HOW TOUGH ARE INVESTORS GETTING ON FEES?

HFMWeek uncovers some hardball tactics from investors looking to drive down charges but discussions are usually more constructive and many are still prepared to pay a premium rate

BY CHRIS JOSSELYN

The debate around lowering hedge fund fees is nothing new and costs are often mentioned among the reasons for high-profile, large-scale redemptions. While other factors were undoubtedly involved, the $300bn California Public Employees' Retirement System (Calpers) and the €156.3bn ($177bn) Pensioenfonds Zorg en Welzijn (PFZW) both cited high fees as one of the drivers behind their decisions to pull out of hedge fund investing in 2014 and 2015 respectively.

Speaking to *HFMWeek* last November, Albourne Partners co-founder and president Simon Ruddick spoke of the 'angry dollar', whereby "institutional investors have to pay out fees when they don't feel like they're winning".

"Different fee structures that are more aligned eliminate the angry dollar, so you've reduced the frustration of your client, but without losing your probability-weighted expected level of fees," he said.

So, how are investors looking to create a greater alignment of interests through the evolution of fee structures?

2/20 STILL ACCEPTABLE FOR SOME

Some allocators are still prepared to pay a high price for the right strategy. "Investors don't mind paying fees, if the risk-adjusted returns justify it," says Anita Nemes, global head of hedge fund capital group at Deutsche Bank.

In its *2016 Alternative Investment Survey* published in February, Deutsche Bank found that despite continued headline pressure on fees, 42% of investors said they would allocate to a manager with fees in excess of 2/20 for a new allocation.

"In general I'd say that the fee topic has become much more dynamic, so rather than 'take it or leave it, this is what it is', now it's much more a dynamic discussion between the manager and the investor," says Nemes.

Sharing research and forming a partnership, she adds, are just as important as fees for some investors.

However, there are other allocators for whom reducing fees is important. "There's been huge evolution," says Toby Goodworth, head of risk & diversifying strategies at consultant bfinance.

"Post-2008 we began to see the trend of more realistic pricing, so rather than a headline fee of 2/20 and then being able to get huge discounts in certain areas and smaller discounts in other areas, I think there's been a wholesale repricing regime."

He highlights some strategies in particular where fees have been pushed down in recent years. "Over the last three years there's been a big price compression trend in the more systematic strategies. Basically this comes down to investors demanding better fees upfront rather than trying to negotiate larger discounts.

"In the CTA space, way back they may have been priced at 2/20, but more realistically now you see 1.5/15 at the top end, and then there's the evolution of the more low-cost alternative beta core trend-following that in some cases can fall to as low as 50bps flat."

In terms of which investor groups are the pushiest negotiators, pension funds are generally seen as the most parsimonious allocators when it comes to fees. In Deutsche Bank's survey, 55% of pensions said they negotiate for every possible allocation, compared with 32% of FoHFs and insurance companies that say they haggle on every occasion.

"A lot of times the governance structure of pension funds is such that they need to talk about the fee issue, and a lot of investment information is publicly available, so headline fees are important from a governance point of view as well," says Deutsche Bank's Nemes.

"But pensions are also usually the people who can fulfil the most persuasive arguments in lowering fees – they are the ones who can lock up capital, who can write big tickets, who are really regarded as high-quality investors."

However, despite the tough talk from some pensions about fee levels, experts say this has not generally led to animosity. "Negotiating on fees is not supposed to be adversarial – it's not a match between us and them," says Himanshu Chaturvedi, senior investment director in the pension practice at Cambridge Associates in London.

"Some hedge funds might be more willing to listen and negotiate if they feel their performance has not been good enough. That's always a good sign, providing you still have conviction in the strategy.

"Fees have to create the right incentives, and be commensurate with the value add you can get. On the whole lower fees are better, unless they threaten the sustainability or distort the incentives of a manager."

Pensions often value a hard-bargaining investment consultant who can assist them in fee negotiations. When it launched a search for a new investment consultant earlier this year, the $12.6bn Orange County Employees Retirement System (Ocers) specified the "ability to secure lower fees… by both portfolio design and club pricing or similar negotiating strategies" as a key factor in its selection process.

The manager of a $3bn UK pension is also a keen hedge fund fee negotiator, telling *HFMWeek* that "we will actively look to negotiate down hedge fund fees whenever we are seriously looking at investing in a manager".

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THE TOP TACTICS

One of the most convincing ways to get hedge funds to lower fees is by agreeing to a lock-up. "According to the survey, locking up your money's still the most persuasive argument," says Nemes. "If you're willing to commit your capital for two to three years you definitely pay less fees."

An allocator's reputation and the size of their chequebook are also big factors. "The size of ticket is an obvious factor," says bfinance's Goodworth. "Quite often we do see tiered fee scalings depending on size of ticket. Generally these are not just for upfront one-off investments, but they are for the life of the investment. As assets grow they get inbuilt cost savings."

Nemes points out a willingness to invest early on in the life of a fund and arguing that a fund has a strong beta element are also strong arguments many allocators use in pushing down fees.

Where an allocator is considering a number of funds for a mandate, a 'blind shortlisting' process can help enhance competition and potentially lower fees.

Bfinance says it keeps the identity of funds in contention for a ticket secret from one another. "The managers participating in that shortlist don't have an idea of who else is on the shortlist, so in essence you're driving competition already because the managers don't know who they're competing against," explains Goodworth.

"If you don't know who you're competing against, generally you're going to put forward your most competitive offer to start with. Then as the process evolves, we can essentially guide those on the shortlist to say 'look, your offer is expensive compared to peers', and we give them options at every stage of the process to revise and get more competitive."

Several multi-family office investors *HFMWeek* spoke to profess a preference for clawback clauses, to claim back incentive fees that have been paid should subsequent performance disappoint. Pushing to take equity stakes in smaller managers – even from those not initially looking for such a deal – is also mentioned as a tactic. However, these approaches a relatively rare.

One investment consultant says he is aware of other approaches to reduce fees with more stubborn managers that some investors may consider ethically dubious. One is to not negotiate at all and commit capital to the fund; then, a year or so later, threaten to pull the investment unless the manager cuts fees. The reasoning here is that while a manager may negotiate hard pre-allocation, once the capital is already committed and is built into their business plans – especially if it is a large allocation – they may soften their stance.

Another tactic is for the investor to go through the motions of allocating to a manager up to the moment of committing capital. Then, before signing on the dotted line, revealing that it is also at the same stage of negotiations with two or three other managers, and that it will only allocate to the one that offers fees to its liking.

These tactics are rare, and investors say they are likely to get an allocator a bad name in the industry. "Is there pressure on fees? Yes, but it's not the main topic," says Fabrice Cuchet, CIO, alternative investment management at Candriam Investors Group, which manages around €7.5bn ($8.5bn) in alternatives funds.

"If you are performing and are delivering attractive net performance, the fee issue is not the number one priority for investors. If you are not performing, they are not going to invest – it's really linked to performance."

He adds: "When we experienced big inflows last year, we didn't see any questions around fees.

"I understand investors' questions and concerns, but [from] what I have seen it's not the main reason you might not attract new clients. It's more about whether you tick all the right boxes around consistency of returns and stability of the team."

END OF AN ERA

Average management and performance fees were largely unchanged over 2015, at 1.6% and 17.9% respectively, according to Deutsche Bank's figures, or 1.5% and 17.7% according to HFR. However, new launches in 2015 had higher average fees than those launched in 2014, with averages of 1.6% and 17.8%, up 3bps and 40bps respectively.

"You've gone from where everything's priced at 2/20 to a more realistic structure where some funds are still priced at 2/20, and they're attracting good assets and no problems, but other funds are now repriced at 50bps, so you've got a full menu of pricing across hedge funds now," concludes bfinance's Goodworth.

"Gone are the days when you don't really know what the true price is to start. Now investors have a clearer idea because there's more differentiated pricing, [but] that doesn't mean you can't negotiate discounts."

"Investors aren't really becoming more aggressive," says Deutsche Bank's Nemes. "It's just that today managers are taking the concept of alignment of interests more seriously, so from the get-go they are a lot more thoughtful about what they charge, how they charge it, and want to prove alignment of interests through that." ■