NARROW ROAD
CAPITAL

The Great Fee Debate – Resetting Manager and Investor Expectations

The recent push by the SEC in the US and ASIC in Australia for greater transparency on fees has reignited the debate about what is fair and reasonable when it comes to asset management fees. The two main sides to the debate predictably defend their respective positions with managers cast as greedy and investors portrayed as ungrateful and focussed more on fees then on total returns. The battlelines have shifted for some in Australia with the introduction of MySuper, which adds to the pressure on many investors to further reduce the total fees their members pay. Having been on both sides of battle at different times in my career I believe I can comment on some reasonable expectations each side should have. Before I jump into some thoughts on each side of the debate I'll first touch on the most important things when picking a manager.

When asked by friends, family and colleagues how to choose a manager I put forward three key factors:

1. Choose a manager with integrity
2. Choose a manager that outperforms a relevant benchmark
3. Choose a manager that takes a small share of the outperformance

The first is often accepted as a given, but clients of Bernie Madoff found out that this assumption can be financially fatal. A portfolio can recover from underperformance of an unskilled and honest manager, but a complete capital loss cannot ever be recovered. This rule applies equally when taking advice from accountants and financial planners who recommend products, with many pre-crisis timber schemes and mezzanine mortgage funds in Australia relying on extraordinary commissions to drum up sales.

The second criteria superficially can appear to be simple. The trick more often comes when a manager compares itself to an irrelevant benchmark such as an investment grade bond index for an unrestricted bond fund or an overnight cash rate for an absolute return strategy. One recent study found that private equity earns around half its total performance from using leverage and from timing its entry and exit points (multiple expansion), thus muddying the comparison with a vanilla equity index. It also needs to be noted that some asset classes have much easier benchmarks to beat than others. For instance relatively few large cap managers materially outperform their index after fees yet almost all small cap managers do.

The last of three key factors is where this debate really takes off. Once you've found an honest manager who is very likely to outperform in the long term, how do you fairly reward that manager? What's the right split between the base management fee and the performance component? I'll start the two sides of the debate by resetting manager expectations before moving on to investor expectations.

Resetting Manager Expectations

In my time acting as an investor a number of things commonly frustrated me:

1. Situations where I thought the manager is being paid way too much to get out of bed, and then takes a decent chunk of any outperformance as well. (Why are managers entitled to be paid so much merely for fund raising not for raising the value of my capital?)
2. Situations where I believed the manager was acting for their financial interest rather than giving investors a choice of what would best suit them. (How can a manager pretend that something is unequivocally the best thing for me when they are clearly conflicted?)

3. Situations where I didn't know what was happening with the investments and then faced stonewalling or hostility when I asked for information. (Was the manager hiding something?)

These situations and many conversations along the way shaped what I think about what managers should expect. I'm always taking on board feedback, particularly from current and potential investors but here's where I stand today.

Managers are not entitled to a million dollar lifestyle until their clients are richly rewarded. If you can't beat a relevant index in the long term you are wasting an investor's time and money.
When I see managers charging 1% or more in management fees on multi-billion dollar portfolios I see that as excessive and unjustified. The cost of salaries for good people, decent systems and modest office space simply isn't anywhere near that. Some managers seem to believe that being able to craft a nice story about their investment process including a pretty slide pack means that they are doing their job. As someone who has started their own business I don't begrudge the success of other managers when they give many investors and asset consultants the nice packaging they want. However, for investors to ultimately benefit, managers need to be rewarded for performance not presentation.

Investors are entitled to 90% of the outperformance over the index
This one is partly economics and partly conscience. Having done the calculations before setting up an asset management business I believe a 90/10 split well rewards managers who outperform. But it is also a matter of conscience and I note that many managers will see 80/20 or 70/30 as the fair split. For the vast majority of managers, they are easily replaceable with another manager of equivalent or better skill. Even in bullish markets when there is much capital around looking for an investment home, the demand/supply balance ultimately rests with investors. They have many alternative managers and sectors to choose from, including index managers.

Fees should be easy to explain and transparent
The recent SEC reviews of US private equity managers has highlighted the chutzpah of many managers in charging underhanded fees and the indolence of many investors in allowing the situation to exist unchecked. Managers should be able to explain in one page or less what fees they charge and how they are calculated. A standard base and performance fee model should suit almost all manager/investor relationships, with the incentive then placed onto the manager to minimise their costs of doing business. Where a specific additional service is required, this should be subject to investor sign-off.

Investors are always entitled to know where their money is and why it has been invested there
If a manager truly believes they have the recipe for a secret sauce and that revealing their positions to an investor will divulge the recipe, then that must be something everyone signs up to on day one. At least quarterly, managers should sit down with their investors and tell them where they see their sector positioned. I suspect many managers don't do this as they fear being exposed as not having anything meaningful to say, or that an honest conversation might result in their investors recognising that other sectors present better risk/return prospects.

Investors are entitled to know the risk/return prospects and be given a choice to change if there is an imbalance
Whether it is has come about by bad experience or is simply an irrational fear, many managers are not able to say to their clients that their sector is not offering great value at a particular time. I've recently attended a number of presentations where US high yield debt managers have put forward the thesis that other cycles have made further gains from this point so investors should remain invested for now. Stripping away all of the hyperbole, their message

could be rephrased “historically markets have become more overvalued then they are now so be greedy and squeeze the last few percent of gains out of this cycle.” This is enormously short term, self-serving advice. Managers should trust investors that if they offer to give some cash back now when prices are high, they’ll be first in line to receive more capital when prices are lower and the prospect for performance fees are much higher.

Managers need to accept that investors may have valid fee or liquidity constraints that rule them out
I cringe when I hear the whining of some managers that investors should ignore fee, liquidity or return targets (often mandated by regulation) and give special treatment to their industry. Why should an investor be expected to change their business model or lobby government for a change in regulation so that a private equity manager can earn high fees? Why should venture capital or agriculture managers be entitled to special treatment if historical returns don’t point to their sector outperforming in the future? Why should an investor take greenfield infrastructure risk because it is good for the economy rather than a good risk/return proposition? If a manager isn’t able to put forward a convincing case of future outperformance and appropriate fees they shouldn’t complain about investors passing on their “opportunity”. They should be looking to either change their business model or to pitch to other investors who have different views and constraints.

Managers should start changing their business models now to reflect a lower fee future
Managers need to start reducing their standards in their salaries, offices, flights, accommodation, entertainment and use of professional services ahead of a sea change in fee levels in the next decade. More large investors are increasing their index positions as they accept that the few managers that can materially outperform an index would be swamped if given a meaningful allocation of the investor’s total capital. I recently heard from one Australian superannuation fund that their cost of adding another dollar to an index equity product was 0.01% per annum. That’s increasingly what managers are competing against. Without the ability to survive in a lower fee environment, managers must excel in either performance or marketing, or accept that they are in a dying business.

Resetting Investor Expectations

At this point, investors might be feeling pretty good about what they’ve read. There may have been a lot of smiling and nodding as I went through the shortcomings of many managers. But this isn’t a one way street and there are some expectations that many investors should be changing for their own good.

Investors need to decide if they are fee driven or return driven
Many managers are partly right in arguing that some investors don’t prioritise total returns, but are instead more concerned with total fees. I say partly right because this makes sense for an individual investor, but partly wrong in that investors are entitled to choose that their business model is a low fee model and they will focus on that primarily or exclusively. Just as high fee managers are better off not pitching to low fee investors, low fee investors should be transparent in what they will pay and outright decline meetings if the manager has no chance of meeting the target fee levels. This requires investors to know what they are willing to pay for each particularly strategy. It also requires investors to know what split of base and performance fees they will pay and to be upfront in asking managers to work with that.

Low fee investors need to decide what their fee bucket is and make decisions about how to get the most out of it
Low fee investors may choose to spread out their fee bucket over all sectors, or choose a strategy that has a core of very low fee index investments with a few satellites that will hopefully deliver the most return for the fees available. Either way, the investor should know in advance how much and which sectors they will make fees available for. This

will allow the investor to spend their time choosing the best managers in their favoured sectors, rather than hearing pitches from managers who have no hope of fitting into the overall strategy.

If you want to beat the index you need to deviate from the index

Some investors seem to believe a fantasy world exists where managers can consistently deliver outperformance relative to the index. As any honest manager will tell you, there is no straight line of outperformance and deviating from the index means there will likely be periods of prolonged underperformance in order to deliver long term outperformance. This has proven true time and again for equities, with many top managers over a ten year period often underperforming the average for a two to three year period at some stage during the ten years. Investors need to accept that hugging an index means getting returns equal to an index, minus the fees charged.

Top managers often don't come wrapped in nice packages

I'm going to talk about two managers you've probably never heard of before to illustrate this point. I first read about Allan Mecham of Arlington Value Management in 2012. At that point he had $80 million under management, twelve years of track record with 400% returns over that period, leaving the S&P 500 for dead. Two years on, a follow up article noted that he now had $470 million under management and has continued to post extraordinary returns. The thing I find most interesting about Mecham is that he isn't closed to new funds. Despite enormous outperformance over a very long period, institutional investors apparently can't deal with his demand for patient capital and his lack of Wall Street polish.

The next example is Michael Burry formerly of Scion Capital. He was previously a medicine student who took up investing as a hobby then decided to start running his own fund in 2000 after successfully blogging for many years. Like Mecham, his returns were off the chart. By 2004 he had built to $600m under management and was turning away investors. Starting in 2005 he began to short sub-prime credit default swaps. His investors, who had seen their investments more than doubled in four years were enraged that their manager had moved away from solely stock picking and began to redeem. By 2008, despite having made a net 489% for the original investors in under 8 years, Scion Capital closed and Burry now manages just his own money.

Both of these guys seemingly came out of nowhere and were not the usual asset manager types. Both manage capital with a long term view, take on concentrated positions and invest where their reading and ideas take them with little regard for typical investment styles. Regardless of the returns the vast majority of institutional investors and asset consultants won't deal with them. Perhaps the real issue is that investing with people like this carries too much perceived career risk for investors, who work in an environment that relies on safety in the herd.

Top managers will inevitably be closed to new funds and will sometimes return capital to protect returns

In the last 12 months Paradice in Australian equities and US hedge funds Appaloosa & Baupost have all returned meaningful capital to their investors. In doing this, they are acting on their views that their future returns will be negatively impacted by their existing size. Investors need to recognise that top performance often comes in the early years for managers that don't close to new funds with outperformance diluted by size. For managers that do close, investors that come late won't be able to invest at all.

There is both skill and hard work involved in identifying top managers

There is arguably as much hard work and skill required to select top managers early, as there is required by those managers themselves when selecting underlying investments. As a guide, less than 10% of all managers can be expected to meaningfully outperform a suitable index after fees in the long term. If investors want to have an edge over their peers, they need to be actively searching for top managers and have clear measures to identify what outperformance looks like.

Investors need to change their managers to get meaningful change in their fees

What most investors mean when they say they want lower fees is that they want their existing managers to charge less. This is a fairly naïve position to hold. In all walks of life people would prefer to pay less, but those who truly care about the issue do something about it. If a manager doesn't have superior performance and won't offer low fees to retain business the capital should be redeployed to another manager or an index fund. For top performing managers, a balance needs to be struck bearing in mind the potential manager capacity issues and the possibility of an investor's capital being returned.

For many investors, the way they choose managers needs to be changed so that fees are always one of the first points agreed. Another change would be to run an open, publicly advertised tender process when evaluating whether to place available capital with an existing manager, an index product or a new manager. By publicly specifying what fees the investor is willing to pay and the outperformance expectations they hold, an investor is likely to discover new managers, strategies and fee propositions that they otherwise would not have considered. Whilst many investors would say that this is what their asset consultants are paid to do, there is clearly a breakdown in this process as there has been very little change in fee levels or manager selection in the last decade.

Conclusion

The average manager and investor both have many things to reflect on and expectations to change in the great debate over fees. Managers need to start taking costs out of their businesses and resetting their expectations of what investors should pay for what are too often mediocre returns. As well as lowering base management fees and eliminating obscure fees, managers should engage with their investors more often noting when their sector is good value and when it isn't. Investors need to be more transparent about their willingness to pay fees, and be willing to change managers in order to have a step change in their fee levels. Investors should actively encourage low fee managers to pitch to them and take action to switch to such managers where the risk/return proposition is merited.

Written by Jonathan Rochford for Narrow Road Capital on August 2, 2014. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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