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INVESTMENT FEES

# Putting a price on high cost of performance

JOE BUNTING

Fees are always very controversial, whether for lawyers, estate agents or investments.

They are under more pressure than ever today as a whole range of competing forces step up the challenge to traditional economics: the shift towards passives and exchange traded funds (ETFs), greater transparency and scale buying power on investment platforms such as Hargreaves Lansdown and AJ Bell, and the concentration of manager skill in mega funds like Woodford and fund houses like Blackrock.

Performance has always been controversial too: while it waxes and wanes, excites and disappoints through the cycle, no matter what your investment outcomes the fees you pay are certain, along with death and taxes.

### Investor choice

But somewhat paradoxically, perhaps now the time is ripe for a re-evaluation of performance fees and the role they can play in the industry's drive to offer better investor choice and value for money. Surveys have indicated for some time that consumers would like to have more choice. There are many complexities involved, but maybe active managers could make more alternative charging structures available and investors, or more likely their advisers, would be prepared to do the extra work to find the hidden value.

'Value' does need to be the operative word here, as performance fees tend to have offered pretty poor value in the past. Firstly, they tend to be mandatory rather than an option, so if you want the manager and the strategy, the attitude is 'take it or leave it'. This became the standard procedure and hallmark of the hedge fund industry. Secondly, they tend also to be quite generous in their rewards for performance. The problem with this is twofold: that investors resent paying high fees even when the performance is successful; and fees can still be quite high even without successful performance.

Another reason they have struggled for mainstream acceptance is that they can be difficult to understand. Fees are quite complex to structure in a way that charges for success but not for failure; and so as to function across all performance outcomes as expected over long term horizons. All things considered, performance fees have developed a poor reputation for themselves: complex, opaque, a bit lopsided in favour of managers, and perhaps even greedy and unethical.

### KEY POINTS

- Now the time is ripe for a re-evaluation of performance fees and the role they can play in the industry's drive to offer better investor choice.
- Performance fees have struggled for mainstream acceptance because they can be difficult to understand.
- Like any other industry the investment sector tries to charge its customers for the quality of service they provide.

So what if performance fee structures represented a better deal for investors? What if they aligned managers' incentives better with investors' long term investment outcomes? What if they were available as charging options alongside traditional fixed fee charges rather than one size fits all obligations? How about performance mechanisms where the break even vs the fixed charge option were more closely calibrated to the investment objective? And absolute caps to high performance upside, in inverse proportion to base fee reductions? Could they meet with a more favourable reception, and might they have a more useful role to play?

### Investor appetite

There have been a number of fund launches in recent years attempting to meet investor appetite, with a variety of mechanisms and features that have received a mixed response. To some extent the behaviour of each performance fee can only be fully assessed over time when the costs of the performance they generate can be more reasonably measured against expectation. For example, performance benchmarks such as cash or Libor may seem very low hurdles of return today but in more normal times they would represent a perfectly respectable proxy for risk averse investing.

Likewise inflation, as virtually anything should deliver a return in excess of inflation today but when inflation is rising, it becomes much tougher.

The whole idea of any management fee at all is that it should be the price of the performance that comes from the active management involved, the skill. So any management fee should be considered a fee for performance in excess of the market's passive return. For example, this would be the case for a long-term track record in excess of a market return, or a 'star' manager. There are even managers in the market today who do not apparently 'do enough' active management, whether buying or selling and turning over the portfolio, to warrant their active management fee charges in spite of the fact their performance is outstanding – to which the response is happily that they will 'do more' but they will have to charge for it without guaranteeing any better performance.

At the end of the day, the investment industry is just like any other industry in that it tries to charge their customers for the quality of the service they are able to provide. And just like other industries, they strive to provide better quality services for more reliability to retain their customers, acquire new customers and develop the strength of their brands. If active fees are part of a business's brand power, they have a right to the rewards, but likewise their customers will leave if products fail to live up to their expectations and they can find better value elsewhere. This is what is happening with the drift to passives and ETFs and presumably what is about to happen with the drift to robo-advice too.

Performance fees can be designed to balance the needs and incentives of investor and manager alike. They have a unique opportunity in this marketplace to redress the dwindling confidence in active management and advice today. And with greater regulatory focus on suitability and investor outcomes, performance fees can serve to place the investors' interests right at the centre of the business case for the investment strategy itself, aligning investors' journeys and investment outcomes with success for the managers who deliver what is expected of them.

### Options

At the very least, a strong case can be made that a performance fee option should be available alongside other charging options, where a breakeven should calibrate reasonably closely with the long term strategy objective, where the investor saves in the event of a shortfall and the manager gains in the event of success. Investors and their advisers would in this way be able to better decide for themselves which fee charging structures may be most suitable: it would even allow for investors to mix and match the different fee charging share classes of their investment to create their own tailor-made fees.

This would go a long way to meeting investor demands in the investment industry today and would enable active management to regain the initiative from passive and ETF substitutes.

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