Hedge fund incentive fees are not as low as investors think

Study reveals that investors get a raw deal from the performance-based charges

By Steve Randall
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Investors should be wary of the fees charged by some hedge funds related to their performance, according to a new study.

That's because the analysis of 6,000 hedge funds over 22 years revealed that investors end up paying incentive fees (also called performance fees) around 2.5 times the average rate on paper.

The fees are typically 20% of the profit made by the funds but the study found that investors are charged almost 50%.

"In general, hedge fund managers have been getting a larger and larger share of the profits and investors have been losing out," said Itzhak Ben-David, co-author of the study and professor of finance at The Ohio State University's Fisher College of Business.

...ted that while ...ed incentive fees, there was no ...stors for those that lost money.

While funds often promise not to charge fees until they are profitable again, the fund that lose the most money often close.

"In essence then, investors have lost the credit they had with that fund. They can't use that credit anywhere else, so if they take their money to a new fund, they will have to start paying fees immediately," Ben-David said. "As a hedge fund manager, you cannot lose."

Another recent study of mutual funds found that managers' language played a role in confusing investors about the fees they are charged.

Other fees

Of course, incentive fees are not the only ones charged. Management fees are typically 1-2% regardless of performance.

Should investors, therefore, seek lower management fees in return for a higher incentive fee?

"That is not likely to solve the problem. If anything, that is just going to make it worse," said co-author Andrea Rossi, assistant professor of finance at the University of Arizona. "Our findings suggest that the management fees will just be replaced with higher incentive fees that are not related to performance in the long run."

The research, published as a National Bureau of Economic Research working paper, suggests that investors would be better with contracts with "clawback" provisions that allow investors to be repaid some of their fees when hedge funds lose money.

"Hedge fund investors need to look at the broad picture of what they are actually paying in fees. They may be surprised at how much they actually pay relative to what they earn," concluded Ben-David.

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