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Incentive Fee

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What is an Incentive Fee

An incentive fee is a fee charged by a fund manager based on a fund's performance over a given period and usually compared to a benchmark. For instance, a fund manager may receive an incentive fee if his or her fund outperforms the S&P 500 Index over a calendar year, and may increase as the level of outperformance grows.

BREAKING DOWN Incentive Fee

An incentive fee, also known as a performance fee, is usually used to tie a manager's compensation to their level of performance, more specifically their level of financial return. Such fees can be calculated in a variety of ways. For example, in separate accounts the fee can be pegged to change in net realized and unrealized gains, or net income generated.



on growth of the fund's or account's [net asset value \(NAV\)](#). A 20% incentive fee is charged for hedge funds.

While they are rare, some fund use a "[shock absorber](#)" structure in which a fund manager is penalized before the investor for downward movement in performance.

In the United States, the use of incentive fees by [registered investment advisors \(RIA\)](#) is covered under the Investment Advisers Act of 1940 and may be charged under only special conditions. Managers seeking to use incentive fees to U.S. pension funds must abide by the Employee Retirement Income Security Act (ERISA).

Incentive Fee Example

An investor takes a \$10 million position with a hedge fund and after a year the NAV has increased by 10% (or \$1 million) making that position worth \$11 million. The manager will have earned 20% of that \$1 million change, or \$200,000. That fee reduces the NAV to \$10.8 million which equals an 8% return independent of any other fees.

The highest value of a fund over a given period is known as a [high-water mark](#). In general, an incentive fee isn't incurred if a fund falls off that high. Managers tend to charge a fee only when they exceed the high-water mark.

A [hurdle](#) would be a predetermined level of return a fund must meet to earn an incentive fee. Hurdles can take the form of an index or a set, predetermined percentage. For example, if NAV growth of 10% is subject to a 3% hurdle, an incentive fee would be charged only on the 7% difference. Hedge funds have been popular enough in recent years that fewer of them utilize hurdles now compared to the years after the Great Recession.

Incentive Fee Criticism

Critics of incentive fees, such as Warren Buffett, contend that their skewed structure—in which a manager shares in a fund's profits but not in its losses—only tempts managers to take outsized risks to throttle up returns.

Related Terms

Performance Fee

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