

# TRULY JUSTIFIED?

Institutional investors are used to paying lower management fees and in most cases no performance fees, given their experience and mindset with traditional asset managers. When it comes to hedge funds, institutional investors are facing fees that are not only layered, as the bulk of them gain hedge fund exposure through fund of funds, but the absolute management fee is often a quantum of the traditional management fees they are used to paying. They are also asked to pay a performance fee, usually with no hurdle, but with a high watermark in place.

Institutions will typically pay a 2% management fee and 20% performance fee to the underlying managers. They then pay between 1% and 2% management fee and 10% to 20% performance fee to the fund of fund manager! This adds up to between 3% and 4% annual management fee and between 30% and 40% of profits in the form of a performance fee. Wow! Allow me to wipe the sweat off my brow.

But let us assess whether this is justified. The most appropriate way of evaluating hedge funds is akin to listed stocks. Consider a publicly-traded stock on any exchange has a finite amount of capital it employs to generate the best earnings possible, irrespective of the interest rates, the oil price and other macro fundamentals. The value of this stock is determined by its after-tax earnings multiplied by its rating (price earnings multiple) the market has bestowed on it, which results in the stock's market capitalisation. There are several resources, which all have their associated costs; such as raw material, labour, and additional functions such as administration that contribute into helping this stock generate profits. These costs are deducted from earnings resulting in the after-tax profit, which is one of two key variables in the valuation of the company.

So how does this compare with underlying hedge fund operations? First, there is an amount of capital, similar to a stock, that is allocated to the single manager hedge fund! Second, the hedge fund manager is tasked with producing absolute earnings in all market conditions. The hedge fund manager's operation, its *raison d'être*, is nothing more than a profit-generating organisation at its core! Costs are associated with a listed equity and a hedge fund, but one's costs are below the line, while the other's are above it. Either way the investor is paying for the generation of profits. If one throws away the parochial lenses in which so many of these issues are seen, it will be clearly evident all profit generation has to be paid. Returns from the long-only side come from multiple expansion and/or increase in earnings, but that earnings generation has been well paid for.

Now listed stocks and single manager hedge funds are realistically compared, the underlying hedge fund management operations should be considered in the same light as stocks, and that costs should not even feature as a consideration. So where does that leave institutions seeking hedge fund exposure? Most likely they will opt for the fund of funds route due to the diversification benefits – itself a daunting task! Even at this level the fund of fund charges are significantly more than traditional charges. Is this justified?

## ACCESS ALL AREAS

A vital consideration is the accessibility of information as well as the complexity of the investments, when considering appropriate remuneration. A traditional manager has online research data available by subscribing to a service provider. This puts them in a position to access consensus earnings forecasts for most tradable stocks around the world as well as market ratings and ratios within seconds.

By contrast a fund of fund manager has

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limited information available through databases. The only way for them to garner information is by sending questionnaires, or making on-site visits. It is often the case a traditional equity manager can be based out of a remote location, yet it is imperative a hedge fund of fund manager is domiciled in close proximity to the underlying hedge fund managers.

So where does this leave us? Institutions should look at the after-cost return on a risk-adjusted basis and this will speak volumes. Due to the similarities of stocks and hedge funds, institutions should be looking at the respective returns on an after-cost basis. Fund of hedge funds are in the business of choosing the best performing stocks or managers.

Certainly hedge fund of funds have a more information exhaustive task in managing hedge funds when compared with traditional managers investing long-only equity portfolio. Therefore the current higher costs are justified, but increasing participation of pension fund investors and more intensive investments in information accumulation, one can see increasing pricing issues becoming a dialogue between institutions and fund of funds managers.

**Robbie Alexander** poses that controversial question: do hedge funds deserve their fees?



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