PERFORMANCE FEES: PAYING YOUR DUES?

INTRODUCTION

“Got to pay your dues if you want to sing the blues
And you know it don’t come easy…
Forget about the past and all your sorrow
The future won’t last
It will soon be your tomorrow”

(It Don’t Come Easy, 1970)

This report examines trends in the use of performance fees by open-ended funds in the UK (Unit Trusts and OEICs) since the ban on such fees was lifted by the Financial Services Authority (FSA) in 2004.

A large proportion of funds with this fee structure are absolute return funds, a sufficient sample size to give the opportunity to see whether there are any differences in historical returns and risk depending on the use of performance fees.

The research builds on previous work presented in the papers ‘Paying for Pain or Pleasure?’ (August 2010), ‘Performance Fees in the UK’ (December 2007), and ‘Are performance fees “heads I win, tails you lose”?’ (April 2001).

Key findings:

• The use of performance fees by Unit Trusts and OEICs has declined in recent years, with the number of new fund launches adopting such fees falling dramatically and other funds being closed or merged.

• Part of the reason for this reduction must relate to what may be called “the Hargreaves Lansdown effect” – intermediaries’ scepticism about performance fees.

• Looking at the IMA Absolute Return sector, the delivery of above zero rolling 12-month returns is not substantially different between funds with or without performance fee structures in place.

• The average standard deviation and maximum drawdown for absolute return funds with performance fees are slightly higher than for funds without this fee. This can be explained by a significant minority of funds with performance fees having historical risk characteristics out of line from the rest of the sector.

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USE OF PERFORMANCE FEES

To see how the industry has evolved since April 2004 this research is specifically restricted to Unit Trusts and OEICs. Before this date – when the FSA lifted its ban in Policy Statement 04/7 – ‘offshore’ funds (those domiciled outside the UK) with performance fees could be sold in the UK and closed-ended funds (investment trusts) could use performance fees (indeed around half of these funds do so today). Therefore it is necessary to restrict the universe of funds examined in order to see how the use of these fees has evolved over the intervening years.

Interestingly, it was also technically possible to get around the previous ban by reducing management fees for under-performance (rather than having an additional fee based on a comparison with fluctuations in the value of an index or other factor). This was first put in place by the Portfolio Performance Fund. Launched in June 1996, the fund charged a 1.75% management fee for first quartile performance (on a rolling three year basis), but only 1% if the fund failed to achieve this target.

A similar system was also used by Gartmore’s Focus fund range (launched in 2001). However the Portfolio Performance Fund was acquired by New Star (now Henderson) and the fund merged and the fee structure dropped, while only one of the Gartmore Focus funds (now also under Henderson) still uses this fee structure.

In our 2007 study, 34 funds had adopted a performance fee structure, a number that had risen to 81 funds in our 2010 analysis, a 138% rise that showed a clear acceleration of interest. But the number of funds with these fees today actually stands at 80 – just 3% of the entire UK funds universe. This reflects not only a slowing of funds being launched with performance fees, but also the closure (or merger) of funds and the removal of performance fees.

As a result of this activity, while 112 funds have at one time or another had a performance fee structure in place, today’s total stands 28.6% below this level.

Some of the comments made by asset managers at the time of these events reveal a mix of the classic reasons for fund closures – lack of a performance and/or lack of assets – and one can speculate that both aspects were adversely affected by having a performance fee in place. However one cannot conclude that these funds being closed is a direct result of performance fees being used.

Alongside the ‘early adopters’ mentioned above, funds acquired by other asset managers have tended to remove performance fees, most notably a range of Singer & Friedlander funds taken over by Williams de Broë (in turn recently acquired by Investec), as well as Walker Crips’ acquisition of the former UK Analyst fund.
At the same time even those groups that are better known for their use of performance fees, such as J O Hambr Capital Management or Dalton Strategic Partnership (Melchior funds), have closed funds with such structures, but not dissuaded these fund managers from using them on other funds.

There are undeniably administration issues in using performance fees on funds with a wider audience than that with which a typical hedge fund manager might engage, both in the daily valuations and the resulting costs borne by the fund. While unlikely to be sufficient to put off an asset manager for this reason alone, it is clearly a consideration when introducing a new fund to potential investors and perhaps even more when a fund is brought into an acquiring asset manager’s existing range of funds.

It is worth remembering that in general there tend to be fewer fund launches when the prevailing market conditions are tougher, but still the picture that emerges shows that there has been a retreat from the use of performance fees in the UK (figure 1).

**Figure 1. Funds launched with performance fees**

![Figure 1. Funds launched with performance fees](image)

**The Hargreaves Lansdown effect**

One key reason why the use of performance fees has not continued to rise is what might be termed “the Hargreaves Lansdown effect”. Pretty much every summer since 2004¹, a senior figure at the independent financial service provider takes up his pen and attacks the principle of paying fund managers a performance-related fee. Such views have culminated in funds with such a fee structure being put in a separate section of Hargreaves’ ‘Wealth 150’ list of favourite funds, ostracised from all the others.

Nor are these opinions a lone voice in the wilderness. For example, Patrick Connolly of Chase de Vere has been scathing in his comments on such fee structures, notably in relation to absolute return funds.

Of course some funds with performance fees have generated good returns – to this end Hargreaves Lansdown has not banished funds using performance fees from the Wealth 150 altogether – and this will be explored later in this report when the performance and risks of absolute return funds are analysed.

But the crucial point is that if intermediaries are, at the very least, sceptical about performance fees, then it is no surprise that asset managers with more than very limited distribution ambitions will think long and hard before using such a fee. (It might also suggest one reason why intermediaries are traditionally more reluctant to use investment trusts).

The interesting twist to the findings in the current report is that expectations had been for the use of performance fees to rise. For example in 2010 this was the finding from both Skandia Investment Group’s research² and at a roundtable discussion of senior figures in the asset management industry hosted by ‘Investment Adviser’ magazine³.

Before moving on from this analysis of the evolving use of performance fees, it is worth highlighting the proportion of funds in different IMA Sectors (again, for the purposes of this particular analysis, just those funds domiciled in the UK), as shown in figure 2.

This reveals that 34% of such funds sit in the absolute return sector and a further 13% are in the Specialist sector, so that virtually half of those funds with performance fees are not in the IMA’s broad Income or Growth groups of sectors, but in the Specialist sectors.

Figure 2. Proportion of UK-domiciled funds with performance fees, by IMA Sector⁴

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³ “Performance fees will be ‘industry standard’”, Investment Adviser, 10 May 2010.
⁴ IMA Sectors with just 1 or 2 funds with performance fees are not labelled, for space reasons.
ABSOLUTE RETURN FUNDS

The proportion of funds with performance fees that sit in the IMA’s Absolute Return sector (established in April 2008) means that there is the opportunity to compare historical returns and risk and see if there are any differences related to the fee structure in place. While the first half of this report looked solely at UK-domiciled funds, because 24 of the 74 absolute return funds (nearly one third) are domiciled in Luxembourg or Ireland, these funds have also been included in this analysis.

47 absolute return funds have performance fee structures in place, 63.5% of the funds in the sector. Funds in this sector are managed with the aim of delivering absolute (i.e. more than zero) returns in any market conditions. Because these funds also commit to the aim of delivering absolute returns on a 12 months basis, it is this criteria that will be used to compare their performance.

Each fund’s performance was calculated at monthly intervals, looking at a 12-month period for each interval. Therefore any fund must have at least a 1 year history (at the end of July 2012) in order for its performance to be included in this analysis. As a result, the data does not reflect a simple snapshot of how absolute return funds have performed over any one period, but instead gives a more detailed view of their ongoing performance since the inception of the sector (or since a fund’s launch, if later).

Because each fund’s aim – within the terms of the IMA’s sector – is to generate a return greater than zero, this was also the criteria assessed for the current analysis, specifically, the proportion of the rolling 12-month returns that were positive.

The average proportion that funds with performance fees delivered positive 12-month rolling returns was 62.1%, compared to 63.5% for funds without performance fees. When the calculation is not based on a simple average that treats each fund equally, but on the underlying periods (i.e. accounting for the fact that some funds have been in existence for longer than other funds), the resulting ‘weighted’ average is 67.0% for the former (i.e. funds with performance fees) compared to 67.5% for the latter (those without such fees).

A summary of the funds’ absolute return performance is presented in figure 3, with funds grouped between those achieving positive 12-month rolling returns less than 50% of the time, those achieving this between 50% and 74% of the time, and those funds achieving this goal at least 75% of the time. The numbers of funds are also split between those with and without performance fees.
Because there are more funds with performance fees than without in this sector, figure 3 is not all that helpful in determining differences between performance related to their fee structure. However the chart does show that more than one third of absolute return funds (34.8%) overall have posted positive one year returns at least 75% of the time.

Figure 4 provides a clearer picture of the performance difference between funds with different fee structures. Funds with performance fees are relatively evenly split between the three performance ‘bands’, while there are more significant differences for those with a traditional fee structure. While the latter have fewer ‘poor’ funds (21% versus 31% among funds with performance fees) and more ‘average’ funds (46% versus 33%), the ‘good’ funds make up a fairly similar proportion of both totals (33% compared to 36%).
A different approach has to be taken when looking at risk. Here two universes of absolute return funds were assessed: funds with at least 3 years history (37 funds, of which 20 have a performance fee), as well as a larger universe of funds with just 1 year history (69 funds, of which 45 have a performance fee).

Volatility of returns, expressed as standard deviation, was calculated (figure 5) as was maximum drawdown (figure 6). To gain a further level of granularity in this comparison, both the simple mean and the median was calculated to present average historical risk measures for these funds.

The findings are reasonably clear: in seven of the eight comparisons made funds with performance fees look to have been more ‘risky’, on average, than those funds without performance fees. However it is worth reiterating that funds in the Absolute Return sector do have a diverse range of investment strategies and objectives and, to this extent, these findings underline this point.

Figure 5. Average standard deviation of absolute return funds

![Figure 5](image)

Figure 6. Average maximum drawdown of absolute return funds

![Figure 6](image)
With the initial findings (figures 5 and 6) not being totally conclusive, further exploration of historical risk is warranted. To this end both standard deviation and maximum drawdown were plotted for each fund over three years in figure 7, distinguishing between funds with and without performance fees.

**Figure 7. Standard deviation and maximum drawdown of absolute return funds over three years**

This chart neatly shows that 8 funds with performance fees are out of line from the other 29 funds (of which 12 have a performance fee) in their historical ‘riskiness’ (as measured by maximum drawdown and standard deviation).

This helps to explain the findings in figures 5 and 6, or at the very least the difference between mean and median for those funds with performance fees. More than this, those funds with historical characteristics that suggest greater risk all have performance fees. This also seems to support the point made earlier that a variety of strategies – with different risk profiles – are employed by funds seeking absolute returns.

The above finding is balanced by the fact that it is also shown that having a performance fee does not inevitably lead to greater risk. 60% of absolute return funds with performance fees sit broadly in the same cluster as those funds without a performance fee. Indeed if one excludes the outliers (albeit that such an exclusion accounts for 40% of funds with performance fees) the mean standard deviation and maximum drawdown for funds with performance fees is lower than for the universe of funds without performance fees (although with no exclusions from this latter group).
CONCLUSIONS

Hugh Hendry, founding partner of Eclectica Asset Management, has been quoted as saying that “It is outrageous that managers with no long/short experience have the audacity to charge a performance fee.”

The findings detailed in this research paper would certainly suggest that scepticism – sometimes manifested as outrage – among intermediaries in the UK has led directly to a dramatic slowing for adopting additional fees related to a fund’s performance. Furthermore, the overall number of funds with such fees has actually fallen slightly as a result of some funds being closed or merged.

Their greatest use can be found in the IMA’s Absolute Return sector, but even here much of their use relates to ‘offshore’ funds, which have been able to use performance fees prior to the lifting of the FSA’s ban in 2004.

While around 3% of Unit Trusts and OEICs overall have a performance fee structure, among absolute return funds (including ‘offshore’ funds) this figure rises to 63.5%. This shows the influence of mutual funds seeking absolute returns mimicking the fee structures traditionally adopted by hedge funds.

Even in the Absolute Return sector investors are not being forced to invest in funds with performance fees, both because a sizeable proportion of these funds maintain a more conventional fee structure, and because funds with performance fees have not demonstrated, on average, that they deliver better returns or lower risk.

While one cannot conclude that the use of performance fees will continue to decline, this research has shown that investors – albeit primarily through their advisers – can have a very real influence on the fees being charged by funds. At the same time it seems much more likely that most of the new launches using performance fees will come from ‘offshore’ rather than locally domiciled funds.

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5 Quoted in Fund Strategy (14 December 2009) with similar comments quoted in Pensions Insight (January 2010).

6 54% of locally domiciled absolute return funds have a performance fee structure.