HEDGE FUNDS

Hedge funds overhaul fees to turn around ‘free market failure’

Funds are responding to polarised performance with a bigger take for the haves, and byzantine fee structures for the have-nots

By Tom Teodorczuk

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UBS’s Capital Introduction days connect institutional investors with the people behind newly launched funds seeking seed capital. But at the event in February, held at the bank’s London headquarters in Broadgate, the 12 companies showcased by UBS hardly needed an introduction. According to a source present, the funds included those run by JPMorgan Asset Management, Carmignac and Odey Asset Management.

Not only were the industry giants out working the floor, but each of their fee structures differed significantly in size and scope. Time was, nearly every hedge fund took a standard 2% management fee, meant to cover staffing and operational costs and rent, and a 20% performance fee drawn from the investment returns.

Those days are gone. Years of lacklustre returns for all but a small group of star performers have killed off traditional "two and 20" fees. In many cases, what the new structures conceal is that hedge funds are simply paying themselves less.

As UBS's 2019 Cap Intro day demonstrated, some hedge fund managers are going to desperate lengths to attract investors that are increasingly baulking at paying high fees. An investor survey in April for JPMorgan Chase found that 52% of the respondents were either negotiating or looking to negotiate their fees with hedge fund managers, a record high.

A handful of top-performing fund houses can still command two and 20, or even more, but most hedge funds have capitulated, taking less in fees, including the management charges that funds collect regardless of performance, to keep investors sweet.

Fees in decline

One hedge fund manager speaking on condition of anonymity said the fee situation for the majority of companies is "more desperate than ever, especially on the management fee side". Caps on monthly management charges have become a widespread practice for new funds, the source added, with a monthly or annual percentage or numerical limit being implemented.

Research for *Financial News* by Hedge Fund Research, the alternative investments consultancy, revealed that between Q3 2008 and Q3 2018 the average management fee for single-manager hedge fund strategies fell from 1.54% to 1.43%. The average performance fee declined from 19.3% to 16.9% over the same 10-year period.

Kenneth Heinz, president of HFR, attributed the decline to "low interest rates and low performance".

Another key factor explaining rising fee pressure is the competition from other forms of alternative investments, in particular the private equity sector. Family offices are investing more of their money in private equity firms rather than hedge funds, drawn by returns like those from consultancy Cambridge Associates' US Private Equity index, which returned 20.4% for the year ending June 30, 2018. That is above its benchmark, the Russell 2000, which returned 17.6% in the same period.

Asset managers outside the hedge fund space believe a re-examination of how funds are paid is long overdue. "There has to be a revolution in the hedge fund sector over fees," said Brandon Zietsman, chief executive of investment management service PortfolioMetrix. "We need new entries [to generate more] competitive pricing."

"There was a joke going round in the 1990s that the world of hedge funds is not an asset class, it's merely a compensation structure," said John Chatfeild-Roberts, head of strategy at Jupiter Asset Management. "Instead of being concerned with how much they pay themselves what they should be concerned about is the outcomes for their clients."

Big funds gain more ground

Businesses that are delivering performance above their benchmarks for their clients — most of which are big quantitative hedge funds — are not facing the pressure of decreasing fees. In fact

their fees are going up. A source at Two Sigma, the $51bn quantitative hedge fund, said while its standard cost remains three and 30, two of its global macro funds now charge a 40% performance fee. Two Sigma declined to comment.

DE Shaw, another prominent quant fund, will raise the fee of its flagship $14bn Composite fund, according to Bloomberg. The Composite fund, which returned 11.2% last year, has returned its costs to three and 30 after cutting them to 2.5 and 25 in 2011. DE Shaw declined to comment.

Oliver Fochler, chief executive of alternative investment adviser Stone Mountain Capital, said outstanding success means some firms will always buck the industry's downward trend. "The established, large-scale managers who have a good track record, have a lot of [assets under management] in their fund and are the ones outperforming their peers will not discount their fees," he said.

Fochler added that the funds that do negotiate their fees down are either new launches or have underperformed. "They will give all the rebates you want," he said. "The bad managers and the new managers are lowering the average, but the premium product will do nothing in terms of lowing their fees. If you aren't performing the only thing you can do is lower your fees."

HFR's Heinz emphasised that new and untested funds in particular are making concessions. "Newer fund launches are getting a lot of pushback on fees from investors pressuring managers for discounts," he said.

The perception that hedge funds charge for far more than administrative and personnel expenses has long rankled investors. "It's just shocking the expenses that pass through that investors don't look at," said Sara Rejal, global head of liquid diversifying strategies at insurance broker Willis Towers Watson. She cited examples of how hedge funds inflate their fees, such as paying for research or making mistakes on a trade, being passed off as expenses.

In the post-two-and-20 world, hedge funds are getting more creative to stay competitive. They are mixing up their fee structures, and reducing various other charges, to retain their appeal to investors.

Rokos Capital Management, the London-based $8bn global macro hedge fund launched in 2015 by Chris Rokos, a former star trader at Brevan Howard, offers two fee structures: two and 20, and one and 30. An investor at the hedge fund said he has been told the company will introduce a zero and 40 fee option next year. Rokos Capital Management declined to comment.

JPMorgan's study found that 17% of hedge funds offer the one-and-30 model, but not everyone is convinced it is the way forward. "When I see a one-and-30 fee structure I think: 'How is this going to work?'" Fochler said. "Managers need to make some money via the management fee to run their operations... whoever accepts [one and 30] is either very rich or very desperate."

Investors have become better at negotiating fees with hedge fund clients. Nathanael Benzaken, chief client officer at Lyxor Asset Management, which is one of the world's leading hedge fund-managed account platforms, said the fees Lyxor now pays vary between 0.9% and 18%, and 0.4% and 20%. "What we're seeing is future launches converging more towards 15%, 16% [performance fees]," he said. "Our fiduciary role is essentially to go to managers, convince them to try and agree [to offer a different fund] format at a lower fee." He added: "It's difficult, but it works."

With complexity comes risk

Along with being less lucrative, hedge fund fee structures are becoming more complex and closely guarded. “I recently met one manager who had a patent on their fee-charging mechanism,” said Patrick Ghali, co-founder of hedge fund advisory firm Sussex Partners. “But it was so complicated you needed a two-hour conference call to understand.”

Zietsman of PortfolioMatrix warned that secrecy and convoluted strategies would make life even more difficult for hedge funds. “The challenge is that clever fee strategies become self-destructive,” he said, adding that the wrong incentives can lead to excess risk taking. “Funds that are highly geared to performance fees can result in all kinds of behavioural messes.”

Meanwhile, industry experts say, the gulf between the minority of hedge funds enjoying stellar performance and those cutting fees is growing. “You have the haves and the have-nots,” said Eric Bernstein, president of Broadridge Asset Management Solutions, a US fintech provider. “There are the organisations that can still get away with higher fees and then everyone else. On the ‘everyone else’ side, there is absolutely a challenge in running the railroad when your fees are getting squeezed.”

Others are less sympathetic. “Hedge funds that constantly moan about fee reductions are like people who walk out on a winter’s day without a coat and then complain it’s cold,” said a hedge fund manager speaking on condition of anonymity. “There is downward pressure on fees throughout the financial industry — not just hedge funds — and if you’re not delivering, then your fee getting cut is how it should be.”

Yet even celebrated hedge fund managers are not immune to the squeeze. Martin Taylor, who rose to prominence at Nevsky Capital, the hedge fund that shut in 2016, is charging a sliding fee scale for his new £1bn hedge fund Crake Asset Management, which will launch this autumn, according to a source close to the company. Crake’s charges will begin with a 0.5% management and 1% performance fee, which will rise to 1% and 12.5%.

Hedge fund sceptics think fee reduction will still not redress the industry’s flaws. “It’s getting harder for the new crop of hedge fund managers to get away with two and 20 which was so prevalent before. That’s good,” said Simon Lack, managing partner of energy asset management specialist SL Advisors and author of 2012 book *The Hedge Fund Mirage*.

The problem is that the opaque nature of hedge funds in general means that “fees remain the last thing people talk about”, Lack said.

Only the largest investors in hedge funds have the power to reform the industry, by demanding a maximum fee structure. For now, Lack said, hedge fund fees are “still an example of a free market failure”.

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