FINANCIAL TIMES
SUNDAY 12 JUNE 2016
FT.COM

The hedge fund fee structure consumes 80% of alpha

Investors bear the risks and managers reap the rewards, says Beachhead's **Andrew Beer**

The average hedge fund earns 1.67 per cent in management fees and is paid 18 per cent of investment profits annually. Over the past ten years, investors paid away half of pre-fee returns. Even more troubling is the fact that fees consumed 80 per cent of alpha, the active return on an investment.

Yes, the industry still generates a lot of alpha, but it goes to the managers, not investors.

How did we end up in a world where investors bear the risks and managers reap the rewards? The fee structure is to blame.

Twenty years ago, the "2 and 20" fee model made a lot of sense because most hedge funds were small. The 2 per cent management fee on a $10m fund covered the rent and paid for a hire or two.

The real money was made on the performance fees. Today, that $10m fund is $10bn and the fee structure is the same. The industry has matured, but the fee structure has not. This is a big problem for three reasons.

First, high management fees distort incentives.

For a $10bn fund, a 2 per cent management fee equates to $200m for the hedge fund company per year. Generously assume $25m in operating costs, and the manager still clears $175m.

The management fee is now a big, big profit centre. Instead of shooting the lights out, the manager's incentive is to keep the game going.

The solution is that, as funds grow, management fees should decline — and disproportionately for early investors. A sliding scale rewards early investors, who then have an incentive to remain invested and preserve their low-fee status.

Second, incentive fees without a hurdle — the level of return a fund must beat before it can charge additional fees — is pure giveaway.

Performance fees should provide incentives to outperform, not just show up. In 2013, investors paid billions in incentive fees to long-biased hedge funds simply because the markets were up. Incentive fees should be paid over a hurdle. Deliver alpha and the performance fee makes sense.

Third, align lockups with incentive fees.

Investors in one hedge fund paid a reported billion dollars in performance fees when the fund was up 40 per cent in 2014, but then got nothing back when all those gains and more evaporated in 2015-16. The obvious solution is to line up the payment of performance fees with liquidity provisions.

Managers who demand a three-year lockup should wait to get paid incentive fees. This encourages long-term thinking by managers and better aligns incentives.

After years of hand wringing, why so little progress? The allocation process is largely to blame. Across the industry, new allocations invariably are made to managers who have performed well — where investors are happy because, net of fees, the numbers look good.

When a manager subsequently underperforms, he or she is fired and replaced with one who has done better. "What we care about are net returns," goes the refrain.

But this misses the point. One should never overpay as a matter of policy. The place to start is to set a fee budget. Force big investors and consultants to decide, in advance, which managers are worth high fees and which are not.

This naturally leads to a core-satellite model: a low-cost, liquid core allocation with discrete allocations to high value-added (and probably less liquid) satellite funds. It also provides valuable benchmarking. If an illiquid fund does not consistently outperform a low-cost alternative, remove it.

Perhaps the industry is at a tipping point. Citi, the US bank, predicted that replication-based strategies — low-cost versions of what hedge funds do — could surpass $1tn in assets in several years.

Standard Life, the UK insurer, runs what is arguably the largest macro fund in the world at $90bn — and charges fees under 1 per cent. Among hedge funds, newer, smaller firms are offering investors more equitable terms, like the solutions outlined above.

Yet for the largest funds, those that have underperformed recently will simply hold the line. When enough investors leave, they simply convert to family offices. The money has already been made.

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