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FTMONEY, MAY 2015

A glimmer of hope in performance fees debate

There has been so much to think about recently that I have been distracted from the nuts and bolts of financial services.

It's hard to focus on the various scams and shenanigans of the UK's money managers when you are worrying about why Scotland has one of the few parliaments in the world without a second chamber; when the UK electorate unexpectedly proves that it gets the point of capitalism; the multi-decade global bond bubble looks to be laying the groundwork for a bust; and some of the stock markets I like are suddenly doing exactly what I suspected they would (I'm thinking of the boom in Chinese shares). It's all rather thrilling.

But behind all this macro drama, exciting things are happening in the world of fund management too.

I have complained here many times about the way in which we are charged by our fund managers. I don't like the fact that most of them charge *ad valorem* fees. That's partly because the fees are almost always too high (fund management is the greediest profession I know). But it is also because this traditional structure incentivises the wrong thing.

If you are paid more for every pound you bring in – regardless of performance – you focus on gathering assets and hanging on to them by making your performance entirely unremarkable relative to some index or other. That's why the UK market is jammed with mega funds devoted partly to collecting more money and partly to ensuring the returns track those of the index. It's expensive and in the context of what investors want (to be rich) it is pretty useless.

But worse than this has been the industry's response to the problem – to chuck in performance fees on top of their rapacious base fees. The idea here is that performance fees align the interests of fund managers with investors – when you make money they get paid (more money).

This is of course nonsense. Why? Because it only aligns half of their interest with ours. When we lose money they don't. So this just adds an extra rubbish incentive on top of the previous rubbish incentives – it encourages them to take whopping risks after periods of underperformance to trigger the bonuses they need to pay their kids' school fees and their outsized mortgages.

The rise of hedge funds has made some difference to the conversation on performance fees in that, while they regularly overcharge, they have at least made high water marks and proper targets the norm. Overall, however, there has been remarkably little movement or innovation in this area for years. It is just maddening.

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But that might be changing. I had breakfast this week with the charming economist Tim Congdon. I complained about this to him and he asked why I bother even thinking about it. "Just leave it to the market," he said. My first response was to say that the oligopoly of distribution in the fund world means the market isn't working here. But then I started to think of some of the meetings I have had recently and I see that it is. It is slow, but it is happening.

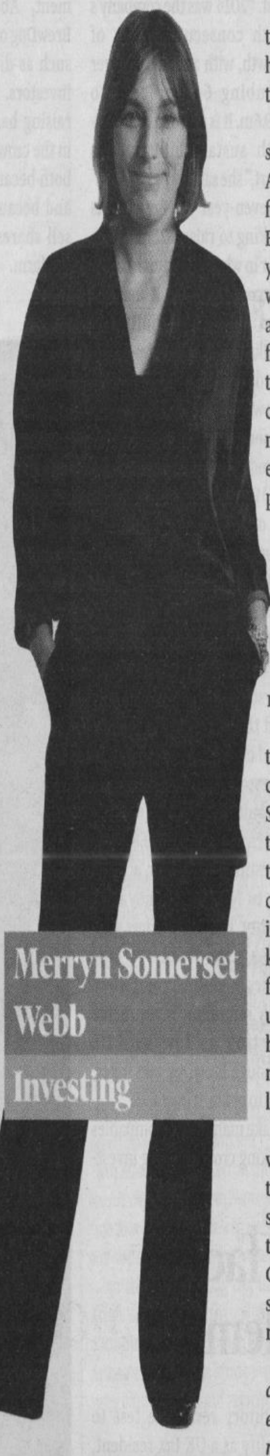
The most obvious move in this area is Neil Woodford's new Patient Capital trust. It charges an administration fee to cover its ongoing costs and then a performance fee on the growth in the net asset value (rather then the share price) of the fund. The performance fee is nicely structured. It's long term, it has a high water mark built in, it is high but not super greedy (although I do wish it was capped) and it is to be paid mainly in shares not cash.

That said, the ongoing charges – expected to be about 0.35 per cent – aren't particularly low – on the £800m Mr Woodford has raised, the annual revenues will still be not far off £3m in the first year. No one is working for free here (I'm not suggesting anyone should, just pointing out that low-looking percentage charges still add up to real money).

A similar model is offered by Tellsons on its Endeavour Fund. You can choose to pay a regular management fee (giving you an ongoing charge of 1.31 per cent) or just pay an admin fee of 0.31 per cent and then a well-structured performance fee – the fund has to make money in absolute terms rather than just relative to an index for the managers to get paid.

Another interesting model comes from Orbis Access. It again focuses on performance with the fee being 50 per cent of anything over the benchmark. It comes with some of the usual problems – 50 per cent is far too much for starters, although the managers' take is at least capped at 2.5 per cent of the fund. It is almost impossibly complicated; and the fee (or lack of) is calculated daily, which I suspect will end up incentivising some of the wrong things.

On the plus side, the system incorporates something I haven't seen before – refunds. Managers put their performance fees into a reserve and on the days they underperform, pay 50 per cent of the underperformance back into the fund. That's a nice touch – though of course if the reserve runs out they will still have to recover running costs from the fund. So nice, but not perfect.



So what's the best model I have seen so far? It may come from Andrew McNally and George Cooper, founders of a new firm called Equitile. There's nothing to invest in yet (when there is I will tell you). But when Mr McNally and I met we talked about a system where a low *ad valorem* fee would be charged on enough of the assets under management to cover costs and basic pay of the business (you have to pay good managers enough to stop them leaving) and a performance fee on the rest.

So perhaps you would charge 0.4 per cent on the first £400m under management (giving you revenues of £1.6m) and then a low and properly aligned (that is, very long term) performance fee on any money you raise after that.

After all, while it might cost £1.6m to run £400m it doesn't follow that it costs £3.2m to run an £800m fund. So this system takes away the fact that even a low management fee turns into a super profit generator at a certain point of asset gathering and it incentivises keeping the fund at the kind of size where regular outperformance is possible (go too big and it usually isn't). It still isn't perfect – I hanker after a flat fee fund management business (one with a set absolute price for the fund as a whole).

The key point is that capitalism is working here – interesting, innovative and clever people are entering a stale market and trying to attract customers with better aligned products. Given that the cost of investment is still the major determinant of our returns, that's a very good thing.

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