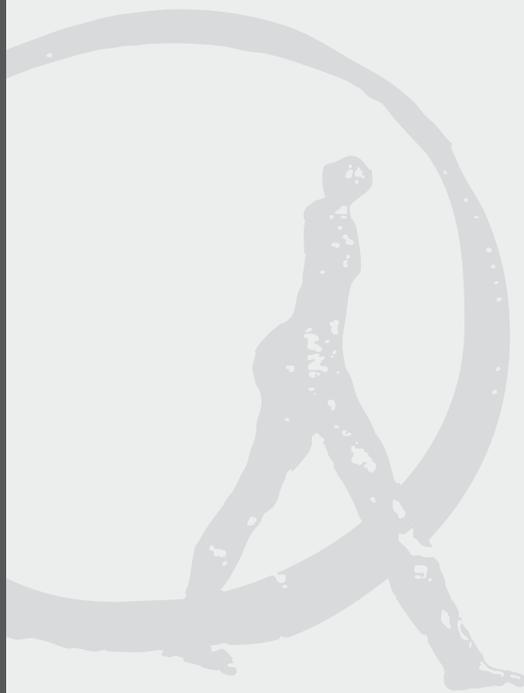


Pricing Traditional versus Alternative Asset Management Services



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Abstract

The delegation of asset management services is a source of potential agency problems between investors and their portfolio managers. Most of these problems can be avoided by using an adequate compensation theme. While the academic literature tends to be somewhat inconclusive as to whether or not, and to what degree, optimal compensation should be linked to relative or absolute performance, industry practice seems to show a clear pattern: mutual funds charge an asset-based fee, while hedge funds charge both an asset-based fee and a performance fee. Hereafter, we discuss the advantages and drawbacks of both types of fees.

EDHEC is one of the top five business schools in France owing to the high quality of its academic staff (100 permanent lecturers from France and abroad) and its privileged relationship with professionals that the school has been developing since its establishment in 1906. EDHEC Business School has decided to draw on its extensive knowledge of the professional environment and has therefore concentrated its research on themes that satisfy the needs of professionals.

EDHEC pursues an active research policy in the field of finance. The EDHEC Risk and Asset Management Research Centre carries out numerous research programs in the areas of asset allocation and risk management in both the traditional and alternative investment universes.

The past thirty years have witnessed an increased separation between the ownership and the control of financial wealth. The emergence of modern portfolio theory, the increased efficiency of markets and the growing sophistication of financial instruments have convinced many, if not most, investors to delegate the management of their portfolios to professional asset managers and their collective investment vehicles. Investment advice is now becoming a commodity.

Initially, actively managed funds took the lead and intermediated much of consumers' investments in financial securities. However, their dismal average performance simply provided more general evidence of just how difficult it is to beat the market. It also opened the way for passive strategies and indexed funds, which were then perceived as a cost-effective way of buying equity market exposure – a strategy that made sense in an environment of rapidly rising market valuations. However, the end of the technology bubble and the subsequent bear market significantly froze the development of passive funds and provoked interest in alternative investments such as hedge funds and private equity. Since then, the number of highly specialised, non-traditional asset management firms has been growing exponentially. Many of them are born from the ashes of the failure of mainstream fund managers.

Whatever the investment vehicle and investment strategy selected, the delegation of portfolio management activities can be seen as a particular case of the principal-agent model initially introduced in the seminal work of Jensen and Meckling (1976). Since the costs to wealth owners of monitoring those who are charged with managing their financial holdings are rather large, agency theory's most basic suggestion is that principals (investors) should compensate the agents (portfolio managers) through incentive contracts in order to align their respective interests. The nature and intensity of these incentives should depend upon a series of parameters such as the incremental profit generated by an additional unit of effort from the manager, the precision with which investment performance and risk can be measured and monitored, the risk tolerance of the portfolio managers and their responsiveness to incentives.

1. Traditional versus Alternative Incentives

From a theoretical perspective, incentive contracts may combine three elements, namely: (1) a profit sharing rule (e.g., fee structure), to align incentives in terms of returns; (2) a relative performance component measured against a benchmark, to monitor performance, make returns comparable and audit for common uncertainty; and (3) checks on risk-taking, such as maximum allowable tracking error, reporting requirements and constraints on available investment choices.

How are incentive contracts implemented in practice? Surprisingly, the empirical evidence seems to suggest that traditional and alternative asset managers have made diametrically opposed choices.

Most traditional investment managers are monitored and evaluated against appropriate style benchmarks, but their compensation is not linked to their relative performance. Rather, they charge a management fee that is generally expressed as a fixed percentage of the assets of their fund. The fee varies depending upon the complexity of the strategy and the asset class considered, but is typically between 1 and 3 percent per annum. In recent years, asset-based fees have been subject to highly competitive pressure and have fallen. This is not surprising, as investors have the option of shifting their assets to another asset manager or investment vehicle as soon as they identify a better opportunity.

By contrast, alternative asset managers target absolute performance, and charge both a management fee (typically 1% of assets under management) and an incentive fee (typically 20 percent of profits) based on their fund's overall performance. Anecdotal evidence suggests that

for most hedge funds, the management fee is roughly equal to operating costs¹ and the primary compensation is the incentive fee. In most cases, a hurdle rate of return must be exceeded by some multiple and any prior losses must be repaid before the fund manager is eligible to receive any incentive income. In recent years, these fees have risen, particularly those of established managers who have been able to create scarcity for their funds, which they then use to increase fees and introduce a lock-up clause.² On the contrary, with start-up funds in the course of raising capital, investors often obtain discounts on the fees in exchange for early money.

2. Asset-based Fees vs. Incentive Fees

One may wonder which of the two models – asset-based fees versus incentive fees – is preferable to reduce the agency costs of portfolio management delegation.

Fees based solely on the size of the assets under management offer a small implicit incentive to managers. As the assets in the fund grow due to capital inflows or the appreciation of the underlying holdings, the fee collected will grow in tandem. If, on the contrary, assets decrease, then the fee collected will be reduced proportionately. Several empirical academic studies have confirmed the positive relationship that exists between a fund's relative performance and subsequent inflow of new investments,³ as well as the fact that some investment funds voluntarily waive their stated fees in an attempt to boost net performance and, thereby, to attract additional assets (fee waiving). This suggests that, even though the link between performance and compensation is not direct, it nevertheless appears to be an important factor in terms of determining fund managers' behaviour. However, we should also note that academic research has evidenced the convex nature of the relationship between fund flow and performance. That is, while superior relative performance generates an increase in the growth of assets under management and, in turn, managerial compensation, there tends to be no symmetric outflow of funds in response to poor relative performance, at least over the short term. The convex flow/performance relation creates an incentive for fund managers to increase risk taking, especially after poor performance. Therefore, the effective incentive of an asset-based fee needs to be carefully assessed on a case-by-case basis.

However, in the case of skill-based and capacity constrained strategies, asset-based fees may also create a fiduciary conflict because adding new assets can harm the interests of existing ones. Managers who have developed a strategy that works may continue selling it past the asset capacity for which it was designed, just because they are rewarded essentially on the basis of the size of their assets under management.

By contrast, performance fees seem to do a better job at aligning the interests of managers (desire for high fees) and investors (desire for high excess returns). When subject to a performance fee, a manager will sell his strategy only up to the asset capacity for which it was designed. Then, he will close his fund to additional investment as he has stronger incentives for performance than for asset growth. Adding too many assets means being forced to put some money into second-best ideas, and these ideas do not often deliver the kind of returns desired, so asset growth is *de facto* limited. At some point, managers may even have to implement net share repurchases. In this context, an increase of revenues should essentially come from increasing the excess returns delivered to investors rather than by increasing the assets under management. This partially explains the relatively small size of hedge funds – about 80% of the hedge funds reporting to commercial databases manage less than \$100 million of equity capital.

However, performance fees also have their drawbacks. The most important ones are linked to their asymmetric nature – the manager participates in the upside, but not in the downside. This

1 - Liang (1999) calculated the average annual management fee for hedge funds to be 1.36%, with a median of 1%. This base fee proved to be much smaller than total management fees surveyed from retail mutual funds.

2 - As an illustration, Steve Mandel at Lone Pine Capital can charge half of the performance fee (i.e., 10%) of any gain the fund makes from its low. This 10% performance fee continues until the fund has made up 150% of the drawdown from the previous high then the standard 20% fee kicks in again.

3 - See Sirri and Tufano (1998).

corresponds to a potentially perpetual call option with a path-dependent payoff – the payoff at any time depends on the high-water mark, which is related to the maximum asset value achieved.

This option-like payoff structure may lead to possible adverse incentive effects, because the manager simultaneously owns the option and controls its underlying asset (the portfolio) as well as its volatility. Therefore, near the end of an evaluation period, managers may decide to increase portfolio risk in order to increase the value of their option.⁴ On the contrary, outperforming managers may attempt to lock-in their positive performance and dampen portfolio volatility.

Alternatively, some fund managers may also try to improve the return of their portfolios by "window dressing" them, for instance, by using stale prices rather than real market values (or vice-versa) for illiquid stocks or non-traded assets around the end of an evaluation period. Between the lack of agreed-upon standards, different views about illiquid markets, and moral hazard, valuation can be akin to numerical quicksand.

It is interesting to note that although mutual funds and hedge funds seem to disagree on what is the best choice between asset-based and performance-based fees for their external investors, they both agree on their own internal compensation structures, which involve asset management firms and individual fund managers. The compensation of portfolio managers tends to be performance-based, with a fixed base salary topped by bonuses based, partially or entirely, on relative performance. This should be kept in mind, as a complete discussion of the incentives facing mutual funds must consider two layers of agency problems: the agency relationship between the fund company and the fund investors and the agency relationship between the fund company and fund management.⁵

3. The Regulatory View

An interesting viewpoint on the question of asset management fees is the one of regulators, which varies from one country to another. In the U.S., for instance, mutual funds are registered investment companies and they are highly regulated by the S. E. C. The latter allows performance incentive fees and enables a fund to charge higher fees when it beats a benchmark – so long as it is willing to charge less when it fails to beat it. As one could expect, many fund managers are perfectly happy to sell their funds to the public on the grounds that it can beat the market, but despite the offer, very few of them are willing to put their own money where their mouths are and take the other side of the bet. According to the Lipper database, less than 2 percent of the U.S. equity mutual funds apply a performance fee.

In Europe, a European Council Directive sets the general legal framework within which undertakings for collective investment in transferable securities (UCITS) may carry on their business. It establishes that "the law or the fund rules must prescribe the remuneration and the expenditure which a management company is empowered to charge to a unit trust and the method of calculation of such remuneration." Therefore, legal restrictions on the way companies managing mutual funds can be compensated for their services, if any, are to be found only at the national level. Several countries, such as Spain, France or the U.K., left a large degree of latitude when it comes to portfolio managers' deciding on the mechanism and the value of their compensation. Strikingly, in practice, even though it is legally permissible, most mutual fund companies are almost never compensated through incentive contracts. Instead, they are paid a fixed percentage of assets under management, and the incentive intensity is set to zero. At the other extreme, hedge funds and other lightly regulated private investments companies are primarily charging incentive fees.

4 - Carpenter (2000) studies the optimal portfolio strategy of a manager compensated with a convex option-like payoff and proves this is optimal behaviour.

5 - See Chevalier and Ellison (1999).

4. The Soft Dollar Arrangements

Our discussion of fees would not be complete if we did not mention soft dollar brokerage – or simply soft dollars. Soft dollar brokerage is a popular arrangement between a fund and its broker. Basically, the fund manager agrees to place a designated dollar value of trading commission business with a broker over a given period of time. In exchange for this promise, the broker provides the manager with research credits equal to some part – say 50 percent – of the promised commissions. Rather than rebating these credits back to investors, the manager keeps them and uses them to buy services and any of the large number of broker-approved research products (hardware, software, subscriptions, databases, etc.) supplied by third-party research vendors. The broker then pays the manager's research bill and simultaneously cancels the appropriate number of credits from the manager's soft dollar account.

From a functional perspective, soft dollars are simply one form of bundling research and execution together into a single commission payment. They are unique in allowing research and execution to be provided by entirely separate firms, thereby promoting vertical disintegration of the research and execution functions.

Do soft dollars decrease or increase the agency costs of delegated portfolio management? Both views can be defended. On the one hand, one may argue that soft dollars allow managers to misappropriate investors' wealth by churning their portfolios to subsidize research for which they should pay directly. This, in turn, generates various inefficiencies, such as the choice of a broker for his willingness to provide research credits rather than on expected execution quality. In the end, because brokerage commissions are included in the price basis of the underlying security, investors implicitly pay the underlying research costs. Soft dollars therefore subsidize the manager's use of research input, and in some cases the existence or amount of the subsidy is unknown to investors. Thus, portfolio managers shift expenses that are normally shouldered by them onto fund shareholders.

On the other hand, one may also argue that soft dollars are aligning the interests of asset managers with those of their investors. Fund managers typically "own" a very small percentage of their portfolio, directly as co-investors or via an annual management fee. If managers were required to pay for all research and execution out of their own pockets, they would bear a disproportionate share of the costs of generating portfolio returns in relation to the private benefits based on their portfolio share. Seen in this light, the agency problem faced by portfolio investors is that, in the absence of agreement, managers will do too little research, identify too few profitable trading opportunities, and execute too few portfolio trades. Thus, soft dollar arrangements allow investors to subsidize investment research and thereby encourage managers to do more of it, which ultimately benefits the portfolio performance.

Finally, soft dollars may also be unique in aligning the incentives of brokers and managers. When a broker provides soft dollar research credits to a manager, it typically does so *in advance* of the commission payments it expects from the manager. But the manager has no legal obligation to trade and may in particular terminate the executing broker relationship with the balance of the soft dollar account unpaid. The broker will then lose a stream of commissions that would have included a premium above the cost of providing low-quality brokerage. The threat of termination dramatically increases the expected losses to brokers who provide low-quality services, and may therefore perform an effective quality assuring function.

5. What Makes a Good Performance Fee?

Coming back to the main topic of our discussion, at this stage, we may wonder what the necessary characteristics of a "good" performance fee should be. Ideally, a performance fee should be

structured to achieve five main objectives. First, it should reward a proficient manager for excess return earned over the measurement period. Second, it should control portfolio risk. Third, it should contain fair but significant consequences for manager underperformance. Fourth, the performance fee agreement should be explicit in its description of the fee structure – to eliminate client misunderstandings and properly frame client expectations. And finally, a thoughtful performance fee structure should be designed so that there is little economic incentive for the manager to increase the assets under management beyond the level at which the performance fees max out. The performance fee structure encourages investment firms to run their strategies at optimal asset levels that permit the maximization of dollars of excess return.

6. Are Hedge Fund Fees Exaggerated?

Throughout the bull market of the 1990s most investors overlooked the fees that a mutual fund charged its shareholders because returns were so impressive. But times have changed. We are now in an era of difficult markets and the level of fees has come under close scrutiny. Many traditional investors who are just beginning to venture into alternative investments find the fees overwhelming. If the industry standard seems to be 1 percent for the management fees and 20 percent for the performance fee, several funds among the largest and top-performing ones are far above that. For instance, Caxton Corporation which oversees more than \$10 billion charges 3 percent and 30 percent, while Renaissance's \$6.7 billion Medallion fund charges a 44 percent incentive fee, more than twice the industry average. Interestingly, both funds are closed to new investors and have returned money to their existing investors in 2003 in order to be able to maintain positive returns. Of course, only the best performing funds are able to dictate conditions like this. Nevertheless, the list of the top ten earners in the hedge fund industry is impressive – see Table 1.

Table 1: The top 10 earners in the hedge fund industry in 2003, according to *Institutional Investor*. For each manager, the gains correspond to the share of the fees generated by the funds they managed, plus the gains on their own capital in the funds.

Manager name	Gains in 2003	Fund name
George Soros	\$750 million	Soros Fund Management
David Tepper	\$510 million	Appaloosa Management
James Simons	\$500 million	Renaissance Technologies
Edward Lampert	\$420 million	ESL Investments
Steven Cohen	\$350 million	SAC Capital Advisors
Bruce Kovner	\$350 million	Caxton Associates
Paul Tudor Jones	\$300 million	Tudor Investment
Kenneth Griffin	\$230 million	Citadel Investment
Daniel Och	\$150 million	OCH-Ziff Capital Management
Leon Cooperman	\$145 million	Omega Advisors

Not surprisingly, traditional investors' first reaction may be to dismiss the hedge fund industry due to excessive layers of fees. Performance fee structures with 25 and 35 percent carry can work out to be tremendous fees, and immediately prompt the question: "Does the return justify the fee?"

The answer is twofold. First, outsiders invest in a hedge fund because they believe the manager has an expertise that they can't replicate for themselves, or that replication is too costly. This is a fact to remember when looking at hedge fund fees – you get what you pay for. Second, if investors achieve their objectives *after expenses*, the fees are justified, even if their level is an especially hard pill to swallow.⁶ But if a fund delivers poor performance, it is not worth a low fee; in fact, it is worth no fee at all. Thus, fees should be directly related to providing what the investor wants.

Consequently, when an investment fund is evaluated or selected, the fee charged should not be the sole determinant. The investment philosophy and quality and tenure of management are also important considerations.

6 - As an illustration, Goetzmann, Ingersoll and Ross (2001) use an option approach to calculate the present value of the fees charged by a hedge fund manager and show that the present value of the incentive fees can be quite high. For instance, for a volatility of 15%, the fee can be as high as 13% of the assets under management.

7. Why so Much Resistance?

So, *in fine*, are performance-based fees a desirable feature for asset management? One argument often encountered is that poorly performing managers will be paid less and, therefore, benefit the plan sponsor. On the other hand, managers who perform well will also be paid more. But since the fund earns more, this extra fee will really not cost anything at all. Perhaps, proponents contend, the carrot of higher fees and the stick of lower ones will make the managers work harder.

The objectives of performance fees are to reduce them for flat and negative performance and to reward managers for positive absolute performance. Structured properly, this makes a lot of sense for the investor and the manager if added value is properly identified. Then the client and manager are simply entering a profit-sharing plan, and profit sharing is effective in aligning incentives. The problem with performance fees starts when they are not structured properly – that is, if the client is giving a manager a fee based on something other than added value (the “true” alpha). This is not sustainable in the long run.

Nevertheless, many traditional managers are still reluctant to use performance fees. If the entire industry shifted to performance fees, one of the things that might happen is a reduction in fees in general. For instance, if two-thirds of the managers underperformed, they would draw one-third of their normal fees, while the one-third that outperformed would draw four-thirds of their normal fees. The industry-wide fees would then be cut by a third. Not surprisingly, at least two-thirds of the asset management industry will keep fighting such a trend.

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