



FUSION
ASSET
MANAGEMENT

Shock Absorber Fees – SAFe

Right Deal for Managers, Investors and Public

April 2010

Summary

The Shock Absorber Fee (SAFe)* is a novel structure for performance-based compensation, designed to remove conflict of interests between managers and investors, improve quality of investment products and mitigate risk to global financial system from irresponsible short term-oriented financial management.

SAFe includes three main structural elements:

- partial transfer of risk from the investor to the manager through a recourse by the investor to accumulated manager's fees
- asymmetric nature of the recourse where the manager covers a larger percentage of loss than he is receiving in gains
- dynamical nature of the exposure with the the amount of protected exposure linked to the fees already accumulated.

Due to the risk-transfer feature of the structure, investment products with the SAFe demonstrate dramatic improvement of statistical characteristics of investment returns, such as downside volatility, maximal drawdown and Sharpe Ratio, which makes the products more desirable for investors.

Managers also benefit from the structure by increasing stability of the investment base, effective mechanism for raising assets under management in performing products, and by ability to earn overall higher fees in performing strategies.

Wide implementation of SAFe-like structures will contribute to improving global financial stability by mitigating the conflict of interests between investors and managers, which is inherent in simple percentage performance fees, and will create an incentive for responsible money management.

SAFe would have considerable social and economic benefits:

- partial de-risking of investments
- better protection of non-professional participants directly or indirectly involved in financial markets
- wider participation in financial markets bringing higher rate of investment and global productivity growth**

* , ** Please refer to page 13

Incentive Fees and Global Financial Stability

Currently, the simple performance related arrangement for compensation of managers for managing capital or other resources has a strong incentive for managers to take short-term decisions and to accept excessive risks

Investors Return Chasing

- Investors try to achieve the maximal rate of return by redeeming from "underperforming" managers to invest in "top performing" ones
- Return chasing has, in average, negative effect on investors returns
- Return chasing creates an environment where investment managers have to accept excessive risks to out-perform the "crowd"

Self Enforcing Herding

Wrong incentives lead to trading style herding

Manager

Being under pressure to demonstrate short-term performance, the manager is encouraged to sell risks of low probability events ("rare events risks") in various forms as the most common yield enhancer and a source of short-term out-performance

Manager is incentivised to accept rare event risks (selling "tails") and leveraging up investment positions and accept risk which they would not otherwise willing to accept

Managers employ leverage to achieve required rate of return, thus pushing the price of rare risk even lower and creating negative optionality profile in the portfolio, which might eventually result in unpredictably large losses

Performance Fees

- The simple performance fee is equivalent a right to benefit from positive part of profit-and-loss of the investment, which investor grants to the manager as an incentive to perform
- This "free" call option gives the manager a right to receive part of positive performance without any obligation to compensate investor for any negative performance
- This is an incentive for the manager to maximize risk to achieve maximal return for himself

Compromise financial stability and worsen quality of investment returns

Criteria for Efficient Incentive Fee

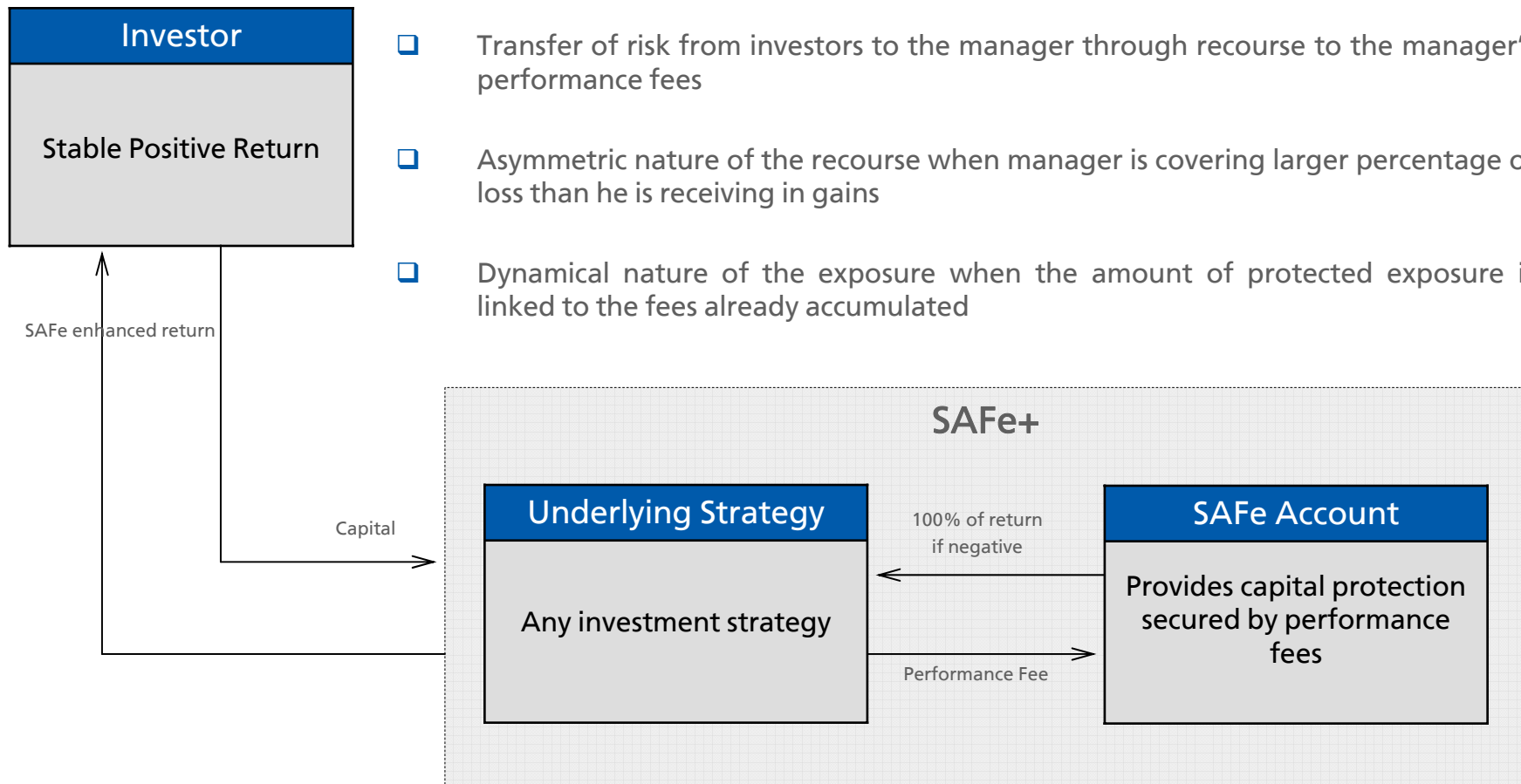
<p>Removing the “free call”</p>	<ul style="list-style-type: none"> • The “free call” feature of the “simple” performance fee prompts the manager to increase volatility of the underlying portfolio to maximize his payout. • To balance the situation, the manager has to sell the optionality back to the investor. Investors do not mind upside volatility, but they do mind if the manager is better protected. • The manager has to sell some of the downside protection back to the investors. Such performance fee will improve risk-return profile for the investors instead of damaging it.
<p>“Same Boat” concept</p>	<ul style="list-style-type: none"> • When a managed investment underperforms, the manager has to suffer not implicit but explicit losses on the same scale as he benefits from gains when the managed investment performs. • Removing this inequality puts investors and managers “in the same boat”.
<p>Stability of capital base</p>	<ul style="list-style-type: none"> • The compensation structure should give a negative incentive to an investor to redeem from a performing manager. This would suppress yield chasing, breaking down the first link in the chain of self-enforcing herding and financial instability.
<p>Incentives to perform</p>	<ul style="list-style-type: none"> • The structure should result in overall increase of fees of the performing managers, in comparison with the “simple fee” structure, to incentivize managers to agree to provide the downside protection to their investors. • This percentage increase in performance fee should be seen as a price investors agree to pay to manager for protecting investors’ capital. • Only the performing managers will earn more money, while the non-performing managers will be penalized.

Investing *in* the manager should not be a better investment than investing *with* the investment manager

Solution: Shock Absorber Fees (SAFe)

SAFe fees features:

- ❑ Transfer of risk from investors to the manager through recourse to the manager's performance fees
- ❑ Asymmetric nature of the recourse when manager is covering larger percentage of loss than he is receiving in gains
- ❑ Dynamical nature of the exposure when the amount of protected exposure is linked to the fees already accumulated



An effective and simple solution with far reaching effects

SAFe as satisfactory solution

SAFe fees satisfy all criteria of efficient compensation structure

Feature		SAFe
Removing the "free call"	<ul style="list-style-type: none"> • Manager undertakes to compensate the investor for loss from his performances fees 	✓
"Same Boat" concept	<ul style="list-style-type: none"> • Manager suffers the explicit loss when performance is negative in any performance period 	✓
Stability of capital base	<ul style="list-style-type: none"> • The investor has a negative incentive to redeem by having recourse to the cushion • Negative signalling of managers who are not ready to take risk on their own strategies, who are defending their preferential position in the existing conflict of interests with investors, who are deliberately causing lower quality of investors returns will face reduction of their capital base and eventual loss of their competitive positions. 	✓
Incentives to perform	<ul style="list-style-type: none"> • Manager agrees to provide the additional downside protection in return for higher performance fees 	✓

A solution by an experienced investment manager offering SAFe on its products

Investor Benefits

Application of SAFe fees improves quality of the investment for the investor

- ❑ The investment products are *de-risked* by transferring risk of short term volatility and drawdown from investor to the manager
- ❑ The accumulating SAFe account balance provides the *capital protection* to the investment
- ❑ Investment products with SAFe demonstrate dramatic *improvement of statistical characteristics of returns*, such as downside volatility, maximal drawdown and Sharpe Ratio
- ❑ The fees can be adjusted to suit the risks of the underlying investment product
- ❑ Aligned interests with the manager

SAFe structure is best suited for investment strategies with systematic risk premium extracting component, which generates steady returns most of the time, but suffers badly from sudden change in the risk appetite or technical dislocations

Manager Benefits

Application of SAFe fees gives stable business and higher fees to performing manager

- ❑ The arrangement gives investors negative incentive to redeem as SAFe investor is protected by the balance of SAFe account. By redeeming from the manager, investor forfeit this protection for free. This, rather than a simple redemption fee, is a *price of liquidity for investors*. Therefore the performing managers with large accumulated SAFe balances enjoy increased stability of the capital base.
- ❑ The dynamical exposure feature of SAFe arrangement implies that as long as the SAFe cushion is accumulated, exposure of the underlying portfolio grows. If the strategy performs, the manager earns fees on larger amount of capital without additional subscriptions, i.e. effectively raising capital without additional marketing, legal and operational expenses.
- ❑ If the manager outperforms the assumed random process for the investment returns, the manager earns more money than in the "simple" fee arrangement.

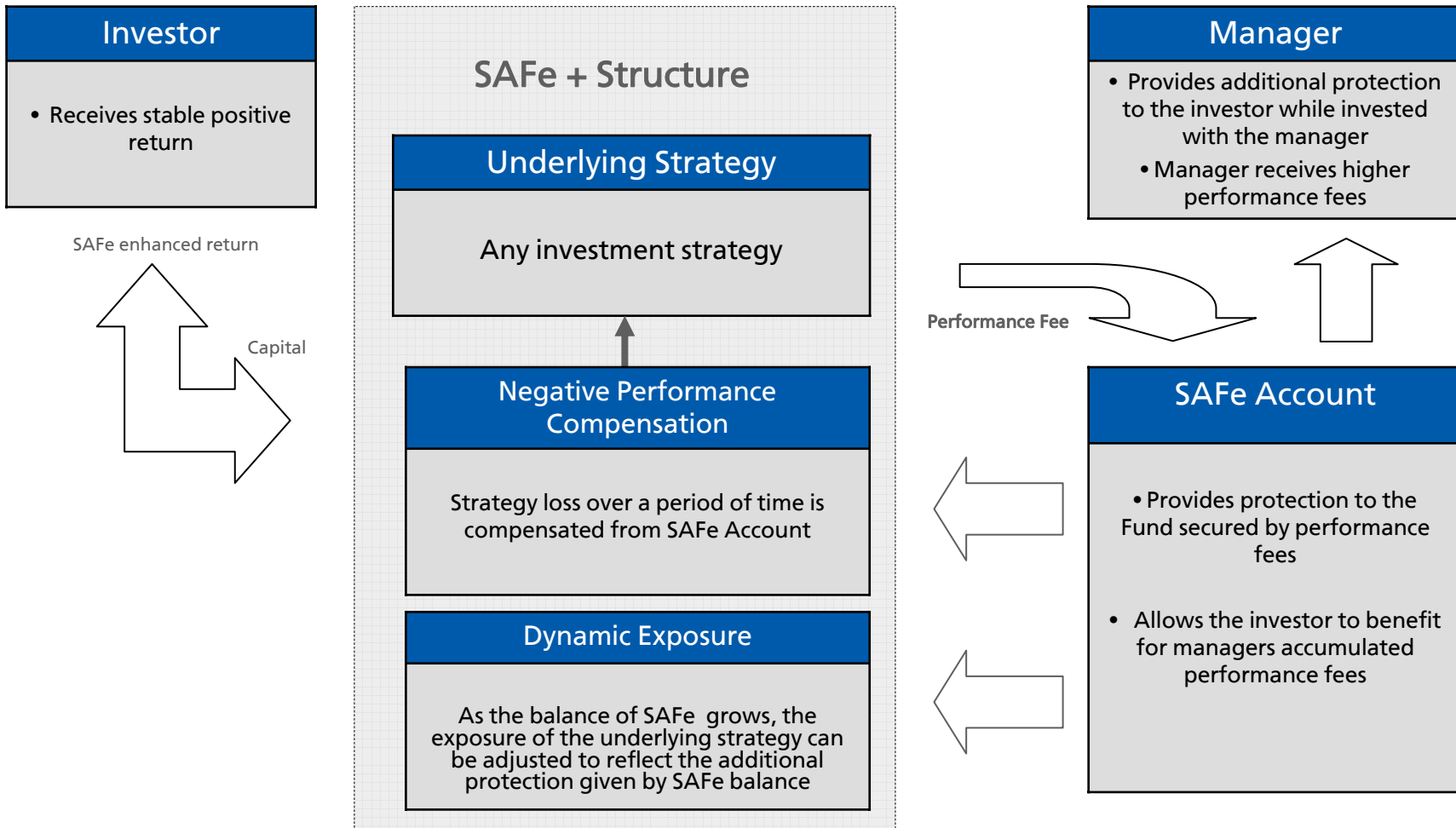
A manager confident in his strategy will be eager to adopt SAFe

Social-Economic Benefits of SAFe

Benefit	Aspects
Better investment products	<p>Shock Absorber Fees allows to absorb short term shocks from technical and risk unwinds and permitting managers to run the strategies in larger size, achieving greater returns for their investors with the same or lower volatility. Typical SAFe improves Sharpe Ratio of investments by 1.5-2 times.</p> <p>Wide acceptance of SAFe-type structures can lead to considerable increase in available investment capital.</p>
Stability of Global Financial system	<p>Interests of investors and managers are now aligned.</p> <p>Managers facing the first loss in SAF structure will be inclined to exercise prudence to protect themselves against rare, but disastrous events, created by systematic biases and amplified by herding behavior.</p> <p>This reduces the extent of irresponsible risk taking practices which lead to “bail-outs” using public funds. Such increase would contribute to wider availability of investment capital and, as a result, to higher investment and higher GDP growth rate</p>
Better Social Security	<p>General public gains from the new arrangement through multiple collective investment schemes, pensions and savings who are among largest institutional investors. By making their investments safer, SAFe contributes to higher level of social protection and better educational and living standards.</p>

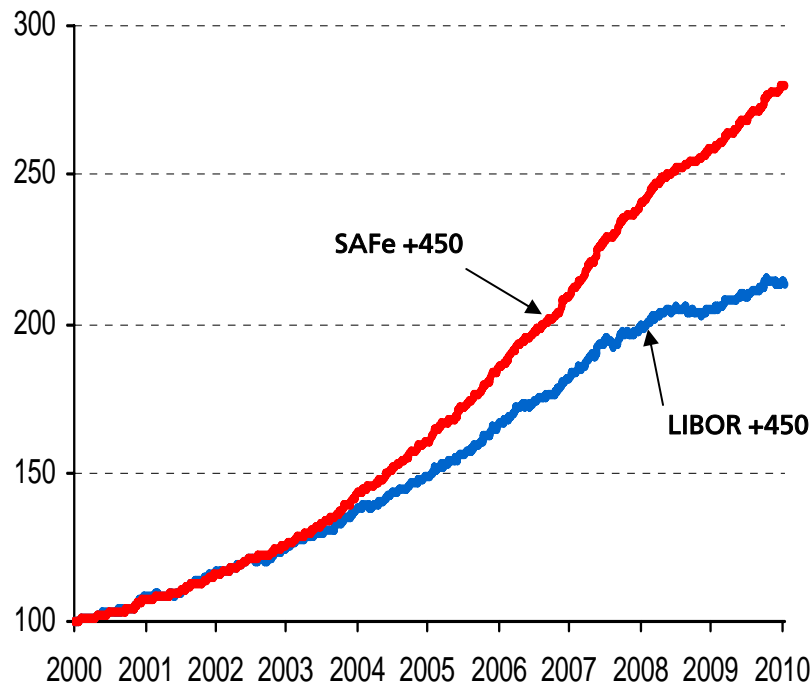


SAFe Implementation

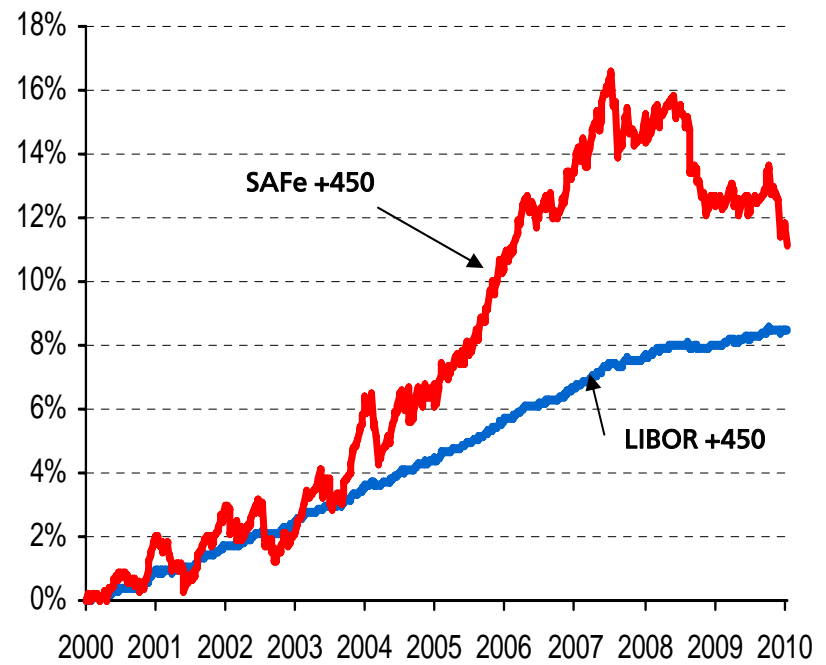


SAFe+: Effects on Performance and Compensation

Performance: SAFe (red) v LIBOR + 450 simple (blue)



Manager's Compensation: SAFe (red) v LIBOR + 450simple (blue)



SAFe+ Implementation Example

KEY TERMS

SAFe Reserve Contribution - payment to SAFe Account is the agreed amount of Performance Fees allocated to the SAFe Account. Once the SAFe balance is over the **SAFe Threshold**, the contribution into SAFe account may vary (100% to 90%)

Manager Direct Payment is the payment amount consisting of the (a) amount of performance fees less SAFe Reserve Contribution; (b) SAFe Released Amount

SAFe Compensation Payment is the amount of the agreed Downside Protection over relevant Performance Period payable to the Fund (to the extent there are sufficient SAFe Account balance)

Dynamic Exposure the total exposure at any time of the underlying portfolio by reference to the Applicable Investment Restrictions. As the SAFe Account balance grows, the exposure is adjusted by increasing or decreasing (as appropriate) the Applicable Investment Restrictions. The exposure is adjusted on 1st of each month. The maximum value of the total permitted Exposure is agreed at 2.

Example of NAV calculation

NAV, \$	P&L, \$	Performance Fees	SAFe Reserve Contribution, \$	Manager Direct Payment, \$	SAFe Compensation Payment, \$	SAFe Account Balance, \$	Dynamic Exposure	NAV, \$
100.00	5	1.75	1.75	0	0	1.75	1	103.25
103.25	5	1.75	1.75	0	0	3.50	1.75	106.50
106.50	0	0	0	0	0	3.50	1.75	106.50
106.50	-4	0	0	0	3.5	0.00	1	106.00
106.00	5	1.75	1.750	0	0	1.75	1	109.25
109.25	5	1.75	1.750	0	0	3.50	1.75	112.50
112.50	5	1.75	1.675	0.075	0	5.18	2	115.75

SAFe parameters

Downside Protection	100%
Amount of Performance Fees	35%
SAFe Reserve Contribution	100% / 90%
SAFe Thresholds	2% / 4%
Maximum Exposure	$L_{\max} = 2$
Performance Period	Month

Statistics

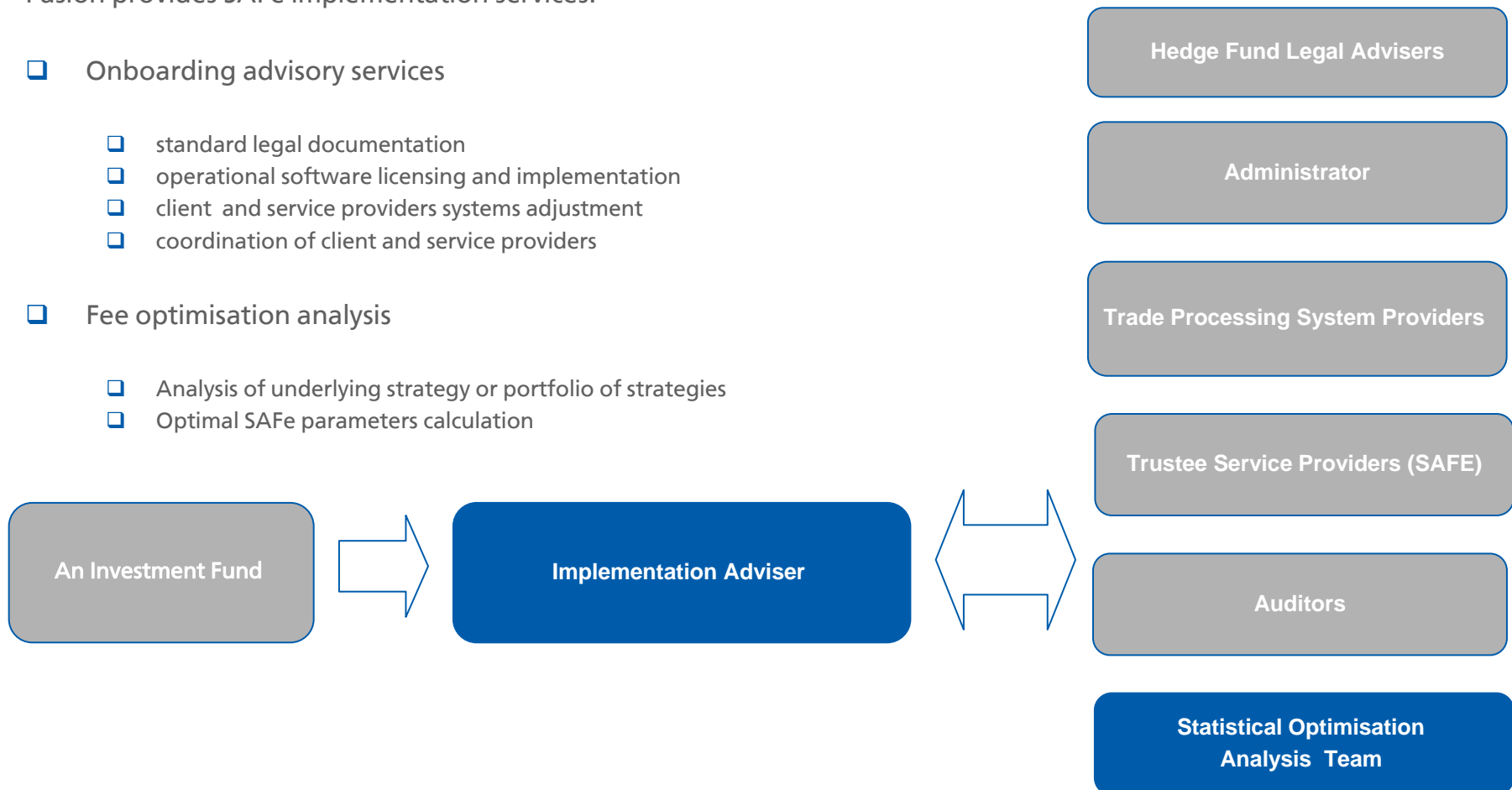
	LIBOR + 450	SAFe +450
Average Annual Return	7.54%	10.25%
Average Volatility	2.10%	1.50%
Max Drawdown	1.84%	0.00%
Sharpe Ratio	2.17%	4.83%

SAFe Implementation

Fusion provides SAFe implementation services:

- ❑ Onboarding advisory services
 - ❑ standard legal documentation
 - ❑ operational software licensing and implementation
 - ❑ client and service providers systems adjustment
 - ❑ coordination of client and service providers

- ❑ Fee optimisation analysis
 - ❑ Analysis of underlying strategy or portfolio of strategies
 - ❑ Optimal SAFe parameters calculation



Contact

Fusion Asset Management LLP
29 Queen Anne's Gate
London SW1H 9BU
www.fusionam.com

Additional information can be requested from
Ksenia Bobkova
+44 207 227 00 65
Ksenia.Bobkova@fusionam.com

* US patent pending number 61/303,397

** "Responsible Compensation Structure: Shock Absorber Fees", Kirill Ilinski,
Fusion Asset Management Working Paper FAM-02-10, available at
http://www.fusionam.com/upload/editor_files/Papers/SAFe.pdf