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INVESTMENT MANAGER FEES: A CRITICAL LOOK

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In this short article, we suggest a number of ways in which the current and common structures for investment managers' fees (for traditional, long-only products) are imperfect, or even worse. We go on to note other possible ways in which fees might be structured, potentially to the benefit of both investors and investment managers. Our aim is to encourage a constructive debate as to the way in which investment managers' fees might be shaped in future.

THE CURRENT POSITION

Almost all investment manager fees are currently structured in one of two ways:

- "Flat" — meaning ad valorem; that is, a percentage of assets, often on a sliding scale, providing a lower average fee for larger investors by approximately 10 basis points.
- "Performance related" — almost always structured as a "base fee" (on an ad valorem basis; for example, 0.25% of assets) and a share of outperformance, such 20% of outperformance above some benchmark or target level.

AND THE PROBLEM IS … ?

1. Business management

Whichever way you look at these fee structures, they have material flaws. Take the position of the CEO of an asset management business. The problem is instability and unpredictability in the revenue stream. Fee income will be a function of market levels (highly volatile, especially equities), manager outperformance to the extent that investors have chosen performance-related fees (also likely to be volatile), and new business gains or losses. So it is quite easy to imagine that a boutique equity manager could experience variability in fee income of 30%–40% a year, without changing what it does or how it's done.

This makes an investment management business very difficult to manage in a controlled and predictable way and, inevitably, it leads to higher levels of fees being sought in order to counteract the volatility in fee income. This structuring of fees therefore appears to be bad from a business management perspective.

2. Diseconomies of scale

We know that, ultimately, all active management strategies generally suffer from diseconomies of scale, such that the ability to add value eventually diminishes as the pool of assets being managed increases. But we also know that asset management businesses benefit, in profitability terms, from economies of scale — that is, profit margins increase significantly as assets grow because a chunk of costs are predominantly fixed in nature. Put another way, the incremental cost of adding an extra billion of assets under management is likely to be very low and is not reflected in fee scales (if anything, it's the opposite — fees for new business are often, on average, higher than the fees for the existing book of business).

There is an inevitable conflict between managers wanting to maximise the amount of assets under management and investors who (to an extent) want the opposite. For a given investment team and process, confidence in the ability to add value is likely to be higher the smaller the amount of assets managed.

3. Value for money
Both of the issues raised already point in the same direction: Investment management fees are structured in ways that are potentially detrimental to the end investor in terms of "value for money". First, fees build in a margin to allow for volatility. Second, for new business, the benefits to the manager of gathering more assets put at risk the value creation, which accrues to the investor.

OTHER WAYS IN WHICH FEES COULD BE STRUCTURED

1. Fixed monetary amounts
You would expect the CEO of an asset management business to be delighted to have a proportion of the business on fees fixed in monetary terms with annual uplifts (RPI would be easiest). This would bring greater stability to the revenue stream with significant benefits for the management of the business.

From an investor perspective, such a fee structure would also bring greater certainty to the budgeting process, as "investment manager costs" would become much more predictable in years ahead.

Wouldn't such a fee structure represent a "win" for both investor and investment manager?

2. Loyalty fees
Retaining existing clients is cheaper than spending time and money on winning new clients. Shouldn't long-term clients be rewarded (and in material financial terms, not just a good dinner) for retaining the same manager for a long period — say, for more than five or seven years? A reduced fee for long service as a client would be a suitable reward. This would likely encourage longer-term and better relationships between clients and investment managers.

3. Fees and limited capacity
We know that the larger the amount of assets under management (past a certain point), the less likely performance objectives are to be achieved. Taking this thought to its logical extreme, a manager with, say, a capacity of $10 billion could legitimately charge a higher fee for the first client taken on (because likelihood of alpha capture is at its greatest). As more clients are recruited and capacity fills up, the fee charged should be reduced across *all clients equally*, so that all get the benefit. So the first $200 million client could be charged 1.00%, and by the time the last of the $10 billion is filled, all clients would be charged 0.50%. This weakens the link between asset growth and revenue growth for the manager and, to an extent, reflects the spread of manager alpha more "thinly" across a wider asset base. This approach would probably work best in the case of a "tried and tested" investment team and process.

4. Share of alpha
Most sophisticated institutional investors recognise that manager skill (alpha) is a scarce resource worth paying for, not only for the additional return, but also the diversifying nature of the return stream it offers. The question is: What share of alpha is fair to both parties — that is, investor and investment manager? Currently, performance-related fees are often structured with a base fee and performance participation in the 10%–20% area. If investors are genuinely convinced of the value and scarcity of alpha, they might be prepared to pay a higher participation rate — for example, 25% — but in exchange they would want the base fee to be as little as possible, with the rate for index-tracking management of the asset being a starting point for negotiation (in practice, the agreed base level should be higher than this to reflect the higher costs of active management). Under this type of structure, the

investor collects a reduced share of the added value but can justify this by paying "minimal" fees if the manager doesn't perform, which tilts the risk/reward balance a little in favour of the investor.

5. Cost of capital

Taking this "share of alpha" argument to its logical extreme, the investor could argue that a performance-related fee should be paid only when a hurdle rate of return has been earned. This hurdle could be related to the underlying market return (beta) of the asset class, or even to the investors "cost of capital", if that could be defined (and if the manager accepted this as reasonable). Think about it this way: if a bank was providing capital to a proprietary trading desk, it would presumably charge the bank's costs of capital (possibly including an appropriate risk premium) to the prop desk, with profits made from trading to be shared equally between the traders and the bank. Why should an institutional investor not structure fees in a way that mimics the investor's cost of capital, so that the manager pays a charge to trade the investor's capital in exchange for a higher share of the excess return.

CONCLUSION

This article is not meant to be a harangue about the level of manager fees and a general plea for them to be reduced. It points out some ways in which current fee structures may be ill-suited to their purpose and how there might be better ways in which fees could be structured — some of which may represent superior alignment of the interests of both investors and managers.

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