

Hedge Fund Fees: Are they Worth It?

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Fee Structure and Levels

Fund sponsors considering investments in hedge funds are struck at first by their high fees compared to more traditional investment products. To start, hedge funds impose three layers of fees:

- 1) An asset fee that is charged on the value of portfolio assets,
- 2) An incentive fee that is based upon a percentage of investment profits, and
- 3) Other fund expenses.

All three fee categories are paid directly by the hedge fund vehicle, generally a limited partnership.

Exhibit 1 shows the range of asset and incentive fees charged by a broad sample of 879 hedge funds.¹

Exhibit 1: Distribution of Hedge Fund Fees *

		Incentive Fee						Total	
		5%	10%	15%	20%	25%	30%		>30%
Asset Fee	>3.0%			0%	0%	0%	0%		1%
	3.0%				2%	0%			2%
	2.5%		0%		0%	0%			1%
	2.0%			1%	22%	2%			24%
	1.5%		3%	2%	32%	1%		0%	37%
	1.0%	0%	1%	2%	29%	1%		0%	33%
	0.5%		0%	0%	1%	0%		0%	2%
	Total	0%	4%	5%	86%	4%	0%	0%	100%

* Based upon an 879 sample of hedge funds from HFR

The rows in Exhibit 1 capture the range of asset fees, from a low of 0.5% of assets to a high that exceeds 3.0%. The columns in Exhibit 1 capture the range of incentive fees, from 5% of profits to a high that exceeds 30%.² The values in the matrix are the percentage number of hedge funds that have the corresponding asset and incentive fees indicated. Blanks indicate fee combinations that were not used by any hedge fund in the sample.

The most common fee combination is a 1.5% asset fee and a 20% incentive fee, chosen by 32% of hedge funds. However, 29% of hedge funds have a lower 1.0% asset fee while 22% impose a higher 2.0% fee. A 20% incentive fee is the overwhelming choice by hedge funds though a few percent have lower or higher levels.

Hedge fund fees are similar in structure and level to fees charged by private equity funds. There are differences however. Private equity funds generally offer investors a “preferred return”, typically set at 8%, which represents a minimum return that needs to be achieved before incentive fees are paid. A preferred return protects private equity investors from paying incentive fees on mediocre performance results. Unfortunately, hedge funds do not follow this practice though a few will charge incentive fees only on profits that exceed a level that would have been earned on a risk-free yield, like short-term Treasury bills or LIBOR.

Hedge fund incentive fees almost always come with a “high water mark”, which means that any losses need to be made up before incentive fees can again be charged. This guarantees that incentive fees will not be paid twice on the same profits. However, a few hedge fund managers have been successful in watering down the high water mark provision in recent years. Suppose an otherwise good hedge fund experiences a year of poor performance that results in investment losses and no performance fees. With the prospect that it may take another year to make up those losses, the hedge fund manager may be vulnerable to key investment professionals leaving to join firms whose incentive fees are “in the money.”

Anticipating such a scenario, some hedge funds have instituted a “modified high water mark.” If losses cause assets to fall below the prior high water mark, the hedge fund manager can still receive a reduced 10% incentive fee on subsequent profits. For example, suppose the high water mark was previously \$100 million and losses cause assets to fall to \$90 million. Under the traditional high water mark no incentive fee would be paid until assets again reached \$100 million and, thereafter, the hedge fund manager would again receive 20% of subsequent profits. Under the modified high water mark, the hedge fund manager earns a reduced 10% incentive fee on the \$10 million in profits from \$90 million to \$100 million, effectively a 30% incentive fee on the same \$10 million profits. To make the modification more palatable to investors, the 10% incentive fee is extended to profits beyond the previous high water mark. Typically, the high water mark is increased by 150% of prior losses, or \$15 million in our example, to a \$115 million level. Assuming the manager will eventually generate profits so that the new high water mark is exceeded, the investor ends up saving \$0.5 million in incentive fees on profits between \$110 million and \$115 million. The modified high water mark is a recent trend that will likely become more common with time as hedge funds seek to bring greater stability to their businesses.

The third category of fees, fund expenses, provides for the administration of the hedge fund. These expenses are typically small and cover legal, audit, accounting, tax, and administrator expenses. The normal range for this category of expenses is 10-20 basis points. However, fund expenses can sometimes be much higher in those instances where the hedge fund directly pays for additional expenses associated with investment research. An expanded list of fund expenses might include travel, fees for outside advisors and consultants, and legal fees associated with specific investments. Normally, investors would expect all research costs to be covered by the asset fee, but some hedge fund managers making investments that require specialized outside professional assistance choose to have the hedge fund directly pick up those expenses. This is a practice that is more common among credit and distressed hedge funds where the legal costs associated with asset restructuring and bankruptcy can be high and unpredictable. Fund expenses can be in the 25-100 basis points range when research costs are included.

In an unusual variation, there are a handful of hedge funds that directly pay for all management expenses, including salaries, travel, rent, etc., instead of paying an asset fee. Fund expenses total several percent of assets in these instances. An incentive fee is also paid by the hedge fund. Citadel, the well known Chicago based firm, uses such a fee structure.

Are Hedge Fund Fees Reasonable?

Investment fiduciaries have responsibility for gauging the reasonableness of fees for investment services provided. The question is whether hedge fund fees are in line with their investment benefits?

In an ideal world, Adam Smith answers the first question. If hedge fund fees were unreasonable relative to the expected investment benefits, the invisible hand would begin moving the \$1.2 trillion dollars already invested in hedge funds to other asset classes and strategies. The fact that hedge funds continue to be the fastest growing asset class, much of it institutional, means that most investors believe hedge funds continue to be a good deal, despite their fees.

Beyond this reliance on market forces to set fees, there are some unique aspects to hedge funds that suggest that fees are not as high as they appear at first glance. To begin, the leverage used by hedge funds dilutes the asset fee. The typical 1.5% asset fee charged by a hedge fund is applied to the net asset value (NAV), not the gross asset value which includes securities purchased with debt financing. The average ratio of gross asset value to net asset value is 2/1 for hedge funds. This means that a 1.5% hedge fund asset fee is equivalent to a 0.75% asset fee for a traditional manager, the latter being a very acceptable fee for a \$25-\$50 million account with a top performing traditional manager.

The 20% incentive fee on hedge fund profits is not found among traditional long-only managers, but is an entrenched part of private equity investing. Why has the incentive fee stuck with hedge funds and private equity funds? Is it simply “because they can get away with it?” or something more?

Incentive fees appear to play an important role in containing the size of individual hedge funds, which in turn can potentially hurt performance. Assuming that asset fees cover normal operating expenses, hedge fund profits will remain unchanged if new money cannot be invested in attractive situations.³ Furthermore, taking new assets that have profitability rates (returns) below existing assets will hurt investment returns, which in turn can jeopardize existing assets. Incentive fees turn out to be a tool to encourage hedge fund managers to keep their asset base at a size that optimizes investor return. The fact that most of the top performing hedge funds and private equity firms limit or prohibit new investors is evidence that the incentive fee has a major affect on manager behavior. This can only benefit hedge fund investors who can gain confidence that it is performance that is motivating management behavior rather than simple asset growth that drives traditional asset management firms.

Ultimately, the reasonableness of hedge fund fees will be judged relative to the incremental value (“alpha”) that is produced. Collectively, traditional long only equity managers have negative alpha and their fees, at whatever level, might be judged unreasonable. And the very best have managed to produce only 1%-2% of alpha over longer time periods.

Hedge funds have a better record of creating alpha. The HFRI Fund Composite Index – the most commonly used index of hedge fund performance – returned 9.6% annualized, net of fees, for the five years ending December 31, 2006. For the same period LIBOR returned 2.6%, so the average

hedge fund produced a 7.0% excess return. Though academic studies debate how much of the 7.0% is beta related and how much is truly alpha, a reasonable estimate is that 5% of the 7% excess return is alpha.

How much in fees did investors pay hedge funds on average for the 5% alpha? Assuming an average 1.5% asset fee and a 20% incentive fee, we estimate a gross of fee five year return of 13.5% for hedge funds and total asset and incentive fees of 3.9%. Adding the 5% net of fee alpha to the 3.9% estimate of fees gives an estimated gross of fee alpha of 8.9%. Therefore, the “split” of gross alpha between investors and the hedge fund manager averaged 56%/44%, respectively, for the five year period. Competitive forces ultimately determine what the split should be, however the roughly 50/50 division for hedge funds is not dissimilar from alpha splits seen in other asset classes.

Do Fees Matter?

Many academic studies show that mutual funds with lower fees tend to perform better than those with higher fees. However, there is no evidence as yet that the same is true for hedge funds. In fact, the opposite may be more likely.

To understand the relationship between hedge fund performance and fees we took the 575 hedge funds from the sample in Exhibit 1 that had a five year performance record and conducted a regression. Asset fee and incentive fee were the two independent variables and the five year return-to-risk ratio was the dependent variable. If hedge funds were like mutual funds, a negative relationship would exist between the two fee variables and risk-adjusted performance. We find that coefficients are both positive. Higher risk-adjusted performance is more generally found in hedge funds with higher asset and incentive fees. While the regression is not statistically significant – meaning that there could be no relationship between performance and fees – the results should give pause to fiduciaries who have become accustomed to focusing on fees as a major criterion in selecting investment advisors.⁴

Conclusion

Most hedge funds use a modified version of private equity fees. The majority of the hedge funds have an asset fee between 1-2% with a 20% performance fee. Asset fees appear high because asset levels are kept low and most hedge fund strategies require higher resource commitments than traditional investment approaches. Additionally, when viewed in the context of total investments, including those leveraged, or as a multiple of the alpha that is expected to be generated, hedge fund fees appear more reasonable.

¹ To avoid replication of basically identical hedge fund products, we included only offshore hedge funds and, where multiple share classes exist, only the U.S. class was used.

² Asset and incentive fee values that lay between those shown were counted with the group whose value was closest.

³ The traditional concept that asset fees cover operating expenses and don't contribute to business profits has come under question as hedge funds continue to grow assets.

⁴ Coefficients (t-statistics) on asset fee and incentive fee regression variables were +0.18 (1.03) and +0.01 (0.43), respectively.