- Most traditional fee structures do a poor job aligning the interests of asset owners and their investment managers.
- Rather than simply focusing on minimizing expenses, we believe it is more important to assess value for money.
- In a well-designed fee structure, managers should share equally in both good and bad performance.

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Few issues in investment management are more contentious than fees. Asset owners are understandably pushing back against entrenched fee structures that have served them poorly for decades, while managers are quick to defend the business models that have traditionally made the industry so lucrative. Fresh thinking is desperately needed to break the impasse.

In this paper, we will argue that the two most common fee structures—fixed fees and performance-based fees with high water marks—both suffer from serious flaws. We will also propose what we believe is a better alternative: a performance-based fee with a symmetrical refund mechanism that better aligns incentives and also increases the likelihood that the fees paid reflect the value added for clients.

The trouble with fixed fees

It's not hard to understand why fixed fees have become the dominant model in the industry. In addition to their operational simplicity, fixed fees provide managers with a predictable and highly scalable stream of revenue that grows in linear fashion with assets under management. Further, because of the high degree of operating leverage—i.e. the manager's costs grow far more slowly than the pace of revenue growth—the incremental profitability achieved from additional assets can be extremely high.

The key problem with fixed fees is ultimately one of incentives. The temptation to pursue asset growth is almost irresistible—even if it means growing beyond the manager's capacity to outperform. Even more powerful than the temptation to gather assets is the imperative to avoid losing them by being different and wrong. As Keynes wrote, "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally." It's no surprise that benchmark-hugging has become such a widespread problem.

To be clear, none of this is to suggest that active managers are simply incompetent or complacent. Quite the contrary, the industry is full of very smart and highly competitive people. But in most cases we think the forces of human nature are simply too overwhelming to resist. As Kahneman and Tversky famously demonstrated many years ago, humans are highly loss averse; the pain from a dollar lost is much greater than the joy from a dollar gained[1]. The implication here is that career risk looms large for individual professionals as does business risk for their firms.

Skilled managers are not immune. The random nature of investment returns is such that there is some probability that even the best investors (and firms) will perform poorly enough over short-term periods to be fired. Since they cannot control either the measurement period over which clients assess their performance and cannot upgrade their skill level—at least in the short term—the only option left to reduce the probability of getting fired is to reduce tracking error. Said differently, hugging the benchmark is a lot harder to resist than it may seem.

Of course, some would argue that good performance attracts positive attention, individual rewards, and ultimately more assets to manage. While this is true to a degree, the influence is highly asymmetric in favor of avoiding bad performance. For loss-averse individuals and institutions alike, the perceived benefits of good performance will almost certainly fall far below the perceived pain of poor performance. Ultimately, the rational strategy for an investment manager running a business with fixed fees is therefore to build a strong distribution platform, avoid making big mistakes by staying close to the benchmark, and grow without bound, even at the expense of investment returns.

The trouble with performance-based fees

Performance-based fees would seem to be an obvious solution. They greatly reduce the temptation to pursue unbridled growth, while also discouraging benchmark hugging—so far, so good. Unfortunately, the predominant performance-based fee structure in use today, which utilizes a high water mark, simply introduces another form of incentive misalignment. Under this construct, clients pay a base fee plus a share of any outperformance, and if performance subsequently suffers, the manager must recover the prior peak before again earning performance fees. While this sounds like a good deal for investors, it's really a "heads we win, tails you lose" proposition. For the manager, the payoff to investment performance is essentially a call option in which the high water mark is akin to the strike price and the client bears the full downside if things go poorly.

With this in mind, how does the manager maximize this option value? He can't really change the time to expiration; clients will redeem when they want to. He can't change the strike price; the high water mark is set. And he probably can't change his skill level; if he could, he already would have done so. The only thing left to change is the volatility of the portfolio, even if doing so is not in the client's interest. Indeed, research has shown that even a manager with negative skill is better off increasing portfolio risk under such a fee structure, despite the fact that this is, by definition, a worse outcome for clients (when a manager has negative skill, clients are better off if he does nothing)[2].

High water mark performance fees are also flawed due to their path dependence. In other words, the fees that an investor pays under such a structure are not just a function of the cumulative return experienced through the time of redemption, but are rather a function of the path that the return took to its final state. Simply put, unless an investor redeems while at their high water mark, they will have paid a greater portion of the return in fees than the stated sharing ratio. For instance, if the manager produces strong returns in the first few years, and subsequently underperforms, the client will have paid substantial performance fees in those first years, despite a potentially negative cumulative total return. This path dependence, the random nature of investment returns, and the fact that very few investors would redeem while at their high water mark means that, in practice, it is very likely that an investor will have paid a substantially larger portion of their returns in fees than the headline sharing ratio implies.

1 Prospect Theory: An Analysis of Decision under Risk, by Daniel Kahneman and Amos Tversky. Econometrica, March 1979.
2 Clare et al, "Heads We Win, Tails You Lose: Why don't more fund managers offer symmetric performance fees?" Cass Business School, October 2014.

Is there a better way?

It is clear that both fixed and performance-based fee structures do a poor job aligning the interests of managers with those of their clients. Fairness is a subjective term, but one could also argue that these common fee structures are unfair because the fee that a client pays is not always proportional to the value that the manager has added for the client. As a starting point, we would therefore argue that any solution should focus on value-for-money, or the ratio of fees paid to value-added, after fees and expenses, and to maximizing net-of-fee returns. In our view, this point is too often lost when the mantra on cost becomes "the lower, the better."

The fundamental truth is that some active managers can deliver genuine value and others cannot. Nobel Laureate William Sharpe demonstrated many years ago, using basic arithmetic, that investment management is a zero-sum game: half of all actively managed dollars must outperform and half must underperform, gross of fees. The implication for investors in a fixed fee structure is that the majority are doomed to receive negative value for money. But it's actually even worse than that. Because fixed fees limit upside for skilled managers, those managers will disproportionately choose to offer performance fees, which means that the average fixed fee manager likely underperforms not just on a net basis but also on a gross basis.

From this perspective, heightened fee sensitivity and the associated influx into passive strategies are perfectly understandable, a natural outgrowth of an antiquated industry structure that has served asset managers well but investors poorly. The surprise, therefore, is not that investors are rebelling against this old paradigm, but rather that it took so long!

So what would an ideal structure look like? In a perfect world, a client would pay no fees until they redeem, at which time they would write a check to the manager for an amount proportional to the value added. In the real world, however, managers have bills to pay, which makes such an idealized structure unrealistic. Fortunately, there is a more practical solution that still gets close to this ideal.

That practical solution is a refundable performance fee in which the manager shares equally in both good and bad performance. Rather than flowing directly to the manager, performance fees flow instead to a fee reserve, where they are available to be refunded should the manager subsequently underperform. In periods of underperformance, fees are refunded to the client from the reserve at the same rate that they are earned. The manager is only able to draw from the fee reserve once it has reached a designated proportion of the client's assets.

While this structure is undeniably less favorable for the manager, the symmetrical nature of a refundable performance fee substantially mitigates the major flaws of both fixed fees and performance fees with high water marks. First, the refundable fee focuses a manager on achieving superior returns, while discouraging the benchmark hugging and asset gathering that are natural outcomes of fixed fees. Second, it reduces the incentive to take unjustified risks, which can occur with a traditional performance fee. Finally, it reduces path dependence and increases the likelihood that the fees paid are proportional to the value added.

Finally, this refundable fee structure has the added benefit of smoothing clients' experienced returns, thereby reducing the likelihood that they capitulate on their managers at exactly the wrong time. It is well established that investor returns substantially lag the returns of the funds in which they are invested, in large part because investors tend to invest when the manager has performed well, and redeem when the manager has performed poorly. By reducing the depths of experienced drawdowns during periods of underperformance, this fee structure can help to reduce the so-called "return gap" by helping investors stay invested during the inevitable periods of underperformance.

Of course, the refundable structure is not perfect, but it reminds us of Churchill's famous quip about democracy[3]—it is the worst type of fee structure, except for all the others.

3 "No one pretends that democracy is perfect or all-wise. Indeed, it has been said that democracy is the worst form of Government except all those other forms that have been tried from time to time."—Winston Churchill, speech to the House of Commons, 1947