

## Hedge funds begin to restructure fee system



By Sophia Grene

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What is a hedge fund? Some say the defining characteristic is the “2 and 20” fee structure, whereby investors typically pay annual charges of 2 per cent of assets under management and 20 per cent of returns.

Funds of hedge funds usually layer “1 and 10” on top of this, claiming this pays for the value added by their manager selection and in some cases access to desirable hedge funds.



Although this structure has been remarkably resilient, it is **finally showing the strain**. Just 38 per cent of global hedge funds surveyed by **alternatives information provider Prequin** still fit into the traditional model. Fees are also coming under downward pressure – the mean management fee in December 2009 was 1.65 per cent, with the median at 1.5 per cent.

“As **institutional investors find their voice**, funds are having to be more flexible in how they charge,” says Amy Bensted, head of hedge fund research at Prequin.



Not only are managers lowering their fees officially, they are open to negotiations of special terms for investors. “There’s a lot of individual changes in negotiations between investors and hedge fund managers,” says Ms Bensted. “It probably happens more than outsiders can be aware of.”

Although there seems to be general agreement that investors do not mind paying performance fees in principle, they have to be convinced they are getting what they pay for.

“I’m a passionate believer in the benefit of performance fees, as long as they are appropriately structured and align the interests of the fund manager to the client,” says Chris Ralph, chief investment officer of wealth manager St James Place.

Alignment of interests is the traditional rationale for performance fees, in contrast to asset-based charges, which give managers an incentive simply to gather as many assets as possible. Since many hedge fund strategies are likely to do worse if the fund is above a certain size, that would clearly not be in the interests of existing investors.

But performance fees do not necessarily do a fantastic job of aligning manager and client interest, particularly in their crudest form where “performance” is any return above zero.

Hurdle rates (where only returns above a target rate count for the performance fee) and high water marks (whereby funds that have given up performance have to regain their previous highs before performance fees can be charged again) have become mainstream, but they are not sufficient to satisfy all complaints about hedge fund fee structures.

One issue investors have with performance fee structures is the period over which they are calculated and charged. Most hedge fund performance fees are paid yearly, so if a fund performs well one year and badly the next, the investor can be left with no return on their initial investment but having had to pay a performance fee in the first year anyway.

This can be dealt with by “clawback”, by which underperforming managers give back performance fees from previous years. The Prequin report, however, found such clauses have not become particularly common because “many investors feel that performance fees are justified if performance benchmarks are met”.

Some fund managers and funds of hedge funds are offering to calculate their performance fees over a longer period. Hilltop Fund Management has launched a fund of hedge funds with a three-year performance period, in which the performance fee remains fully at risk for the entire period.

“We felt there was a lot of anger and frustration with the current fee structure,” says Rory Hills, founding partner and portfolio manager at Hilltop. “We can’t do much about the underlying hedge funds, but we can create our own fairer fee structure.”

Because he believes one year is “too short a period of time to judge a manager”, as well as giving managers the incentive to take inappropriate risks to get short-term performance, he decided to offer a three-year option.

“For the right amount in a segregated account, we’d happily go to a five-year period,” he says.

Another issue is the asymmetry of performance fee structures. Managers share the joy when they outperform, but stand back from the suffering when their fund underperforms. Kirill Ilinski, chief investment officer and founder of London-based hedge fund manager Fusion Asset Management, has come up with an ingenious structure, called a shock absorber fee, to mitigate this problem.

**Performance fees** are calculated as normal, but, instead of being paid yearly to the manager, are held in an escrow account until the investor redeems his investment in the fund. If the fund falls in value, however, the money held in the escrow account is used to top it up.

Mr Ilinski points out an inbuilt asymmetry in the investor's favour, whereby the manager gets just 20 per cent (or whatever the agreed performance fee is) of gains but will have to make good up to 100 per cent of losses.

The most obvious advantage for the manager, says Mr Ilinski, is that it makes staying with the fund more attractive for the investor, so there is likely to be a more stable asset base. After a difficult year in 2008 when investors redeemed money despite positive performance from Fusion's funds, he wanted to develop a structure that would keep clients for longer.

He is so pleased with the concept he has applied for a patent and is in the process of setting up a separate business to offer support to other funds using the idea.

Although Fusion has had a positive response from its clients, including fund of funds Signet, which has already asked to implement the shock absorber fees, it may be hard to push the concept in the private wealth market, judging by remarks from Mr Ralph.

"The more complicated a structure is, the harder it will be to explain [to wealth advisers and investors], and the less likely I am to use it."

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