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Active Equity and Bond Management: Do Managers Really Earn the Fees They Charge? Seeking Alignment with Manager

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The debate between believers in passive and active management rages on most often ending in an evaluation of whether active managers add enough value to justify their higher fees. I am not sure that this debate will ever be resolved and it is not one I wish to step into. What I will do is present the view of the Marathon Club, a neutral party, i.e. one that is not a seller of active or passive management, on seeking alignment with the manager.

As background, the Marathon Club is a group of senior executives from pension funds and trustees who wish to promote a long-term investment approach. It encourages institutional funds to be more long-term in their thinking and actions, and to place greater emphasis on being responsible and active owners. To promote this approach, the Club develops and disseminates practitioner led guidance notes. The Club presently has 19 members who represent public and private pension funds with over £120bn in combined assets. The Club was formed in 2004 with leadership from the Universities Superannuation Scheme (USS) and Hewitt.

In the Spring of 2007, the Club published its Guidance on long-term investing. One of the central features of the Club's recommended approach is that trustees should articulate their investment beliefs. For example, beliefs cover aspects of investment such as the sources of return, the way in which the fund is governed, the styles of management and how managers are compensated. The Club recommends that trustees should seek an alignment of beliefs with their manager. An important implication of this is that they should engage an active manager only if they believe that active management adds value. Also, their view of what active management comprises should coincide with how the manager manages.

Active management has many variations. The evidence that is often cited in a case against active management is that on average active managers fail to outperform a passive index after fees. This comparison fails to take account of the differences between active managers. Managers that hug benchmarks are viewed as equally active as managers that may ignore the benchmark. In a study of mutual funds performance, dated October 2007, researchers from the Yale School of Management showed that funds with a higher fraction of the portfolio that is different from the benchmark have higher returns. Giving managers more freedom seems to help their returns, if they have conviction.

The best long-term investment performance is often found in boutique investment houses, where the manager has invested his or her own money in the same strategy or fund. The Marathon Club strongly supports co-investment as probably the clearest

and strongest mechanism for gaining alignment of interest. The concept makes sense. In ancient Rome, when a bridge was completed, the architects and engineers who had initially designed it stood beneath the structure as the first carriages drove over. It is interesting that co-investment is a common feature in the hedge fund industry.

How can management fees be designed to align manager incentives with that of asset owners? To answer this question we need to step back and understand what fees are paid for. Successful portfolio management requires a series of tasks, a process, for construction of a portfolio. The process includes an investment philosophy, research and analysis, valuation of securities, selection of securities, trading, and risk control, monitoring and reporting. There is a cost to delivery of this process related to experienced staff, services, systems, building, utilities, etc. Fees need to cover the cost of the production and a return on capital. The outcomes of the process are uncertain and not easy for a manager to control. A good outcome or in other words, performance deserves to be compensated. The difficulty we have is that the investment management industry has bundled the production cost with the compensation for performance in the form of an ad valorem charge.

The problems with ad valorem charges are well recognised. They encourage managers to build asset bases. Larger amount of assets tend to hinder performance. Separating payment for process from performance is a better starting point for gaining alignment. A performance fee encourages managers to earn higher excess returns. Clients are likely to be more patient if they pay a reasonable cost for the process and pay for good performance when it occurs.

The Marathon Club supports the wider use of suitably tailored performance fee structures. The likely components of a performance fee structure are:

- A low base fee, ideally a monetary amount, designed to cover the manager's process costs plus profit margin.
- Performance related fees designed initially to bring total manager remuneration towards the level of a "normal" ad valorem fee for the asset class when the target return is achieved.
- A ratcheting effect, so that reward progressively increases with out-performance of various "hurdles", subject to a ceiling or absolute cap.

There is a concern that performance fees could encourage more risk taking. This can be controlled through specifying investment guidelines or high water marks. Another important feature to align long-term incentives is to pay the performance fee over rolling periods, e.g. three years.

There is another myth that performance fee structure produce better returns. Most managers will frankly admit that the fee structure makes no difference to the way they manage money. This is probably true but the advantage of a performance structure is that it discourages asset gathering.

The recent financial crisis has rightly focused attention on compensation in the hedge fund and the investment banking world. The common structure of ad valorem fees that bear little relationship to the costs of production and produce huge rewards for short-term performance is under scrutiny. It is not surprising therefore that recent

surveys including one from bfinance have shown that a high proportion of institutions in Europe are already using performance fee structures for active equity management and intend to make greater use of these structures across all asset classes. Managers beware!