

Debating Investment Management Fees: Will This Time Be Different?

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It recent months there has been considerable focus in the global investment community directed on the fee structures of investment managers. Periodically the scale of investment fees rises to the surface in the broader context of the active versus passive debate, particularly in down markets, only to subside when equity values recover. What is interesting in this instance, despite the performance of equity markets globally since the financial crisis of 2008-09, is that a crescendo of voices is combining to keep the issue of investment fees squarely on the global agenda of investment managers and asset owners. So we ask: Will this time be different?

Perhaps debate is too strong a characterization as it implies a contested thesis. Rather over the past 2 years the case that management fees are “too high” has gain momentum, in both the media and professional journals, accentuated by high-profile cases of manager fraud, public outcries against opacity in fee reporting (as in the recent case of the North Carolina pension system), and provocative advice by the likes of Warren Buffet² to go “low-cost”. As importantly, commentary and anecdotal evidence has continued alongside new academic research and analysis and changes in the investment behavior of asset owners that lends strength to an argument of structural change in management fee structures. We advance this argument by first clarifying our scope and offering some empirical context.

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² See “Will Invest for Food”, *The Economist*, 3 May 2014. Buffet purportedly suggested in the event of his passing that the trust “put 10%...in of the cash in short-term government bonds and 90% in a very low-cost S&P 500 index fund”.

Investment fees generally take the form of base management fees charged as a percent of asset under management and, most applicably in the case of managers of alternative assets – hedge funds, private equity, real estate, infrastructure – performance fees calculated using an agreed benchmark or hurdle rate. While the latter in scale can be substantial (ranging generally from 15-20%)³, certainly detract markedly from overall returns, and can create agency issues between managers and asset owners, they are nonetheless based upon excess performance and usually payable based upon cumulative performance. Management fees, conversely, are payable regardless of performance based strictly on assets and are very much a function of the strategy under which the assets are invested.

Focusing specifically on fees for active management, both Burton Malkiel⁴ and Charles Ellis⁵ are quick to note that when expressed as a percentage of AuM, management fees do not appear excessive, e.g. 1% of AuM. Assuming, as Ellis points out, that investors already own the assets, a more practical approach is to examine fees as a percentage of manager performance. More appropriate still, as a true measure of net benefit, would be to measure fees against the “excess” returns of active managers.⁶

A stylized analysis of investment management fees is presented in Figure 1, which plots average management fees across 19 distinct styles or strategies deployed in scale through comingled pools. Easily discernible in the chart are the breakpoints between passive, active, and alternative strategies. At the base of the spectrum fees for passive strategies range from as low

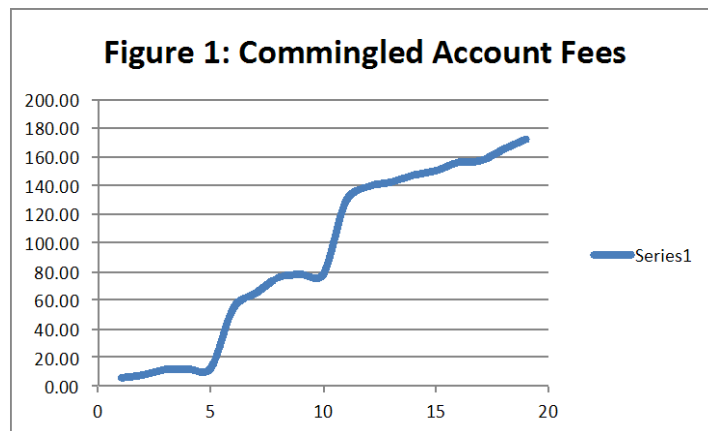
³ See Preqin Hedge Fund Analyst

⁴ Burton G. Malkiel, “Asset Management Fees and the Growth of Finance”, Journal of Economic Perspectives, Volume 27, Number 2

⁵ Charles D. Ellis, “Investment Fees Are (Much) Higher Than You Think”, Financial Analyst Journal, May/June 2012

⁶ Malkiel, “Asset Management Fees”

as 6 bp for global fixed income to 12 bp for US equities. Active fees range on average from 54 bp for global fixed income to 78 bp for global equities. Finally, at the top of the spectrum we report mean management fees for hedge fund strategies, which range from 129 bp for fund of hedge fund vehicles to 172 bp for managed futures strategies.



Passive is cheaper, but are not higher fees associated with greater investment value? Certainly active mandates have and continue to dominate the global investment landscape. A recent study by PwC⁷ clearly establishes that active funds – some 80% of total global AuM in 2012 - dwarf passive strategies. This is notwithstanding an increase in the expense ratios charged to large institutional investors for actively managed equity funds (from 47 bp to 55 bp from 1996 to 2011).⁸

⁷ “Asset Management 2020: A Brave New World”, PwC

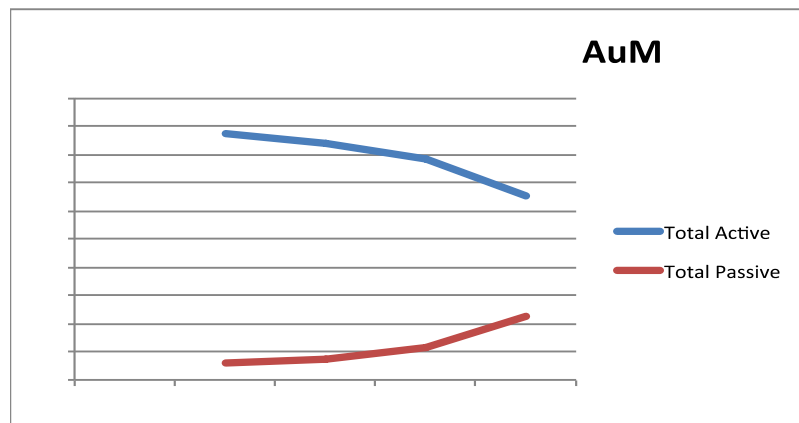
⁸ Malkiel, “Asset Management Fees”

Table 1

	2004		2007		2012		2020 (e)	
Mutual Fund AUM								
Active	15.1	40.4%	23.3	39.2%	23.6	36.9%	30.8	30.3%
Passive	1.0	2.7%	2.0	3.4%	3.4	5.3%	10.5	10.3%
Mandates								
Active	17.6	47.1%	26.5	44.6%	26.6	41.6%	35.3	34.7%
Passive	1.2	3.2%	2.3	3.9%	3.9	6.1%	12.2	12.0%
Alternatives	2.5	6.7%	5.3	8.9%	6.4	10.0%	13.0	12.8%
Total Global AUN	37.4		59.4		63.9		101.8	
Total Passive	32.7	87.4%	49.8	83.8%	50.2	78.6%	66.1	64.9%
Total Active	2.2	5.9%	4.3	7.2%	7.3	11.4%	22.7	22.3%

Source: PwC

Perhaps more important to our argument, as global AuM continues to grow, capital committed to passive strategies – based on PwC’s analysis - is expected to nearly triple in scale by 2020 to over 22% of global AuM. In the same period, funds committed to active strategies are also expected to grow, but at a considerably slower pace thereby reducing their proportion of total AuM by some 25%.



While these future trends are starkly apparent in Figure 2, a transition is clearly underway. Critically, it appears to be driven in part by an interest on the part of asset owners to reduce the costs of investment services. For example, in late December 2013, the UK’s

Department for Communities and Local Government, which is responsible for the UK's Local Government Pension Scheme (LGPS), recommended that the actively managed equity assets of 89 funds under the scheme be moved to passive management, specifically to save the funds an estimated aggregate £420m a year in investment fees and transaction charges.⁹ Similarly, an analysis conducted of US state pension funds suggested an available savings of \$6B a year in fees from a transition from active to passive or indexed strategies.¹⁰

But, once again, are not higher fees associated with greater value? It seems not. We refer to the study of US state pension funds cited above, which also found that higher fees actually were associated with *poorer* investment performance. Specifically, in the five-year period ending June 2013, the 10 state pension funds that paid the highest fees (61 bp) realized net annual returns of 1.3%, while the 10 funds that paid the least fees (39 bp) returned 2.4 per cent.¹¹ Such results are in fact by no means counterintuitive, but rather grounded in a rich tradition that leads from Sharpe, Maikiel, and Fama among others. It rests on a mathematical construct proposed by Sharpe that unfolds simply: The market return in any period represents a weighted average of all security returns in the market. Passive managers by definition earn the market return. Because the market return is equal to a weighted average of gross returns on the passive and active segments, active managers will likewise on average earn market returns. However since active managers have higher cost/fee structures, their net returns will underperform those

⁹ See "Alarm Bells Ring for Active Managers", Financial Times, at <http://www.ft.com/intl/cms/s/0/22b03864-d535-11e3-9bca-00144feabdc0.html#axzz32BbEkWXC>.

¹⁰ Ibid

¹¹ Ibid.

of passive managers.¹² Thus, as Ilmanen points out, “[a]ctive management is a zero sum game before costs and fees and a negative sum game after they are included”.¹³

Beyond the anecdotal, a sizeable body of research on the returns to active management tends also to support this thesis. A review of the more recent literature suggests two studies to illustrate. Fama and French examine the question of luck versus skill in the performance of active mutual fund managers from 1984 to 2006. They examine the excesses returns of over 3,100 active funds and find that only the 99th percentile (about 32 funds) deliver statistically significant alpha.¹⁴ Similarly, researchers at the Pensions Institute at the Cass Business School, London examine the returns on equity mutual funds in the UK and find that the average equity mutual fund manager does not generate excess returns based on a conventional set of common risk factors. Furthermore, nearly all managers fail to outperform a “zero-skill distribution” net of fees, suggesting that any outperformance on a gross of fee basis is extracted by managers through fees.¹⁵

The eventual acknowledgement that such performance is to some extent endemic, resulting from a large beta component in active returns, has led to a movement to decouple alpha from less costly beta to reduce costs, enhance aggregate net of fee returns, and make risk allocations more efficient.¹⁶ The result is an integrated approach to asset allocation and manager selection, which takes on a barbell effect: the combination of low cost passive beta positions with

¹² William Sharpe, “The Arithmetic of Active Investment”,

¹³ Antti Ilmanen, Expected Returns: An Investor’s Guide to Harvesting Market Rewards (West Sussex: John Wiley and Sons, 2011)

¹⁴ Eugene Fama and Kenneth French, “Luck versus Skill in the Cross Section of Mutual Fund Returns”, Journal of Finance

¹⁵ David Blake, Tristan Caulfield, Christos Ioannidis & Ian Tonks”, New Evidence on Mutual Fund Performance: A Comparison of Alternative Bootstrap Methods”, forthcoming Journal of Econometrics [confirm reference], 2014

¹⁶ See Ilmanen, Expected Returns

selected higher cost active - including alternative - positions.¹⁷ According to IImanen, if alpha can be logically defined as "the part of asset or fund return that cannot be explained by common risk factors", then one must also accept that there exists a continuous process of apparent sources of alpha being redefined as beta.¹⁸ IImanen's characterization of the compartmentalization of alpha and beta helps illuminate the rapid evolution of advanced beta strategies (a topic to which we will return in a follow-on article). As importantly, from a fee perspective, because systematic factors do not warrant as high compensation as pure alpha, downward fee pressure will persist as a result of structural shifts in factor returns.

Kim Chow Kiat, CIO of the GIC in Singapore,¹⁹ perhaps unwittingly, provides a useful illustration of barbell. GIC focuses on the selection of alternatives managers with "niche expertise" capable of delivering strong returns in a given market context. These he contrasts with low-cost passive vehicles, including exchange-traded funds or bespoke structures that GIC is "able to find or build [at] lower cost...for the same kind of exposures." This case serves to illuminate yet another point critical to our overall argument: asset owners can add value to their portfolios by engaging in cost efficient implementations that specifically apportion sources of returns/value and compensate managers only for value added.

But why have not most asset owners yet adopted Kim's focus on cost efficiency. Ashby Monk, writing for Institutional Investor, suggests that most investors frankly "have better things to do than worry too much about how many extra basis points they're paying to Wall Street",

¹⁷ Ibid.

¹⁸ Ibid.

¹⁹ See "CIO of Singapore's GIC sees added scope for opportunistic investments, alternatives", 12 March 2014, P&I Online at http://www.pionline.com/article/20140312/ONLINE/140319943/cio-of-...sletters&utm_medium=email&utm_campaign=P%26I+Plan+Sponsor+Digest

thus relegating cost management to an “afterthought”. He accentuates this point by suggesting that many institutional investors might prefer opacity on the management issue for want of the will required to address it.²⁰

Why is a focus on fees challenging among managers or asset owners? There are several possible reasons, some of them structural, others behavior and some simply operational. Malkiel, for example, proposes a behaviorist argument to explain the continuing flow of funds into active management, fee structures notwithstanding.²¹ From a more practical perspective, the performance of third party managers is frequently reported on a net of fee basis. Without the proper systems and reporting infrastructure in place, calculating deconstructed gross of fee performance from net returns is painstaking and error prone. Secondly, performance fees are not uniform across managers, nor should we expect them to be. In fact performance fees vary widely by manager, strategy, etc. This makes them difficult to monitor, audit, or use as input into performance attribution models. While asset owners do prepare such analyses, they are frequently adhoc or otherwise not prepared monthly or quarterly as part of a regular “board” package. Lastly, definitions of value (i.e. alpha) vary widely. Is it enough simply to compare a manager’s fees against the net excess performance of the strategy against the benchmark or, to Imanen’s point, should we apply definitions of alpha derived from risk factors?

Why will this time be different? There are several structural reasons to believe it will be. First, and most basically, regulatory changes generally have driven a closer focus on

²⁰ See Ashby Monk, “The Fee Machine Rolls On”, 11 April 2014 at <http://www.institutionalinvestor.com/blogarticle/3329910/Blog/The-Fee-Machine-Rolls-On.html#.VAT1clZcVcP>

²¹ Malkiel, “Asset Management Fees”

compensation, in particular asymmetric compensation, but also on the need for transparency. As fiduciaries on investment committees consider their own exposures, they will require a more detailed accounting of fees paid to investment managers. This has already begun. Second the dramatic increase in the use of alternative investment vehicles by asset owners (documented elsewhere²²) dramatically increased fee expenses, but also brought attention to the diversity and opaqueness of fees calculations. In addition, the rollout of barbell investment strategies has both heightened the dispersion of fees, but also brought greater attention and clarity to notion of “value” in investment management. Finally, and perhaps most importantly, the proliferation of passive, i.e. beta, products and increasingly too, alternative beta indices, delivered at a lower cost, facilitate the implementation of strategies that allow the asset owner the ability to unmask beta hiding as alpha and to compartmentalize sources of both return and risk in order to drive the lowest possible cost of implementation.

²² See Patrick J. Schena, Eliot Kalter, Suzanne L. Duncan, and Nidhi V. Shandilya, “By the Numbers: The Quest for Performance”, SovereignNET, The Fletcher School, 2013 at <http://fletcher.tufts.edu/SovereignNet/Research/The-Quest-for-Performance>.