Can Hedge Fund Managers Justify High Performance Fees?

Selina Sy examines whether hedge funds that charge higher performance fees are producing higher net returns for investors.

As our first feature article "Investor Outlook on Hedge Fund Terms and Conditions" shows, investors are continuing to exert pressure on fund managers to improve fee structures despite witnessing improvements in the past year. Investors are not just seeking changes in the level of fees paid, but also in how fees are charged and many want to see performance hurdles set on funds. Preqin's Hedge Fund Analyst currently tracks 311 funds that charge no performance fee at all, while the highest performance fee currently stands at 55%. Can higher performance fees be justified? In this article, we examine whether funds that charge higher performance fees are providing stronger net returns or whether investors should be looking for savings on performance incentives.

Performance Fees vs. Net Returns

Fig. 1 illustrates the net returns generated by funds with different levels of performance fee between 2008 and 2013 YTD. Funds that charge performance fees higher than 20% have delivered the highest net returns in four out of the last six years, suggesting that the higher fees charged by these managers are at least partly justified by their outperformance of their peers. Funds charging performance fees of more than 20% have also achieved the highest net returns over the last three and five years on an annualized basis, as shown in Fig. 2, with funds charging 20% outperforming those that charge 20% or less. This shows that funds with higher performance fees are generally producing better and more consistent longer-term net returns, which is attractive to many investors in this low interest rate environment. However, funds charging less than 20% have achieved the highest net returns over the past 12 months (as of 31st July), highlighting the fact that higher fees do not always correlate to better short-term performance.

Volatility and Consistency of Net returns

When investing in hedge funds there is no guarantee that positive returns will always be delivered. Investors allocate to hedge funds for a variety of reasons, with diversification and reducing volatility among the leading attractions of the asset class. As a result, many investors are seeking consistent absolute returns from their hedge fund investments rather than substantial returns in the short term. Using Preqin's Hedge Fund Analyst to identify hedge funds with a track record of at least three years, Fig. 3 illustrates that those funds generating the highest percentage of positive monthly net returns are typically able to charge higher performance fees without pressure from investors for reductions. At the highest end of the scale, funds with a positive return every month have an average performance fee of 19.50%, while funds with positive performance in less than a quarter of the months studied have an average performance fee of 16.67%. This shows that the funds performing consistently well come at a higher cost to investors, whereas the funds which are performing less consistently come under more pressure from investors for lower performance fees.

Fig. 4 shows the rolling three-year volatility of single-manager hedge funds by the performance fee charged. The figure highlights that funds charging a performance fee of over 20% have tended to have less volatile performance compared to their peers with a lower performance fee. Higher performance fees are justified for managers achieving consistent net returns over the longer term and those investors looking for low volatility of net returns will are prepared to pay extra for this. The three-year Sharpe

Fig. 1: Annual Hedge Fund Performance by Performance Fee Charged , 2008 - 2013 YTD (As of 31st July)

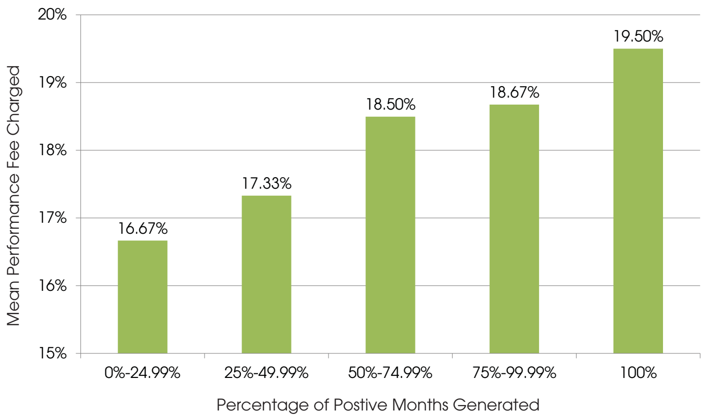
Source: Preqin Hedge Fund Analyst

Fig. 2: Comparison of Hedge Fund Net Returns by Performance Fee Charged

	Less than 20%	20%	More than 20%
2013 YTD Returns (As of 31st July)	6.35%	4.10%	7.29%
12-Month Returns	13.32%	8.69%	13.29%
3-Year Annualized	6.89%	7.98%	10.73%
5-Year Annualized	7.31%	8.34%	10.55%
Sharpe Ratio (2%) - 3 Years	0.70	1.18	2.11

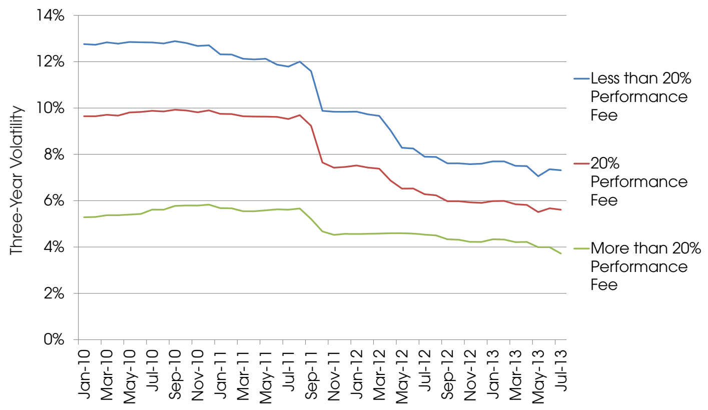
Source: Preqin Hedge Fund Analyst

Fig. 3: Mean Hedge Fund Net Performance Fee since Inception vs. Percentage of Positive Months*



Source: Preqin Hedge Fund Analyst

Fig. 4: Three-Year Rolling Volatility of Long/Short Hedge Funds by Performance Fee Charged



Source: Preqin Hedge Fund Analyst

** Based on hedge fund within a minimum three-year track record.*

ratio, measured with a risk-free rate of 2% for funds charging a performance fee of greater than 20%, was 2.11 as of 31st July 2013, which was significantly higher than funds charging 20% and those charging less than 20% which had Sharpe ratios of 1.18 and 0.70 respectively over the same timeframe. Therefore, the funds that charge the highest performance fees have been the most successful at providing strong risk adjusted net returns over the past three years.

Outlook

Investors have been demanding lower fees from hedge fund managers in recent years, moving away from the days when they seldom questioned the standard 2 and 20 fee structure. In this challenging fundraising environment, managers have been quick to respond to investor demands for lower fees, but despite some progress being made on these terms over the last 12 months, investors are still looking for further improvements. So why are some performance fees still so high, and is this bad news for investors? Not necessarily. Preqin data shows that funds charging higher performance fees are more successful at producing consistent long-term absolute returns. For investors seeking consistent, strong, risk-adjusted returns, the larger fees being charged by managers are justified and they have been willing to pay higher fees. However, that is not to say that funds with higher fees are generating higher net returns: in fact in the past 12 months it is the funds that have charged fees below 20% that have produced the strongest performance. Managers that fail to live up to expectations regardless of what fee they charge will find that investors will not hesitate to appeal against performance-based bonuses incongruent to returns, or even exit the fund completely.

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