

# **SHOCK ABSORBER FEES – SAFe**

## **The Future of Performance-based Compensation**

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# Mission Statement

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## Shock Absorber Fees\* (SAFe) - the future of performance-based compensation

- SAFe removes the inherent conflict of interest between investors and managers
- SAFe improves the quality of investment products
- SAFe protects the global financial system from irresponsible short-term oriented management

\* Please see final slide

# SAFe Structural Overview

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- **Partial transfer of risk**  
Investor has recourse to manager's accumulated fees
- **Asymmetric nature**  
Manager covers a larger percentage of loss than he receives in gains
- **Dynamic nature of exposure**  
Amount of protected exposure linked to fees already accumulated



**SAFe – A REVOLUTIONARY STRUCTURE REDRESSING THE BALANCE IN PERFORMANCE FEES**

# Summary

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## **SAFe benefits the investor**

SAFe's risk-transfer characteristics create significant improvements in the statistics of investment returns- including downside volatility, maximal drawdown, as well as Sharpe and Sortino Ratios

## **SAFe benefits the manager**

SAFe increases stability of investment base, creating an effective mechanism for raising assets under management and earning higher overall fees in performing strategies

With wide adoption...

## **SAFe helps stabilise the global financial system**

SAFe aids financial stability by reducing conflicts of interests between investors and managers, and creating an incentive for responsible money management

## **SAFe brings social and economic benefits**

Wide adoption leads to the partial de-risking of investments, better protection and wider participation non-professional participants in financial markets, increasing investment and global economic growth



# Dangers in Current Fee Structures



## Investors Chase Returns

Investors redeem from “underperforming” managers and invest with “top performers”

### But return chasing:

- Often has a negative effect on investors’ returns
- Puts pressure on investment managers to take excessive risks to out-perform the crowd



## Managers Chase Fees

Current Fee structures create incentive for managers to maximise risk to achieve maximal fees

- The simple performance fee is equivalent to 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



## Recipe for Bad Decisions!

Under pressure to show short-term performance, the manager is encouraged to sell risks of low probability events (“rare events risks”)

- Manager is motivated 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

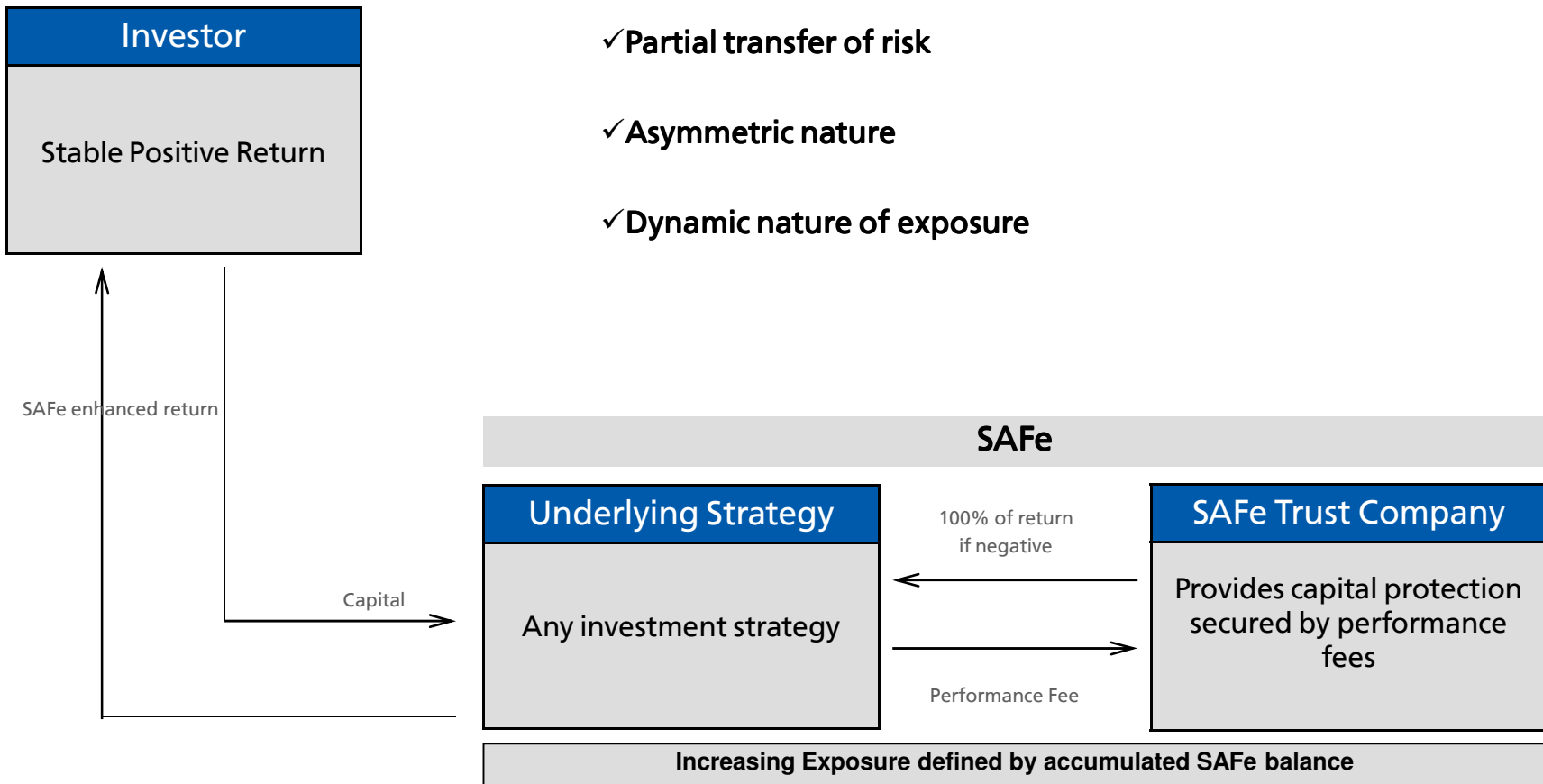
**SAFe MAKES MORE SENSE THAN DEFERRED FEES AND CLAWBACK**

# Criteria for Efficient Incentive Fee

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<b>Removing the "free call"</b>	<ul style="list-style-type: none"><li>• The "free call" feature of the "simple" performance fee prompts the manager to increase volatility of the underlying portfolio to maximise 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 their managers are better protected than they are</li><li>• The manager <i>should</i> sell some of the downside protection back to the investors. This type of performance fee would improve risk-return profile for investors</li></ul>
<b>"Same Boat" concept</b>	<ul style="list-style-type: none"><li>• Investors and Managers <i>should</i> be "in the same boat", although often they are not</li><li>• When a managed investment underperforms, the manager <i>should</i> suffer not implicit but explicit losses on the same scale as he benefits from gains when the managed investment performs.</li></ul>
<b>Stability of capital base</b>	<ul style="list-style-type: none"><li>• Compensation structures <i>should</i> give a negative incentive to an investor to redeem from a performing manager</li><li>• This would suppress yield chasing, breaking down the first link in the chain of self-enforcing herding and financial instability.</li></ul>
<b>Incentives to perform</b>	<ul style="list-style-type: none"><li>• A fee structure which works for everyone must incorporate in an overall increase in fees of the performing managers- in comparison with the "simple fee" structure- to incentivise managers to agree to provide 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.</li><li>• <b>Only performing managers will earn more fees - non-performing managers will be penalised</b></li></ul>

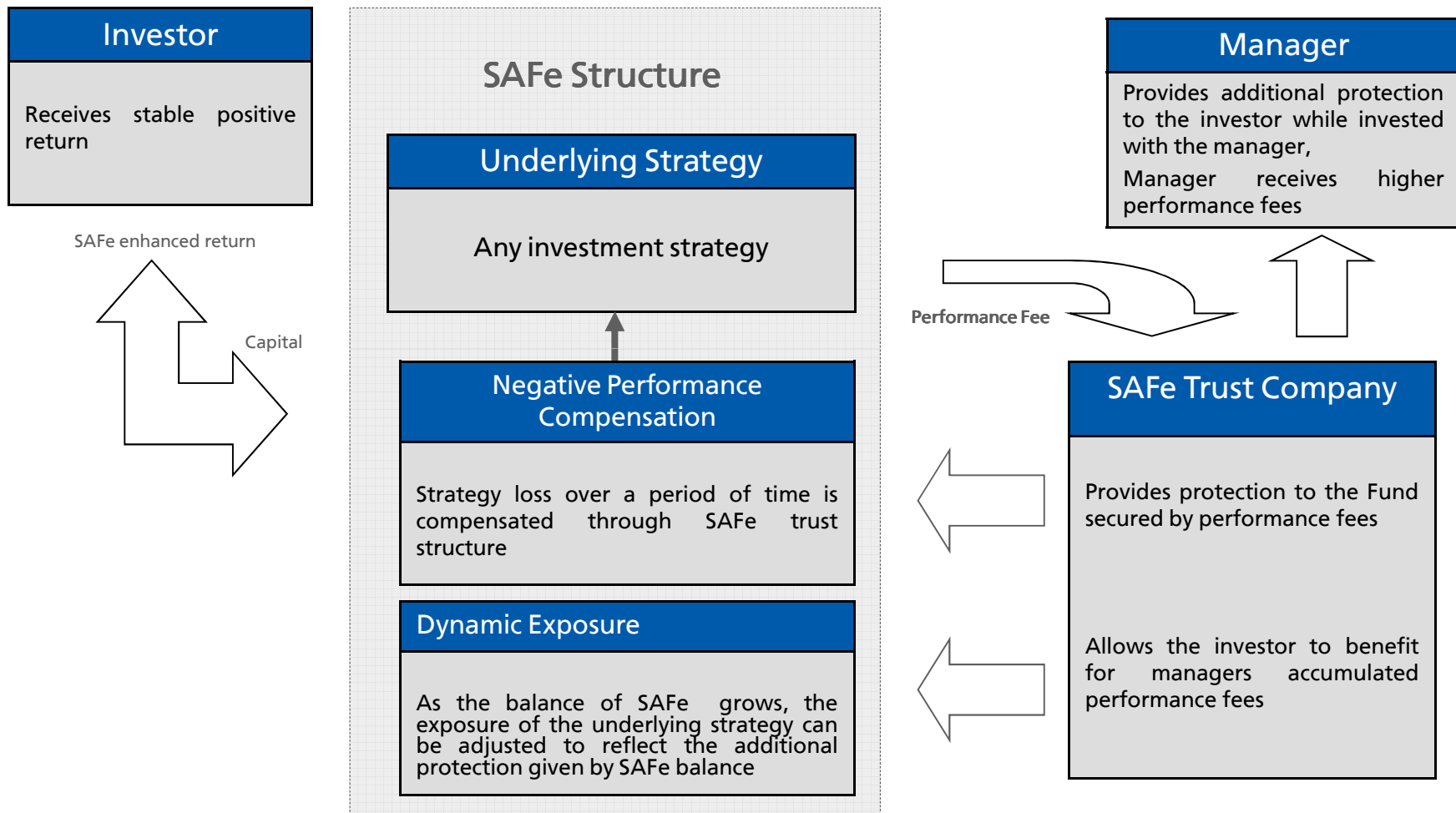
# SAFe is the Solution



- ✓ Partial transfer of risk
- ✓ Asymmetric nature
- ✓ Dynamic nature of exposure





**SAFe CAN INCORPORATE HIGH WATERMARKS AND BENCHMARKS**

# SAFe Implementation



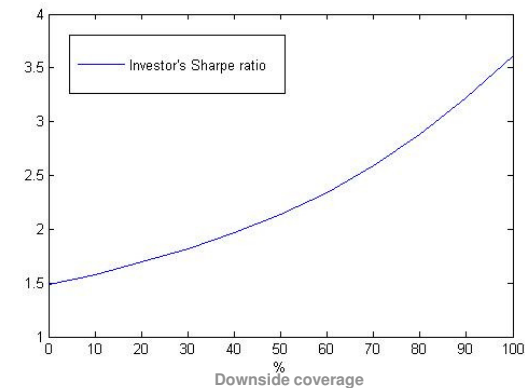
# SAFe Satisfies all Criteria

SAFe

<b>Removing the "free call"</b>	<ul style="list-style-type: none"><li>• Manager undertakes to compensate the investor for loss from his performances fees</li></ul>	
<b>"Same Boat" concept</b>	<ul style="list-style-type: none"><li>• Manager suffers explicit loss when performance is negative in any performance period</li></ul>	
<b>Stable capital base</b>	<ul style="list-style-type: none"><li>• The investor has a less incentive to redeem, because he has recourse to the cushion</li><li>• It will be clear who bad managers are:<ul style="list-style-type: none"><li>– Those who are not ready to take risk on their own</li><li>– Those defending their preferential position in the existing conflict of interests with investors</li><li>– Those causing lower quality of investors returns</li></ul>They will face reduction of their capital base and eventual loss of their competitive positions</li></ul>	
<b>Incentives to perform</b>	<ul style="list-style-type: none"><li>• Manager agrees to provide additional downside protection in return for higher performance fees</li></ul>	

# Investor Benefits

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



**INVESTOR AND MANAGER INTERESTS ARE ALIGNED**

# Manager Benefits

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- **SAFe gives the investor less incentive to redeem as he is protected by the SAFe balance**  
By redeeming from the manager, the investor forfeits this protection, and this- rather than a simple redemption fee- is the price of liquidity for investors. Performing managers with large accumulated SAFe balances enjoy increased stability of their capital base
- **The dynamic exposure of SAFe means that as the SAFe cushion is accumulated, exposure of the underlying portfolio grows**  
If the strategy performs, the manager earns fees on a larger amount of capital without additional subscriptions, i.e raising capital without additional marketing, legal & operational expenses
- **Higher fees for the manager**  
If the manager outperforms the assumed random process for the investment returns, the manager earns more money than in the "simple" fee arrangement

**SAFe BRINGS TAX INCENTIVES FOR THE MANAGER- HE RECEIVES COMPENSATION THROUGH TRUST SHARES  
MEANING HIS TAX RATE IS 27% INSTEAD OF 50%**

# Socio-Economic Benefits

Benefit	Description
<b>Better investment products</b>	<ul style="list-style-type: none"><li>• Shock Absorber Fees allows investments to absorb short term shocks from technical and risk unwinds and allows managers to run the strategies in larger size, achieving greater returns for their investors with the same or lower volatility</li><li>• Typical SAFe improves Sharpe Ratio of investments by x1.5-2</li><li>• Wide adoption of SAFe leads to considerable increase in available investment capital</li></ul>
<b>Stability of Global Financial system</b>	<ul style="list-style-type: none"><li>• Interests of investors and managers are now aligned</li><li>• Managers facing the first loss within the SAFe structure will be inclined to exercise prudence to protect themselves against rare-but-serious events created by systematic biases and amplified by herding behaviour</li><li>• SAFe therefore reduces the extent of irresponsible risk taking practices which lead to “bail-outs” using public funds. Such increases will contribute to wider availability of investment capital and, as a result, higher investment and higher GDP growth rate</li></ul>
<b>Better Social Security</b>	<ul style="list-style-type: none"><li>• General public gains from the new arrangement through multiple collective investment schemes, pensions and savings who are among the largest institutional investors. By making their investments safer, SAFe contributes to a higher level of social protection and better educational and living standards</li></ul>

# Socio-Economic Benefits

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## Let's take an example...

Capitalisation of the FTSE 350 is GBP 1.6 trl. Let's assume 25% of this is actively managed within performance fee structures= GBP 400 bln

Imagine this GBP 400 bln is all being managed by SAFe...

- Only half of managers perform and have SAFe 2x leverage= GBP 400 bln new deployed equity capital
- Same contribution from corporate bond market is GBP 200 bln

Equal to approximately GBP 400 bln in new risk capital= GBP 400 bln new investment into the economy!

- Average dividend yield (Eurostoxx50)= 5%
- Leading to an additional 5% of GBP 400 bln in new risk capital= GBP 20 bln

UK GDP is approx GBP 1.5 trl...

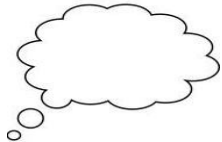
So, an additional GBP 20 bln into the economy = additional 1.3% added to GDP!



**INDUSTRY-WIDE SAFe IMPLEMENTATION LEADS TO STABILITY AND GROWTH**

# More Good News

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## Think about this...

Implementation of SAFe could potentially fill the GBP 57 bln pension gap in the UK within 4-5 years simply through this structural change

- **Pension assets in the UK are around 70% of GDP**  
An average pension portfolio is split like this- 60% "safe" bonds: 40% "risky" investments
- **Assuming that at least 50% of the "risky" part is run actively, with performance compensation**  
Application of SAFe would lead to the slow re-allocation of 20% from "safe" bonds into "risky" investments without increased risk (as long as managers perform!)
- Taking a 10% return on the "risky" part (5% dividends, 5% long-term capital gains)  
Instead of 4% (30 year swap) on "safe" bonds=

**Additional 6% return on 20% of pension assets= Additional 6% on 14% of GDP**



**In the UK, this means an additional GBP 12-13 bln per year in pension returns!**

**AN INNOVATIVE SOLUTION FOR PENSION FUND WOES**

# Industry-wide Solution: SAFe Partners PLC

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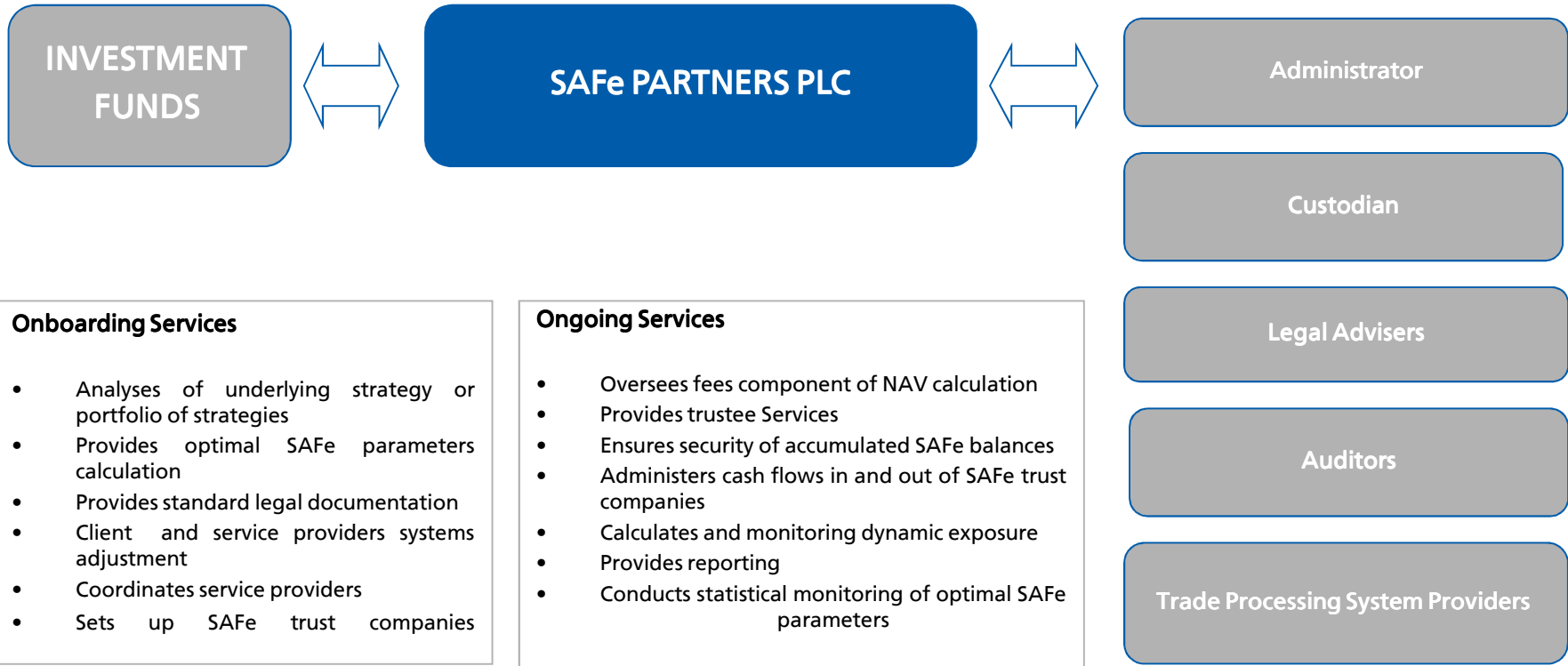
**SAFe Partners PLC- an industry-wide structure to implement and maintain SAFe structures**

- SAFe Partners PLC is owned by industry participants
- SAFe Partners PLC co-ordinates service providers for SAFe Trust Companies, including Administrators, Custodians, Legal Advisors, Auditors and Trade Processing System Providers
- SAFe structure is overseen by FSA and provides transparency on compensation and financial leverage



**SAFe IS EFFECTIVE THROUGH CREATION OF A PARTNERSHIP BY THE INDUSTRY FOR THE INDUSTRY**

# SAFe Structure



**TRANSPARENCY, REGULATION AND RETURNS - PROVIDED BY INDUSTRY-WIDE STRUCTURE**

# Contact

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\* "Responsible Compensation Structure: Shock Absorber Fees",  
by Kirill Ilinski, Fusion Asset Management Working Paper FAM-02-10