When performance-fee structures end up costing investors

Reversal at prominent fund and new academic research suggest hedge-fund costs can be higher than they seem

By Leo Almazora

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For cost-conscious investors in hedge funds, the performance-based component of the fees charged by managers provides much-needed reassurance that, to some extent, they pay for what they get. But when performance suddenly vanishes, investors may find themselves paying more than they thought.

That was the point driven home by *Wall Street Journal* columnist Jason Zweig, who cited the case of SkyBridge Multi-Adviser Hedge Fund Portfolios. A fund-of-funds, it charges investors as little as US$25,000 for access to a basket of strategies run by about two dozen different managers, each of which would typically require millions of dollars as the cost of entry.

"From 2009 through 2013, SkyBridge earned an average of 14.5% annually after expenses," Zweig said, noting that it beat the HFRI Fund of Funds Composite Index by almost 10 percentage points annually over the period. It also nipped at the heels of the S&P 500 while offering investors less jarring performance bumps.

That ended in March, when Skybridge lost 24.7% amid coronavirus-driven losses. In the 10-year period terminating in the end of February, a US$100,000 investment in SkyBridge would have grown to nearly US$186,000; by the end of March, that 10-year gain would have deflated into US$186,000 – far behind what an investor could have gotten from a high-quality bond fund.

While SkyBridge's returns plunged in March, its fees didn't fall. According to Zweig, it charges a 1.5% management fee, with 0.85% annually going to brokerage and investment-advisory firms that sell the fund. Its underlying funds also pass through higher expenses via management and incentive fees totalling 5%. All told, even though SkyBridge doesn't charge a performance fee itself, its total costs end up exceeding 7.1%.

Anthony Scaramucci, founder and co-managing partner at SkyBridge, told Zweig that an investor who puts 3% to 8% of their total portfolio in their fund-of-funds would find that it is "a return stabilizer" in the long run. He also maintained that structured credit will "do phenomenally well in a recovery," and that the additional fees investors pay SkyBridge are well worth the opportunity to invest with some of the world's most successful money managers.

But that doesn't exactly square with new academic research conducted by Itzhak Ben-David and Justin Birru of Ohio State University and Andrea Rossi of the University of Arizona. According to Zweig, the finance professors found that from 1995 through 2016, the management and incentive fees paid by hedge-fund investors amounted to 3.44% annually on average, but they earned net returns of just 1.96% annually.

"Nowadays, many hedge funds take a hefty cut of any return above zero, so long as the portfolio isn't below its previous high," Zweig said, referring to a [2019 review of hedge-fund fee structures and other fee-moderating arrangements] conducted by the Alternative Investment Management Association. The ones in the study, he said, produced cumulative losses before expenses of US$1.3 billion between 1995 and 2008, but the managers still took in almost US$52 billion in performance payments.

The upshot, according to Zweig, is that investors in the hedge funds studied had to pay 64% of the excess returns they earned back to the managers. Between those costs and the taxes they had to pay on their investments, as well as the extra risk at many of the funds, and it appears that hedge-fund investors should expect a little less bang for their buck.

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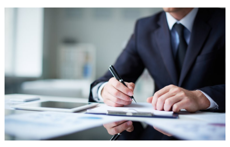

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