Shock Absorber Fees (SAFe): Right deal for investors and managers

FUSION ASSET MANAGEMENT

Kirill Ilinski, CEO, Fusion Asset Management

One of the hotly debated topics in the financial industry over the past two years has been the appropriate remuneration structure for the industry as a whole. This has resulted in responses ranging from investor demand for lower fees in hedge funds to the one-off government tax on bonuses in the UK, in addition to various initiatives and directives from regulators globally. Yet all of these efforts fail to adequately address the desired qualities of an ideal performance compensation structure.

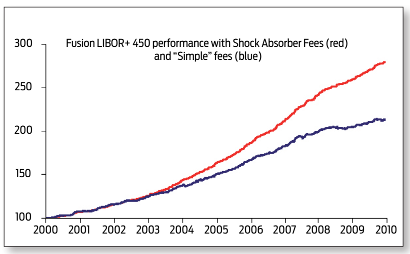
The right incentive structure should remove the free call feature of the standard performance fee, where the manager does not participate in negative performance to the same extent as investors do. This creates a strong incentive for a manager to take short-term decisions and accept excessive risks. To counteract this imbalance the performance incentive fee structure needs to incorporate a feature whereby the manager sells the optionality back to the investor.

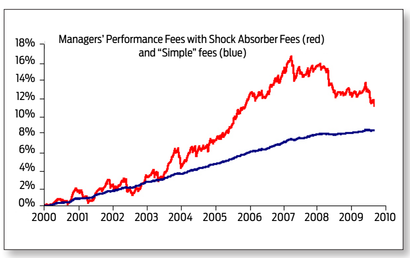
As well as balancing the skewed incentives on managers' fees, this **risk transfer** feature will also significantly improve the risk-return profile of a fund. Implemented correctly, the compensation structure should result in an increase of overall fees for **consistently performing managers**, in comparison with the standard fee structure. This is the attractive incentive for managers to agree to provide the downside protection to their investors and strive to achieve consistency of the returns.

Investing **in** the manager should never be a better deal than investing **with** the manager. When a fund under-performs, the manager needs to suffer not implicit but explicit losses on the same scale as he benefits when the investments perform.

London-based Fusion Asset Management have designed a unique compensation structure to specifically achieve these characteristics, known as Shock Absorber Fees (SAFe)[1]. Fusion now offers this fee structure across all of its investment products. The transfer of risk onto performance fees results in a smoother volatility profile and reduced downside risk leading to a higher quality of returns for investors. Simultaneously, it provides performing managers with a more stable and profitable business. Fund managers working on SAFe fees have the opportunity to earn higher overall compensation in return for agreeing to provide the downside protection to investors.

The charts below demonstrate the benefits of SAFe arrangement using the Fusion LIBOR + range as an example (a systematic G10 FX carry strategy offered by Fusion through its fund, managed accounts and index products).





The first chart shows the investor return with and without SAFe fees. **The Sharpe Ratio of the product doubles and reaches 4.8 while the worst draw-down virtually disappears.** The bottom chart compares manager compensation with and without the SAFe arrangement.

> One can spend years on developing know-how to prevent large drawdowns. This might only marginally improve statistical characteristics of the strategy.
>
> Shock Absorber Fees allow to make a big step in this direction by absorbing short-term shocks from technical and risk unwinds and permitting managers to achieve better returns for their investors.

SAFe can be applied to single-manager funds, fund of funds, or any actively managed portfolios with similar mutual benefits for investors and managers. The arrangement does not affect the liquidity characteristics of the investment product and provides a very compelling enhancement of the investment characteristics of the product. As important, it is also a strong signal of the manager's commitment to the success of his investment strategies.

The specifics and benefits of application of SAFe fees will vary with the characteristics of the underlying strategy but the benefits are apparent, especially for all liquid strategies. There is no reason to believe that the features of the SAFe structure will not be widely adopted as an industry standard for fund compensation structures over time. By directly addressing skewed incentive structure of the traditional performance fee structure, SAFe compensation arrangements will ultimately result in more responsible and disciplined investment management which is desirable from both a public interest and regulatory perspective.

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SAFe fees features

Transfer of risk from investor to the manager by recourse to the managers' compensation

Asymmetric nature of the recourse where manager covers larger portion of loss than he is receiving in gains

Dynamic nature of the protected exposure depending on the amount of reserves stored away

ABOUT FUSION ASSET MANAGEMENT

Fusion Asset Management LLP (www.fusionam.com) is a quantitative asset management firm set up in 2004. It runs several specialist investment products including

- Fusion LIBOR + range: G10 currency management program with a range of target returns (Bloomberg: FUAM <GO>)
- Fusion SAFe + combining Fusion LIBOR + range with Shock Absorber Fees
- Fusion Long Volatility Fund
- Hedge Overlay program – tactical hedging for FOF

Fusion Asset Management offers advisory services to investors and managers on optimal SAFe fee structures both for new funds and existing investments. The services cover all aspects of the structure including legal, operational and financial implementation. Fusion Asset Management also provides discretionary advisory services.

[1] US Patent Pending 61/303,397