CHAPTER 9

Fees

One of the most contentious issues in the hedge fund and fund of funds industry is fees. According to PerTrac Financial Solutions LLP, a New York–based software company that aggregates hedge fund data and provides analytic tools for asset allocation, the average hedge fund charges a management fee of 1.50 percent and an incentive fee of 20 percent.

INCENTIVE FEE

Before the mid- to late-1970s, most managers that operated hedge funds charged just an incentive fee. This meant that if they made money for their clients, only then would the manager get paid. It also meant that if the manager lost money or the portfolio was flat, the manager had earned nothing. The interests of both parties were aligned. This alignment of interests is what A. W. Jones had in mind when he launched his fund in 1949, with just an incentive fee. The change came as fund complexes grew, overhead grew, and the management firms needed additional capital to operate their businesses.

The fee structure during most of the 1980s and the 1990s consisted of a 1 percent management fee and a 20 percent incentive fee. As the market grew and investor appetite for products grew, the fees increased; over time, they have settled into 1.5 and 20 percent. However, in light of the market dislocation of 2007, 2008, and 2009, don't be surprised if fees change again—this time, however, on the downside. In order to maintain assets and attract assets, some fund managers have lowered their fees and changed liquidity terms. This seems to be the trend going into the summer of 2009.

Remember this: The only people who complain about fees are those who cannot charge them. The market dictates the fees and, more importantly, puts a number or worth or value on the manager. Consequently, he or she can charge what the market allows—nothing more and nothing less.

In all the years that I (Dan) have been working with and writing about hedge funds, I have never met an investor who complained about fees. The only people I have ever come across who complain about fees are mutual fund and other long-only managers.

MORE OR LESS

The fees that fund of funds charge are less than the standard of single manager funds. Many fund of funds managers charge only an asset-based fee, which ranges from 1 to 2 percent, while others have both a management fee of 1 percent and an incentive fee. The incentive fee can range from 10 to 20 percent of net assets. The fees charged by the fund of funds are in addition to the fees charged by the underlying managers.

What does "1 and 10" mean in a fund of funds? If the underlying managers of a fund of funds earn 10 percent in aggregate, then the fees paid to the fund of funds managers would be a 1 percent management fee on the total assets and an additional 1 percent in incentive fees, because the underlying managers achieved a 10 percent positive rate return.

Are Fees Justified?

The fees are justified because the fund of funds manager has created a portfolio that achieved the target rate of return for the investors. However, because some investors believe that the fee structure is too high, many fund of funds managers have put in place benchmark hurdle rates that the manager must achieve before incentive fees are earned.

While absolute returns are important to many investors, many institutional investors view fund of funds as "LIBOR beaters" or "Treasury-bill beaters." The investors seek fund of funds investments that exceed short-term money market rates by a margin that is often based on these aforementioned benchmarks.

Therefore, an investor who receives a margin of 100 to 500 basis points in excess of the benchmarks will believe that the investment in the fund of funds is worth the additional fees. It all comes down to risk profiles and the ability of fund of funds managers to achieve their objectives for their investors.

Reasonable Costs

Additionally, one of the benefits of fund of funds investing is that investors have a single point of entry into a diversified portfolio of hedge funds at a very reasonable cost. Doing the research, completing the due diligence, making the allocations, and staying on top of the managers—it may not be cost-effective for an investor that allocates just a portion of overall portfolio to alternatives for less to take on this burden. Fund of funds provide an excellent way to gain exposure to hedge funds and other alternative managers for a very reasonable price. However, one thing is for sure—whichever way you go, it is important to perform due diligence. In light of the Madoff scandal, some well-known and well-respected fund of funds turned out to be simply investing with one or two managers, and this is just wrong. Funds of funds are supposed to be invested in a diversified portfolio, not a single manager. The idea is to reduce risk and exposure. In these funds, neither was achieved and the investors suffered greatly. You need to get answers and verify information about which managers to select and the amounts of money allocated by the fund of funds before and during your investment period.

MULTI-MANAGER FUNDS

In the post-Dot.com bubble and in the new era of corporate governance, many investors looking to make allocations have decided to allocate to another type of multi-manager funds. These products are called multi-strategy funds. The manager operates a team of investment professionals who trade various markets under a single fund structure. This differs from a fund of funds in that a fund of funds allocates to different strategies by investing in multiple funds, versus a multi-strategy fund which operates multiple trading desks under one roof. Multi-strategy funds will be discussed in greater detail in Chapter 13.

Recently, to say in the last three years, it seems that most investors have become frustrated with investment returns, and both hedge fund and fund of funds investors are concerned with two aspects of alternative investing: mediocre performance and fees. However, in years that hedge fund and fund of funds outperformed the benchmarks, major indexes, and frankly put up good numbers, nobody seems to care one bit about fees. It is important to note that fees are not indicative of performance. However, it is imperative for the investor to consider that what that fee includes is the cost "to run a research effort to service institutional investors."

Getting Returns

"The marginal cost to source, select, and service a portfolio of hedge funds can be close to 50 basis points," said Robert Schulman, the former chairman of Tremont Group Holdings, Inc.[1]

Naturally, most investors do not want to pay the fee to build out an infrastructure for a firm, they simply want the returns. However, this is just not possible. While the costs associated with operating a $2 to $3 billion fund of funds with a staff of 35 to 40 professionals can exceed $15 million, the margins may be thought to be excessive by institutional investors that are accustomed to paying fees of 15–25 bps for long-only investment services. However, remember, the fund of funds business is in the asset management business while the long-only manager is in the asset-gathering business. (If you don't understand this, e-mail us: dsrb@hedgeanswers.com.)

The challenge of many fund of funds managers is a struggle between cutting fees to acquire larger, stickier pools of assets while the cost of running the business like everything else in the world is going up. Most fund managers do not like to talk about fund discounts publicly; this is one of the final questions that many large investors ask as a final due diligence question. Many fund of funds managers are not as skillful in differentiation like hedge fund managers seem to be in their ability to command investors to pay "list price."

Differentiating

In order to differentiate themselves in the marketplace, fund of funds are introducing new products or are offering to provide advisory services or customized or private label funds for investors.

Fees are a critical issue for manager and investor alike. There are some investors who express dissatisfaction with fees especially when it comes down to concerns about the alignment of investors' interests with the manager. Many investors that we have talked to believe that fees should decline as the overall asset base of the fund of funds grows, but there has been no evidence that this is causing fees to shrink. And while the press seems to complain about fees in every article it writes about hedge funds and fund of funds, when investors are asked about the most important requirements in the manager selection process the answers are:

- Returns (source and repeatability)
- Professional staff
- Operational excellence
- Risk management systems
- Performance record and length

RESULTS VERSUS FEES

Investor dissatisfaction with fees is often caused by the fund of funds manager's inability to explain performance and the relationship to the benchmarks, the current market conditions, or the relationship of the managers' investment process and performance results. Fund of funds that are able to articulate the investment process in a timely and cohesive manner and with adjusting performance expectation as market conditions change, provide a high level of satisfaction for investors—and are more likely to see their business thrive and grow. Investors, regardless of market conditions, scandals, and political situations want to know what is going on. Communication is key—managers who don't communicate may make it for the short term, but in the long term they will go out of business no matter how good their performance.

Prior to the recent credit crisis and market meltdown, as the fund of funds turf grew quite competitive, consultants liked to boast to clients that they could save the investor 40 to 50 basis points in fees because they would be able to use their scale to demand discounts. However, in the summer of 2009, it seems in an effort to maintain asset levels and attract new capital that will stay locked up, managers are putting the sale sign up from the get-go.

The problem is like everything that gets discounted; just because something is cheap does not mean it is worth it and sometimes you do just get what you pay for. Fees are not what make a manager worth investing with or not; it is their ability to perform on a consistent basis. If the lowest priced fund can do this then go with it, but first make sure you do your homework. It comes down to "caveat emptor." Fees are linked to returns and capacity, and the markets will determine the point of equilibrium. Some people like to shop at Wal-Mart Stores, Inc. or other discount retailers and always pay the lowest price. Others go to Tiffany & Company and pay top dollar.

Making Smart Decisions

Making an investment comes down to a number of factors and the answer lies with the investor who should be making informed, prudent decisions. If not, use of a consultant or other investment professional will aid in the investment decision.

In the final analysis, fund of funds are justified if the manager executes the advertised strategy and achieves the targeted returns. Ultimately, the investor must determine if the fees have impacted the overall risk and return profile of the portfolio and if the investment is worth it.