



# FEE COMPRESSION ON THE RISE, IS IT FINALLY TIME TO SAY HINDSIGHT IS 2 AND 20?

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**D**uring the hedge fund industry's heyday, 2 and 20 — meaning a two percent management fee and twenty percent performance fee — became the quintessential fee structure. Although the 2 and 20 model was significantly higher than the typical fees associated with other active and passive investments, investors were willing to pay more because the average fund's performance justified

the higher fee. Take, for example, the HFRX Global Hedge Fund Index's stunning 16.1 percent return between its inception in 1998 to 2003. The HFRX Index's return was particularly impressive as compared to other indices during the same period, such as the S&P 500 Index (4.5 percent), the Bloomberg BC Aggregate Bond Index (8.4 percent), and the MSCI ACWI EX-US Index (4.3 percent). But, over the next 12 years (partic-

ularly those following the Great Recession) the average return for the HFRX Global Hedge Fund Index was an anemic 0.6 percent, which was 4.2 percent lower than the next lowest index (the Bloomberg BC Aggregate Bond Index). Another illustration of this trend is evident upon review of the HFRI Fund Weighted Composite Index over the past 30 years. From 1990 to 1993, the HFRI Index's alpha returns were an eye-popping

15.3 percent, followed by respectable alpha returns of 4.5 percent, 5.0 percent, and 6.6 percent for the years of 1994 to 1997, 1998 to 2001, and 2002 to 2005, respectively. Then, after a decade and a half, the index's alpha returns fell to around 3.3 percent from 2006 to 2009, -.09 percent from 2010 to 2013, and 0.2 percent from 2014 to 2017.

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The 180-degree turn in performance over the past decade has been linked to several factors, including the Federal Reserve Bank's zero interest rate policy following the Great Recession, enormous industry growth (which in 1997 had a little over 2,000 funds and just over \$100 billion in assets and now has close to 15,000 funds and over \$3.2 trillion in assets), and the misaligned interests between funds and their investors that this explosive growth in assets has created, among other reasons. Regardless, aside from the very top echelon of funds, the adage "come for the high fees, stay for the underperformance" seems to become more reflective of reality year after year. Thus, the question now becomes, will the vast majority of hedge funds be able to survive by maintaining the status quo with their current fee arrangements in the new world of robo-advisors, low-cost index funds, liquid alternative funds, and their own (in the aggregate) performance, or will a totally revamped fee structure hit virtually the entire industry?

In 2009, the average hedge fund charged around 1.6 percent in management fees and 20 percent in performance fees. By the middle of 2018, those amounts were slightly lower with the average management fee tracking at around 1.5 per-

cent and the performance fee at around 17 percent. This fee range would put the fee trend in line with the idea that fees could settle around 1.5 and 15 instead of old arrangement of 2 and 20 (besides, of course, for the select few over-performers in the industry). But simply reducing the fees leaves intact what many investors and commentators constantly complain about—similar or better performance by passive investment strategies and diverging interests between funds and investors. That is where an added emphasis on primarily alpha-based fees could come in to play.

#### ALPHA-BASED FEES

Several funds have begun experimenting with elevated levels of performance-based fees, lower percentages of management fees, and, in some cases, penalties for underperformance to address the criticism that the industry is not compensated on creating alpha returns but is instead favorably compensated by posting beta-level returns and pulling in extravagant amounts of assets. Although there are many variations of these primarily alpha-based fees (also known as Fulcrum Fees), their hallmarks are that funds do not receive compensation for beta-level returns, and the fund commonly accrues a higher percentage of the alpha-level returns.

## A SYSTEM EMPLOYING ALPHA-BASED FEES, AS THE ARGUMENT GOES, ALIGNS INTERESTS WITH INVESTORS BECAUSE THE STRUCTURE WILL RICHLY REWARD FUNDS THAT OVER-PERFORM MARKET RETURNS WHILE NOT OVERPAYING FOR UNDERPERFORMANCE.

A system employing alpha-based fees, as the argument goes, aligns interests with investors because the structure will richly reward funds that over-perform market returns while not overpaying for underperformance. This alignment of interests between funds and their investors is even greater when the management fees are reduced to a percentage seen for other active investments; or in the alternative, penalty payments for not achieving alpha, which provides a great amount of risk mitigation for investors.

To see how this works on paper, imagine a fund that has \$100 million in assets and charges a 1 percent management fee, a 30 percent performance fee on alpha returns, and returns 30 percent for returns below beta. In that example, if the market rises 8 percent in the first year, and the fund outperforms the market by 100

would gain \$1.3 million in fees (\$1 million from the management fee and \$300,000 from the 30 percent gain on the 1 percent over performance). On the other hand, a typical 2 and 20 fee structure without a hurdle rate would gain \$3.8 million (\$2 million from the management fee and \$1.8 million from the performance fee, which means a very small percentage of the fee is tied to an alpha-related return). Using the exact same assets-under-management numbers, imagine a world in which the market rose 8 percent, but the fund underperformed by 100 basis points. Here, the alpha-based fees fund would gain \$700,000 (\$1 million in management fees and a refund of \$300,000 due to underperforming the market by 100 basis points). For comparison, the typical 2 and 20 fee structure would gain \$3.4 million (\$2 million in management fees and \$1.4 million in performance fees for finish-

ing 100 basis points below the market).

Much like investing generally, it is challenging to know what the future holds. But with the advent of low-cost passive investing and the rapidly changing landscape for funds, it is likely that the fund industry will continue to feel fee compression going forward. What is certain is that most investors are willing to pay a premium for returns that exceed market-based returns, and they are becoming less inclined to pay a premium for returns they could receive on one of the hundreds of ETFs or Fintech apps that will charge 20 basis points yearly to secure beta-level returns. Our prediction is that this pressure will lead the hedge fund world to consider putting more of an emphasis on outperforming the market and less of an emphasis on asset accumulation as it moves forward into a reality where 2 and 20 is not the norm but the exception. ■