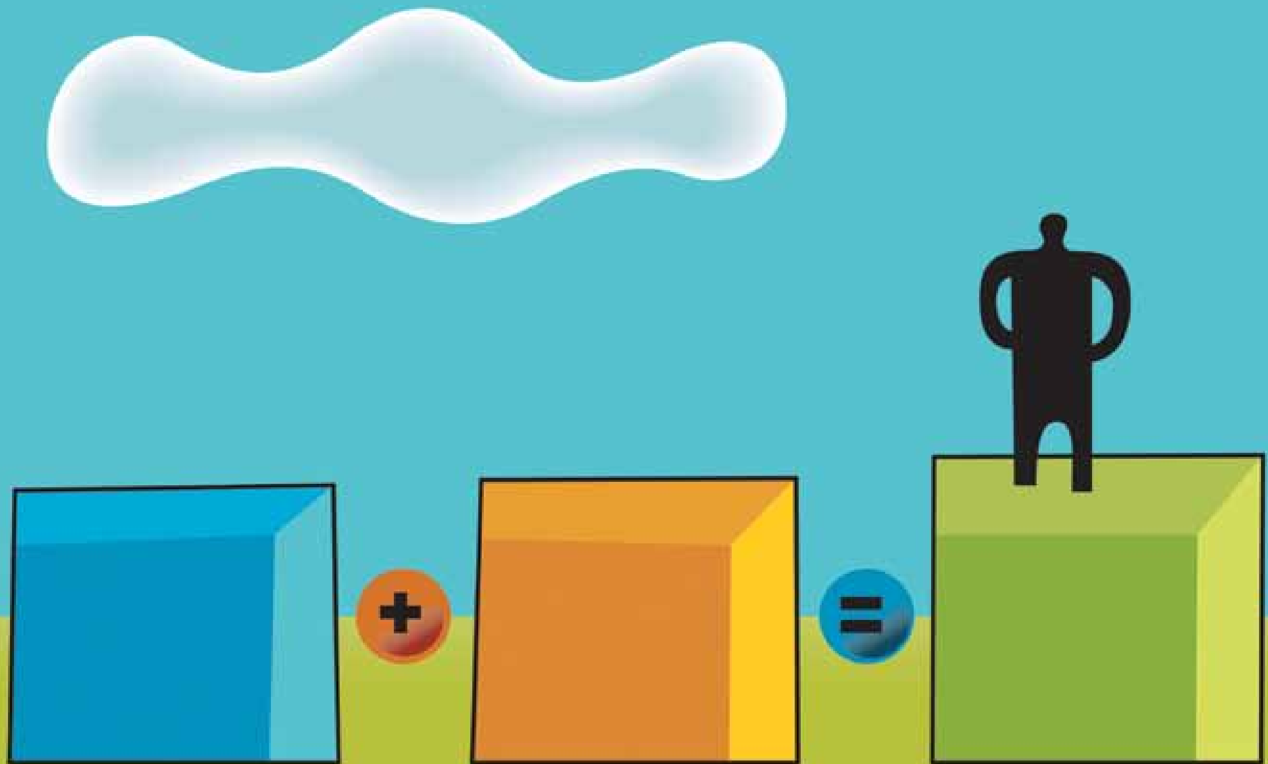


# LINKING INVESTMENT MANAGEMENT FEES WITH PERFORMANCE

BY GIRARD MILLER

*This article is from* One of Kind! A Practical Guide for 21st Century Public Pension Trustees *(Funston Advisory Services LLC, 2017).*

Knowing about fees is one thing; doing something about them is quite another. Public pension trustees are increasingly criticized from various corners for the fees they pay to investment managers (which collect enormous sums for the services they provide), and as expected investment returns decline, fees are gobbling up a larger share of pension funds' actual returns on capital.

This article focuses on overseeing how pension plan fees are managed. Oversight includes creating and sticking to a governance structure, and taking a coordinated team approach to minimize fee drag in the portfolio, while aligning the interests of alpha-seeking managers with those of plan beneficiaries. Trustees can use a variety of tools to better oversee investment managers' fees, including a fee policy, a fee workshop, an assessment of how well the interests are aligned, an annual fee report, and a fee management assessment.

Wall Street adage: "It's not what you earn that counts; it's what you keep."

At the end of the day, a prudently governed institutional portfolio strives to optimize net (after-fee) risk-adjusted returns. We will focus on the relationships and trade-offs between fee drag and risk-adjusted performance.

In a perfect world, the plan's capital allocation team would pay as little as possible for a given strategy's inherent risk to capital (beta) and align its interests with portfolio managers by tilting compensation to those that produce alpha (risk-adjusted outperformance). As you would expect, the world is not perfect and it's not that easy to quantify all these moving parts, let alone achieve optimal results. But there are some basic principles that will move pension plans closer to an optimizing system that is both transparent and efficient.

## FEE POLICY

Developing and formalizing a fee policy provides an advanced and practical application of the fund's investment beliefs. Working with staff and consultants, trustees can discuss and formalize core concepts to drive the management and oversight of investment fees. A written fee policy can address questions such as:

- How should trustees discharge their oversight responsibilities with respect to fees? What kind of fee reporting should trustees receive and how frequently?
- What parts of the portfolio are best suited for passive management? Which are best suited for internal management? What strategies require external managers that seek to outperform a well-understood market benchmark versus an absolute-return or expectational performance target?
- When is a low fixed fee preferable to a performance-based variable fee?
- Who will negotiate the fees, and at what point in the manager selection process? When and how are the results of negotiations reported to trustees? Who will assure compliance with contractual fee terms? How can staff be better trained for fee negotiating, management, and reporting?
- When should fulcrum fees[1] be preferred over flat fees or other performance fee structures?
- What guidelines should be followed in pursuing hard versus soft hurdles?[2] What constraints are placed on performance fees to avoid inducing excessive risk-taking by the manager?
- In most cases, a performance fee or carried interest with a hard hurdle should be preferred over soft hurdles. The latter effectively compensates the manager for beta (risk to the fund's capital) in addition to alpha (skill).
- How is risk considered in the fee structure? Can performance be risk-adjusted in the calculation of fees?
- What fee and expense information will become public information? Will any of your strongest-performing, but secretive, private equity managers forsake your business to avoid fee and expense transparency?
- How does the board define success in fee management and mitigation, relative to other investment objectives? Who should be reviewed or evaluated, and with what criteria?

## GETTING STARTED

A good starting point for any system is to conduct a special workshop on fees, how they work, what the plan is paying (both visibly and invisibly), who is responsible for management and oversight, and which fees should be targets for

further study. The focus should be on education at first, and then on governance and reporting/accountability. The workshop should set the stage for an ongoing oversight function that identifies opportunities for future improvement in fee structures and empowers the staff to bargain more effectively. Staff can run the workshop, or it can serve as the kickoff meeting for a consultant-led fee management assessment process (described later in the article).

At the end of the day, a prudently governed institutional portfolio strives to optimize net (after-fee) risk-adjusted returns.

## ALIGNMENT OF INTERESTS

Low flat fees are perfectly appropriate for passive/index investment strategies. For active public markets strategies (both equities and bonds), some plans prefer low fixed fees, while others prefer a performance fee that includes a low base fee to "keep the lights on at the management firm." Non-traditional alternative investments such as private equity, direct lending, non-core real estate, and hedge funds usually have performance fees with higher base management fees than other strategies, along with a carried interest, or a total-return performance, fee that is also much higher than prevailing fees in public markets.

Performance-based compensation is the key to stronger alignment of interests. Low fees mean nothing if a manager underperforms, and most stakeholders are tolerant of above-average fees that are competitively priced and driven by strong relative and absolute returns. However, excessive or poorly structured performance fees can reduce risk-adjusted returns to inferior levels that undermine the investment strategy itself.

It is not uncommon for total fees paid to managers of non-traditional investments to cost pension investors 200 to 500 percent more than the average fees paid to traditional active managers. The fund needs to know:

- Whether all fees and expenses are disclosed or reported to trustees, including indirect or "at source" fees. What fees and expenses are not presently reported in financial statements and included in budgets? Trustees may be shocked to see that budgeted and reported fees are only the tip of the iceberg with many of their alternative investments that deduct management and performance fees from investment returns instead of billing explicitly.
- Whether there a logical and demonstrable relationship between the historical and expected returns and volatility of investment strategies and asset categories, and higher fees, preferably paid for performance and not just the risk of the asset class? Analysis and graphics at the asset category level for non-traditional investments can be very illuminating.
- Whether incumbent public-markets managers' fees are systematically reviewed for competitiveness and whether underperforming managers have made fee concessions or restructured their fees to better reflect performance prospectively. Bear in mind that incumbent managers of closed funds (such as private equity) are typically a "done deal" and fee renegotiation isn't usually possible.
- Which managers have hard hurdles that require them to outperform a target return and receive their variable compensation only for the returns above that bogey?
- When prospective managers and general partners propose soft hurdles and "catch up" fees, are the fees competitive overall? Is their base fee justified if they are eligible for a catch-up? Are these managers asked to present an alternative hard-hurdle pricing option?
- How do staff and consultants approach "most favored nations" (MFN) pricing opportunities and barriers? Obtaining MFN pricing provides comfort that nobody is getting a better deal from a given manager for the amounts invested, but nowadays MFNs can be an impediment to negotiating even lower fees. (The manager would have to make fee concessions to other clients if your plan gets a fee below the MFN floor.) Creative customized investment strategies or account structures can sometimes secure even better pricing by making your investment a unique "one off" deal. A healthy discussion of strategies to overcome MFN barriers may be worthwhile.
- Whether plan consultants are proactive in fee mitigation. How are their interests aligned with the trustees' interests? What incentive or commitment do they have to focus on fees as well as performance? Do they seek "club pric-

ing" discounts from managers they underwrite? Do their reports focus on net returns rather than gross returns? Do consultants' projections of future investment returns by asset class fully account for fee drag, especially the data they provide to actuaries and trustees for use in formulating discount rates?

## ANNUAL FEE REPORT

An annual fee report can provide transparency and establish accountability for compliance with contractual fee arrangements, but most importantly, it can provide context for fee differentials in light of recent investment performance. The annual fee report can link directly with periodic assessments of risk-adjusted investment performance to provide a comprehensive perspective on which parts of the portfolio are contributing alpha and not just beta, and whether the fees paid for those services are properly aligned.

Statutes for the State of California now require public pension plans to report on fees annually, but the law applies only to certain fees and does not affect numerous investments made prior to its adoption date. Other states are following suit, or at least considering similar legislation, and the clear trend is toward greater visibility of the fees and expenses paid to investment managers. In the alternative investment world (such as hedge funds and private equity), the Institutional Limited Partners Association has produced a template for fee and expense reporting that has the advantage of standardizing the information provided by such managers.

To be useful, this raw fee information needs to be presented in context. Simply listing the dollar amount of fees paid or translating them into basis points doesn't tell anybody much about whether the fees were competitive, reasonable, and earned by performing better than what the fund expected or other managers performed. The fee report should include sufficient performance data to enable readers to compare fee levels with managers' performance.

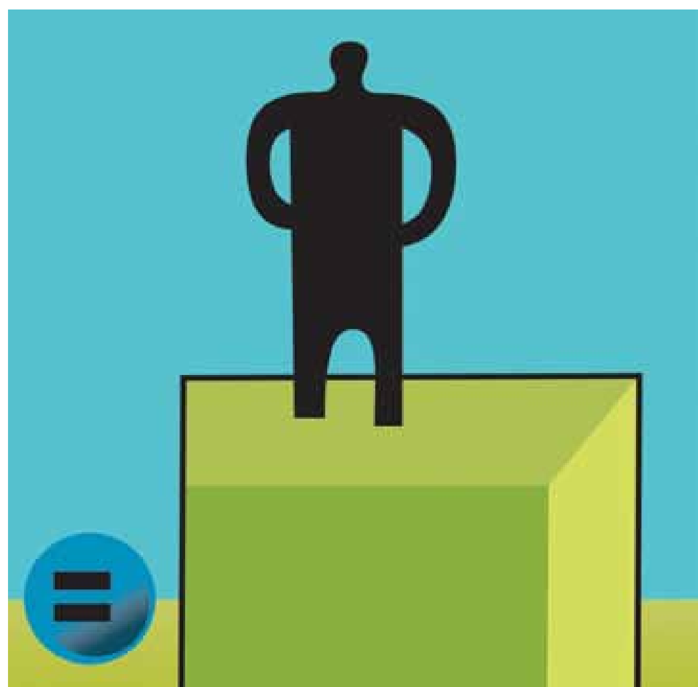
For recently hired managers, performance data can be labelled as "not meaningful" until their track record is established. One-, two- and five-year performance[3] is more meaningful for contextualizing the latest annual fees, which can be expressed in basis points of assets managed.

The annual fee report should include presentations and discussion of total fees and expenses for each manager, including all indirect costs, as compared with the fees billed directly to the plan. Governmental financial reports and many pension plan budgets do not include the indirect fees and expenses that are charged at the fund level, especially for funds of funds, where underlying partnership fee structures often escape reporting and analysis. The Institutional Limited Partners Association template seeks to secure this data at the general partner level, but it may not capture underlying fund fees, especially for funds of funds.

## FEE AUDIT VERSUS FEE MANAGEMENT ASSESSMENT

Some pension plans have undertaken fee audits to assure compliance with the contractual terms of their many investment managers' fee provisions. These engagements can provide comfort that the managers have not overcharged, and sometimes they unearth discrepancies that deserve correction.

To be done properly, a fee audit of alternative investments arguably includes a quasi-forensic review of investment returns and fund expenses. The costs of such investigations can outweigh the payoff from errors detected to the plans' benefit. Some have questioned the cost benefit of repeating such an exercise beyond spot checks by the internal auditor or work performed by the investment or finance staff. A more comprehensive, oversight-level approach that also warrants consideration is a fee management assessment.



A fee management assessment is a holistic process review of staff's current practices in screening, negotiating, and managing fees; the system's governance and oversight structure and practices; and consultants' fee consciousness and strategic opportunities to restructure fees prospectively. As with other management audits, the objective of a fee management assessment should be process improvement, team-building, improved fee management assessment transparency, and smarter strategies (not fault-finding or finger-pointing). In some cases, the fee management assessment may produce strategies to streamline, adjust, or re-focus the portfolio if fee drag is impairing returns in certain asset classes. The latter approach is considered more likely to produce significant long-term cost savings and portfolio performance improvements, and it can be undertaken separately or along with a fee audit.

Developing and formalizing a fee policy provides an advanced and practical application of the fund's investment beliefs.

## LINKING THE ANNUAL FEE REPORT TO RISK-ADJUSTED PERFORMANCE ATTRIBUTION

The net returns of each manager and each asset class or strategy are essential information needed to perform a meaningful risk-adjusted investment-return evaluation, so the contributors and detractors to portfolio performance can be more clearly identified. This includes the strategic asset allocation and portfolio structure recommended by staff and consultants and approved by the board, the contributions of staff and/or consultants in manager selection, and then the net-of-fees performance of the managers themselves. An annual fee report can provide the bedrock data for net risk-adjusted performance attribution and should shine a spotlight on any existing fee drag. However, a fee management assessment can provide a forward-looking roadmap to improved portfolio performance.

## CONCLUSIONS

The oversight and management of investment fees has attracted stakeholder and media attention. Whatever its form, periodic fee reporting should include enough of the granular information on total fees and "net-net" returns categorized by relevant asset categories or strategies to facilitate performance attribution using the same database to present net returns. Fee workshops and formal assessment processes can help trustees to review and evaluate the effectiveness of all parties involved in the investment decision-making process, including risk management and fee management as well as the traditional performance attribution that is most often focused only on the money managers.

A three-dimensional oversight model (risk, cost, performance) will position trustees to receive useful portfolio performance attribution reports that they can make use of, allowing them to discharge their fiduciary responsibilities incisively. The linkage between fees, results, and strategies will become far more evident through such oversight.

**Notes**

1. Fulcrum fees are centered on a base fee that is adjusted up or down based on performance relative to a clearly defined benchmark. They are usually symmetrical with floors and caps.
2. Hard-hurdle performance fees compensate managers only for returns that exceed the hurdle rate of return. Soft hurdles compensate the manager for all returns above zero, once the bogey has been achieved, and usually include a "catch up" formula to accelerate compensation above the investor's "preferred return."
3. For private equity funds, especially venture capital, a longer fee crystallization and performance period is usually necessary.

GIRARD MILLER has worked for and with public retirement systems for several decades in the capacities of pension-plan CIO, consultant, CEO of a defined contribution plan provider, technical expert and trainer, author and columnist, and plan sponsor. Most recently, he was CIO of the Orange County (California) Employees' Retirement System, where he produced award-winning fee reports, system's fee policy, and strategies to mitigate fees through collaborative procurement. Previously, Miller was a senior strategist at the PFM Group, a voting member of the Governmental Accounting Standards Board, president of Janus Mutual Funds, chief operating officer of Janus Capital Group, chief executive officer of ICMA-RC, and director of technical services for GFOA.

*See GFOA's best practice,* "Investment Fee Policies for Retirement Systems," *for recommendations for minimizing the impact of investment management fees on portfolio returns.*