The complexity of performance fees

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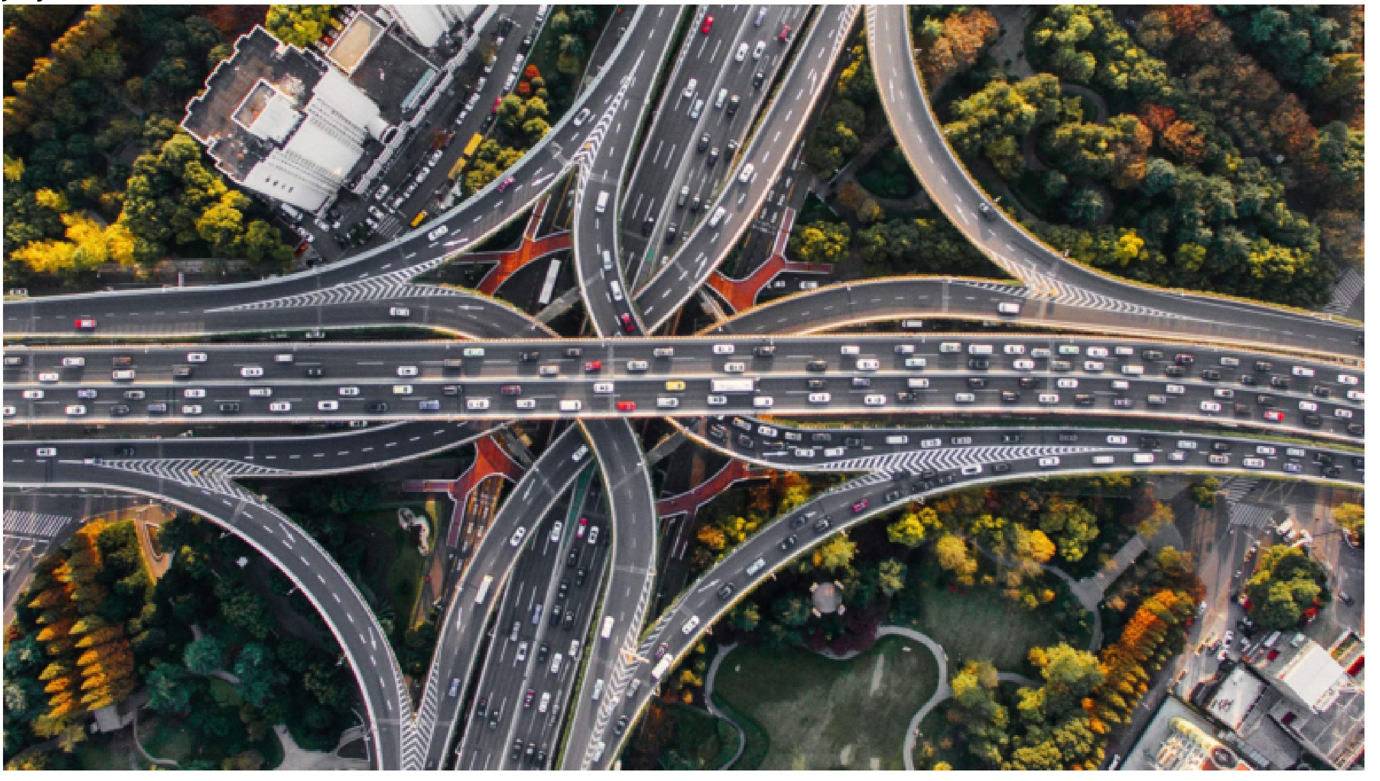

Performance Based Fees: a lot more complex than you're likely giving them credit for, and that may come back to bite you.

Previously the purview of hedge funds and private equity, performance-based fees (PBFs) are an increasingly popular way for retail asset managers to align incentives with their investors and reduce headline base fees. They are also vastly more complicated than they first appear.

Given their growing use (>80% of advisers use funds with PBFs[1]), and what we see as a very limited appreciation for their complexities in the retail market, we thought it worth spending some time talking about what makes a good (or a bad) PBF, where managers frequently get it wrong, and why it's important that they are better understood.

The basics

PBFs incentivise a manager based on investment performance. They accrue as a liability against the fund as a manager outperforms their chosen benchmark and become payable to the manager at the end of each performance period (*usually* annually or semi-annually).

Performance benchmarks can be linked to a hurdle rate (performance over a set rate incurs PBFs), linked to an index (performance over the index incurs PBFs), they can be absolute (any positive performance incurs PBFs), or some combination thereof.

Whilst choosing an appropriate benchmark structure is critical, and the most common area of focus, it is not the only area that can undo managers – there are several other structural considerations which are often forgotten and just as important. We'll discuss a few of these here.

Given the growing use of PBFs, and advisers' ever-increasing understanding of their structural implications, it is critical for managers to understand their complexities and be deliberate in their implementation.

What does the 'good' look like?

In an ideal world, PBFs would be designed around three simple principles:

1. Investors should *only* be charged for performance they receive
2. Investors should be charged for *all* the performance they receive
3. There should be *no value transfer* between investors or the manager resulting from subscriptions or redemptions

Where do things go wrong?

Complicating matters is the fact that most retail managers are intermediated by platforms. Platforms interact with managers on a net basis (aggregating the net buy/sell position for each fund over the period and transacting on that net basis) which obscures the comings and goings of individual investors and means that managers must calculate PBFs at the fund, rather than at the individual investor level – and this is where the fun starts.

The interaction between managers and platforms means that not all the principles set out above can be applied perfectly, but they can be applied far better than they generally are. Starting from the top:

1. ***Don't charge people for what they haven't received***

Seems simple enough, however it is not uncommon for incoming investors to be slugged with the cost of historically accrued performance fees. Fund documentation usually looks to absolve the manager of responsibility for this with vaguely worded statements about the "nature of co-mingled funds".

This one is a particular bane for advisers, who have long since shed the delusion that this is an unavoidable fact of life when investing via co-mingled vehicles. The fact is that if PBFs are structured properly, there is no reason for incoming investors to bear any of the cost of previously accrued performance fees – this only comes about through lazy accounting or (hopefully) more commonly, lack of understanding/capability.

2. *Charge people for all of what they received*

Somewhat unsurprisingly, this one is better understood.

The aim here is to make sure that investors who leave the fund prior to a performance fee falling due do not leave behind the PBF liability accrued against their units – which would see remaining investors picking up the tab.

In practice this means that most funds will crystallise accrued PBFs upon redemption, i.e., the PBFs attributable to redeeming units become payable to the manager upon redemption. This prevents anyone from gaming the system.

3. *Avoid value transfers*

This is the least well understood of our three principles and consequently, where most of the issues arise. There are quite a few places where you can trip up on value transfers between managers and unit holders, but let's focus on the two that are of the largest consequence. These two issues relate to the treatment of subscriptions and redemptions when a fund is underperforming its chosen benchmark, i.e., the fund is carrying a negative performance accrual.

Starting with subscriptions – this is where the interactions of managers and platforms force us to make some trade-offs between our three principles.

The problem here is that when a fund has underperformed, it generally needs to earn back prior underperformance before any new PBFs are generated, so an investor who enters at the bottom gets a free ride back to benchmark-parity.

Whilst there are a few mechanisms that managers can (and are) use to try and address this, none of them work particularly well. Our advice will always be; if someone is prepared to invest with you whilst you're underperforming, rewarding them with some performance fee reprieve is the least you can do.

As for redemptions – this is one that we fear may be quite topical for an unlucky few – the question is:

> *What happens to my accrued underperformance when unit holders redeem?*

The danger here is that (if you've not structured your PBF properly) large redemptions can leave you with a much higher hurdle to overcome, as you have a smaller asset base with which to make back a fixed underperformance amount. Making appropriate adjustments to accruals for redemptions can solve for this – getting it wrong will leave you with a very unhappy investment team come bonus season.

So, whilst PBFs are a good way to align incentives (and may be a good commercial way to manage declining base fees), there are complexities that are not immediately apparent that warrant proper consideration.

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[1]*Source: NMG Australian Adviser Insights Programme 2021*

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