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HERE'S THE THING!

In our last issue of **Quaero** *JOURNAL***,** we scratched the surface on fee transparency. I opened the discussion with several theoretical arguments against "the industry standard" fee structure that charges bps as a % of assets and I promised to share my radical solution to the problem in this, Issue 3.

My novel idea calls for all investment management fees to be quoted in absolute dollar (or other local currency) terms, what we shall refer to as "flat fees". Additionally, active management strategies should be compensated with a pre-determined share of "alpha" generated against a carefully developed, passive benchmark. In short, I argue for more transparency and for more performance fees.

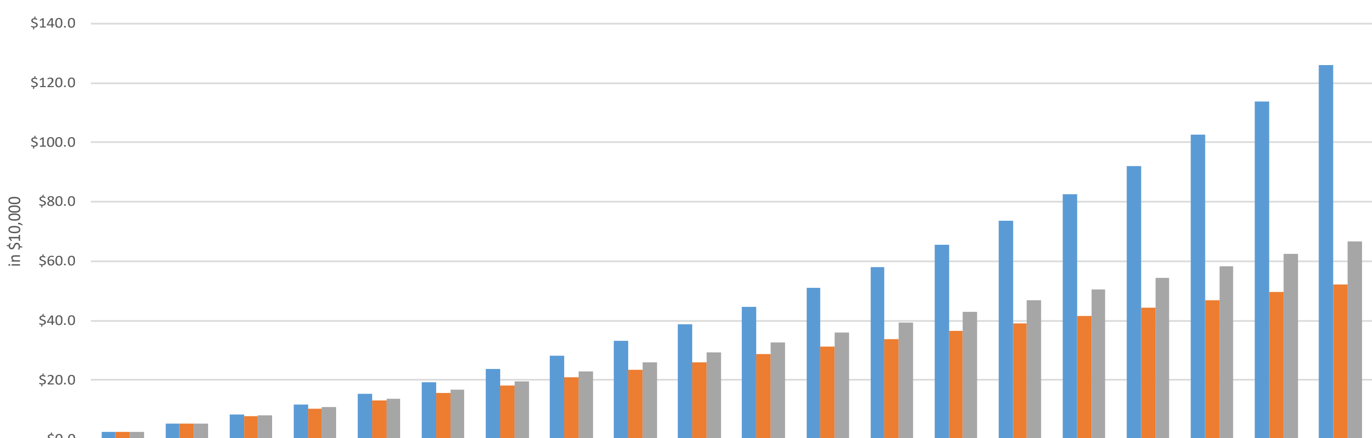
"BPS VS. FLAT FEES": IT'S IN THE MATH

If it is true that an excellent way to test your idea is to put it in writing, then surely an even better way is to put it into a spreadsheet. So on the issue of "bps vs. flat fees" I have done both, and here are my findings.

Let's begin with a set of expectations derived from observations of capital markets history. In our last issue of **Quaero** *JOURNAL* we suggested that from market equilibrium, *before* transaction costs, one might reasonably expect real returns of 7% on equities and 3% on long bonds, thus 5.4% on a balanced fund using a 60/40 mix. Today one might hope for another 0.6% of manager generated alpha yielding a gross real return of 6.0% on a balanced, diversified portfolio. Now let's assume inflation of 2.5% per annum and first year fees at 50 bps (or $26,063) on an account with opening market value of $5 million. With this as our base case, ("**Scenario #1**") we developed a spreadsheet to test the outcome, over 20 years, of our bps vs. flat fee alternatives. In fact, we tested three fee alternatives – 1) bps only, 2) flat fees only, and, for those who feel kindly disposed towards their investment manager and who would therefore like to offer an inflation protection clause, 3) flat fees adjusted for inflation. The results (see Chart 1 below) are enlightening. Over 20 years our bps formula assesses the client with fees of $1,260,826 vs. flat fees at $521,250 and inflation adjusted flat fees of $665,758. Wow! We can certainly make an excellent business case for the bps formula – from the investment manager's perspective, that is. But what about our poor client? Well, that depends . . . it depends on what kind of value added the investment manager brings to bear on the problem.

CHART 1

Cumulative Fees Over 20 Years



	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
■	$2.6	$5.4	$8.5	$11.8	$15.4	$19.4	$23.6	$28.2	$33.2	$38.7	$44.6	$51.0	$57.9	$65.4	$73.6	$82.4	$92.1	$102.5	$113.8	$126.1
■	$2.6	$5.2	$7.8	$10.4	$13.0	$15.6	$18.2	$20.9	$23.5	$26.1	$28.7	$31.3	$33.9	$36.5	$39.1	$41.7	$44.3	$46.9	$49.5	$52.1
■	$2.6	$5.3	$8.0	$10.8	$13.7	$16.6	$19.7	$22.8	$25.9	$29.2	$32.5	$36.0	$39.5	$43.1	$46.7	$50.5	$54.4	$58.3	$62.4	$66.6

MY RADICAL SOLUTION

To further develop our thinking we tested three more scenarios providing for Alpha generating possibilities ranging from 0.0% to 2.0% per annum over our 20-year time horizon. Key results appear in the Chart below, from which you can readily draw your own conclusions, but the core of our idea is as follows:

	Chart 1 20-Year Outcomes	Performance Fee Percent	Scenario #0 (0% Alpha After Fees)	Scenario #1 (0.6% Alpha After Fees)	Scenario #2 (1.0% Alpha After Fees)	Scenario #3 (2.0% Alpha After Fees)
1	Expected Beta		$12,219,715	$13,061,794	$13,659,175	$15,289,725
2	Expected Alpha		$0	$1,451,310	$2,529,477	$5,662,861
3	Expected Inflation		$5,657,276	$6,047,127	$6,323,692	$7,078,576
4	Expected Total Return		$17,876,991	$20,560,231	$22,512,344	$28,031,162
5	**Active Fees (bps=$)**		**$1,176,148**	**$1,260,826**	**$1,321,019**	**$1,485,793**
6	Flat Fee		$519,750	$521,250	$522,250	$524,750
7	**Flat Fee Adjusted for Inflation ("AFI")**		**$663,842**	**$665,758**	**$667,035**	**$670,228**
8	Alpha After Fees		-$663,842	$785,553	$1,862,442	$4,992,633
9						
10	Performance Fee	20%		$157,111	$372,488	$998,527
11	**Performance Fee**	**30%**		**$235,666**	**$558,733**	**$1,497,790**
12	Performance Fee	40%		$314,221	$744,977	$1,997,053
13	Performance Fee	50%		$392,776	$931,221	$2,496,317
14						
15	Total Fees (Flat AFI + Performance)	20%	$663,842	$822,868	$1,039,523	$1,668,755
16	**Total Fees (Flat AFI + Performance)**	**30%**	**$663,842**	**$901,423**	**$1,225,767**	**$2,168,018**
17	Total Fees (Flat AFI + Performance)	40%	$663,842	$979,979	$1,412,012	$2,667,281
18	Total Fees (Flat AFI + Performance)	50%	$663,842	$1,058,534	$1,598,256	$3,166,544
19						
20	Client Retained Alpha	80%		$628,442	$1,489,954	$3,994,106
21	**Client Retained Alpha**	**70%**		**$549,887**	**$1,303,709**	**$3,494,843**
22	Client Retained Alpha	60%		$471,332	$1,117,465	$2,995,580
23	Client Retained Alpha	50%		$392,776	$931,221	$2,496,317

1. Our preferred solution is the concept of a "flat fee adjusted for inflation" which supports the contention that active management bears considerably more costs than does passive management and assumes that those costs will rise in line with inflation through time. The buyer agrees to a fee that will cover those costs and provide a reasonable operating margin. In the example above we have assumed (generously perhaps) that the appropriate starting fee in dollars is equal to the fee that the manager would normally charge were he/she applying their normal bps formula – in this case the dollar equivalent of 50 bps.
2. The highlighted rows in Chart 1 tell the essential story. Over 20 years the traditional bps formula generates fees ranging from $1.1 to 1.4 million, depending on the chosen scenario (see row 5 highlighted red). By comparison our flat fee adjusted for inflation assesses fees ranging from $663,000 to $670,000, (row 7 highlighted green).
3. If however, we concede the value of performance fees and we settle on a performance fee equal to 30% of the calculated Alpha ***after*** deducting the assessed flat fee adjusted for inflation, investment managers retain the ability to achieve total fees equivalent to, or better than the traditional bps formula, (row 16 highlighted green) while the client rightfully retains a healthy percentage of the Alpha generated with his/her capital (row 21 highlighted green).
4. Clearly, the numbers in Chart 1 can be easily modified for different asset classes, Alpha expectations and individual predispositions regarding the appropriate emphasis on flat fees vs. performance fees. But the essential point is made, and . . .

HERE IS A FEE STRUCTURE THAT:

- insists on regular accountability on the part of the asset manager by eliminating automatic salary increases in every year that asset values increase,
- lends clarity to fee negotiations by directing investor attention to the value of services provided for dollars paid and to the important question of the reasonability of the industry standard (bps) itself,
- avoids the deception of the industry standard that seems so very reasonable when measured against the unrealistic return expectations of the uninitiated,
- enables active investment managers to generate reasonable profit margins on their incremental (i.e. higher than passive management) cost base and to further enhance their firm's profitability by out-performing carefully established benchmarks to deliver excess profits net of fees,
- in no way precludes investment managers from structuring first year fees to limit the size of individual accounts or total assets under management to protect their limited alpha generating potential for any given strategy,
- truly does align investment manager interests with those of the client,
- serves to rebuild investor confidence in the motives of our active management community and,
- to Ashby Monk's concerns, represents one important step on the road to "militant fee and cost transparency . . . to save capitalism from endemic short-termism and rent seeking and to unlock the capital we require to finance critical projects."

Or have I missed something?

Oh, BTW, I believe that the spreadsheet I used to think this through could prove helpful to investors (particularly institutional and high-net-worth investors) who would like to use these ideas to work out alternative fee arrangements with their investment managers. If you would like a copy, please call; I will be happy to share it with you.

OUR HOPE:

trans·par·en·cy

synonyms: translucency · limpidity · clearness · clarity · openness · accountability · straightforwardness · candor

This is our hope.

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