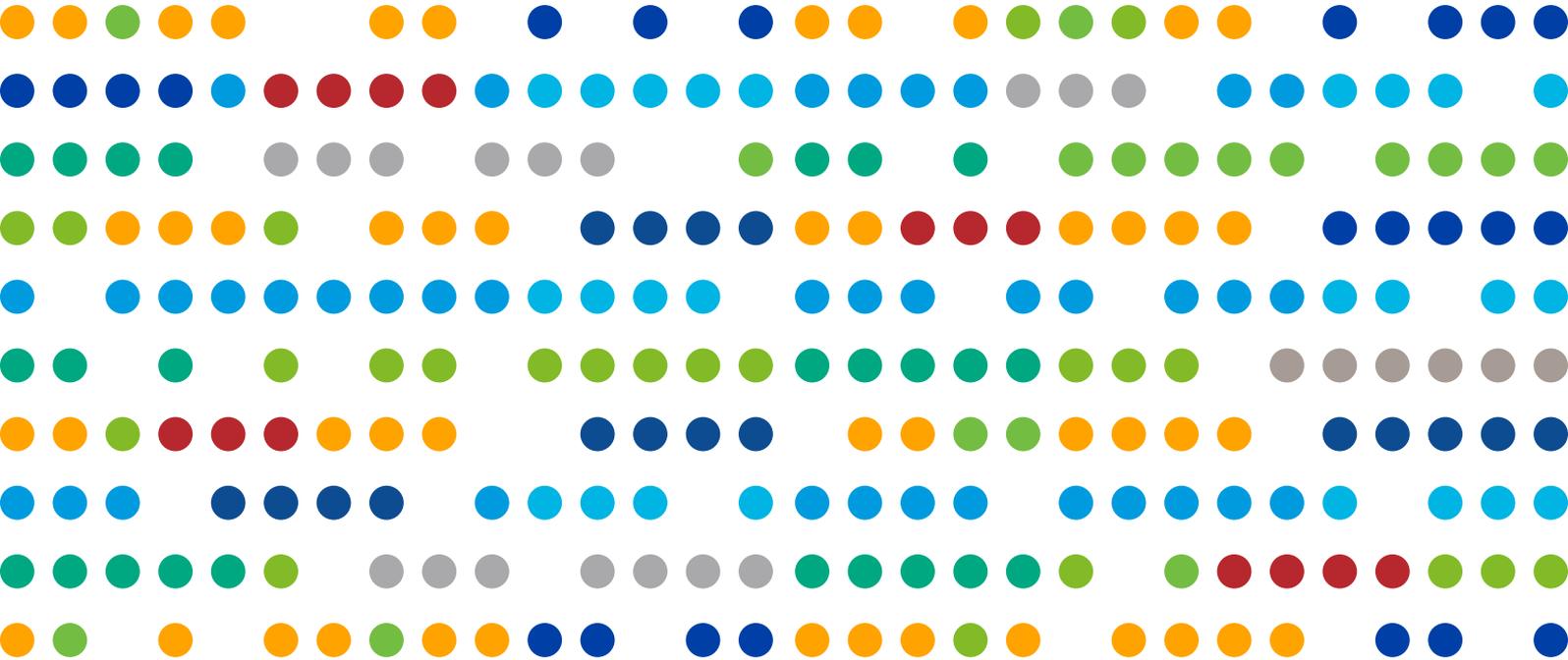


INNOVATIONS IN RETAIL FUND FEES

December 2019



About CFA UK & CFA Institute

CFA UK: serves nearly 12,000 leading members of the UK investment profession.

- The mission of CFA UK is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence in order to serve society's best interests.
- Founded in 1955, CFA UK is one of the largest member societies of CFA Institute (see below) and provides continuing education, advocacy, information and career support on behalf of its members.
- Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute: is the global association for investment professionals that sets the standard for the professional excellence and credentials.

- The organisation is a champion of ethical behaviour in investment markets and a respected source of knowledge in the global financial community.
- Our aim is to create an environment where investor's interests come first, markets function at their best, and economies grow.
- There are more than 170,000 CFA charterholders worldwide in 165 markets. CFA Institute has nine offices worldwide and there are 157 local member societies.
- For more information, visit www.cfainstitute.org or follow us on Twitter at @CFAINstitute and on Facebook.com/CFAINstitute.

Contents

Executive Summary.....	5
Introduction.....	6
All-in Fees	7
Discounted Share Classes	7
Tiered Fees	9
Zero AMC Funds	10
Discretionary Fee Waivers.....	10
Performance Fees.....	11
Fulcrum Fees.....	16
Performance Fees Operated Through a Reserve.....	17
Passive Linked Pricing	18
Conclusions & Recommendations	19
Appendix: Further Reading	21

CFA UK is grateful to the following members of the Fee Structures Working Group for their input into this paper: Keith Bonin, CFA (Chair), Andy Burton, Sejuty Chowdhury, CFA, Pavel Fedorov, CFA, Jonathan Francis, CFA, Claire Gallagher, CFA, and Ludmila Nola, CFA. Views expressed are those of CFA UK and not necessarily those of the working group. The working group members are acting in a personal capacity.

Executive Summary

- Developments in UK regulation, including the new assessment of value regulation, and competition are both driving innovation in retail fund fee structures.
- CFA UK believe that, in the best interests of retail investors, fee structures should embrace the four principles of: (i) simplicity, (ii) transparency, (iii) aligning the interests of managers and investors and (iv) treating all investors fairly. CFA UK recognizes that the optimum fee structure for a certain fund may involve the balancing of these principles.
- The paper evaluates innovations in retail fund fees including: all-in fees, discounted share classes, tiered fees, zero fee funds, discretionary fee waivers, performance fees, fulcrum fees, performance fee reserve structures and passive linked pricing.
- Tiered fees, where management fees are charged on a sliding-scale based on tiers of assets under management, are an effective way of aligning the interests of managers and investors. They enable the benefits of scale to be shared with investors and reduce the incentive for managers to gather assets at the expense of performance. CFA UK recommends that managers and fund boards actively consider how tiered fees can be introduced to retail funds.
- Performance fees can be also be an effective tool for aligning the interests of managers and investors. However, due to their inherent risks and complexity extra care and attention is needed to ensure that investors are treated fairly in all scenarios. CFA UK recommends that:
 - Hurdle rates reflect the risks of the fund relative to the benchmark.
 - Performance measurement periods should balance both the requirements of incentivising long-term performance and treating new and existing investors fairly.
 - Fee caps should be used to limit the fees paid.
 - Downside protection is provided in the event of underperformance. Although this is traditionally achieved through a high-water mark, fulcrum fee and reserve structures offer alternative approaches to protect investors.
 - When assessing value, the range of potential outcomes after fees (reflecting both underperformance and outperformance) is compared to alternative products with *ad-valorem* fees and a passive portfolio alternative with a similar risk profile. This should also consider the outcomes for investors entering and leaving the fund at different points in the performance cycle.
 - Fund managers should go beyond the minimum requirements of regulation to disclose, in plain English, how performance fees work in various performance scenarios to improve transparency for investors.
- CFA UK supports recent developments in performance fee structures which are providing better protections for investors and creating greater alignment of interests. These include:
 - Mechanisms, such as fulcrum fees and performance fee reserves, which allow the manager to symmetrically share in the downside when there is underperformance.
 - A minimum or base fee set to match the fees of a passive equivalent.
 - Total fees at target outperformance which broadly equal average fees for competitor funds with *ad valorem* fees.

Introduction

This paper describes and evaluates the nature and attributes of both current and new fee models evolving in the UK retail market in response to competition and regulation. The scope is limited to retail investment funds domiciled in the UK, that is Open-Ended Investment Companies ("OEIC") and unit trusts, which are covered by new assessment of value regulation. However, evidence from UK Investment Trusts and US retail funds is referenced to help identify attributes and trends. It should be noted that although the scope is limited to retail funds many of the principles and findings may also be applied to institutional mandates.

The purpose of the paper is to provide information that might be helpful to members, investment managers, fund selectors and independent non-executive directors of fund boards in developing and evaluating fee structures. In evaluating fee structures the paper assesses how they align with the requirements of the CFA Institute's Asset Manager Code¹ to act for the benefit of fund investors.

"Fees matter. They matter to investors because fees affect investment returns. They matter to investment managers because fees provide them with the means to operate and to build their businesses by attracting and retaining talented staff²."

In its response to the Financial Conduct Authority's ("FCA") Asset Management Market Review, CFA UK expressed a hope that competition in the investment sector would be enhanced by the use of different, innovative fee structures³. Although standard *ad valorem* fee models continue to dominate the retail fund market, a variety of different fee approaches have been launched which are now challenging the standard *ad valorem* approach. Some of these more complex fee structures, such as performance fees, have historically existed in the institutional market and within many of the 'alternative' asset classes. In retail funds, with a large pool of potentially less sophisticated investors, there is a greater need to ensure investor interests are protected.

CFA UK believes that acting in the best interests of retail fund investors requires consideration of how the fee structures meet the following principles:

- simplicity – the retail investor can easily understand the structure
- transparency – it is clear how the fee structure works, potential outcomes can be accurately predicted, and the risks are clearly identifiable
- alignment of interests – a fair relationship exists between manager and investor and the opportunity for conflicts of interests are reduced

¹CFA Institute Asset Manager Code, specifically principle F. Disclosures, provision 4d: <https://www.cfainstitute.org/-/media/documents/code/amc/asset-manager-code.ashx>

²CFA UK, Fees and Compensation (April 2013)

³Response to Market Study MS15/2.2 – Asset Management Market Study, Interim Report (Nov 2016): <https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/cfa-uk-response-to-ms15-22.pdf?la=en&hash=6DC244AB3A4598CA403D82F06A312F381F2AA4C4>

- equality amongst fund investors – all investors in the fund are treated fairly regardless of the timing of their entry or exit. This is a potential issue for performance fees as there is a timing difference between when performance is achieved and when fees are accrued and paid.

There may be trade-offs between the above principles. For example, it may be appropriate to reduce simplicity for investors if it leads to better alignment of interests.

In evaluating emerging fee structures, it should be noted that they are not mutually exclusive. It is quite possible that more than one fee structure could be combined within a single fund, thus enabling a blend of benefits.

Recent Changes in UK Fund Regulation

In conclusion to the FCA's Asset Management Market Review new rules have been introduced covering the assessment of value for authorised funds (PS18/8)⁴. These have been influenced by US practice known as the Gartenberg Principles (or Factors). The purpose behind both sets of rules is to ensure investors are getting value for the fees they pay and to encourage price competition amongst asset managers.

From 30 September 2019, UK fund boards are required to annually assess the fees charged in relation to the value funds deliver and publish their process and conclusions. The process is strengthened by the requirement for a minimum of two directors, or a quarter of the fund board, to be independent.

UK fund boards are required to assess fees in relation to:

- the range and quality of services provided,
- performance over an appropriate timescale having regard to the fund's investment objectives, policy and strategy,
- the cost of providing the service,
- savings and benefits from economies of scale, particularly if there has been growth in assets under management resulting from the sale of further units,
- the market rate for any comparable services,
- the manager's charges for comparable services provided to institutional mandates, and
- whether it is appropriate to charge higher fees on different share classes of the same fund.

Value for investors will largely be impacted by the quantum of fees. However, fee structures are important to the assessment of value as they determine how fees are calculated and balance interests between investors and managers. In this paper, CFA UK's views are directed at fee structures rather than the level of fees. As a result of these new regulatory requirements, it is anticipated that there may be further changes in retail fee structures in the UK market, continuing the trend of innovation.

⁴Financial Conduct Authority, Policy Statement 18/8: Asset Management Market Study remedies and changes to the handbook – Feedback and final rules to CP17/18, published April 2018.

All-in Fees

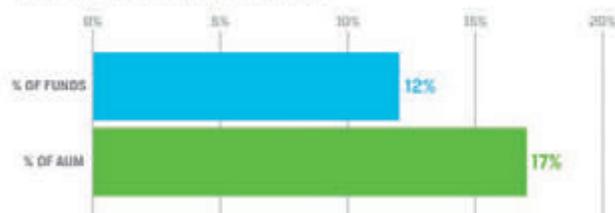
All-in Fees A number of managers, especially those focused on passive investing, have offered their clients all-inclusive fee structures ("all-in fee"). In such cases the Annual Management Charge ("AMC") incorporates all the fund costs included in the fund's Ongoing Charges Figure ("OCF"). This includes most of the costs of the fund including investment management, administration, distribution, audit, custody and depository costs. It should be noted however that the OCF does not include trading costs, performance fees and other non-recurring fund expenses. Under existing regulation, the OCF must be clearly shown to aid investors in evaluating fees. Therefore, all-in fees ensure that the AMC is equal in amount to the headline OCF visible to investors.

In an all-in fee structure the manager makes a single AMC charge to the fund. The manager therefore takes responsibility and risk for paying 3rd party providers to the fund out of the AMC. Investors have the comfort and predictability of knowing that the OCF will not rise in the future, which may not be the case for a fund whose AMC excludes ancillary costs. For example, a significant increase in trading activity could give rise to an increase in a fund's custody fees and therefore OCF if it did not employ an all-in fee.

All-in fees are potentially unsuitable for investment trusts as the board of the trust is responsible for the costs of the fund not the manager. The manager can only control the AMC, the investment trust board controls all other OCF related expenses including registrar, custodian, depository and directors' fees.

All-in fees structures are widely used by passive funds and ETFs but are less common among active funds. All-in fees on UK equity passive funds, a particularly large and competitive part of the retail fund market, typically vary between 0.06% and 0.1% pa.

GRAPH 1 - PROPORTION OF UK OEICs AND UNIT TRUSTS WITH ALL-IN FEES



Advantages, Disadvantages & Risks

All-in fees provide more certainty and fix the OCF of the fund. They are, therefore, simpler to understand for investors compared to the traditional fee model of an AMC and separate other fund charges. The simple fee structure enhances fund comparability and therefore price competition among asset managers.

The responsibility for paying for all services provided to the fund rests with the manager. Therefore, the manager is incentivised to minimise fund operating costs, whether those services are provided by the manager themselves or by a third party. This increases the alignment of interests between managers and their investors and should improve value for money considerations provided that cost savings are not achieved at the expense of quality of service.

With a greater focus on input costs, large asset managers with high assets under management ("AUM") should have a competitive advantage in driving down the cost per asset of fund services. There are, however, potential routes for smaller managers to compete more evenly. For example, there are several fund vehicle providers who group smaller investment managers under a fund umbrella to create scale.

Some fund costs by their nature are fixed or enjoy economies of scale, decreasing in marginal cost as AUM rise. With an all-in fee, as AUM rise the benefits of additional scale are retained by the manager and not automatically passed onto the investor. However, general price competition and the recently strengthened regulatory requirement for fund boards to assess fees against the market rate for comparable services should ensure that the interests of managers and investors remain aligned.

Discounted Share Classes

A fund may have discounted share classes, in addition to its standard share classes, that are restricted to certain investors or distributors. Investors must meet certain criteria (typically the size of the AUM invested) in order to attain access to the discounted share class. Some discounted classes may be restricted to early investors who helped seed the fund. The level of discount reflects both the economies of scale for the manager and the more competitive environment for large asset flows, where investors or distributors with the largest pool of assets can demand the lowest management fees.

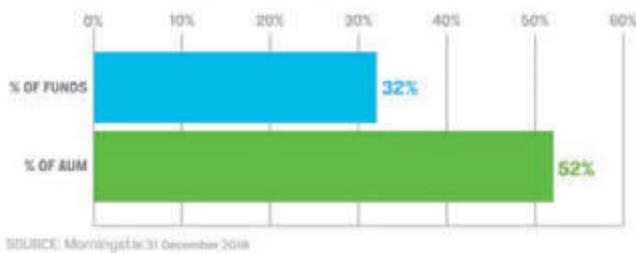
For example, a retail equity fund may have the following pricing:

RETAIL EQUITY FUND PRICING		
Standard share class 'X'	0.75% fee	Available to all investors
Discounted share class 'Y'	0.55% fee	Restricted to investors or platforms with over £50 million invested in the fund

The Retail Distribution Review ("RDR") was implemented by the Financial Services Authority, the predecessor body of the FCA, in 2012. "The rules aimed to make the retail investment market work better for consumers. They raised the minimum level of adviser qualifications, improved the transparency of charges and services and removed commission payments to advisers and platforms from product providers⁵." Post the implementation of the RDR and the subsequent banning of commission payments from managers to distributors, there has been a proliferation of discounted share classes in the UK market.

⁵ FCA, Post-implementation review of the Retail Distribution Review, Dec 2014

GRAPH 2 - PROPORTION OF UK OEICS WITH DISCOUNTED SHARE CLASSES



SOURCE: Morningstar to 31 December 2018

Under the new assessment of value rules, the fund board must be able to justify the price differentials on share classes of the same fund. In addition, fund boards need to assess the value of each share class in the annual assessment statement. These regulatory requirements should improve transparency and fairness around discounting. Post implementation, it will be interesting to see what impact this has on the application of discounted share classes in the market.

Advantages, Disadvantages & Risks

Discounted share classes clearly benefit the investors holding those classes through the lower fees paid. In addition, discounted prices are in the public domain, which is increasingly encouraging price competition in favour of investors. As a result of the way funds are distributed the largest retail platforms and distributors are likely to become increasingly influential in negotiating discounted share class access for retail investors.

From the manager's perspective, discounted share classes offer a powerful sales tool to reward loyalty and seed investors.

Overall discounted share classes are simple for investors to understand and the impact of discounts transparent. However, transparency on discount eligibility does not appear to be consistent, with the details of requirements in some cases opaque. There may be circumstances where platforms and distributors may not be aware of their ability to access a discounted share class, thus forgoing potential fee savings for their end investors. Furthermore, end retail investors may be mostly unaware of the competitiveness of the discount they are receiving compared to the level of discount available via a different platform or distributor.

The complexity of multiple priced restricted share classes also creates other disadvantages through the use of investment platforms. When investors switch between investment platforms, it is not uncommon to find that the share class they hold is not available on their new platform. The common solution to this is for the investor to be required to sell one share class and buy the other, thus exposing the investor to the risk of temporarily being out of the market and potential tax liabilities and transaction costs. This added complexity has been known to also impact the cost of moving other investments within the same investment account by introducing lengthy delays to the whole platform switch process. In addition, investors may not automatically be moved by their platform into lower cost share classes that they are entitled to access. Over the long-term the investor may be missing out on potentially significant fee savings.

In the FCA's recently published Consultation on Investment Platforms Market Study remedies, the UK regulator has acknowledged these issues and has drafted proposed rules to remedy.

"The proposed rules would require that: if the consumer has chosen an 'in-specie' transfer but their investment is in a unit class which is not available for purchase in the receiving platform, then the ceding platform must request the fund manager to carry out a conversion of the units to a class which the receiving platform can accept as an 'in-specie' transfer (and take any other reasonable steps to bring it about); and the platform must offer consumers the opportunity, as part of the funds transfer process, to convert units into a discounted unit class, where such unit class is available for investment by the consumer on the receiving platform.⁶"

Overall from an investor's perspective, if the FCA's proposed remedies are implemented then the benefits of discounted share classes probably out-weigh the drawbacks.

Zero AMC Share Classes

One form of discounting is the use of zero AMC share classes. These share classes are typically used for institutional investors (pension plans, funds of funds, charities, family wealth offices, etc.) where the client has a separate fee agreement with the manager. Fees are invoiced to the institution at a lower rate than what is available to the retail market. Lower fees are justified by the scale of assets held by the client, and arrived at through commercial negotiation. By their nature, this pricing is opaque and only known to the manager and their client.

Under the new regulation, the manager needs to demonstrate to the fund board that the fees charged to retail share classes are fair in relation to what is charged to institutional clients. This requirement exists whether the manager uses zero AMC share classes or, alternatively, rebates fees on retail share classes to institutional clients.

⁶ FCA, Consultation on Investment Platforms Market Study remedies, CP19/12, March 2019, Section 3.9

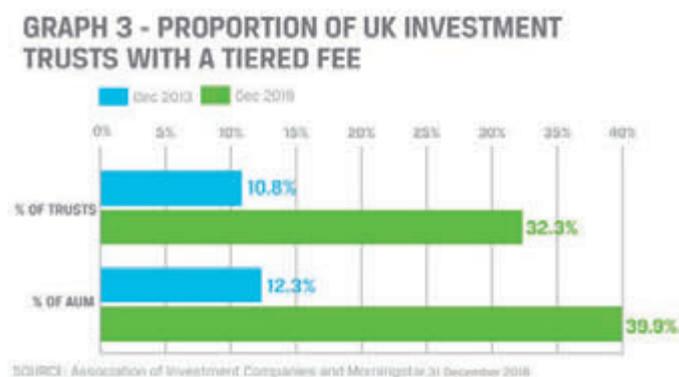
Tiered Fees

Tiered fees are management fees charged on a sliding scale based on tiers of AUM. Tiered fees are designed to automatically pass on savings from economies of scale from the manager to investors.

The management fee is charged at a declining scale as the AUM rise. For example, the management fee on the first £500 million may be charged at a fixed percentage of AUM, while the management fee on the AUM above £500 million may be charged at a lower fixed percentage.

In the UK, this fee structure appears to currently only exist within the closed ended Investment Trust universe. To pick one example, one of the largest UK investment trusts operates under a tiered fee structure. As of January 2019, the annual management fee of this global equity fund is quoted as 0.3% pa on the first £4 billion of net AUM and 0.25% pa thereafter.

Over the last five years, there has been a material increase in the proportion of UK investment trusts, and related AUM, that apply tiered fees.



Advantages, Disadvantages & Risks

Tiered fees are aligned with the requirements of the new assessment of value rules as an effective method to ensure that economies of scale are shared to a greater extent with investors. Tiered fees clearly benefit end-investors as the marginal management fee paid decreases as assets rise through the fee tiers. In this way the benefits of scale are shared with investors rather than accruing entirely to the manager. They are also simple and transparent, with the risks and outcomes easy to understand and predict.

For investment managers, tiered fees have the advantage of protecting a greater share of revenues during a bear market given the first loss of AUM will be at the lowest fee rate. Tiered fees also indirectly encourage and reward customer loyalty.

Tiered fees create further potential alignment between investors and managers; a well-structured tiered fee should encourage an increased focus on the trade-offs between investment performance and asset gathering. If additional marginal fees are lower, a manager is more likely to consider the AUM capacity of the investment strategy more proactively and less likely to gather assets at the expense of performance.

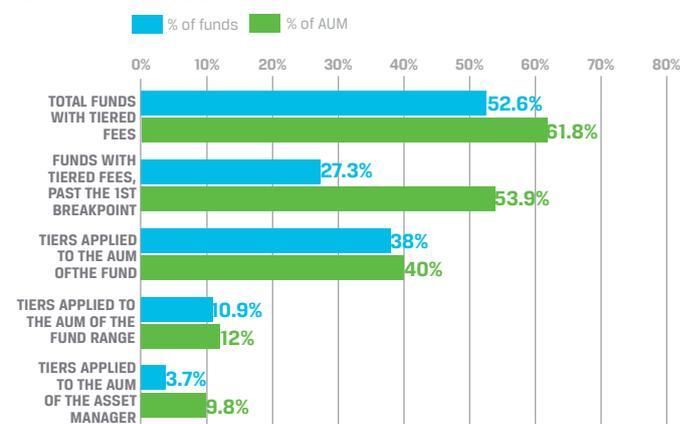
The arguments against tiered structures are less convincing. True, they add slightly more complexity than *ad valorem* fees but most investors can understand the concept of benefits of scale. They can, however, also create some additional uncertainty for investors. Investors in a fund, could find the OCF increasing back to a previous higher level (and so possibly beyond their expectations) because of redemptions or market falls. However, by the nature of tiering such increases should be gradual. In the investment trust example above, a 50% reduction in AUM from £8 billion to £4 billion would result in a 9% increase in the AMC rate from 0.275% to 0.30% of AUM.

The structure of investment trusts lends itself well to tiered fees. The application to OEICs is more complex, however, for the following reasons:

- Their open-ended structure could result in a loss of scale from redemptions, resulting in remaining investors having to pay higher fees, which may be perceived as an undesirable and potentially unsustainable outcome. There is also an administrative challenge of how to apply scale benefits when differently priced share classes of the same fund will be increasing or decreasing in size at different rates.
- Multiple share classes also create the challenge of how to apply scale benefits when share classes of the same fund may already be priced differentially to reflect their respective scale, as described in the previous section.
- OEICs form part of a multiple fund corporate structure, raising the question as to what level in the manager's organisation should scale benefits be recognised: (i) the share class, (ii) the fund, (iii) the fund range / umbrella corporate entity or (iv) the total AUM of the asset manager.

However, these issues will likely be addressed as managers respond to requirements to demonstrate that their retail investors are receiving value. In the US market, where regulatory requirements to pass economies of scale onto investors have existed for many years under the *Gartenberg Principles*, the majority of open-ended retail funds apply a tiered fee structure. In the US, the most common level to recognise scale benefits is at the individual fund-level.

GRAPH 4 - PROPORTION OF US RETAIL FUNDS WITH A TIERED FEE



Zero AMC Funds

A major fund house, in the US market, gained widespread publicity last year for their launch of passive funds with zero fees. This can be achieved through the low-cost use of in-house indices and by generating revenues from securities lending. It also has the follow-on benefit of attracting investors to other products and services through their proprietary investment platform.

Zero-fee structures are only economically viable for passive funds, where the fees given up are relatively small (less than 0.10% on AUM) and the manager's costs low.

There is, as yet, no sign of this type of structure in the UK market. If such a structure were to emerge it would likely need to be sponsored by one of the larger retail investment platforms.

Advantages, Disadvantages & Risks

A zero-fee pricing model has an obvious advantage for any investor pursuing value – it offers the cheapest possible investment solution. This structure is simplistic on the surface, however more transparency is necessary for retail investors to fully understand the trade-offs and risks. For example, the investor needs to evaluate the other fees of using the sponsoring platform. Once platform fees are incorporated the investor may be receiving less value than a competitive alternative.

Securities lending can create the income stream necessary to cover the costs of the manager, but in return it adds tail risks both for managers and investors. As security lending flows are dependent on the market conditions and the demand for securities, managers may find their revenues do not meet their costs at certain times in the economic cycle. Securities lending also creates credit risk for the fund, that although remote, is ultimately borne by the investor. In addition, there is a lack of transparency as to the returns on security lending that the manager is retaining to cover their costs.

One indirect disadvantage of this approach is the barrier to entry it creates for new entrants who lack the scale, brand recognition and vertically integrated revenue streams necessary to compete.

Discretionary Fee Waivers

A discretionary fee waiver is a common tool used by the manager to reduce or cap the fund's OCF. Waivers have most often been used when funds are small, typically less than £50 million AUM, to ensure that the OCF remains competitive against funds which have already reached scale. The amount of the waiver is variable and reduces in both pounds and percentage of AUM as the size of the fund increases, eventually being removed altogether.

In the US retail market, discretionary fee waivers are a common tool used to ensure that funds remain competitively priced and investors are receiving value for the fees they pay. Fee waivers are used widely and are not limited to small funds. For fiscal years ended in 2018, 57% of US retail funds waived fees⁷. Some waivers have specific time limits attached to them, with a review of the waiver expected at the end of a multi-year period.

Advantages, Disadvantages & Risks

The benefit of the discretionary fee waiver is that it offers the manager greater flexibility to adjust pricing to changing circumstances. This approach doesn't commit the manager to future fee reductions that may not be matched with corresponding cost reductions. Future, changes in inflation, regulation, taxation, competition and other factors beyond the control of the manager may increase costs and offset the benefits of scale.

A potential disadvantage of using fee waivers to pass on economies of scale is the difficulty for a manager to remove the waiver in future if AUM were to materially fall due to market movements or redemptions. Attempting to remove a waiver, and allowing the OCF to rise, may come up against concerns of unfair treatment of remaining investors and potential for negative public relations. For this reason, a tiered fee approach described above which contractually, automatically and transparently adjusts fees to rises and falls in AUM, may be a preferable approach.

Although the impact of fee waivers adds value to the investor, the overall effect of such industry practice for investors lacks transparency and is not always well understood. As regulators are taking measures to improve the market transparency and promote informed decision-making, waivers might be perceived as a distortion of fee comparability due to their discretionary and unpredictable nature.

⁷ Source: Broadridge

Performance Fees

A performance fee is a variable management fee the amount of which is contingent on the investment manager generating positive returns above a stated objective (the hurdle rate). The performance fee will be calculated as a fixed percentage of out-performance (the participation rate) over a specified performance measurement period multiplied by the AUM.

$$\text{Performance Fee} = (\text{Fund Performance} - \text{Hurdle Rate}) \times \text{Participation Rate} \times \text{AUM}$$

A fixed base fee will typically be charged in addition to the performance fee. Often a fee cap will be applied to limit the total level of management fees that the investor will pay.

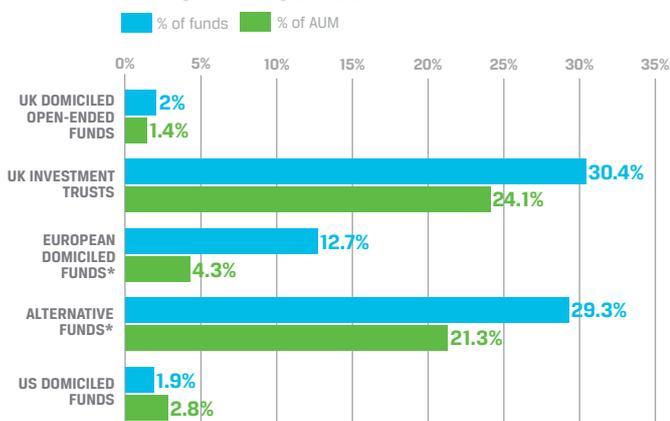
For retail funds performance fees are typically calculated and accrued daily. Daily accruals are an attempt to ensure that investors buying or selling the fund only pay for the performance they receive. However, as demonstrated further in the paper, daily pricing alone does not ensure fairness across investor groups.

ILLUSTRATION 1 - STANDARD PERFORMANCE FEE STRUCTURE



Where performance fees exist on retail funds, it is more common for investment trusts and alternative funds than for open-ended funds invested in the mainstream asset classes. Despite some recent high-profile introductions, performance-based fees are currently applied to a very small number of UK open ended retail funds and AUM (2.0% and 1.4% respectively). Even in the US, one of the most innovative and competitive markets for retail funds, only 1.9% of funds and 2.8% of AUM maintain a performance fee structure.

GRAPH 5 - PROPORTION OF RETAIL FUNDS WITH A PERFORMANCE FEE



SOURCE: Morningstar *Registered for sale in the UK

DEFINITIONS:

Base Fee: The base fee is the management fee chargeable when the criteria for a performance fee (meeting the hurdle rate) has not been met. The base fee usually will be charged in addition to any performance fee. For retail funds the base fee is typically calculated and accrued daily based on a fixed percentage of the assets under management. The base fee should be deducted when calculating fund performance subject to the performance fee.

Hurdle Rate: The minimum amount of performance a fund must achieve before it can charge a performance fee. The hurdle rate is typically connected to the risk profile of the fund. The higher the risk of the investment strategy of the fund, the higher the hurdle rate that is likely to be set. For retail funds the hurdle rate is typically set to the return of the fund's benchmark.

Fee Cap: The maximum management fees (base fee + performance fee) that can be paid.

Performance Measurement Period: The set time period over which performance is measured.

Calculation Frequency: A period of time specified in the prospectus over which an increase in the net asset value is evaluated and performance fees are accrued if outperformance is achieved. For retail funds the performance fee is typically calculated and accrued daily.

Crystallisation Period: The period over which the performance fees accrued are payable to the manager. Once a performance fee is crystallised there will not normally be a mechanism to return performance fees from the manager back to the fund. The crystallisation period will normally align with the end of the performance measurement period. Some retail funds operate a rolling performance measurement period with a new measurement period ending more regularly (daily, monthly, quarterly or annually). With a rolling measurement period, although the performance is measured over the long term (say 3-5 years), crystallisation can occur more frequently.

Participation Rate: The proportion of the outperformance generated by the fund that is accrued to the investment manager. This is typically, but not exclusively, shown as an annualised percentage.

High-Water Mark: A high-water mark is the highest peak in value or out-performance that a fund has reached. High-water marks attempt to ensure that investors do not pay performance fees for poor cumulative performance over several periods and that investors do not pay twice for the same amount of out-performance due to fluctuations in performance over time. If the manager underperforms over a period, they must get the fund above the high-water mark before being eligible to recommence receiving a performance fee.

The relative greater popularity of performance fee structures on UK investment trusts could be explained by the balance of power provided by independent boards. This structure likely provides the fertile environment required to ensure that performance fee structures provide value for both investors and managers. In addition, compared to OEICs, investment trusts have a greater ability to demonstrate high levels of active management through the use of gearing, concentrated holdings and access to illiquid investments. This degree of flexibility offers the investment trust manager greater opportunity to achieve outperformance of the benchmark, but with greater risk. If designed well, performance fees can be an effective tool to balance the interests of managers and investors in this higher return/ risk environment.

For performance fee structures to experience greater take-up in the UK market there needs to be perceived value from both the investor and the manager. If one or both parties do not see the value in exchange for the additional risks and complexity that performance fees create then they will not be introduced. Until this is resolved, performance fees are unlikely to be widely adopted. The risks and complexity, which detract from the perceived value of performance fees, are explored in detail below.

Advantages, Disadvantages & Risks

Performance fees have the ability, if designed well, to better match fees with value delivered to investors. In a market where passive funds are increasing in popularity and market share; performance fees offer the ability for active managers to differentiate their product and demonstrate their commitment to producing outperformance. Performance fees also provide less incentive for managers to gather assets at the expense of performance. For investors, performance fees offer downside protection; a form of insurance against under-performance.

However, performance fees, when compared to *ad valorem* fees, introduce an additional element of risk for both managers and investors. Should the performance of the fund be weaker than benchmark, the managers remuneration will be reduced to the base fee, which may not cover the full costs of portfolio management. Should performance exceed expectations, investors will pay more in management fees than they would otherwise in an *ad-valorem* model.

In performance fee structures there is the danger that the portfolio manager may make unsuitable portfolio decisions or take excessive risks to boost near term performance and fees. While this conduct might occur even in funds that apply *ad valorem* fee structures, performance fees would increase the incentives for such behaviour. The existence of the potential positive outcome to the manager (while the investor bears the very real negative consequences of unnecessary risks), can therefore distort the apparent greater alignment of interests between manager and investor.

Performance fees may not be suitable for products whose primary objective is to produce low volatility outcomes or income. For such products the expectation of benchmark outperformance, and therefore any performance fee, is low relative to total returns. In such a case the benefits of a performance fee might be outweighed by the disadvantages.

For retail fund managers, and their custodian, performance fees increase the level of complexity required to calculate and verify fees, often requiring specialist software. For investment platforms, wealth managers and funds of funds, the variability of performance fees increases the administrative complexity and volatility of regulatory cost disclosures to underlying retail investors.

Performance fees are also disadvantaged by the complexity and uncertainty they create for the retail investors. This includes consideration of a number of issues which we discuss below.

Selection and evaluation of hurdle rates

Generally, the hurdle rate should be based on the benchmark against which the fund's performance is measured. However, to best match the interests of the manager and the investor, hurdle rates should be adjusted to reflect the risk profile of the fund. Setting the hurdle at the market benchmark would not be appropriate for a fund which targets significantly more risk than the benchmark. A common example of this is absolute return funds, the most common type of retail fund to include a performance fee. The hurdle rate for absolute return funds is usually a cash benchmark such as three-month money market interest rates. However, "the money market benchmark is inappropriate because it does not capture the risk characteristics of the absolute return strategies"⁸, which are significantly higher than cash.

TABLE 1 - COMPARISON OF PERFORMANCE FEES ON DIFFERENT RISK HURDLES

	Absolute return fund A	Absolute return fund B	Passive portfolio ^a	FTSE all share tracker	Cash (3 month MM)
Gross return	4.00%	4.00%	2.83%	7.00%	0.75%
OCF	1.00%	1.00%	0.03%	0.10%	-
Return Net of OCF	3.00%	3.00%	2.80%	6.90%	0.75%
Hurdle rate	0.75%	2.75%	n/a	n/a	n/a
Performance fee (20%)	0.45%	0.05%	n/a	n/a	n/a
Net Return to investor	2.55%	2.95%	2.80%	6.90%	0.75%
Volatility	3.00%	3.00%	3.00%	9.00%	-
Sharp Ratio	60%	73%	68%	68%	-

^a1/3rd FTSE all share tracker and 2/3rd Cash

The table above compares two absolute return funds to illustrate the application of appropriate risk-based hurdle rates. The funds are identical except for the choice of hurdle rate. Fund A has a performance fee hurdle of three-month money market rate (0.75%); Fund B has a hurdle of three-month money market rate plus 2% (2.75% in total) to reflect the increased risk above cash. Both funds have a volatility of 3%, which is equivalent to a portfolio of 1/3rd FTSE All Share tracker and 2/3rd cash, representing the passive alternative. Fund A's hurdle rate is too low as it does not reflect the level of risk taken by the investor. As a result, the outcome for the investor as measured by both net return after fees and the Sharp Ratio is inferior to the passive alternative. Fund B, with a risk appropriate hurdle rate, has the optimal outcome with a net return and Sharpe Ratio above both Fund A and the passive alternative.

⁸ CFA Society UK, Benchmarks and Indices, page 7

Identifying the correct hurdle rate creates challenges in determining the correct measure of risk and how to adjust the hurdle rate appropriately for risk. This is an issue for both the manager in selecting the hurdle and the investor assessing it. The challenges are compounded by the unpredictability of risk in both the fund and the benchmark.

The issue is not isolated to absolute return funds but is also relevant for funds which use leverage or target high beta investments. Regulation now requires fund managers to explain why their chosen benchmark is appropriate for their fund⁹; this should help but not completely eliminate the complexity for both fund boards and investors of evaluating the appropriateness of the hurdle rate.

High-water marks

High-water marks ("HWM") can be interpreted in two ways. Many retail funds apply a HWM on an absolute return basis typically measured in terms of net asset value ("NAV") per share. The HWM therefore includes both the benchmark return and the performance of the fund. An alternative HWM mechanism considers only the relative performance of the fund against the benchmark. A relative return HWM allows performance fees to accrue once underperformance has been recovered, even if the fund has negative total returns over the performance measurement period due to market movement.

If the HWM is based on the absolute return of the fund there is the potential for negative market movement, rather than specific manager performance, to activate the HWM. In this case, until the market recovers, the manager may not be rewarded for actual outperformance compared to the weak market. Conversely, in a bull market a manager could unfairly take fees resulting from rising markets. This has the potential to create misalignment of interests between the manager and the investor, where the manager is less incentivised to create outperformance. For this reason, CFA UK recommends that the HWM is set based on relative performance.

HWM mechanisms create other risks, for any fund or mandate which employs them. In their study of hedge funds, Clare and Motson (2009)¹⁰ found that the further managers were below the HWM the more likely they were to reduce risk taking. This could be motivated by a desire to protect existing AUM from further potential underperformance and redemptions of investor capital.¹¹ In addition, for retail funds, HWM have the potential to create disparity between different investors. Investors coming into the fund while a HWM is in force will pay lower fees and benefit from a 'free ride' if performance recovers.

⁹ AMMS Remedies - Policy Statement Ps19/04: Fund Benchmarks and Objectives (February 2019): <https://www.fca.org.uk/publication/policy/ps19-04.pdf>

¹⁰ A. Clare, N. Motson, 2009. Locking in the profits or putting it all on black? An empirical investigation into the risk taking behaviour of hedge fund managers. *Journal of Alternative Investments* 12 (2), 7-25.

¹¹ A Clare, N Motson, R Payne and S Thomas 2014. Heads we win, tails you lose. Why don't more fund managers offer symmetric performance fees?, Centre for Asset Management Research at Cass Business School, p3-4

Despite the above risks and weaknesses, the benefits to investors of a high water mark still outweigh the drawbacks. However, as explored later in the paper, there are new developments in performance fee structures that remove or reduce the reliance on a high-water mark, while still protecting the interests of investors.

Timing of purchase and sale on individual investor outcomes

When calculating a performance fee on a retail fund it is important to ensure fairness between investors entering and leaving the fund at different points in the performance cycle. Ideally an investor should only pay for the performance that they have received. This creates two challenges. First, how to design the performance fee structures to ensure maximum fairness. Second, it will be difficult for investors, particularly individuals, to assess if the fee structures are fair and to compare the relative fairness of competing funds with different structures.

For retail funds, despite daily accruals of performance fee, it is quite possible that an individual investor's experience may diverge from that of the fund. The impact on individual investors will depend on the terms of the performance fee and the volatility of returns.

Investors who invest following a period of underperformance (particularly when the fund is below the high-water mark) are likely to benefit from lower than expected fees and a free ride. Conversely, an investor who sells the fund when it is below the high-water mark has likely overpaid performance fees.

Before crystallisation, if purchases materially increase the size of the fund after a period of outperformance there is the potential for the new investors to benefit at the expense of existing investors if there is a subsequent period of underperformance. This occurs because the build-up of the performance fee accrual was paid for by the initial investors, while the unwinding of the accrual is credited to both initial and new investors. Therefore, new investors receive performance fee credit for which they didn't contribute, at the expense of the original investors. This issue can be resolved by employing a rolling performance measurement period with frequent (daily / monthly) crystallisation.

However, when a rolling performance measurement period mechanism is employed, an investor who purchases the fund following a period of outperformance which is subsequently not maintained is likely to end up paying for performance that they did not experience. In this case, the retail investor will be exposed to the risk of mismatch until they have held the fund for a full performance measurement period. The potential for overpayment of performance fees during the initial holding period can be calculated as follows:

Potential over payment = tracking error (corresponding to the relevant performance period) x participation rate (subject to the limits of the fee cap) x AUM.

The following table shows the potential overpayments for a £10,000 investment given different levels of tracking error, participation rate and fee cap.

TABLE 2 - POTENTIAL FOR OVERPAYMENT OF PERFORMANCE FEES ON £10,000 INVESTED

	Fund A	Fund B	Fund C	Fund D
Tracking error	6.0%	12.0%	6.0%	6.0%
Participation rate	20%	20%	10%	20%
Performance fee cap p.a.	2.5%	2.5%	2.5%	1.0%
POTENTIAL OVERPAYMENTS (PROBABILITY)				
One standard deviation (34%)	£0-£120	£0-£240	£0-£60	£0-£100
Two standard deviations (13.5%)	£120-£240	£240-£250	£60-£120	£100
Three standard deviations (2.3%)	£240-£250	£240-£250	£120-£240	£100

Generally, the higher the potential performance fee then the higher the potential for overpayment. Therefore, funds with lower relative participation rates (Fund C above) and fee caps (Fund D above) will provide better protection for retail investors against performance mismatch.

CFA UK recommends that managers and fund boards, as part of their assessment of value, should consider the risk of performance mismatch for investors entering and leaving the fund at different points in the performance cycle. In addition, the risk of the potential for a fee miss-match should be made clear to investors through the Key Investor Information Document ("KIID").

Performance measurement period

Another of the complexities of performance fees is the choice of a performance measurement period which best balances the interests of managers and investors.

An analysis of performance fees by the CFA Institute found that a "three-year time period provides a good balance between smoothing the manager's fee revenue and reducing his opportunity to "game" the fee by altering portfolio risk."¹² Shorter periods encourage managers to take too much risk when past performance has been poor and too little when the manager has 'banked' outperformance. This analysis also noted that "longer measurement periods also help dampen fee volatility. A growth stock manager with high residual risk could produce a return that varies substantially from his objectives over a one-year period. [However,] over three- year periods, residual risk is reduced, dampening the manager's excess return." As a result, the analysis found that performance fees tended to be higher and more volatile when calculated over one year as compared to three years. Though the analysis is over 30 years old it is still very relevant today. The longer the performance measurement period the greater the alignment of interests between the manager and the fund.

However, as presented in the previous section, the longer the performance measurement period the greater the risk that individual retail investors will experience a mismatch between the fees they pay and the performance they have experienced. Therefore, the period chosen needs to balance the need to incentivise long term manager performance, while minimising the potential to create conflicts between different groups of investors.

¹² Performance Fees for Investment Management: Financial Analysts Journal, Volume 43, Issue 1 (January 1987)

Calculating performance fees from inception

One issue with performance measurement periods is determining how to calculate the performance fee during the initial period of life of a new fund while balancing the interests of managers and investors. The methodology employed must take into consideration the potential for volatility of performance over a short period

This is ultimately a matter for the fund board to decide and the choice will be influenced by the nature of the fund in question, but below we briefly set-down several mechanisms that could be considered. These include:

- Employing a fixed *ad valorem* fee, with no performance element, for part or all the initial period.
- Prorating the performance fee over the initial period.
- Applying a performance fee carry over mechanism. In this structure a percentage of the performance fee is carried over to the next period. The carried over amount can be used to offset any potential underperformance in the following period.

The carry over mechanism is preferable from a perspective of aligning the interests of managers and investors. It employs a degree of symmetry similar to the reserve mechanism detailed later in the paper. In the other two options there is more opportunity for either the manager or investor to be relatively disadvantaged depending on the performance outcome.

Assessment of value

Investors buy and hold an active fund because they expect it to outperform the benchmark. Investors will not / should not purchase a fund with a performance fee where the total fee at and above expected performance (the fee cap) materially exceeds the *ad-valorem* fee of a substitute. The maximum fee paid above an *ad-valorem* fee alternative should reflect the fair price of the insurance against under-performance. The benefit of this insurance is the lower fee paid when the fund unexpectedly underperforms compared to an *ad-valorem* fee alternative. Although managers are required to disclose details of the performance fee calculation and illustrations of potential outcomes, these are difficult to compare across competing funds. It is also difficult for investors, particularly individuals, to access whether the performance fee structure creates value when compared to an *ad-valorem* alternative.

Under the new assessment of value regulation, fund boards will need to analyse performance fee structures to ensure that they are providing value for investors. It is recommended that fund boards look at potential long-term fund performance after fees compared to alternative products with *ad-valorem* fees and a passive portfolio alternative with a similar risk profile, considering both underperformance and outperformance scenarios.

Complexity, transparency and disclosure

Performance fees are more complex and difficult to understand than *ad valorem* fees. Therefore, evaluating performance fees adds to the time and cost of professional fund selectors and investors. This raises the question: is there a way that performance fee mechanisms could be more easily compared to reduce the burden on investors?

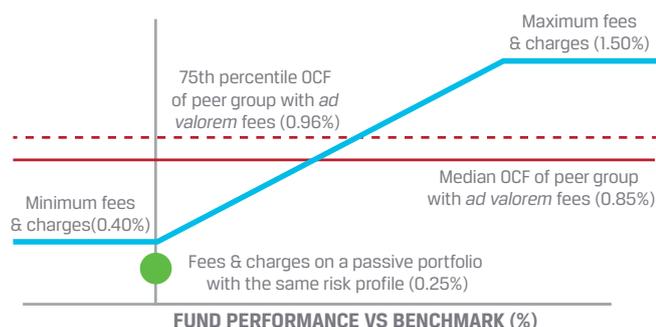
CFA UK recommends that fund managers should go beyond the minimum disclosure requirements of regulation. This should include clearly visible descriptions of key characteristics such as the hurdle rate, performance measurement period, base fee, minimum fees, maximum fees, etc. in the fact sheets.

However, this should also include transparency of how the performance fees work in various performance scenarios. This should clearly disclose in 'plain English' the same or similar information that the board used in their value assessment.

Further innovation

In response to rising competition pressures from passive funds and in recognition of some of the disadvantages and risks of standard performance fee models, new innovations in performance related fees have been introduced to the market to better align the interests of managers and investors. In the UK, performance fee innovation includes the introduction of fulcrum fees, reserves and performance fees with 'passive linked pricing'. These innovations are explored in greater detail below.

ILLUSTRATION 2 - EXAMPLE OF PERFORMANCE FEES DISCLOSURE



German Regulation of Performance Fees

In June 2018, the German regulator ("BaFin") published rules relating to fee structures for retail investment funds; nearly half of the paper was dedicated to performance fees and they are clearly designed to protect investors' interests.¹³ These rules may indicate the potential future direction of European regulation. The rules prescribe three different types of performance fee structures each dependant on the objectives and asset-mix of the fund and the availability of a suitable benchmark. They are too extensive to review fully in this paper. However, some of the highlights of the rules are:

- The requirement to have a fee cap.
- The requirement to apply high water marks.
- The requirement to have a performance measurement period made up of a five rolling periods of a minimum of one year. This implies that the minimum performance measurement period is five years and the minimum crystallisation period is one year. Where a fund has less than five measurement periods of performance history, performance is measured from inception.
- There is the option for the manager to apply a contingent deferred crystallisation. If a fund manager outperforms its benchmark in a measurement period but fails to generate a higher fund value at the end of the year compared to the start (outperforms in a bear market, for example), it may not be permitted to receive a performance fee. Instead, this out-performance of the benchmark may be rolled forward for up to five measurement period (five years) to be crystallised once an absolute return, net of fees, has been achieved.

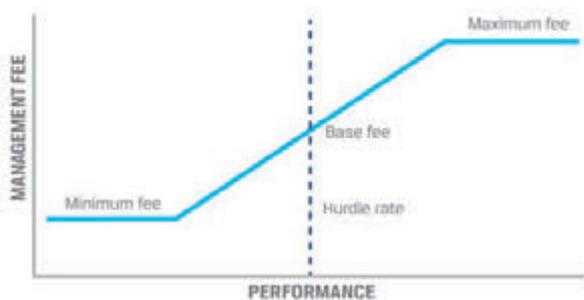
¹³ BaFin rules on permitted performance fees for non-property retail funds, published 20 June, 2018: https://www.bafin.de/SharedDocs/Downloads/DE/Merkblatt/WA/dl_180620_musterbaustein_kosten_off_pub_wa4.html

Fulcrum Fees

Fulcrum fees are a form of performance fee that adjusts up and down from the base fee reflecting performance. If the manager underperforms it reduces its management fee from the base. A minimum and maximum fee are also applied, with the base fee equidistant between the minimum and maximum. A fulcrum fee is designed to align interests of investors and asset managers, by introducing symmetry in the remuneration received by the manager. The performance element of fulcrum fees can be known under several names including 'variable management fees' and 'performance adjustments'.

The fulcrum fee structure is designed to remove the requirement for and complexities of a high-water mark. This is done through a combination of automatically lowering fees for underperformance and keeping fees within a symmetrical range bordered by the minimum and maximum fee collar.

ILLUSTRATION 3 - FULCRUM FEE STRUCTURE



In the US, by law¹⁵ performance fees on retail mutual funds must use a fulcrum fee structure, with increases in fees for performance above the benchmark matched by decreases in fees for performance below the benchmark. For most funds, the range of movements are relatively small, typically between 0.15% to 0.20% and centred around a base fee which is very close to the market average price for competing *ad valorem* funds. Fulcrum fees sometimes do not kick in unless performance has exceeded (or fallen short) of the benchmark by a fixed amount. Also, the performance fee adjustment can sometimes be stepped, moving in fixed intervals.

The introduction of fulcrum fees in the UK has been limited to a few funds based on the typical US practice described above. Since their introduction there has been minimal assets gathered in open-ended share classes with fulcrum fee structures; however, a few investment trusts have also adopted the structure. The US market has seen greater traction with fulcrum fees, yet after many years they still represent less than 3% of the retail market by AUM¹⁶.

Advantages, Disadvantages & Risks

A key advantage of the fulcrum fee is the manager shares in the downside as well as upside, creating greater alignment of interests between manager and investor than both an *ad-valorem* fee and standard performance fee.

The fulcrum fee is also less complex and easier for investors to understand than the standard performance fee model, particularly given the absence of a high-water mark. The structure also removes the specific risks associated with a high-water mark.

Compared to standard performance fees, the practice of using a narrow fee range around the base fee limits the amount that the investor could pay through the maximum fee. This allows the investor to retain more of the upside when performance significantly exceeds expectations. This also limits the amount of potential overpayment that a new investor could pay on entering the fund for performance they haven't received.

Fulcrum fees are disadvantaged by the same issues arising from complexity and uncertainty as standard performance fees, however, to a lesser extent, due to their simpler structure and narrower range of fees.

One potential criticism of the fulcrum fee is that it lacks symmetry when there is long term underperformance. If the manager persistently underperforms investors are worse off compared to investing in a passive fund, paying higher fees while receiving underperformance. Nonetheless, in this circumstance, fulcrum fees still offer a better investor outcome than an *ad valorem* fee.

¹⁵ Investment Company Act of 1940

¹⁶ Source: Broadridge and Lipper

Performance Fees Operated Through a Reserve

With this next structure, as a variation to a standard performance fee, rather than paying fees directly to the investment manager, an amount equivalent to the outperformance of the fund multiplied by the participation rate is set aside into a reserve. To add symmetry, the reserve is used to make refunds to the fund in the event of underperformance based on the same participation rate.

At the end of the performance period, the manager will take a portion of the reserve as its performance fee. The fee paid to the manager could be based on a fixed percentage of the reserve, the excess of the reserve above a predefined level or a combination of both. The amount paid to the manager, from the reserve, may be subject to a performance fee cap calculated in relation to the NAV of the primary fund. However, once fees flow from the reserve to the manager, they are no longer available for refund.

The reserve cannot have a negative value. If the reserve falls to nil, and the underperformance continues, then a reserve recovery mark is set. When the fund starts to outperform again, this mark must first be overcome before performance fees can accrue to the reserve again. The reserve recovery mark ensures that when the reserve is fully depleted and refunds cannot be repaid, the fund will not be charged for outperformance until any subsequent underperformance is fully recovered. This is similar to a high-water mark mechanism, but (due to the presence of the reserve) should take effect less frequently and preferably not at all.

A reserve introduces a greater degree of symmetry into the performance fee structure than either a fulcrum fee or the traditional performance fee structure.

Currently there are only a few funds in the UK market that apply a performance fee structure with a reserve.

Advantages, Disadvantages & Risks

A key advantage of the reserve structure is the manager shares in the downside as well as upside, creating greater symmetry and alignment of interests between manager and investor than both an *ad-valorem* fee and standard performance fee. Compared to a fulcrum fee, the reserve potentially also offers a greater range of symmetry and alignment of interests. For example, when performance is below the benchmark the fund receives a refund from the reserve; with a fulcrum fee the fund would still be paying management fees at the minimum level. However, the symmetry of the reserve works both ways; if outperformance exceeds expectations investors will pay more into the reserve than they would pay to the manager under a fulcrum fee, which incorporates a maximum fee.

Similar symmetry to a reserve could be achieved through the manager making rebates to the fund directly from their own account. In such a theoretical structure the manager would be paying rebates into the fund (negative fees) during periods of underperformance. However, this would expose investors to the credit risk of the manager and would expose the manager to significant financial risk. The advantage of the reserve is the refund potential is protected from credit risk by the separate reserve and its independent custodian.

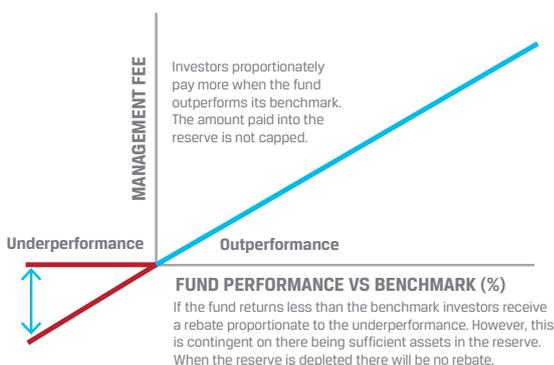
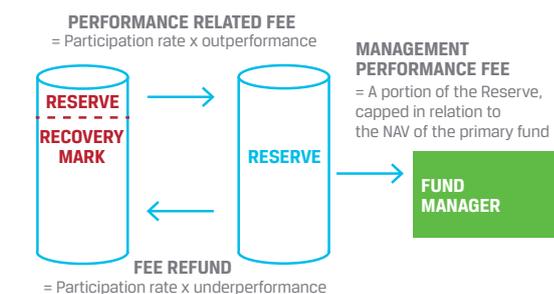
The primary disadvantage of the reserve structure is the risk that the reserve will be depleted and there will be insufficient or no funds to rebate the fund during a period of further underperformance. When this occurs the benefits of alignment of interests become substantially diminished. In addition, this creates potential disparity between different investors, depending on the timing of their investment in the fund. Until performance has recovered back above the reserve recovery mark, new investors will have the potential of receiving outperformance without contributing to the reserve and exiting investors will have experienced underperformance without having received the benefit of a rebate from the reserve.

The risk of the reserve being depleted is impacted by:

- The level of fund subscriptions and redemptions. To ensure fairness, when an individual investor purchases the fund, they are not required to provide funds into the reserve (i.e. pay for past performance). This creates the potential for the primary fund to become out of proportion to the reserve. If purchases materially increased the size of the fund after a period of outperformance the size of the reserve may not be adequate to compensate the fund and investors for a subsequent period of underperformance.
- The portion of the reserve taken as the manager's performance fee. The higher the portion taken by the manager the higher the risk that the reserve will be depleted. CFA UK recommends that the portion taken by the manager is subject to a cap in relation to the primary fund NAV to reduce the risk of reserve depletion.

CFA UK recommends that managers operating reserve structures undertake regular stress testing to determine the probability of the reserve being depleted. The results of these stress tests should be presented to the fund board as part of their annual assessment of value review.

ILLUSTRATION 4 - RESERVE STRUCTURE



If the risk of reserve depletion is low, then the benefits to investors of the reserve structure should outweigh the potential drawbacks.

Performance measurement periods

The reserve structure has two performance measurement periods to consider. First, the period used to measure the performance fee / rebate to be moved between the primary fund and the reserve. Second the performance measurement period over which the manager is compensated from the reserve.

On an open-ended retail fund, the ideal performance measurement period for moving assets between the primary fund and the reserve is daily. Provided that there are funds in the reserve, this resolves the risk of investors experiencing performance mismatch. Investors entering and leaving the fund only pay for the performance they have received. This is a significant advantage of the reserve structure over fulcrum fees; however, as explained above, it is dependent on avoiding reserve depletion.

The performance measurement period over which the manager is compensated reflects cumulative performance since the inception of the fund, i.e. the life of the reserve. An advantage of the reserve structure is that it reduces the incentive for the manager to take excessive short-term portfolio risk. The reserve should smooth the performance fees received by the manager over the life of the fund, therefore, preventing the crystallisation of 'windfalls' after a strong year. In order to receive the performance fees from the reserve, the manager must sustain outperformance over the long term. This meets the recommendations of CFA UK that the performance measurement period should be long enough to ensure alignment of interests between the manager and investors.

Passive Linked Pricing

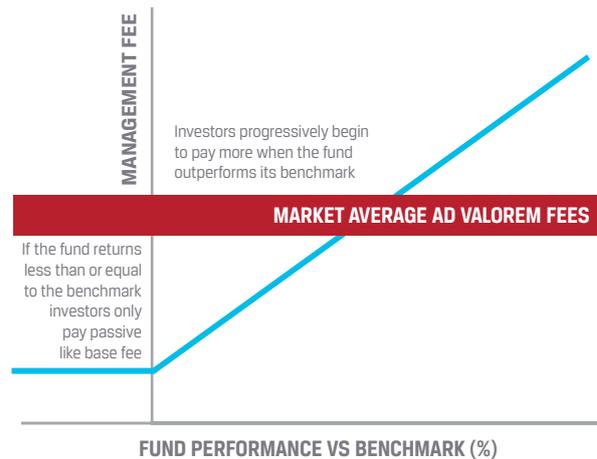
In the past two years some managers have introduced new performance fee structures with the aim to better align active fees with passive pricing. The dynamic performance fee structure is intended to combine the low fees of passive management with the outperformance potential of active management.

There are two qualities of this fee model which are innovative. First, the base fee is set to match the fees of a passive equivalent. If the fund returns less than or equal to the benchmark then investors only pay the 'passive equivalent' base fee. Under this design investors only start paying an active fee if their fund actively beats the benchmark after the deduction of the OCF.

Second, significant outperformance is required before total fees paid are broadly in line with the average fees for competitor *ad valorem* funds. This requires the manager to deliver active outperformance net of fees before it receives the market average active fee.

In order to achieve the above two requirements, the gross participation rate is automatically moderated. For the funds identified that employ this structure, the gross participation rates vary between 20% and 25%. Some of the funds also employ a fee cap.

ILLUSTRATION 5 - PASSIVE LINKED PERFORMANCE FEES STRUCTURE



Advantages, Disadvantages & Risks

Performance fee structures linked to passive pricing have several key advantages which work for the benefit of investors.

- The passive equivalent priced minimum fee ensures clients are not charged for underperformance or simply meeting the benchmark.
- The structure requires the manager to significantly beat the benchmark, after fees, before the manager earns a market average active fee. This, combined with the passive equivalent minimum fee, creates a strong alignment of interests between manager and investor, with active fees only paid for producing active outperformance.
- The gross participation rate is reasonable; at 20-25% the vast majority of excess returns are accruing to investors.

The risk of this model is the increased financial risk taken on by the manager. If the manager fails to deliver outperformance the passive equivalent minimum fee will not cover the higher costs of running an active management business. This risk could be mitigated in two ways. First most managers benefit from the diversification benefits of managing a variety of funds across several disciplines. It is unlikely that all of a manager's funds will be underperforming at the same time (note: this fee structure may not be appropriate for boutique managers with only a small number for funds). Second, managers can hold more capital to protect against the potential for an extended period of underperformance and resulting operating losses. The manager's internal capital assessment process would need to factor in the impact of such an event.

Conclusions & Recommendations

There has been a variety of innovations in retail fund fees in the UK resulting from both competition and regulation. The introduction of the new assessment of value regulations combined with the requirement for independent representation on fund boards should create a fertile environment for further innovation in retail fund fees to the overall benefit of the end investor.

Tiered fees

There has been an increasing trend of tiered fees applied in both the US market and on UK investment trusts. Tiered fees are a useful tool for passing on economies of scale to investors while being simple, transparent, aligning interests of managers and investors and not treating investors differently. They align the interests of managers and investors by:

- Increasing the manager's relative incentives to focus on performance rather than asset gathering, and
- Ensuring the benefits of economies of scale are shared with investors, rather than being retained entirely by the manager.

CFA UK recommends that managers and fund boards actively consider how tiered fees can be introduced to retail funds.

Performance fees

Performance fees can be an effective tool for aligning the interests of managers and investors. However, due to their inherent risks and complexity extra care is needed on behalf of managers and fund boards to ensure that investors are treated fairly. Where performance fees are applied to retail funds, CFA UK recommends the following minimum requirements are met:

- Hurdle rates should be set that reflect the risks of the fund relative to the benchmark. For example, it may be more appropriate for hurdle rates on absolute return funds to be higher than a money market return.
- Performance measurement periods should both incentivise the manager to produce performance over the long term and minimise the potential for individual investors to pay for performance they haven't received.
- Fee caps should be used to limit the fees paid when performance significantly exceeds expectations, provide better protection for retail investors against performance mismatch during their initial holding period and help to protect any reserve.
- Downside protection is provided in the event of underperformance. CFA UK believes that a fulcrum fee structure or use of a reserve, where the manager symmetrically shares in the downside as well as the upside, are preferable structures to a traditional high-water mark.
- When fund boards assess value of performance fee structures, they should compare potential long-term fund performance outcomes after fees to alternative products with *ad-valorem* fees and a passive portfolio alternative with a similar risk profile. This should include underperformance and well as outperformance scenarios.
- Fund boards' assessment of value should also consider the risk of performance mismatch for investors entering and leaving the fund at different points in the performance cycle.
- Fund managers should go beyond the minimum disclosure requirements of regulation to improve the transparency of how their performance fees work in various performance scenarios. Consideration should be given to disclosing the information used in the value assessment in fund fact sheets in easy to follow 'plain English'.

In addition to the above, in the best interests of investors, CFA UK recommends that the ideal performance fee structure for a retail fund would attempt to include as many of the following elements as appropriate:

- Any structure where the manager symmetrically shares in the downside as well as the upside. Both fulcrum fees and reserve structures offer a degree of symmetry. Which is more beneficial for investors will depend on the risk and performance characteristic of the fund.
- A minimum or base fee set to broadly match the fees of a passive equivalent. Therefore, investors do not pay active fees unless they receive active performance. Also, the manager is receiving some income to cover their costs and is therefore not entirely reliant on performance fees.
- Total fees at target outperformance which broadly equal average fees for competitor *ad valorem* funds. This requires actual active outperformance to generate active fees.

Two examples of how all these elements can be combined into an effective performance fee on a UK All Share Equity OEIC are shown below.

ILLUSTRATION 6 - FULCRUM FEE STRUCTURE FOR UK ALL SHARE EQUITY OEIC

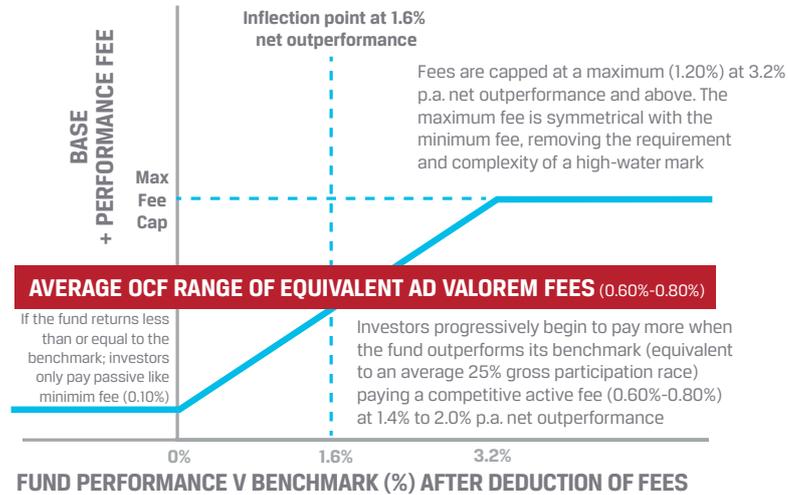
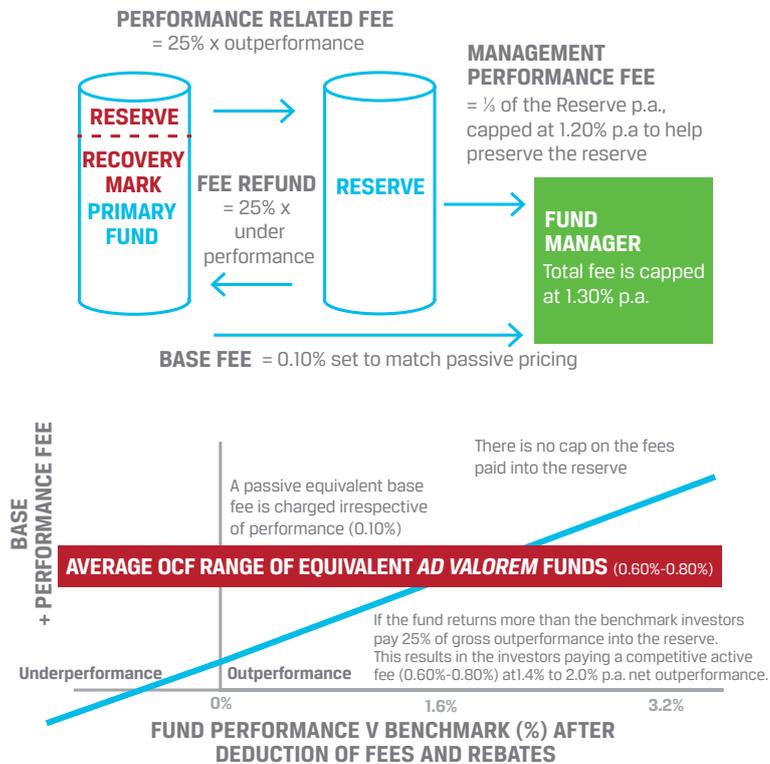


ILLUSTRATION 7 - RESERVE BASED PERFORMANCE FEE STRUCTURE FOR UK ALL SHARE EQUITY OEIC



Appendix: Further Reading

Relevant previous CFA UK publications:

Benchmarks and Indices:

<https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/3-research-and-position-papers/benchmarks-and-indices.pdf>

Value for Money: A Framework for Assessment (November 2018)

<https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/3-research-and-position-papers/value-for-money--a-framework-for-assessment.pdf>

Fees – The Cost of Investing (December 2015):

<https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/3-research-and-position-papers/fees.pdf>

Fees and Compensation (April 2013):

<https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/3-research-and-position-papers/fees-and-compensation.pdf>

Response to Market Study MS15/2.2 – Asset Management Market Study, Interim Report (Nov 2016):

<https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/cfa-uk-response-to-ms15-22.pdf?la=en&hash=6DC244AB3A4598CA403D82F06A312F381F2AA4C4>

Relevant previous CFA Institute publications:

Performance Fees for Investment Management: Financial Analysts Journal, Volume 43, Issue 1 (January 1987):

<https://www.cfainstitute.org/en/research/financial-analysts-journal/1987/performance-fees-for-investment-management>

Curriculum CFA Program Level II Alternative Investments (2014):

<https://www.cfainstitute.org/-/media/documents/protected/refresher-reading/2014/fee-structures.ashx?auth=true>

Relevant FCA publications:

AMMS Remedies - Policy Statement PS19/04: Fund Benchmarks and Objectives (February 2019):

<https://www.fca.org.uk/publication/policy/ps19-04.pdf>

AMMS Remedies - Policy Statement PS18/08: Measures to Improve Fund Governance (February 2019):

<https://www.fca.org.uk/publication/policy/ps18-08.pdf>

Asset Management Market Study ("AMMS") MS15/2.3: Chapter 13 – Transparency of Fees & Charges - (June 2017)

<https://www.fca.org.uk/publication/market-studies/ms15-2-3.pdf>



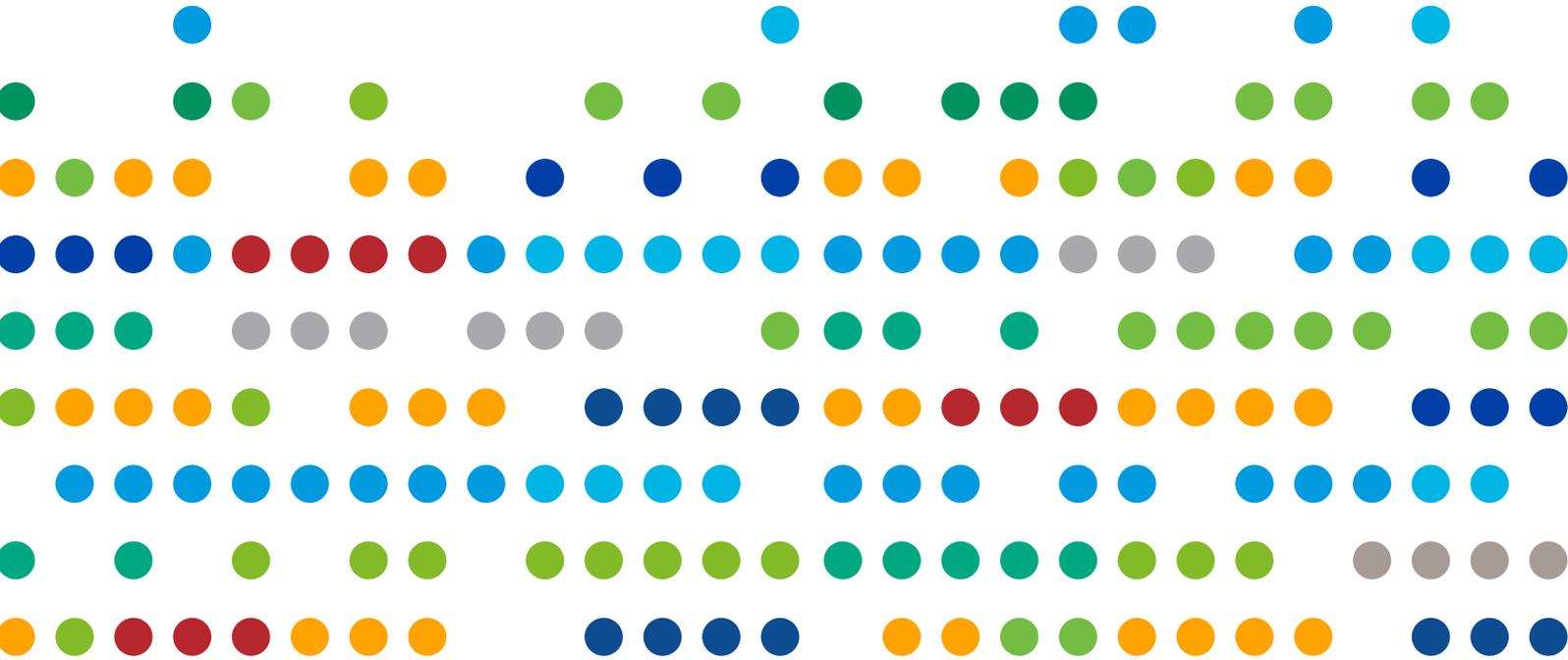
4th Floor Minster House

42 Mincing Lane

London EC3R 7AE

info@cfauk.org

www.cfauk.org



CFA Society
United Kingdom

www.cfauk.org