PORTFOLIO MANAGEMENT

Five Myths about Fees

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Journal of Portfolio Management
vol. 32, no. 3 (Spring 2006):56–64

The authors identify and correct five myths about fees. They also provide guidance for investors seeking to maximize expected alpha after fees. The authors find that high fees are justified only if the investment product delivers sufficiently higher return and lower risk.

Active investment management consists of three dimensions, namely, risk, return, and cost (which includes investment management fees and transaction costs). However, not many studies have been carried out on the cost dimension despite the fact that over a long period of time, the present value of fees could represent a substantial transfer of the investor's capital to the investment manager. In this study, the authors provide guidance for investors seeking to maximize expected alpha over fees by identifying and correcting a number of myths about fees. They also analyze the factors that determine investors' preference for fixed fees over incentive fees and vice versa.

The first myth about fees is that fees should be as low as possible. This myth is often based on the premise that compared with index fund fees, the fees for active investment management products appear high, and because aggregate alpha of active management is zero, on the average, most clients waste these fees. Furthermore, active management fees could represent a substantial transfer of capital from the investors to the investment managers in expectation of an uncertain alpha. However, the authors question the validity of this myth by stating that despite the perceived notion of active fees being higher

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than index fees, institutional and retail investors still allocate a significant portion of their assets to active managers.

The second myth concerning fees is that incentive fees are always better than fixed fees. The authors note that although incentive fees have many advantages over fixed fees (such as aligning the manager's objectives with those of the investor and leading investors to select better managers), instances still exist in which it will be advantageous for investors to pay fixed fees. The authors note that the volatility associated with incentive fees makes it difficult for investors to budget for fees' cost and also contributes to a volatile revenue stream for the investment managers. Furthermore, the option-like characteristics of incentive fees, which result in the fees being higher because of increasing alpha volatility, could result in managers engaging in investment strategies to the detriment of the investor.

The authors subsequently discuss what the right level of active management fees should be by considering investors' utility and managers' risk. The authors suggest that fees be below the expected alpha and that investors pay higher fees only to managers that consistently achieve strong alpha and high information ratios.

The authors also identify the various circumstances in which investors might prefer fixed fees over incentive fees and vice versa. They state that whereas this choice may depend on the weight the investors place on the various advantages and disadvantages of each fee structure over the other, another deciding factor could be the investors' ability to pick skillful managers. The authors demonstrate that an incentive fee structure would be more suitable to investors who have no ability to identify skillful managers, whereas the fixed fee structure would suit investors who can pick skillful active managers. The authors also note that investors would prefer incentive fees as fixed fees increase and increasingly prefer fixed fees to incentive fees as manager skill improves.

The third myth that the authors address is the belief that high-water marks always help investors. The authors note that high-water mark provisions are put in place to make incentive fees more attractive because this prevents investors from making duplicate fee payments for the same performance. The authors argue that although high-water marks reduce fees for a given sequence of investment returns, they could also lead to investment managers altering future return patterns by taking on additional risks in order to achieve higher but less probable returns. This additional risk, however, might conflict with the investor's preference for lower but steadier returns. The authors also state that investment managers may be motivated to close the fund and start a new fund if a low probability exists of achieving the high-water mark, thereby making investors face a new high-water mark with a new fund. The authors point out that a high-water mark is beneficial to the investor only if a decline in net asset value will not motivate the manager to increase risk or start a new fund. They suggest that investors closely monitor managers that have high-water marks if they are losing money.

The fourth myth suggests that hedge funds are where the alpha is and the fund managers thus deserve their high fees. The authors note that as a result of underfunded pension funds caused by declining equity markets, a number of institutional investors and pension funds are increasingly seeking alpha. This demand has resulted in a huge flow of funds into hedge funds. The authors also observe that there has been a significant rise in the fees charged by hedge funds, driven partly by the increase in demand and limited supply of hedge funds. The authors subsequently investigate whether hedge funds are where the alpha is.

The authors note that factors such as the flexibility in investing in different asset classes, in addition to avoiding constraints such as long-only constraints and attracting talented fund managers, provide hedge funds with distinct advantages over traditional investment firms. However, they note that hedge funds are not the only place where pure alpha exists for several reasons. First, the aggregate alpha in active management is zero, and hedge funds have not created any additional alpha in aggregate. Second, the influx to hedge fund managers has attracted not only skilled managers, as generally perceived, but also unskilled fund managers. Unfortunately for investors, it is not easy to differentiate between these two groups of managers. Third, traditional long-only investment firms have started offering products with the same structural advantages of hedge funds in addition to addressing issues to retain their talented staff. The authors argue that these are sufficient reasons for investors to continue to use more traditional firms. The authors note that although hedge funds attract talented managers, these managers should not always be entitled to high fees. They suggest that when selecting a hedge fund, investors analyze the impact of managers' fees on the net performance delivered to them.

The fifth myth states that investors can easily separate pure alpha from beta on investment products and that they can pay the appropriate fees for each. However, the authors note that most active management products contain a mixture of both alpha and beta that is not easily separable. They note that some managers deliver beta that is not correspond to any available index and that sometimes alpha is achieved through the timing of beta exposures. They also note that some asset classes, such as real estate and private equity, do not have pure beta instruments to facilitate benchmarking. They argue that these mixed products pose a risk of investors paying alpha fees for beta performance. They suggest that where a product offers alpha and beta characteristics, investors should clearly analyze the composition and pay the appropriate fee for each.

Finally, the authors note that most investors consider fees late in the investment decision process; however, they suggest that fee consideration should not be the overriding single concern. They conclude by stating that high fees could be justified where the product offers substantial high returns and lower risk, and they recommend that investors analyze fees in this context.

Keywords: Portfolio Management: portfolio construction, rebalancing, and implementation; Portfolio Management: hedge fund strategies; Alternative Investments: hedge fund strategies