

A fairer deal on fees

Fee structures in the asset management industry are too high for the value they offer.

It is time for superannuation funds and other institutional investors to take a hard look at the fees they are paying to their active managers, and what it is they are paying for. On a global basis total annual investment costs for superannuation and pension funds have, on average, increased by around 50% over the past five years. According to our research, fees and costs¹ now average around 110 basis points per annum for large funds compared with around 65 basis points in 2002. The vast majority of these costs are paid in fees to external investment managers and brokers.

A key reason for this is the rise in investors' focus on alpha, which has increased their appetite for alternatives, such as hedge funds, private equity and real estate. Hedge funds typically charge an annual base fee of 1-2% on the value of committed capital, plus a 20% performance fee, and private equity fees are similar. This is far more than the typical annual fees charged by traditional long-only managers (which would often be below 50 basis points).

Investors naturally assume that they are paying these high fees to reward manager skill, or alpha. But in most cases they are wrong. Instead, they are paying 'alpha' fees for 'beta' performance, because the main driver of returns in recent years has been the strength of the markets. This has encouraged managers to leverage their portfolios to boost returns, which means that investors are often paying up for leveraged beta (market returns multiplied by gearing).

This is clearly a very good deal for the managers, but not necessarily for their investors. We strongly believe that managers should be compensated for a job well done. But fees are too high for the value they currently represent, particularly as we move to an environment in which market returns are lower.

¹ Includes fees paid to investment managers, brokers, custodians, consultants, performance measurement fees and all other investment costs.

EASY PICKINGS

Performance fees have two main functions. One is to provide managers with an incentive to perform; the other is to align the managers' interests with those of their clients. It is this alignment of interests that is seriously lacking at present.

A couple of very simplified examples illustrate just how easy the pickings have been for managers, and how far fee structures are tipped in their favour. Take a long/short equity fund that is 100% long and 30% short, charging a 1.5% per annum base fee on net asset value, plus 20% of absolute performance (a fairly typical situation). Assume the manager can add an impressive 5% per annum alpha on both the long side and the short side for every 100% gross exposure (it should be noted that over the long term this would be a remarkable result), on top of a long-term annualised market return of 10% and an annualised cash return of 5%. On this basis, the gross annualised return would be 15%², so investors pay an annual fee of 4.2%³, or 65% of the alpha produced by the manager (4.2%/6.5%). In order to pay the manager only 50% of the alpha in fees (the client is taking all the risk after all), the manager must generate about 7.5% per annum alpha on each side, and that is Warren Buffett territory!

Now admittedly this does not allow for the fact that the manager can add value by varying the gross and net exposures over time, but that typically does not have an enormous effect, and certainly does not alter the key message.

To make matters worse, many superannuation funds achieve hedge fund exposure through a fund of hedge funds, which might charge an additional 1% annual base fee and 10% of net returns as a performance fee. Under this scenario 95% of the alpha is paid away in fees, and remember that in this example the manager is doing a great job!

Another major problem with the fee model is that annual performance fees amount to a free option for the manager, as the upside is uncapped but the downside is limited to the base fee. High water marks reduce the option value but do not remove it as all the positive performance could come in the initial period. The more volatile the performance stream produced by the manager, the greater the option value. An unskilled manager who produces volatile results can make a very decent living in this way.

Now it should be noted that long-short equity funds with higher gross exposure and lower net exposure would look better on these calculations so it is important to understand the nature of the fund.

We can do a similar calculation for private equity fees, which have been criticised for being excessively high. Assume that the manager holds 30% equity and 70% debt (which we might say is approximately twice the leverage inherent in public equity markets and which therefore results in twice the exposure to the equity market), and charges a fairly typical 2% base fee plus 20% of performance. Let's again assume that long-term equity market returns are 10% per annum, cash returns are 5% per annum and borrowing costs are around 6% per annum.

If the manager again adds 5% per annum alpha per 100% gross exposure, then the fee would be 64% of the leveraged alpha (note that whilst private equity managers often claim to have a 'preferred return' which is needed before the performance fee is payable, there is almost always a catch-up provision such that with positive market returns they effectively have no hurdle rate of return to beat).

Then of course there is the slice of the fee taken by a fund of funds, which would lead to 91% of the alpha being paid away in fees. And this is before we allow for the fact that clients pay fees on money waiting in cash to be drawn down for investment, and ignores hidden deal costs.

Once again, it should be noted that different private equity funds can have very different levels of gearing, and that gearing can change dramatically over the life of the fund, hence the detailed fee analysis needs to be done in each case.

It should also be noted that this is not just a problem in the alternatives world, as many performance fee structures in the more traditional mandates have also been badly structured.

² $(70\% \times 10\% + 30\% \times 5\% + 130\% \times 5\%)$

³ $(1.5\% + 20\% \times (15\% - 1.5\%))$

SOME SOLUTIONS

The industry needs to act now to get fees back into line, and the first step is for investors to understand what proportion of alpha their managers are taking in fees, even if they are doing a good job. This needs to be set at a reasonable level, and be better structured to align interests.

We suggest that managers should always set hurdles, such as cash, or a realistic fixed percentage reflecting the expected long-term beta exposure (which may even be leveraged beta). They would then collect fees only on performance above this benchmark rate.

Far too few alternatives managers do this and even some managers in the more traditional mandates are starting to remove the benchmark in performance fee calculations.

Setting the benchmark at zero when cash is returning around 5% per annum means that a performance fee of 1% is levied on clients' money (as well as the base fee), even before it is put to work.

As mentioned, the hurdle rate should also reflect a fund's market exposure. For instance, a long/short equity fund with an average net exposure of 70% should base its hurdle rate on 70% equities and 30% cash. This is clearly complicated territory as average exposures and alpha contributions are difficult to pin down ex ante, but it is unfair for the manager to be paid for beta exposure.

Instead of calculating performance fees based on annual results, these should be charged on a rolling three-year basis, or longer. This reduces the 'option value' and makes performance fees a fairer deal for investors.

It also makes sense for base fees to reflect actual costs. Calculating base fees on the value of assets under management (the 'ad valorem' structure) encourages asset gathering, which can harm performance. It is ironic that only a few years ago investors welcomed performance fees as an antidote to this problem.

Finally, it makes no sense for fee structures to be as standardised as they are across the industry when investment strategies are so different. A low capacity strategy, or one that requires a costly global infrastructure, is justified in charging higher than average base fees. Conversely, a strategy that can absorb several billions of dollars, or has low infrastructure costs, should not have that luxury. High base fees on an ad valorem basis were put in place at a time when assets under management were low, and were designed to cover the base costs of the manager, with performance fees being the mechanism for paying good bonuses. It is clearly inappropriate that these base fees have not been cut as assets under management have grown significantly.

SUMMARY

The whole area of fees and incentives is extremely complex, and the solutions will take some time to work through. However, there are signs of movement. Flaws in fee structures tend to become exposed when markets falter, and many managers will no longer be able to justify their charges without beta to bail them out. Larger institutional investors are also aware of the roles played in their portfolios by alpha and beta, and are embracing new products and risk management tools that separate the two. If active managers want to win over more of this sophisticated, long-term money, as they often say they want to, they will need to offer institutional clients a fairer deal.

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No action should be taken on the basis of any article without seeking specific advice. For more information on this subject please contact:

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A fairer deal on fees

PART 2

Fee structures in the asset management industry are too high for the value they offer.

There has been a lot of discussion in the press recently regarding the level of fees that institutional investors are paying for active management, and fees continue to be a significant issue for institutional funds and their members. Watson Wyatt recently published a newsletter "A Fairer Deal on Fees", outlining research supporting our belief that, across the global superannuation industry, fee structures in the asset management industry are too high and that institutional investors should be offered a fairer deal on fees. We have also recently carried out a survey to look at the fees being paid by our client base in Australia, which highlighted some interesting points. Overall, we make the following observations:

- Fees for segregated mandates in Australian and international equities are in general lower than the fees charged within pooled funds for the same mandates, suggesting that the size of the investment and therefore the negotiating power of investors has a large impact on the fees paid.
- Outside the alternatives space, performance fees are rarely used by Australian institutional funds.
- Fees for most alternative assets continue to be significantly higher than those charged in mainstream asset classes. These include significant levels of performance fees, many of which are skewed in favour of the manager.
- Median fees for cash enhanced mandates tend to be higher than core Australian fixed interest mandates.

We examine the results of the survey in more detail below.

For the purpose of this analysis we have used published 2007 investment management fees including an adjustment for any performance fees paid. Investment management fees do not include other product fees and expenses, transaction costs such as brokerage, or the buy/sell spread.

The charts below show the range of investment management fees payable for different types of Australian equities mandates accessed via discrete (segregated) mandates and via pooled vehicles (unit trusts).

Australian Equities

We make the following observations about Australian equities mandates:

- There is a wide range of fees charged for active management, especially for concentrated mandates.
- Investors with discrete mandates, who tend to be investors with larger investment balances, on average pay less in fees than investors in pooled investment vehicles. This is true when looking at the median fee, but also in the spread of fees, which suggests that smaller funds will have a significant fee hurdle to overcome in order to achieve similar results to their larger peers.
- Performance fees were not widely used within our sample, which indicates that many funds prefer not to use these.

Figure 1 | Australian equities - discrete mandates

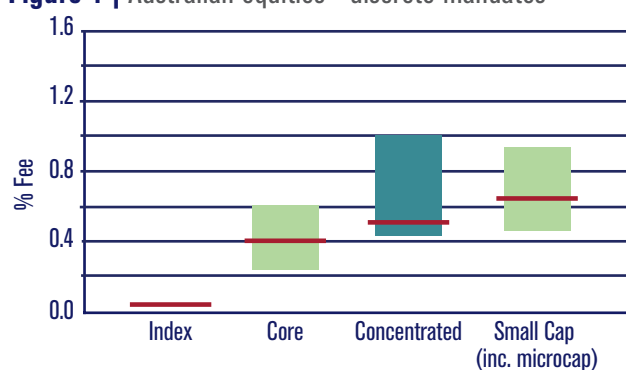
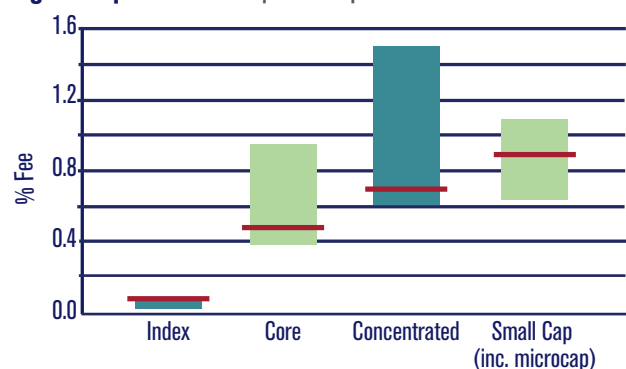


Figure 2 | Australian equities - pooled vehicles



■ Median

International Equities

We make the following observations about international equities mandates:

- Within discrete mandates, and particularly for concentrated mandates, the fees paid for international equity mandates do not differ that significantly from the fees paid for Australian equity mandates. This is not the case when considering investment in pooled vehicles, which suggests that investors' negotiating power has a greater impact on fees than the actual cost of managing the product.
- As for Australian equities, discrete mandates are generally cheaper (reflecting larger investment balances), there is a significant variety in active management fees and for concentrated mandates the average fee is higher than the median fee.
- Our survey also revealed that pooled funds are much more widely used within international equities than within Australian equity mandates.

Figure 3 | International equities - discrete mandates

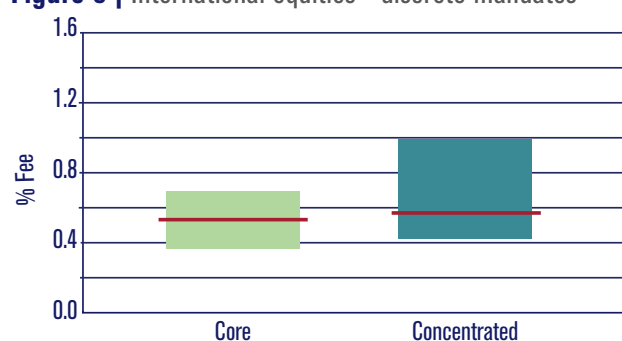
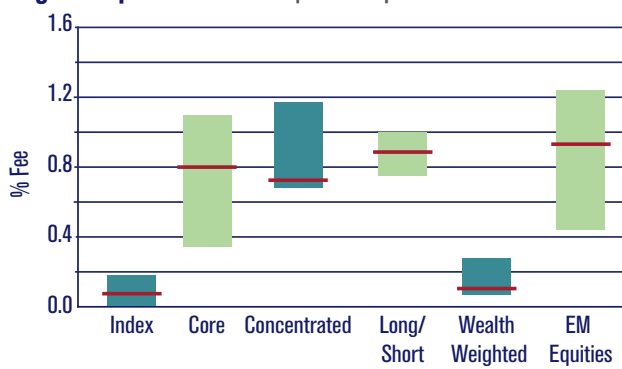


Figure 4 | International equities - pooled vehicles

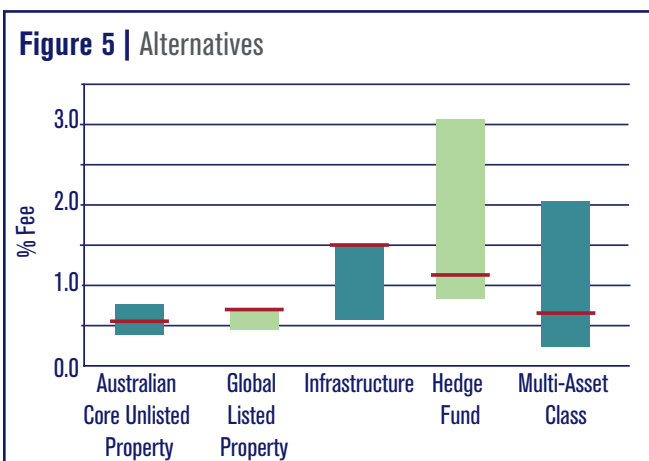


■ Median

Alternatives

We make the following observations about alternative mandates:

- Fees for alternative asset classes are generally high compared to mainstream asset classes.
- Relative to other alternative investment opportunities, fees for core unlisted property and listed property investments are relatively modest.
- We note that performance based fee structures are standard with infrastructure managers. As noted in our earlier newsletter on fees, this can give rise to substantial fees for those infrastructure managers who deliver their targeted returns. A median level of fees at the upper end of the fee range for infrastructure reflects the trend for newer managers to charge a base fee of at least 1.5% p.a. and often a performance fee on top of this as well.
- The hedge fund fees above represent a range of hedge fund products from fund of hedge funds (fees are typically at the lower end) to global macro and multi-strategy products (fees are typically at the higher end). However, we note that fund of hedge fund fees here do not include underlying hedge fund manager fees (due to a lack of transparency provided by fund of fund managers) which masks the total cost of such investments. We note that performance fees are also prevalent in this asset class.
- Multi-asset class fees represent a range of currency, “structured beta” and “balanced” investment products.



■ Median

Fixed Interest

We make the following observations about fixed interest mandates:

- Median fees for cash enhanced mandates tend to be higher than for core Australian fixed interest mandates.
- Comparing Figures 7 and 8, the cost of investing in core fixed interest mandates is significantly higher for international (0.35%) than for domestic (0.09%) mandates. The cost of investing in international inflation-linked bonds also exceeds the cost of investing in domestic inflation linked bonds, but the difference is not as great as it is for nominal bonds.
- Fees for core plus fixed interest mandates in Figure 7 vary widely, but the median fee is comparable to core international fixed interest mandates.

Figure 6 | Australian fixed interest - discrete mandates

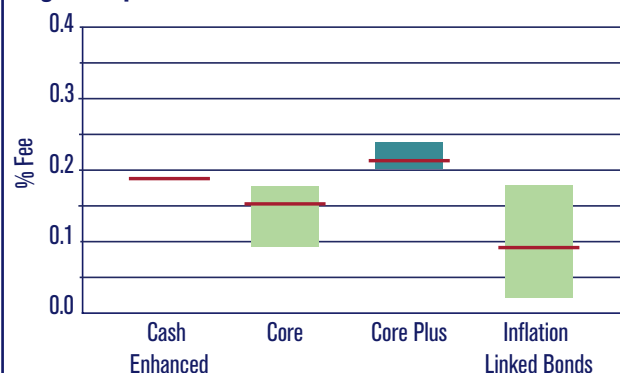


Figure 7 | Australian fixed interest - pooled vehicles

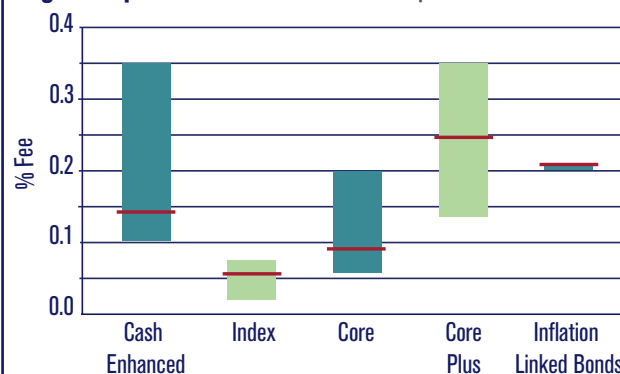
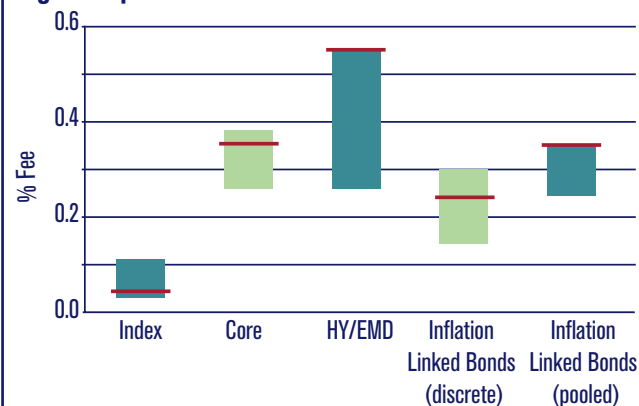


Figure 8 | International fixed interest



■ Median

Summary

Fees continue to be an important consideration for Australian funds and their members. Any fee paid to a manager that is above the cost of index management is a hurdle that must be overcome in order to add value for members. Value in this space is hard to define, as in many cases there can be good reasons to pay a lot of money to a good manager, but investors must be confident in the value proposition put forward by a manager, whether that be access to a niche area of the market or a superior skill level. Our view is that in many cases managers charge what they can for a product, rather than something that is reasonable based on expected value add, and that in every case investors should think about what alpha is expected, what fees are being paid and whether that seems like a fair deal.

Further information

If you would like to discuss any of the areas covered in more detail, please contact your usual Watson Wyatt consultant or:

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