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How Hedge Fund Performance Fees Fail Investors

BY ITZHAK BEN-DAVID, JUSTIN BIRRU, ANDREA ROSSI *August 3, 2020*

In the hedge fund industry, there is a material disconnect between funds' lifetime performance and lifetime incentive fees for managers. A new study analyzes the performance of investor capital flows among nearly 6,000 hedge funds and finds that when management fees are considered, hedge fund managers received 64 percent of the dollar excess returns before all fees.

Hedge funds are often used as an example of aligned interests between managers and investors.

The common contract in the industry includes a fixed management fee and a variable performance fee, which is sometimes called an incentive fee. The management fee is typically in the range of 1-2 percent, and the incentive fee is typically 20 percent of the gains earned over a specified period, such as a quarter or a year. Managers receive performance fees only if the gains net of the fixed management fee are higher than the hurdle rate, or risk-free rate, and higher than the previous highest valuation of the portfolio, called a high-watermark provision. The latter provision ensures that investors pay incentive fees only on new gains.

This asymmetric contract creates severe distortions. In our new working paper, we analyze the performance of investor capital flows of nearly 6,000 hedge funds from 1995 to 2016. In

our sample, the average incentive fee is 19 percent, yet over a 22-year period, hedge fund managers collected nearly 50 percent of the profits made by investors above the hurdle rate and after management fees.

Further, when management fees are considered, hedge fund managers received 64 percent of the dollar returns above the hurdle rate before all fees. These results are not due to a particular episode in financial markets. Instead, they reflect a long-term phenomenon.

Three mechanisms lead to divergence of the actual fees paid to managers from the contractual rate. In the following examples, we assume that investors are protected by a high-watermark provision, and for simplicity, we ignore management fees. The incentive fee is 20 percent of annual gains.

First, profitable funds receive incentive fees that equal a fraction of the gains, while funds generating losses do not receive incentive fees but do not refund investors for their losses, either. This means the aggregate fees paid by investors will be positive, but aggregate returns can potentially be quite small, or even negative, if a large number of funds generate losses.

For example, consider an investment split equally between two hedge funds, A and B. Fund A generates a gain of 25 percent, and Fund B generates a loss of 25 percent. Because gains and losses cannot be offset across funds, an investor in both funds pays the manager of Fund A 5 percent of the invested amount (i.e., 20 percent of profits), although, in aggregate, the investor has a zero return.

Second, a similar mechanism takes place within a given fund over time. Consider a $100 investment in a fund that generates a gain of 25 percent in year one and a loss of 20 percent in year two. After the first year, the investor pays $5 in incentive fees on the $25 gain. However, by the end of the second year, the investor has lost all of the first year's profits but has nevertheless paid performance fees, which are not recoverable, to the hedge fund manager. The manager gets $5, but the investor gets $0.

Third, consider the fund in the previous example. At the end of the second year, the investor is underwater, with a cumulative loss below the previous high at the end of the first year. As a result, the investor has fee credits that exempt her from paying performance fees until the fund returns to its previous high. This credit is an asset that belongs to the investor, and it has value so long as the relationship with the specific fund is maintained.

These fee credits, however, are often destroyed. Our analysis shows that both managers and investors are more likely to discontinue investment activity after losses: managers are more likely to liquidate their hedge funds, and investors are more likely to withdraw their capital. When this happens, the investor loses the fee credit with the fund. When the investor takes the withdrawn capital to a new fund, the investor will resume paying performance fees starting with the first dollar gain in excess of the hurdle rate.

These three mechanisms help account for the fact that investors pay about 50 percent of their gains as incentive fees to managers, compared with the average contractual rate in our sample of 19 percent. In other words, the realized incentive fee is 2.5 times the average contractual rate.

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The asymmetry in hedge fund contracts leads investors to pay significantly higher fees than the contractual rate. And a large part of the incentive fees paid by investors is unrelated to the long-run performance that funds deliver. When we calculate the lifetime performance for each fund and compare it to the incentive fees that it collected, we find that the excess incentive fees are shared fairly equally across the entire spectrum of fund performance, from the worst-performing funds to the best.

In recent years, some investors expressed their dissatisfaction with hedge fund performance and looked for ways to tighten the relation between performance and incentive fees. Specifically, some suggested moving from the traditional 2-and-20 fee structure to 1-and-30, to lower the management fee and increase the incentive fee. Our results imply that this arrangement is not likely to dramatically change the relationship between performance and fees, since the reduced management fees will be replaced with excess fees that are unrelated to performance in the long run.

The most effective way to tighten the link between hedge fund performance and incentive fees is to make contracts more symmetrical. Funds could allow investors to claw back fees paid earlier if they experience later losses. Further, fund families could allow investors to offset gains and losses across funds, an agreement known as performance netting or carry netting.

The financial sector engages in the intermediation of capital between investors and businesses, but despite its technological advances, there is little evidence of increasing efficiency. The lion's share of the profits earned using the capital of hedge fund investors ends up in the hands of hedge fund managers.

Itzhak Ben-David is with Ohio State University and the National Bureau of Economic Research. Justin Birru is with Ohio State University, and Andrea Rossi is with the University of Arizona. Ben-David is a co-founder and a partner in an investment advisor that manages a small number of friends-and-family accounts for an incentive fee. Until 2016, the investment advisor was a general partner in a hedge fund.

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