IN THE PRESS

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Hedge fund myths: higher fees - lower returns

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Back in 1997, when I started working for my first hedge fund, almost all hedge funds would charge a 1% management fee and 20% performance fee. This was the clear standard, but even then we managed a Russia Value fund, for which we charged a 2% management fee. The subject as to why we charged a higher management fee for this fund was never raised in any investor meeting, partially because of the excellent net returns, until the fund blew up in 1998. Ten years on, now working for one of the largest third party marketing organisations for hedge funds, the more common management fee charged has risen to 1.5% (and rising) and it still does not seem to be a subject for discussion in investor meetings.

The fact that management fees are not really an area of concern to most investors is in itself logical given the investors' focus on NET returns. However the popular press will still now and then make an issue out of fees. While hedge fund fees have risen, the net returns for hedge funds have decreased from 18% per annum in the 1990s, to 8% per annum during this decade.

Rather than relying on simple anecdotal evidence, we decided to calculate how much average fees for hedge funds have actually risen.

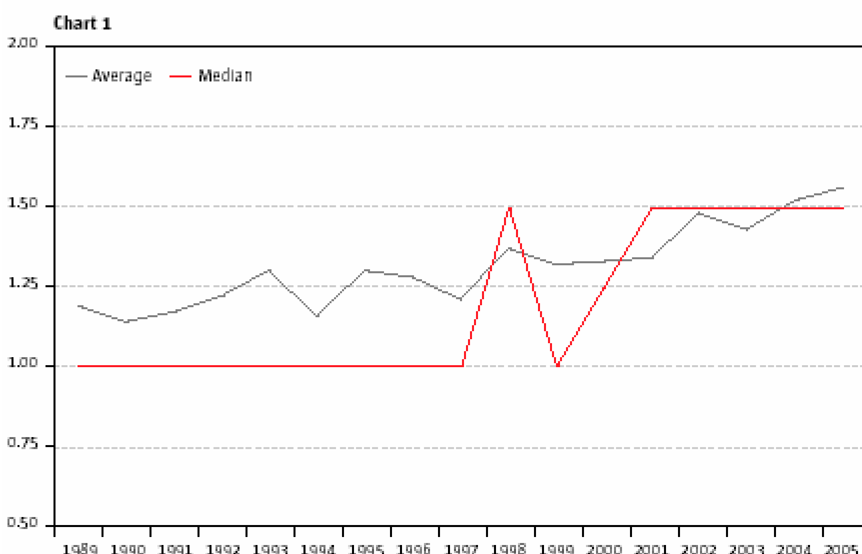
We focused on equity long/short hedge funds in order for style specific issues not to impact the data. Chart 1 shows the actual average and median management fee for equity long/short hedge funds broken down as to which year the fund commenced. All numbers were derived from the TASS database. The actual average management fee increased between 1989 and 2005 from 1.19% to 1.56%, with the median moving up from 1% to 1.5%.

Hedge funds charging a 1% management fee accounted for 63% of the total for equity L/S funds commencing between 1994 and 1996, while nine years later, between 2003 and 2005, this percentage had decreased to 24%. Over the same period hedge funds charging 2% management fees rose from 2% of the total, to 20%. This trend is clearly continuing.

Other than looking at the management fees we also studied performance fees, as shown in chart 2. Although the median performance fee has remained the same at 20%, the average performance fee has risen from 17.5% in 1989, to 20.1% in 2005.

Even from a simple perspective the decline in absolute hedge fund returns as mentioned earlier cannot be explained by 37bps higher management fees and the increase in performance fees by 260bps.

Chart 1



Looking at the returns of the individual hedge funds, with all things being equal, it would be logical to assume that hedge funds with higher fees would generate lower returns.

However, this simply is not the case. In fact the opposite is true. Those equity long/short funds which charged 2% instead of 1% generated on average higher returns. Table 1 shows the annualised returns over the last three years for equity L/S funds which commenced trading between 1996 and 2002.

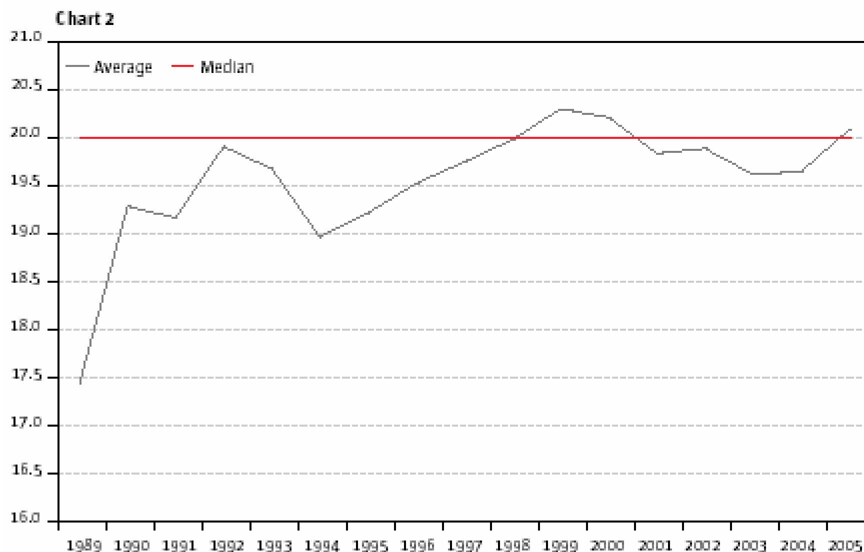
Table 1

No of Funds	Management Fee	Ann. Ret 2003-2005
286	1.0%	16.0%
183	1.5%	13.4%
45	2.0%	17.7%
514		**15.2%**

In order to ascertain if this outcome was the result of new funds (often with higher fees) doing better than old funds (possibly with greater AUM) we further broke down our sample. In table 2 we depict the annualised returns over the last three years for the equity long / short funds which commenced between 1994 and 1996, between 1997 and 1999, and between 2000 and 2002.

Looking at the data in table 2 you do not have to be a statistician to see there is no correlation between hedge fund fees and hedge fund returns, and hence we will not bore you with such technical data.

An explanation for the higher returns of 2% management fee funds, rather than 1% management fee funds, could be that the former have the ability to use the higher management fees to invest in the management process. Most small to medium sized hedge funds will increase overhead to fully cover the management fee, with the performance fee treated as a year-end bonus for the partners and employees. As annual salaries are often capped (if only for tax reasons) this means a greater number of analytical staff will be



hired as well as back-office staff, in order for the actual fund managers to stay focused on generating hopefully higher returns.

It seems the market is aware of this and has not questioned new managers starting with these higher management fees. Neither has the market questioned those managers which have increased their management fees, as long as the market believes those managers will continue to perform well. In any case, existing investors usually are allowed to continue to pay the old lower fees on current and future investments and the higher fees tend to only apply to new investors.

As investors are focused on net returns, and look at the resources of a fund manager and its capability to pay for these, and may know there is no correlation between fees and returns, there is no competitive marketing edge from lower or alternative fee structures to hedge fund managers.

Of course this does not mean that every manager can charge whatever they like. Only a very select group of hedge fund managers can charge more than 2% and 20%, mostly as a result of their proven track records over long periods of time. These funds are often closed to new investors, and a lot of pent-up demand ensues. When such a successful manager decides to reopen the fund, the pricing power is on the side of the manager. We would argue that to date we have still seen these managers taking a conservative stance. For instance, in such circumstances where a new fund is established with long lock-ups, the manager could theoretically auction off his new capacity, setting the fees in such a manner that demand equals the limited supply.

Table 2

	1994-1996 "birth date"		1997-1999 "birth date"		2000-2002 "birth date"	
	# funds	Return	# funds	return	# funds	return
1% Mngt Fee	64	15.3%	100	16.6%	122	15.8%
1.5% Mngt Fee	24	16.5%	42	14.6%	117	12.4%
2% Mngt Fee	4	14.6%	8	21.3%	33	17.2%
Total/Average	92	15.6%	150	16.3%	272	14.5%

It still is highly sensible for any hedge fund manager to understand the type of NET returns investors are looking for from a particular investment style, and given different fee levels what GROSS returns must be achieved, and if this is achievable. Specifically, many long biased equity funds, such as country or sector funds, may find it difficult to achieve NET return in excess of what an investor may achieve through buying an ETF or a mutual fund, if they set their fee levels too high.

Another example relates to a fundamentally driven market neutral sector fund which we recently attended a presentation of. While the manager had run a long-only fund, he had outperformed his benchmark by about 4% per annum. Now his new hedge fund will be about 100% long and 100% short. If he replicates his past outperformance levels on both sides, he will generate gross returns of about 8% and at 2% and 20% fees, net returns of 4.8%, quite a bit less than his return target of 10% to 12% per annum. In order to generate his target, while being 100% long and 100% short, the manager will need to be able to produce a gross alpha of 7.25%, which is substantially more than in the past.

Whereas in the preceding paragraphs we indicated that investors and the managers themselves should look at the fees, it also should be taken into consideration that 50bps higher or lower management fees would not make a material difference as to the suitability of the fee structure for the investment style.

Finally, given the large number of hedge funds trying to raise capital as well as the large number of FoHFs looking for opportunities to invest, from a macro-economic perspective the circumstances for a price setting mechanism to be efficient clearly do exist. Hence, if hedge fund managers in the aggregate will set fees too high, the result will be capital outflows. Over the last decades this clearly has not been the case.

The irony of the above conclusion that the pricing of hedge fund services may be efficient, is that the essence of the industry is based on managers exploiting market inefficiencies.

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