

## Principles for the Establishment of Fees

### *Principle 1 – Quantum of Fees*

Investment management fees should normally be limited to a maximum of 33% of expected active returns generated by the investment manager.

### *Principle 2 – Performance Fees*

The desirability of performance fee structures depends upon:

- The willingness of the investor to share the potential upside of outperformance with the manager, and also the desire of the investor to pay less in the case of manager underperformance
- The mechanics of the structure of the performance fee
- What alternative structures are available (eg flat fee only)
- What the impact of the performance fee would be on the total level of fees to be paid.

### *Principle 3 – Structuring Performance Fees*

In the main, performance fees should include deferred payment terms, high water marks, clawbacks and/or caps. Hurdle rates should reflect the risk inherent in the mandate.

### *Principle 4 – Unlisted and Illiquid Investments*

Performance fees relating to illiquid investments should preferably be based on realisation of the investments. For open ended funds, where realisations may be detrimental to the investment strategy, the performance fee structure should be based on independent valuations and calculated over periods of three years or longer. These should be calculated on net asset values and should preferably include deferred payment terms/clawback as well as high water marks and/or caps.

### *Principle 5 – Investment Costs*

Other costs intended to be charged to the investor (or through the unit price of the investment) should be clearly identified at the time of initiating the investment, should be reported regularly to the investor and should be regularly reviewed as to their reasonableness and consistency with the terms of the investment agreement.

## ***Principle 6 – Review of Fee Structures***

At the time of entering a new investment mandate, the Investment Management Agreement should include a provision for the investor and the investment manager to renegotiate fees at a set time. The period should be consistent with the objectives of the mandate. A period of three years for listed investments should be typical. This should not preclude fee reviews at other times should circumstances warrant.

## Principles for the Establishment of Fees

### *Purpose of this document*

This communiqué sets out a statement of principles to assist institutional investors in negotiating investment management fees.

These principles are not and do not intend to be prescriptive in their application. In many areas, the type and nature of the fee structure will vary according to different investment strategies and objectives of each investor. Negotiation should always remain the means by which buyers and sellers of services should come to agreement.

### *Statement of Objectives*

There are two primary objectives in setting investment management fees:

1. The investment manager should be **rewarded** for its effort and intellectual property, and the fee should reward the investment manager sufficiently to attract and retain quality staff to manage the portfolio in the investor's best interests.
2. The fee should be structured to provide **incentives** to the investment manager to maximise net returns for the investor.

### *Current Investment Management Fee Arrangements*

It is difficult to generalise with regard to current fee arrangements due to the vast array of different fee structures in place and the large number of different investment markets and mandates and objectives.

That said, the investment community has expressed its concern with certain aspects of some fee structures, including:

- Fees which provide reward to investment managers from rising market values, rather than skill or value added provided to the investor.
- Performance fee structures that have allowed investment managers to be rewarded highly, even after periods of poor relative performance.
- Fee structures which encourage inappropriate management of an investor's assets (eg such as excessive leverage, delayed or accelerated realisation of assets etc).
- Fee structures that are based on unrealistic assumptions of future outperformance.
- Fee structures that result in excessive remuneration to investment managers.

## ***Principles***

The following six principles form a sound basis for investors to apply in their negotiation of investment terms with their investment managers.

### **Principle 1 – Quantum of Fees**

**Investment management fees for active management should normally be limited to a maximum of 33% of expected active returns generated by the investment manager.**

Investors should not enter investment management arrangements where the share of expected outperformance payable to the investment manager exceeds a limit based on:

- The expected outperformance from the mandate
- The expected reliability of the delivery of that outperformance
- Other benefits and services provided by the manager or delivered through the mandate.

For most active managers/mandates, the share of expected outperformance (net of base fees that cover costs) that should accrue to the investment manager should be less than 25%. However, this share may be increased or decreased according to the degree of expected reliability in the manager's ability to deliver such outperformance.

To be clear, manager outperformance should be based on the additional return above an investable passive-type portfolio that offers comparable risk characteristics. This definition has two implications:

- Typically higher risk portfolios (ie by increasing beta) should have higher performance hurdles
- Some mandates may bring broader portfolio benefits such as diversification or active risk management that are not easily replicable, and it may be worth paying a higher share of outperformance for that benefit.

The level of fees should reflect the level of assets of the mandate and ideally would include a tiered structure to account for growth in asset size over time.

### **Principle 2 – Performance Fees**

**The desirability of performance fee structures depends upon:**

- **The willingness of the investor to share the potential upside of outperformance with the manager, and also the desire of the investor to pay less in the case of manager underperformance**
- **The mechanics of the structure of the performance fee**
- **What alternative structures are available (eg flat fee only)**
- **What the impact of the performance fee would be on the total level of fees to be paid.**

Performance fees offer a means to share the risk and returns of future outperformance with the investment manager. Performance fees also change the incentive relationship between the

investor and the investment manager and should be designed to increase the alignment of interest between the investor and the investment manager.

The investor should assess each proposal which includes a performance fee component against:

- Alternative base-fee only structures where available
- Versus the limits set out in Principle 1 (based on expectations of future outperformance).
- The impact that such performance fees may have on the behaviour and incentives of the investment manager.

While the case for performance fees will vary according to the factors highlighted above, in many cases performance fee structures can result in an unequal distribution of gains to the investment manager and do not adequately reflect the risks taken by each party.

### **Principle 3 – Structuring Performance Fees**

**In the main, performance fees should include deferred payment terms, high water marks, clawbacks and/or caps. Hurdle rates should reflect the risk inherent in the mandate.**

Preferably, performance fees would be paid only where the investor has realised or had the opportunity to realise actual outperformance. Accordingly, performance fees should be assessed over an extended period (ideally three years or longer) and the following features should be included within performance fee structures:

- High water marks – ie recovery of past underperformance prior to accrual of future performance fees
- Annual caps to performance fee payments.
- Deferred payments or clawback provisions
- Fees calculated on an after-tax basis (where realistic) and after all base fees.

Performance fees should be paid only for performance that exceeds a hurdle rate consistent with the risk inherent within the mandate. The greater the risk, the higher the hurdle rate.

### **Principle 4 – Unlisted and Illiquid Investments**

**Performance fees relating to illiquid investments should preferably be based on realisation of the investments. For open ended funds, where realisations may be detrimental to the investment strategy, the performance fee structure should be based on independent valuations and calculated over periods of three years or longer. These should be calculated on net asset values and should preferably include deferred payment terms/clawback as well as high water marks and caps.**

Fee structures for unlisted investments need to reflect the nature of the underlying investments and the terms of the specific mandates.

That said, the following principles should be applied:

- Where fees are paid on unrealised valuations, then such valuations should be determined by a professionally qualified party independent of the manager.

- Base fees should be calculated on net asset values rather than gross values (after leverage).
- Where commitment fees are agreed, their cost should be factored into the calculation of total fees for the purposes of the reasonableness calculation set out in Principle 1.
- Performance fees can have an important role in aligning the interests of the investment manager with those of the investor. However, where performance fees are a significant component of the investment manager's anticipated remuneration, then there should be only a low component of profit inherent within the base fee and the performance fee should be calculated over periods of at least three years.
- The case for performance fees should remain intact. That is, if the case for a performance fee is made on the basis of limited capacity with little or no profit from base fees for a fund, then the same rationale should apply for successor funds.

## **Principle 5 – Investment Costs**

**Other costs intended to be charged to the investor (or the unit price of the investment) should be clearly identified at the time of initiating the investment, should be reported regularly to the investor and should be regularly reviewed as to their reasonableness and consistency with the terms of the investment agreement.**

Other investment costs can be substantial in the context of overall management fees. Such costs might include debt or equity raising costs, accounting and auditing, legal and compliance, investment feasibility studies, transaction fees, advisory fees, Directors' fees and due diligence costs.

Some of these costs are costs paid to the manager, and some paid to third parties.

## **Principle 6 – Review of Fee Structures**

**At the time of entering a new investment mandate, the Investment Management Agreement should include a provision for the investor and the investment manager to renegotiate fees at a set time. The period should be consistent with the objectives of the mandate. A period of three years for listed investments should be typical. This should not preclude fee reviews at other times should circumstances warrant.**

After a given period of time relevant to the mandate objectives, say three years, the investor should reassess the fee structure of each of its mandates in regard to any revisions in respect of expected future outperformance and any reassessment of the reliability of the future expected outperformance.

Factors to be considered in a review should include:

- Growth in assets under management by the investment manager
- Evidence of past reliability of returns
- Developments within the investment management firm and a reassessment of expected future returns.

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