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Sustainable fee structure helps rebuild trust

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The recent announcement by Zurich-based sustainable investment specialist SAM of a new “sustainable” fee structure has put the spotlight once more on the way asset managers are rewarded.

The new fee scheme, for institutional mandates of €50m (£44m, $70m) or more, combines a fixed fee amount to cover the costs of setting up and running the mandate with a performance-based fee. The incentive structure more closely aligns the interests of asset owners with their investment managers, says SAM, which is part of Dutch group Robeco.

The new structure is a move away from the traditional **industry fee structure**, where charges are based on the amount of funds ùnder management. “Fees linked to a percentage of assets under management do not always reflect the costs of service provision and, investors fear, can result in a misalignment of interests,” says Mark Geday, funds and asset manager partner at Herbert Smith, the law firm.

“On the other hand, in recent years, when assets under management have fallen, such structures have put the managers’ business models under real strain.

“This structure [fixed fee plus performance fee] offers greater transparency for investors and greater predictability for the managers.”

The traditional fee model overcompensates asset managers in rising markets, implies no sharing of economies of scale with the client and bears no relation to the value added by the manager in the process of realising the client’s long-term investment objectives, SAM says. “By addressing these flaws, the new fee scheme aims to transform the relationship between asset manager and asset owner into a value-oriented long-term partnership.”

Many asset managers, owned by larger financial conglomerates, have been beholden to the needs of the parent company to produce growth, rather than to those of the customer, says John Wilcox, chairman of Sodali, a governance consultancy.

“There is evidence that many institutions were ignoring the interests of customers in favour of themselves or their shareholders.”

SAM’s initiative, which the group says has been well-received by clients, was a smart move, according to Matt Christensen, chief executive of the European Social Investment Forum.

“It shows they realise the winds are changing around how pension funds and asset managers work together. It is far better to be proactive than to sit on your hands and let change happen to you.”

David Blood, co-founder of Generation Asset Management, says incentive structures are crucial in realigning the interests of fund managers with asset owners.

“If you pay people on the basis of quarterly or annual returns, you should not be surprised if they perform on that basis.”

Generation is one of a number of managers, including Hermes Asset Management and Newton Investment Management, which charge a multi-year rolling performance fee to discourage excessive risk-taking just to meet performance targets.

“We think it is best practice and we would love to see more institutional investors demanding it – and more managers offering it,” Mr Blood says. Asset owners should be moving their managers towards this structure, he adds, but it can be difficult for an incumbent manager to make the shift.

Offering performance fees is a real vote of confidence in your own investment strategy, points out Helena Morrissey, head of Newton. “If you have a process that you believe in, it makes sense to offer performance fees with a lower base fee.”

Fees based on the amount of funds under management encourage managers to spend their time chasing new business rather than concentrating on their existing customers, she adds.

Performance fees also benefit asset owners because they ensure they only pay for genuine outperformance rather than the wider gains that accrue across the board in a bull market, says Farah Foustok, chief executive at

ING Investment Management in Dubai. “The strategy must be an actively managed one to justify a performance fee, otherwise the investor may as well invest in an ETF,” she adds.

Saker Nusseibeh, head of investment at Hermes Asset Management, says: “Asset owners will want to be assured they are paying a fee for alpha. You don’t need to pay a lot of money for beta.

“However you need to see alpha over the long term, not just for one year.” Hermes requires fund managers to invest part of their bonus alongside their clients.

“We often look for managers to be co-investing as a way to align interests,” says Peter Hill, global co-head of liquid alternatives at pensions consultancy Hewitt, “and we think the high water mark principle is important.”

This ensures that investors do not pay twice for the same performance – if a fund grows from a baseline of 100 to 120 – which triggers payment of a performance fee – and then falls to 80, the fund cannot collect another fee until it exceeds the high water mark of 120.

A cap on performance fees is also important, he adds. “You do not want your manager to take risks just so they can earn the fees.” Some investors are also asking for deferred fees and clawback structures that mean performance fees are returned if the fund has negative returns, says Lisa Fridman, associate director, Pacific Alternative Asset Management Company, a fund of hedge funds manager.

“There is definite pressure on fees,” she adds. “Early-stage hedge funds, for example, are finding it difficult to raise funds so there is a lot more flexibility now on fee structures.”

While SAM, which lost its chief executive last week because of differences over the future strategy of Robeco, is focused on sustainable investing, such changes will not be restricted to this particular niche of the market.

“It’s clear to me this is the way of the future,” says Hermes’ Mr Nusseibeh. “There will be a clearer delineation between passive and active management and it will be a global phenomenon.”

Pars Purewal, UK asset management leader at PwC, points out that “performance fees have as many critics as they do supporters – particularly if they are triggered by performance relative to an index and have to be paid even if the fund falls, but by less than the index they are benchmarked to”.

Too often, performance fees “have ended up being a way of charging more fees, with much the same base fee and upward-only performance fees”, says David Norman, managing director of TCF Fund Managers.

“I haven’t seen many performance fees that give money back when the returns are negative – and when the fund drastically underperforms it is wound up (resetting the base level).”

Clearly, it is important to get the details right, but as long as the base fee is set at the right level, increased use of performance fees can help the industry to rebuild the trust it has lost, according to Ms Morrissey of Newton, which offers clients a credit if a fund underperforms.

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