

Investment Fees: Theory & Application

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Fees paid to investment managers should be consistent with four objectives:

1. An alignment of interests between investor and manager,
2. Fees which are largely conditional upon the manager exceeding a performance benchmark for measuring true excess return, either from alpha or alternative beta, that can't otherwise be replicated passively,
3. A level of fees that represents a fraction share of expected gross excess return and where that fraction is inversely related to the uncertainty in excess return, and
4. Fund expenses that reflect only administrative items, exclusive of investment related expenses.

1. *Alignment of Interest*

"We make money when you make money" is a familiar refrain from alternative managers whose fees include a performance fee linked to profits.¹ This idea is appealing but often misses the mark in practice.

The first concern is "asymmetry". Managers are sharing in the upside (profits) but not the downside (losses). One possible way to mitigate this problem is to ask managers to invest a significant fraction of their own capital into the same investment or fund.² While indirect, at least the manager has more motivation to mitigate losses knowing its own money is at risk. Conversely, sometimes a concern arises if the manager has too much money invested in the fund, causing the manager to become too risk averse for fear of losing significant personal assets.

A second concern is known as "crystallization", or the frequency with which performance fees are paid. Ideally, performance fees are paid only when the investor exits the fund. All profits and losses are fully netted against each other and over time. Anything less, the investor is at risk of paying a performance fee on profits which potentially can't be recaptured if losses follow afterward. In practice, managers don't want to wait until the fund terminates or the investor exits because they need periodic payments to compensate their professionals for retention or tax payments. The more frequent the payment of performance fees, the more costly this potential problem becomes to the investor.

Many private equity funds pay performance fees as each asset is realized (sold). A "clawback" potentially protects investors if performance fees are paid on early profits from realizations but are followed later by realized losses. Clawbacks, which allow investors to recoup earlier fee payments, are often partial, being limited to after-tax proceeds. A potentially more significant problem is with hedge funds, which generally pay performance fees annually on realized and unrealized net gains. Sometimes, a year of sizable investment gains can generate performance fees that are not recouped when followed by a year of investment losses. A mitigating factor is that hedge funds generally have a "high water mark" where future performance fees will not be paid until cumulative past losses have been recovered. This investor protection, however, only works if the investor stays in the fund and the manager is able to recoup losses, which is not always the case. In the most perverse of

¹ Performance fees are also known as "carried interest".

² Also known as "GP commitment".

circumstances, the manager, unable to recover, closes the fund and later starts a new one, escaping the high water mark.³

2. The Performance Benchmark

Conceptually, investment profits can be divided into two parts: (1) profits that come from the general market and could have been achieved through index funds at low cost, and (2) profits which are produced only by an active manager. The first is known as beta and the second, alpha. Ideally, managers should be paid on profits identified as alpha and not profits generated by beta. A benchmark index can be used to identify profits which are beta with the remainder defined as alpha.

Very few performance fees charged by alternative investment managers today are tied to profits above a performance benchmark, as suggested above. In the case of hedge funds, the performance benchmark is most frequently a zero percent return.⁴ Only if managers purposefully keep their portfolio market beta at or near zero would profits equate to alpha. Otherwise, the investor is paying performance fees on at least some part of return that is generated by the market and not the manager. This is a persistent problem with hedge funds that maintain a positive net exposure (beta) to the market.

Private equity and debt managers also calculate performance fees on total profits without reference to a market benchmark. However, they almost always have a “preferred return”, generally 8.0%, below which they earn no performance fee. If performance is above the preferred return, manager performance fees often “catch up” to what the manager would have earned absent the preferred return. Again, this calculation in almost all cases pays the manager for market performance and any excess return created by the manager.

In summary, performance fees paid to alternative managers are generally imperfect in tying fees to manager alpha.

3. Fractional Share

Investors pay both performance fees and asset-based fees to managers for the returns they produce. We believe a key statistic in measuring the value of asset management services is the ratio of all fees, asset- and performance-based, to manager excess return, or alpha, before fees. This ratio, expressed as a percentage, measures the fraction of gross of fee alpha that goes to the manager. The remaining percentage represents the fractional share of alpha that goes to the investor.

We know of no academic research that pinpoints what the investor fraction should be. Our experience tells us that skilled managers generally take between 30% and 40% of gross alpha in fees and expenses. Given the relative certainty of fees, particularly asset-based, and the uncertainty of alpha, it seems reasonable that investors should expect a greater share of profits derived from alpha than the managers who produce it. Years ago, Cliffwater built an “alpha split simulator” for hedge funds that incorporates fee, expense, and investment assumptions to derive a distribution of alpha, fees, and fractional percent of alpha likely to be earned by the investor. This tool is used by clients to gauge the value proposition of individual managers.

Hedge fund fees are structured to explicitly allocate total return between investor and manager, ignoring the impact of this structure on the sharing of alpha. In the vast majority of cases, total return will exceed alpha. Therefore, basing performance fees on total return and charging a fixed

³ “Modified high water marks” allow managers to charge partial performance fees even when net losses exist, a variant of performance fees that potentially disadvantages investors.

⁴ Though not widely used, performance fees for traditional asset managers generally are net of a performance benchmark that reflects an index representative of the manager investment style. See “Performance Fees for Investment Management”, (Nesbitt/Davanzo), *Financial Analysts Journal*, Jan/Feb 1987 for a general description of how performance fees are used with traditional stock and bond managers.

management fee will result in the investor receiving a lower share of alpha than they do of total return. The example below illustrates this:

Fund X earns a 10% gross return (net of fund expenses) and charges a 1.5% management fee and 20% performance fee. The investor will receive a net return of 6.8%, and the manager will earn 3.2% in fees. In this instance, the investor nets 68% of the total gross return.

Further assume that Fund X has a beta of 0.4, and the index returns 15%. Assuming a risk-free rate of zero, Fund X produced gross alpha of $10\% - (0.4) \times 15\% = 4\%$. The manager's 3.2% fee amounts to 80% of gross alpha, leaving the investor with only 80 bps of alpha, or an "alpha split" of only 20%.

Our Cliffwater Alpha Fee Split Simulator evaluates the "alpha split" metric across a range of scenarios an investor could theoretically encounter given the risk and return characteristics of a particular fund. The model produces a distribution of alpha split across these scenarios. Cliffwater is favorable toward funds that demonstrate a median alpha split of 60% or greater - i.e., deliver 60% or more of gross alpha to investors in half of the simulated scenarios. The model can be used both to compare different funds as well as to compare different fee structures for the same fund.

4. Expenses

An unwelcomed trend has been to allocate some investment expenses to funds that normally would be paid by the manager from their investment fees. These investment expenses may include Bloomberg terminals, travel and third party research costs. Investors should closely monitor these expense allocations and require managers to charge only administrative items to the fund.

Conclusion

Alternative investment fee structures are often complex with significant agency problems. If not understood correctly, they can create a "heads we win, tails you lose" situation for investors. Our alpha split simulator model provides an objective measure of fees, measuring the expected share of profits between the manager and fund investors under multiple performance scenarios. Cliffwater seeks to increase fee and expense transparency and negotiate favorable business terms, which can lead to fee arrangements with a stronger alignment of interests between our clients and their managers.

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