The Evolution of Fee Structures

Philip Niles of Butterfield Fulcrum, discusses the evolution of fee structures.

Philip Niles
Butterfield Fulcrum

One of the interesting, though seemingly obvious, results of the financial crisis of 2008 is that investors took a long, hard look at their holdings in alternative investments and precisely what those investments entailed. This sober second look at the world's portfolios has led to some noteworthy trends in the industry, many of which continue to develop and will likely continue for some time. For example, more than ever before, investors are concerned not just with the return a hedge fund can generate, but also the risk it incurs to generate that return; risk and its careful management has become a major focus before capital allocation to a fund. Another example comes in the offering documents of a fund; before 2008, little attention was paid to the fine print. However, since the wholesale usage of items such as redemption gates and side pockets, investors have been careful to note such clauses.

Another trend, continuing to gain strength, is the evolution of the fee structure. Once nearly standard across the industry, the last few years have seen a plethora of new and dynamic methodologies. An examination of where fee structures were, and where they are today, will help us gain an insight as to where this trend is headed. Prudent investment managers, at least those who seek to actively grow their funds, would be wise to consider different structures. However, one naturally needs to strike the right balance between being a "fee-friendly" fund and providing for adequate compensation.

Fee Structures – A Brief History

Two percent management fee, twenty percent incentive fee. Yep, that is just about the history of fee structures in hedge funds (it was said it would be brief). Though this is certainly an exaggeration, for nearly as long as anyone can remember the "2-20" fee structure was effectively standard across the industry. Naturally, there were certain funds that deviated from this path: consistently strong performing funds would often charge a premium, while smaller funds who sought to raise capital might offer a discount to these figures. However, the general theme remained the same and the fees at most funds hovered around the "2-20" mark.

Of course, these were not necessarily the extent of the fees, operating in complete isolation and without adjustment. A frequent caveat to these fees was the hurdle rate, or minimum rate of return for a fund before an investment manager was entitled to the incentive fee allocation. For some funds, this was a token amount such as the risk-free rate of return, while for other funds it was perhaps a target rate. The logic here was simple: an investment manager should be at least able to replicate a certain risk-free rate or the return on a given benchmark. If the investment manager was not able to replicate this return, then the investor would be better off investing their capital in a treasury note or a market index, thus gaining the same (or better) return without the additional fees.

In addition, another typical modification to the usual "2-20" structure was the use of different share classes featuring different fee profiles. For instance, a share class with a one-year lock-up might feature the "2-20" fee structure, but a share class with a two-year lock-up might have a "1-15" fee structure. The idea is that the investment manager wants to gain "stickier" capital that they will be able to manage for a longer period of time and is willing to forego some fees in order to do so. In this case, the investment manager was quite willing to give a discount on fees in exchange for the longer-term allocation of capital, but generally on the terms as set forth by the manager.

Having said all this, the fact remains that fee structures were previously quite straightforward. While there were some nuances to certain funds, for the most part things were of the plain vanilla variety. Calculations were straightforward, terms were predictable and stable, and investors (for the most part) simply accepted the terms put forward by an investment manager. Much like future generations when considering their ancestors, it is easy to lament the loss of simpler times with respect to fee structures, for the industry would soon be turned on its head.

Fee Structures – After 2008

Indeed, the financial crisis of 2008 changed just about everything in the alternative investment industry, with fee structures being no exception. As investors pulled capital from every conceivable investment around the globe, investment managers who were previously flush with cash suddenly found themselves faced with redemptions and a profoundly difficult environment in which to raise capital. In an industry not used to dealing with economic equilibrium, supply abruptly outstripped demand and investment managers were fighting for capital. Post-Lehman, post-crash, those with the money were in charge, and as the proverbial shoe shifted to the other foot, investment managers quickly realized that they must evolve and meet their investor's demands, which included more dynamic fee structures.

For example, in an effort to be seen as fee-friendly, a number of funds have introduced a declining management fee for large-scale investors. To these investors, the incentive fee should be all the compensation that is required with the management fee meant to simply cover the operational costs. With increasing scale, the additional management fee gained from a larger asset base is generally not required for operations; if a fund grows, the costs of operating the fund generally do not grow in proportion, but rather by some fraction. Hence, many funds have introduced a sliding scale for management fees at the investor level, which may look something like the following:

Assets Under Management	Management Fee (Per Annum)
Assets Under $100 million	2%
Between $100 million and $250 million	1.50%
Between $250 million and $500 million	1%
Assets Over $500 million 0.50%	

As assets go up, management fees go down as a percentage of the investment, a notion that very much appeals to investors. However, this is just one alternative fee structure that funds have incorporated in order to meet investor demand. Truly, investor-level fee structures are bound only by the creativity of the engaged parties.

Also, funds are getting creative with respect to a multitude of other concepts including hurdle rates, lock-up periods, and incentive fee rebates. This author could go on ad infinitum with respect to the variations regarding these clauses, but suffice to say the possibilities are effectively endless. One common item that has been enhanced in the last few years is a longer period for accrual before incentive fees crystallize. For instance, many funds previously worked on a one-year cycle, with incentive fees crystallizing at year end and being allocated to the investment manager at that time. Recently, there has been a shift to longer durations between crystallization periods, meaning that the manager has to perform well over a longer period of time in order to receive the incentive fee. Poor performance over the long term, naturally, will result in the reduction of the incentive fee, which under a shorter duration could have already crystallized and sitting in the hands of the investment manager. To be sure, a longer duration is not a new concept (private equity funds have successfully used longer durations regarding carried interest for years) however it is becoming a more prominent component for hedge funds.

Conclusion

Still reeling from the most crippling financial crisis since the Great Depression, hedge funds have quickly discovered that they do not operate in a vacuum. Really, we are seeing that hedge funds (as much as we might like to think otherwise) are really no different than any other industry. There are large, established firms and there are small, nimble start-ups. There are those who specialize in niche offerings and there are those who offer a broader mandate. And, at the end of the day, the laws of supply and demand govern the alternative investment sphere like they do any other industry. Investment managers, more than ever, are yielding to investor demands for more complex and customizable fee structures in an effort to retain and increase capital in their funds. The past few years have seen a number of creative fee structures and surely there are unique methodologies yet to be tested in the marketplace.

Whatever the future may hold, the balance of power has somewhat shifted to investors, who more than ever are dictating terms to alternative investment funds. However, the most important aspect of this trend is not necessarily that fees are declining, but rather striking the appropriate balance based on operational circumstances. People respond to incentives, and without the appropriate compensation scheme in place, it will be difficult to continue to attract and retain top talent as well as reward superior performance. A prudent investor should always prefer to pay a 20% incentive fee on outsized gains rather than a 10% incentive fee on an underperformer. Investors should be mindful that, though a penny saved is a penny earned, you also get what you pay for. *