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Hedge Funds: Falling Fees

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Fees are often a topic of discussion regarding hedge funds. The higher fees associated with the fund structure are sometimes challenging to see beyond when deciding where to allocate capital. Recent years of underperformance and a growing number of cheaper alternatives have collectively played a role in challenging hedge funds to develop reasonable fees.

The appeal of hedge funds largely stems from the vehicle's flexibility. This fund structure allows for a less restrictive mandate compared to traditional mutual funds providing the ability to capture differentiated investment opportunities. The chart below illustrates that over the long term, a 20% allocation to hedge funds has improved risk-adjusted returns over a conventional stock/bond portfolio. Hedge fund managers are able to mitigate certain risks, such as interest rate duration or equity market beta risk, while focusing on generating a combination of skill-based and targeted market performance. Historically, hedged strategies have produced steadier returns, outperforming equities in bear markets while lagging during bull markets. The benefit of these return expectations offering lower drawdowns with quicker recoveries has resulted in a compounding effect for better long-term absolute performance net of fees.

However, in recent years, extraordinary monetary policy has created a difficult environment for hedge funds to keep pace with an extended bull market. As a result, some investors are second guessing the role of hedge funds in their portfolios, with fees often being part of the discomfort. For the fee structure to make sense, hedge funds must generate a considerable amount of skill-based performance to produce a competitive after-fee return for investors. The multiple years of recent underperformance relative to equities has put greater pressure on managers to improve terms and fees for the benefit of investors.

Source: Goldman Sachs

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The hedge fund industry's fees have begun to decline (displayed in charts below). Since 2012, the average management fee and performance fee paid by investors have decreased by roughly 13% and 7%, respectively. This is a result of established funds taking advantage of their economies of scale, emerging funds offering lower fees to attract capital, and investors increasing their allocations to funds with preferred relative terms. Due to increased competition, the rate of fee reduction is accelerating, which we expect to continue for some time. Overall, fees seem to be trending in a beneficial direction for investors.

Hedge funds have been offering more attractive fee arrangements by offering multiple share classes. While offering additional share classes is not a new concept, it is a progressively widespread method used to create a more attractive value proposition for investors. Share classes typically give the option to elect discounted fee terms in exchange for various requirements including early or start-up capital, less frequent liquidity terms, larger investment amounts, and/or to simply reward long-standing investors for their loyalty. These produce mutually beneficial arrangements allowing the business to strengthen capital stability while providing investors with more reasonable fees.

New fee arrangements have become popular to provide investors better alignment, by decreasing asset-based fees and increasing fees based on outperformance. Many investors desire a fee split that would pay 30% of excess skill-based returns to the manager while 70% of this excess performance goes to the investor. An example of an increasingly popular fee arrangement is the 1-or-30 fee structure. The manager only gets paid the 30% incentive fee on returns above an established benchmark, while the 1% management fee is only an advance on future skill-based outperformance. This incentivizes the manager to focus on performance as opposed to asset gathering. Truly skilled managers are adequately compensated for their efforts, while returning 70% of excess performance plus any market-based returns generated to investors.

While we acknowledge that average hedge fund fees remain high and many large funds have not budged in this regard, we feel that overall declining fees, additional investor options through multiple share classes, and better aligned structures are positive trends for the industry. Nevertheless, fees are just one dimension of evaluating a hedge fund's merits. For this reason, we remain firm believers in performing thorough due diligence on every aspect of a hedge fund's investment process and operations. The Multi-Manager Investment Team at CIBC Atlantic Trust will continue to monitor developments as the hedge fund industry evolves.

Mark Zarella is an investment associate in CIBC Atlantic Trust Private Wealth Management's Boston office, with more than five years of industry experience. In this role, he works on CIBC Atlantic Trust's Multi-Manager Investment Program (MMIP), where he assists the traditional, private equity and hedge fund teams in performing and monitoring investment due diligence on external managers.