Performance Fees – They Win, You Lose

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As the old saying goes, the only certainties in life are death and taxes. But let's not forget about fees. Just like taxes, fees are a necessary evil. And for investors, they come in all forms. One of the most poorly understood is the performance fee.

A performance fee is an arrangement whereby a manager takes a portion of a fund's annual profits, in addition to a base fee, as a reward for outperforming a benchmark or specified return (or, in some instances, for simply providing a positive return).

While performance fees are widespread in hedge fund land, they have also crept into the mutual fund world, although they are far less prevalent here. The most common fee structure is known as "2 & 20". The manager charges a base fee of 2%, and collects a performance fee of 20% of the fund's outperformance over the benchmark. For example, if a fund's benchmark is the S&P/TSX Composite Index, and said fund produces a return of 25% in a calendar year when the TSX gains 15%, the manager would take 20% of the outperformance. In our example, this would equate to an additional 2% in fees (20% multiplied by the 10% outperformance). So, in total, the fund's fee for the year would be 4%.

In years when the fund underperforms its benchmark, no performance fee is taken, but the manager still receives the base 2% fee. Some funds that charge performance fees have a "high-water mark" in place, whereby the manager cannot collect a performance fee following periods of underperformance until any ground lost against the benchmark is regained. In other words, they have to catch up to the benchmark before they can start collecting a performance fee again.

Performance fees are justified on the basis that they are used to reward and retain talented managers who often have a greater tool set and expertise in a form of non-conventional investing (such as short selling or the use of derivatives). In theory, if a manager consistently beats the benchmark, she deserves to be rewarded. When these fees are brought to light, however, investors are often surprised to discover just how much of their return they may be giving up to their manager. Under the 2 & 20 structure, you could be forgoing over half of your return to fees over the long term.

To illustrate, let's look at two funds – the Chou Associates Fund and the Sceptre Equity Growth Fund. We chose these funds because they have long track records – both have 22 years of performance history; they have beaten their respective benchmarks over the long term; they are run by skilled, highly reputable managers (the Sceptre Equity Growth Fund was managed by Alan Jacobs from 1993 to 2007, and Mr. Jacobs was largely responsible for the outperformance of the fund over the period analyzed); and they are similar to hedge funds in that the managers have a lot of flexibility in pursuing their mandates. (Note: neither fund actually charges a performance fee.)

As at December 31, 2008, the Chou fund produced a 22-year compound annual pre-fee return of 12.2%, according to our calculations. A $10,000 investment made at the beginning of the period would have grown to roughly $126,000 by the end of 2008. Similarly, the Sceptre fund produced a pre-fee return of approximately 12.3% over the same period. A $10,000 investment would have grown to nearly $128,000.

Both funds charge reasonable fees. At the time of our analysis, Chou Associates had a Management Expense Ratio (MER) of 1.73%, while Sceptre Equity Growth charged 1.64%. If these MERs were held constant over the life of the funds, Chou's fund would have achieved a return of 10.4% (for an ending value of $88,900) after fees by the end of 2008, while Sceptre's fund would have grown by 10.6% per annum ($91,500). (Note: the MERs for the two funds have changed slightly over the past 20 years. Our calculations are for illustrative purposes only.) As calculated by the difference in ending wealth between the pre-fee and post-fee figures, fees ate up roughly 29% of the Chou fund's return, and 28% of the Sceptre fund's return.

Now, let's assume both funds charge a 2 & 20 fee (with a high-water mark), rather than their current MERs. Based on their mandates, we'll use a benchmark of the MSCI World Index ($Cdn) for the Chou fund and the BMO Small

Cap Index for the Sceptre fund. Chou Associates would have produced an annual compound return of 9.3% ($70,200), while Sceptre Equity Growth would have grown by 9.2% ($68,800). Under this scenario, fees would have eaten up close to 50% of each fund's gross return. If no high-water mark were in place, fees would have consumed over half of each fund's return.

HYPOTHETICAL PERFORMANCE AND GROWTH OF $10,000 (1987-2008)

Fund	Pre-fee		Current MER		1 & 10 (HWM)		2 & 20 (HWM)	
Chou Associates	12.2%	$126,000	10.4%	$88,900	10.7%	$92,700	9.3%	$70,200
Sceptre Equity Growth	12.3%	$128,000	10.6%	$91,500	10.6%	$92,500	9.2%	$68,800

	1 & 10 (No HWM)		2 & 20 (No HWM)	
Chou	10.4%	$87,400	8.6%	$61,700
Sceptre	10.5%	$89,200	8.8%	$63,600

HWM = high-water mark

Admittedly, the long investment time horizon amplifies the impact of fees on performance in our examples. If we looked at a shorter time period, the difference in ending wealth would not be as dramatic. The results are nonetheless a good example of the power of compounding and illustrate why investors should not gloss over fees when making investment decisions for the long run.

As illustrated in the accompanying table, we ran the numbers using a variety of hypothetical fee structures to determine the impact that performance fees can have on returns.

The numbers speak for themselves. Interestingly, the 1 & 10 fee scenarios produce very similar returns as those calculated using the funds' current MERs. Perhaps it's not surprising that more hedge fund managers are facing pressure to move toward this structure.

The 2 & 20 fee structure eats up 2.9% to 3.1% of each fund's annual return (12.2% - 9.3%; 12.3% - 9.2%). In other words, this fee structure is equivalent to an MER of about 3% in our examples. By all accounts, that's pretty steep. And if no high-water mark were in place, the fee would be closer to 3.5%. Moreover, in certain years of significant outperformance, the total fee would have exceeded 8%. Yet, in years of underperformance, the manager would have still collected a healthy 2%.

On the other hand, it can be argued that if these funds charged performance fees, the resulting high fees would be earned. After all, it is only by beating the market that the manager collects the additional fee.

To this observer, the 2 & 20 structure is egregious. For managers who choose to charge a performance fee, 1 & 10 is much more "unitholder friendly". Managers are still rewarded for outperformance without milking investors. Better yet, if managers had a significant amount of their own money tied up in the funds they manage, wouldn't any outperformance be reward enough?

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