CFA Society United Kingdom

FEES AND COMPENSATION

Position paper

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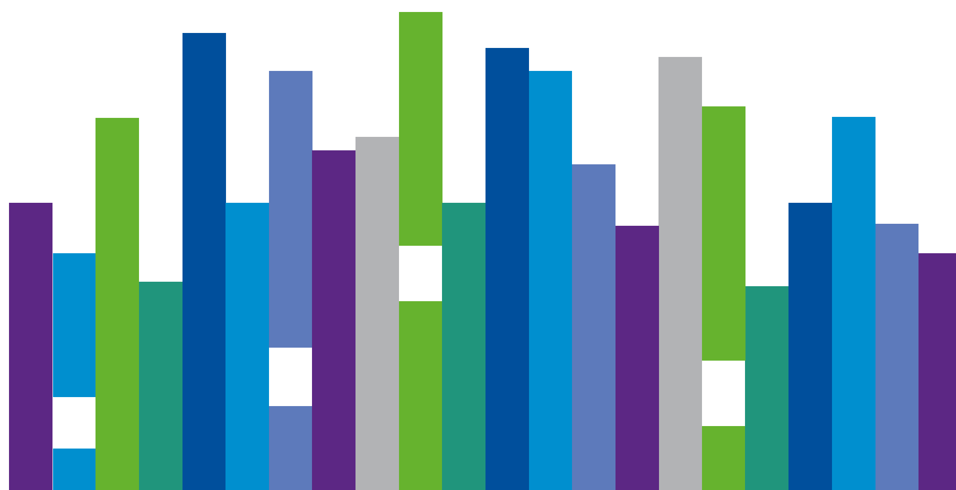

FEES AND COMPENSATION

This paper describes CFA UK's views on the fee and compensation structures used by investment professionals.

The purpose of the paper is to inform members about the society's views on fees and compensation practices; to provide a document that might be helpful for clients and consultants (as well as investment managers); and to encourage the attainment and maintenance of high ethical and professional standards in structuring and reporting fees and compensation.

PREFACE

Fees and compensation matter. They matter to clients because fees and compensation affect investment returns. They matter to investment firms because fees provide firms withthe means to operate and to build their businesses by attracting and retaining talented staff. Compensation matters because it influences behaviour at firms.

CFA UK believes that fee and compensation structures should be transparent and aligned with clients' interests.

Transparency encourages trust and longer relationships than might otherwise be the case between investment managers and their clients. Long client-manager relationships should benefit both parties as transaction costs will be lower than they would be if there was frequent switching between investment managers. Alignment is appropriate as it allows for a fairer relationship between investment managers and their clients and reduces the opportunity for conflicts of interest to arise.

CFA UK's views are directed at structures rather than the quantum of either fees, or compensation. In 2005, Jack Bogle, founder of the Vanguard group wrote:

'The overarching reality is simple: Gross returns in the financial markets minus the costs of financial intermediation equal the net returns actually delivered to investors.'[1]

That is clearly true. However, the net return will not always be greater for a lower cost of financial intermediation. Higher fees need to be paid to access manager skill in markets where greater alpha is available whereas a lower cost approach to developed, efficient, liquid markets may be more appropriate.

INTRODUCTION

CFA UK believes that clients need to have a complete picture of the fees and charges that apply to their portfolios or segregated accounts. Clients need to understand the impact of fees on returns (other things being equal, the more that is paid out in fees, the less money there is available to compound across future returns) and should be aware of the types of charges that might be incurred in investing their assets (and the purpose of those charges). They should have an understanding of the behaviour that different fee structures might encourage and should know in advance what many of these costs will be. It is also important for clients and their advisers to understand compensation models within firms so that they can assess the extent to which those structures are aligned with their own interests.

CFA UK believes that investment managers should communicate fully and regularly about fees and compensation.

The costs levied against invested assets fall into two categories: fees and charges. Fees, in turn, can be broken down into two types: management fees (raised for the investment and reporting of assets) and performance fees (based upon pre-agreed return targets). Charges are additional costs such as the custody, legal, audit, dealing and transaction costs (broker commissions and taxes) that are incurred in the investment of assets.

Management fees are either set as a fixed proportion (%) of a client's assets (the typical 'ad valorem'

[1] *The Relentless Rules of Humble Arithmetic; John Bogle, FAJ 2005.*

approach), or as a fixed (£) amount. Both the rate of an ad valorem fee and the amount of a fixed fee may vary according to the size of the client's invested assets. The amount paid out against an ad valorem fee will depend on the value of the portfolio at the point at which the fee is calculated.

Performance fees (paid on top of a base management fee) vary based on the return delivered to clients (which may be described as the total return in excess of a target or as a share of the alpha[2] generated by a manager).

Unless a manager utilises a fixed amount fee, the precise amount of both fees and charges will be unknown in advance of the close of a reporting period, though the way in which the fees will be calculated is known and the likely charges can reasonably be estimated. Clients whose investments are material to a manager may be able to negotiate fee structures that are more specifically appropriate to their needs. Retail clients and investors whose assets represent a small proportion of a firm's total assets under management are unlikely to have that option.

MANAGEMENT FEES

The standard investment management fee compensates the manager for stewardship of a client's assets: their investment and reporting. Typically, management fees are calculated as a percentage of total assets (ad valorem), so that the fee levied will rise or fall depending on whether the client's total assets increase or decrease. Management fees for active investment management strategies are typically higher than those for passive strategies because of the higher costs (of security analysis, asset allocation and timing considerations) incurred in active management.

There are, though, variations on the standard ad valorem structure. Management fees may be fixed at a specific (£) amount, may be calculated ad valorem up to a particular level and then become fixed, or management fees may vary between funds offering the same strategy, but where one fund operates with a minimum investment period or a lock-up and another does not. Most management firms use standard ad valorem fees.

The argument put forward in favour of fixed fee models is three-fold. First, ad valorem fees reward managers for asset growth and punish them for asset shrinkage. This sounds appropriate, but asset growth or shrinkage may be more a function of the market's performance, rather than of the manager's ability to generate risk adjusted excess return for their clients. In addition, asset growth in a fund or vehicle may hurt the future performance of present investors by raising the funds applied to a strategy beyond the strategy's capacity. Second, it is not always the case that a manager's costs move in a linear fashion as an expression of assets under management. Some costs will fall (rise) on a per unit basis as assets increase (decrease). Third, some believe that it is more productive to combine a fixed fee with a performance fee to stimulate manager performance rather than to have managers simply benefit or suffer from market movements.

There are strong arguments against fixed fees and in favour of the ad valorem approach. First, while asset growth or shrinkage may not be due to manager performance alone, it is in existing clients' interests to see the sort of strong relative performance that is likely to drive asset growth and reward ad valorem managers. Also, while it is the case that some investment strategies have economies of scale, not all do. More idiosyncratic asset classes (property, for example) may not see substantial unit cost reduction as assets under management grow. The use of a stepped scale of fee charges (that fall as invested assets increase and vice versa) can help clients and investors to share in the costs and benefits of scale. Last, combining too low a fixed fee with a high reward for performance may not be in clients' interest as it would expose their managers to high levels of business risk. Clients may not benefit from supporting fee structures that lead to high volatility in fee income. If a firm's relative performance is poor, assets will leave soon enough, but leaving a firm's survival dependent on the absolute performance of the market is probably not a productive approach.

A client may be best served by the standard ad valorem approach, by a combination of an ad valorem fee and a fixed fee or by a fixed fee (plus performance fee) alone. The right approach depends on the nature of the strategy, the size of the investment and the behaviour that the client intends to encourage.

In periods of low or negative returns, fee structures and the absolute level of fees come under close

[2] *The return on an asset in excess of the asset's required rate of return; the risk-adjusted return (CFA Institute glossary)*

scrutiny. This is unsurprising given that fee charges can represent a significant proportion of the total return generated in a portfolio over a reporting period. So, whereas a 1.25% management fee is accepted readily easily at a time when annual gross returns are, say, 7%, that same fee will be a focus of greater attention when the gross return is 2.5%.

CHARGES

Like management fees, greater attention is paid to charges at a time of low returns to clients. This is particularly so because, while the level of management fee is understood in advance of the reporting period (either as a proportion of assets or as a fixed amount) the amount levied in charges is not known, though it may be reasonably estimated. Clients may be surprised by the degree to which residual returns to their portfolio (post-fees) are eroded by charges such as transaction costs. It is for this reason that there is growing demand[3] and increasing agreement that clients should receive reports that include not only annual management charges and related administrative costs (such as custodian and trustee costs) – commonly referred to as the total expense ratio (TER) – but also information on average trading costs (such that the investor or potential investor can estimate the total cost of investment or ownership). The Investment Management Association recommends that unitised funds should disclose the three-year average figures for broker commissions and any transfer taxes as a percentage of the fund's net asset value (NAV)[4].

European regulations require the key investor information document (KIID) that must be produced for any collective investment scheme offered in the European Union to show:

» the maximum entry and exit charges that can be levied;

» a single figure for the charges deducted from the fund in the prior year (the investment manager's annual management charge and the additional costs that combine to represent the total expense ratio) as a percentage of the fund's NAV;

» the cost of any performance fee expressed a percentage of the NAV; and

» a statement where portfolio transaction costs are thought likely to be material.

Where possible, managers should explain their strategy to investors so that they can understand the extent to which the manager is likely to trade the portfolio and incur trading costs. Where market circumstances change so as to require a responsible manager to undertake appropriate portfolio changes, clients should be reminded that this may lead to an increase in dealing costs.

It is important to note that managers do not benefit from trading. They only trade if they believe that doing so will benefit the client's portfolio (and thereby themselves) by dint of improved relative or absolute performance. It is also important to note that dealing costs will vary significantly across asset classes and investment strategies (depending on liquidity and approach). However, managers that generate above average dealing charges for a given strategy across more than a few reporting periods (and with no stated reason) should be asked about their investment philosophy and process and the discipline with which they are holding to those.

It should be possible for an institutional or retail client to have a clear understanding of the likely total cost of investing with a firm or fund. The management fee should include all of the costs of investment and reporting and information about all other charges should be provided to potential clients before they invest and should be reported regularly to clients. Charges matter and clients should be provided with appropriate information about their likely level and impact. However, it is usually more important for clients and their managers to determine appropriate fee structures as these will likely have greater influence on manager behaviour and, ultimately, on client returns.

PERFORMANCE FEES

The debates about the merits of different management fee structures and charges are relatively simple in comparison to those relating to performance fees.

As Mark Kritzman, CFA wrote some 25 years ago[5]:

'The incentive concept is a crucial underpinning of a free enterprise economy. It seems only natural that the investment community should embrace the concept.' But, as he also noted in his conclusion, 'Incentive fees are not without problems'.

[3] *i.e.The True Cost of Investing in Funds, Investors Chronicle, February 2012 (http://www.investorschronicle.co.uk/2012/02/07/funds-and-etfs/isa-funds/the-true-cost-of-investing-in-funds-oUc8VLh2BcMBacjws7u9UM/article.html)*
[4] *Enhanced disclosure of fund charges and costs, Investment Management Association, September 2012*

CFA UK believes that fee and compensation structures should be transparent and aligned with clients' interests. Whereas transparency is relatively easy to achieve in relation to management fees and it is relatively simple to make a case that different management fee structures are aligned with clients' interests, both are harder to achieve in relation to performance fees.

The academic studies of incentive fee structures suggest that clients should welcome performance fee structures because they encourage extra effort (though there is a counterargument that the risk of termination should be a sufficient disincentive against poor performance) and promote risk-sharing. Some clients like performance fees as they help to keep base fees lower than they might otherwise be (at the expense of a greater cost for manager outperformance), while others take the view that managers should not need to be incentivised beyond their management fee to do their job.

Most UK investment funds available to retail investors do not use performance fees. The IMA estimates that less than 100 out of a total of more than 2,000 UK funds operate a performance fee. However, performance fees are more common in institutional portfolios and, particularly, in hedge funds.

There are a variety of different performance fee structures in use in hedge funds, but a common one is the 2% and 20% model. Under that model, the manager is paid a base fee of 2% and a performance fee of 20% of the return. The performance fee should relate to the return (net of the 2% management fee) above a pre-determined hurdle rate, with the client and manager also agreeing to impose a high watermark (the performance target that must be achieved for future performance fees to be triggered) so that clients do not pay repeatedly for the same outperformance. Performance fees with high watermarks are not normally applied to fund units and are usually specific to individual clients' performance experience owing to equalisation issues.

There are a number of issues with performance fees. First, they can be difficult to understand (particularly in relation to their pay-off characteristics) and thus may not be as transparent as they could be. Second, the benchmark against which performance is to be measured may not be the right one. Third, poorly designed fee structures can encourage managers to act in ways that might be in their own interest, but not in their clients'. Fourth, the time period over which performance is assessed might be inconsistent with the client's time horizon, that is, it may be too short. Last, many performance fee structures are asymmetric and do not encourage true risk-sharing.

Benchmark selection and monitoring can be an issue. Managers have an incentive to select benchmarks against which they are most confident of outperforming and hurdle rates that are low, whereas clients' interests are best served through the selection of benchmarks that match the profile of their assets and the intended investment strategy. Managers should take care to recommend benchmarks and hurdle rates that are, respectively, appropriate to their clients and which encourage managers to generate returns that meet their clients' risk and return criteria. Irrespective of the success or otherwise of that process, clients and their advisers must closely monitor the selected benchmark to ensure that it continues to perform as expected.

Another danger of some performance fee structures is asymmetry. Where structures are asymmetric, managers are given an additional reward for above average performance, but do not have to refund fees for below average performance. As a consequence, as Kritzman and others have observed, the typical performance fee structure essentially represents a call option for the investment manager on some part of the additional return. Investors have plentiful stories of hedge fund managers that shorted volatility and earned impressive performance fees until tail risk was realised. Clients should closely monitor manager behaviour to make sure that their manager doesn't see the asymmetrical nature of a performance fee contract as an invitation to ramp up risk.

It is also important that performance fees are calculated against appropriate time periods. It would be foolish for a client to accept a fee structure that could see a manager underperform across the anticipated duration of an agreement in aggregate, but receive multiple payouts based on instances of single year outperformance. (One way to guard

[6] *Incentive fees: some problems and some solutions. Financial Analysts Journal January/February 1987.*

against this outcome is to provide for clawbacks so that performance fees are refunded if performance is relatively poor. Managers may be unwilling to accept the use of clawbacks – and they are also criticised as complex to calculate – but the more that clients demand them, the more common they would become). The use of high watermarks can prevent the sort of unfortunate outcome described above, but the additional danger of watermarks that cannot be adjusted and which are far out of a manager's reach is that the manager has little incentive to stay with a fund.

Despite these caveats, well constructed performance fee structures can encourage managers to pursue greater risk-adjusted returns on their clients' behalf than they otherwise would and might also simply be the cost that clients have to pay to gain access to a particular manager. Another benefit may be that whereas 'ad valorem' management fees can encourage investment firms to focus on asset gathering (and, therefore, to invest in sales and marketing at the cost of potential distraction to the manager), performance fees may encourage greater relative investment in research and analysis.

But, as suggested above, clients need to take care to agree to performance fee structures that they understand, for which appropriate benchmarks and hurdle rates have been agreed and against which they are able to monitor and manage benchmark and manager performance.

Clients should seek performance fee structures that are likely to encourage the generation of additional risk-adjusted returns, in the pursuit of which they will share the costs of failure or the fruits of success with their manager. However, it is important for clients to bear in mind the possible impact of clawbacks on their managers in terms of those firms' need to set capital aside to provide for clawbacks and in terms of their potentially destabilising impact on a firm.

Unfortunately, the academic world does not have a clear answer as to how best to structure performance fees so as to generate additional risk-adjusted returns. As Molenkamp states in his 2010 paper: *'There is no good solution available for the one period delegated management problem that holds under general conditions and addresses the three objectives (encouraging effort, encouraging risk-sharing and acting as a signal).'*[7]

COMPENSATION

Fee structures should be aligned with clients' interests. So should manager compensation.

The compensation practices of investment managers can help to align clients' interests with those of the firm by encouraging managers to behave as co-owners of their funds. The potential benefits of such an approach are obvious; the potential disadvantages are less clear.

Before looking at co-investment and other similar structures, it is important to put manager compensation in context.

Most investment professionals receive both a fixed salary and a variable bonus. CFA UK's 2010 survey of remuneration practices showed that 25% of portfolio manager respondents and only 18% of analyst respondents received variable compensation equal to or greater than their salary. For 50% of portfolio manager respondents and for 41% of analyst respondents, fixed compensation represented 50% to 75% of their total compensation.

Variable compensation was typically linked to personal or team performance, rather than to the firm's business performance and most variable compensation for both analysts and portfolio managers was paid in cash and was related to performance over the single prior year.

Since the 2010 survey, the regulatory framework relating to bonus payments and compensation – both in terms of their size and form – has evolved considerably. Bonus payments are now more frequently paid in non-cash form and deferred over multi-year periods.

Whereas the greatest level of transparency achievable should be practised in relation to fee structures, it would not be appropriate for investment firms to be wholly transparent in relation to staff compensation. However, it would be valuable for clients to have an understanding of the variable compensation structures used by the firm (and the balance of fixed and variable compensation within the firm) and it would be particularly helpful for a client to know that where performance was a factor within variable

[7] *Performance-Based Fees and Moral Hazard: Aligning the Interests of Investors and Managers*, Jan Bertus Molenkamp in Rotman International Journal of Pension Management Volume 3, Issue 1, Spring 2010.

compensation calculations, that it was calculated over a time period aligned with their own time horizon for return generation. Clients may also find it helpful to know whether the firm paid competitive overall compensation, whether bonuses were paid for team performance, individual performance or both and whether performance was calculated as that achieved for the client (in terms of return) or that achieved for the firm (in terms of profitability).

There are various ways in which firms can make variable compensation arrangements for staff. These include: cash, equity in the firm, shadow equity and co-investment. Each of these can be paid over immediately, or may be accrued by staff, but with payment deferred.

All compensation arrangements that see an individual's compensation linked to the achievement of a clients' objectives are welcome, though payments made in cash or equity in the firm (shadow or actual) do not provide lasting alignment (unless deferred). For instance, the relationship between the future value of the firm's equity and the firm's performance for a particular client can be tenuous, especially for large firms. Deferred compensation arrangements help because, though the relationship between the form of the reward and the client's interests is weak, the performance for the client must be maintained over time for the deferred compensation to vest.

Co-investment can provide a direct means to align the interests of clients and their managers. Co-investment sees portfolio managers and analysts invest their own assets alongside their clients' in the funds that they manage. They eat their own cooking. While co-investment helps to align client and manager interests, managers should not invest too great a share of their personal wealth in their own fund. After all, it is unlikely that a client will have a significant proportion of their own assets in the fund and, more importantly, the manager needs to be able to maintain a calm and considered approach towards managing the fund in clients' best interest rather than in line with their own personal risk preferences.

While there are mechanisms that can be used to improve the alignment between manager compensation and the investor's interest, it is practically impossible to perfect it. Not only do different investors in a vehicle or strategy have different risk tolerances and time horizons (which will adjust as their downside risk tolerance is approached), but managers have their own differing time horizons and risk tolerances relative to compensation. Employers, too, are conscious of the competitive environment for skilled investment professionals.

RECOMMENDATIONS

Fee and compensation structures should be transparent and aligned with clients' interests.

Clients and potential clients should know about the full range of fees and charges which will be applied against their assets. They need to understand the purpose of these fees and charges, they need to know what the approximate amount of these costs will be and they need to understand the impact of these costs on their returns in different investment environments.

Clients and potential clients should understand the different fee structures used by a firm across its client base and the potential behavioural impact those fee structures might generate across different strategies.

Clients and investment firms should agree performance fee structures that are reasonably simple, use appropriate benchmarks and hurdle rates and can be assessed over appropriate time periods.

Potential clients should be provided with worked examples of the impact of the fees and charges that their assets may incur in different environments.

Clients and potential clients should understand the compensation models that investment firms use and the extent to which the performance generated on their behalf will impact compensation (and how this will be paid).

Clients need to invest time and effort in analysing the extent to which fee and compensation structures are aligned with their interests. They need to take a disciplined approach to monitoring the factors behind performance fee structures (if used) and should take care to ensure that performance fees are designed to reward outperformance.