THE Frontier Line

Thought leadership and insights from Frontier Advisors

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The New Deal

A fair day's pay for a fair day's work

FRONTIER ADVISORS

Frontier Advisors

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $250B in assets across the superannuation, charity, public sector and higher education sectors.

Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflicts.

The New Deal

"The New Deal" was one of Franklin D. Roosevelt's most famous speeches, on 24 May 1937, when he implored his nation to "… devise ways and means of insuring to all our able-bodied men and women a fair day's pay for a fair day's work."

In this issue of The Frontier Line, we re-look at the issue of investment management fees and the commonly overlooked concept of value for money, or "a fair share" of the economics between investment managers managing capital and investors providing that capital.

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Glossary: Issue 111

Long-only: A "long" position is taken when the buyer of an investment expects it to increase in value. The investor gains their return by holding the investment to sell at a future higher price. By contrast a short position is expecting an investment will fall in value. A short investor borrows shares (for example) to sell before they fall in value so the cost to repay the shares to the original holder is less than the price received for selling them while on loan. The return is the difference.

Beta: Beta measures the volatility of an investment against its market index. It is a measure of the amount of risk associated with the investment itself. A beta of 1 means the investment will move in line with its index – in the same direction and to the same degree. A beta of less than 1 means the investment moves less while beta greater than 1 means it moves more than the index. If an equity product has a beta of 1.4, it is thought to be 40% more volatile than the share market. A negative beta means the investment is expected to move in an opposite direction to its index.

Alpha: Alpha is seen as a measure of the skill or value added by a fund manager. Although commonly used as a measure of excess return, the two are not interchangeable. Alpha measures excess return against an index after allowing for Beta. For instance, if a fund manager has a Beta of 1.4, the index returns 10% p.a. and the manager delivers a 15% p.a. return, the manager has delivered 5% p.a. in excess returns, but only 1% p.a. in alpha, once adjusting for the portfolio's Beta.

Equity Risk Premium: The equity risk premium is based on the risk-reward trade off and means the extra return investing in equities (shares) delivers over a risk-free investment, such as government bonds.

The New Deal

The time has come
To say fair's fair
To pay the rent
To pay our share

The time has come
A fact's a fact
It belongs to them
Let's give it back

"Beds are burning", Midnight Oil, 1987[1]

There has been a lot of talk about investment management fees, which is a debate that continues to intensify, globally. Franklin D. Roosevelt and Peter Garrett talk about minimum wage and indigenous land rights, both tangential to the topic of investment management fees. Whilst it may seem unusual that they appear side-by-side in an edition of The Frontier Line, both give us the inspiration to reiterate the importance of "a fair share" in fee structures.

Plan members or plan sponsors (generally on behalf of plan beneficiaries) provide capital to investment managers. In return, investment managers are entitled to a fair share of those returns, commensurate with the outcomes delivered. All things being equal, the higher the return delivered, the more a manager deserves to be paid.

Of course, this is just one dimension. Clearly a manager who delivers the return with more skill and less market exposure (and adds more diversification benefits) may be worth paying more for. Likewise, a manager who delivers a higher risk-adjusted return may be worth paying more for.

Over the course of 2015, Frontier has spent more time (and this author has spent more time than he would care to admit) revisiting this concept of value for money, or a "fair share" to the manager, across a variety of dimensions.

It has long seemed anomalous to us that managing tax leakage from net returns is considered prudent, but managing fee leakage from net returns is somehow considered by many to be overly frugal.

With all the talk around investment management fees in the context of superannuation and how fees in a $2 trillion industry should be "lower", it is easy for the debate to get away from the concept of value for money or a "fair share". It is plan members and sponsors who provide that capital to investment managers and who take the bulk of the risk. It is quite reasonable, in our view, that those taking the bulk of the risk get to keep a commensurate share of the returns.

After all, in the words of Midnight Oil, "it belongs to them".

1. For our offshore readers, "Beds are burning" is a 1987 protest song in support of giving native Australian lands back to the Pintupi, an indigenous Australian tribe who moved from the Gibson Desert to settlements and missions in the 1930s, with many forcibly moved in the 1950s and 1960s. Midnight Oil and its lead singer, Peter Garrett, were known for their political activism, particularly on issues such as the environment and indigenous causes.

Different strokes for different folks

In the original Frontier/JANA 2010 Fee Principles, we introduced the concept of a fair share of excess returns between manager and investor. This concept works well in relatively vanilla sectors such as long-only listed equities, where the manager gives the investor the return of the index plus (hopefully) a margin above that index. In those sectors, fees should be limited to a fair share of excess returns, which we concluded back in 2010 should normally be no more than 25% and certainly no more than 33.3%. This is a position Frontier maintains in 2015/16.

The concept of a "fair share of alpha" is also not specific to Australians (although it sometimes feels that way) and is discussed elsewhere, such as this recent quote from Chris Ailman (the CIO of CalSTRS, the US$186 billion Californian teachers' pension plan):

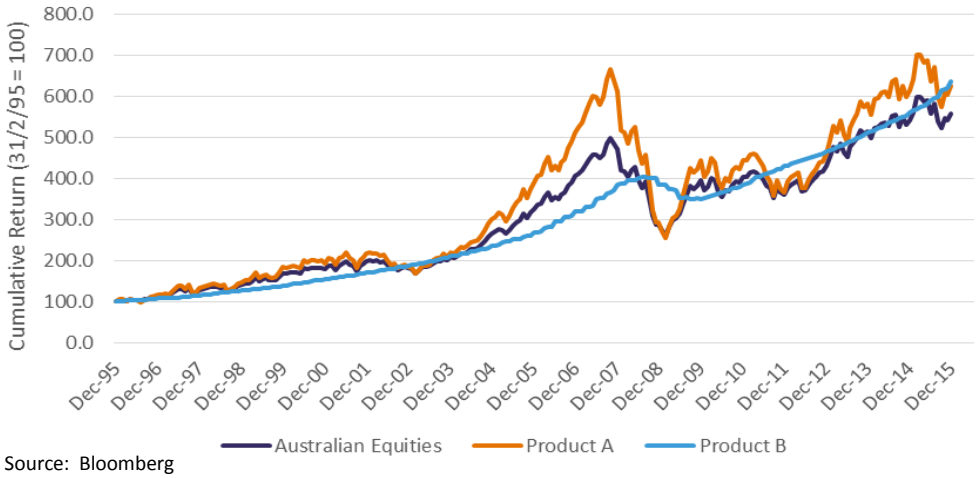
"I'll pay for alpha – not 50 per cent of the alpha, but I'll pay as much as 20 per cent of alpha. But I don't want to pay for beta, especially when we can replicate it in-house." [2]

This concept of a fee for alpha works well in traditional sectors such as listed equities, however in alternative and/or unlisted sectors, managers may generate other features for the investor, such as a diversifying return stream, or the ability to generate counter-cyclical returns when equity markets crash (without giving up too much in "normal" markets). In some cases, it is also not possible to obtain these alternative return streams in a passive form – for instance, there is no passive method to obtain unlisted property or unlisted infrastructure "beta". Even delivering a return in-line with the index in those sectors is labour-intensive and incurs a relatively high management fee.

For a fund that obtains most of its risk via listed equities (i.e. most balanced and growth funds), then from a total portfolio perspective, investments that actively diversify away from the Equity Risk Premium are worth paying more for, as opposed to an investment with an identical return but with higher equity beta. The example in Chart 1 shows the cumulative return from two hypothetical products that have both delivered a circa 10% p.a. return over the last 20 years, as compared to the Australian equities index.

Product A is simply a leveraged Australian equities fund (leveraged at 140%, with a cost of funds of the UBSA Bank Bill Index + 1.0% p.a.). Product B is simply the return of Australian unlisted property. The return stream of Product A can be obtained very cheaply via passive leveraged Australian equities and is not worth paying any materially higher management fee for, as there is no "skill" in this return premium. Product B may be worth paying some additional fees for, as it has delivered a relatively diversifying return stream, compared to Australian equities, and cannot be easily achieved in a passive form.

Chart 1: Comparison of cumulative returns – two hypothetical products



Source: Bloomberg

2. White, Amanda. "We Don't Have To Be Friends", *Top 1000 Funds,* 11 December 2015.

Frontier's fee principles v.2.0

Over the course of 2015, Frontier revisited the aforementioned fee principles. Back in 2010, we acknowledged the difficulties in applying a set of Fee Principles that work well in traditional sectors, but often work less well in alternative assets.

Therefore, we assigned investment grade ratings to products that didn't pass this primary "one-third of alpha" test, but satisfied a subjective overlay that allowed for issues such as diversification. Many of these products still exhibited "value for money" on a subjective measure and "value for money" means different things to different people. However, this "subjective difference of opinion" has been a major contributor to the lack of traction on fees for many institutional asset owners, particularly in alternatives, where they find they have less bargaining power and less benefits of scale than the traditional sectors.

So in 2016, Frontier will be drawing a line in the sand and defining what value for money means to us and what is a fair share of the economics between the investment manager and the investors providing the capital. In order to do that, we have to look at the concept of value for money from multiple angles. Looking at the issue quantitatively, a product that has the following three factors does not represent value for money to Frontier:

1. the manager keeps more than a fair share of expected active returns above a common market benchmark (which includes the listed alternative – e.g. listed equities instead of private equity);
2. the manager keeps more than a fair share of the expected total returns; and
3. the manager keeps more than a fair share of the diversification benefit or the "Allocation Alpha" (explained in a latter section).

Other factors may assist a product's value for money proposition to an institutional asset owner, such as:

a. its ability to lower the total fund Management Expense Ratio. For instance, Alternative Beta strategies may not offer much "alpha" and therefore incur a high fee as a percentage of a small amount of alpha. But they are often cheaper than traditional active management; and

b. a product's fee structure may offer innovative features. For instance, the fee may be relatively high today, but will decline as the product's features "kick in" (such as a dollar-based fee with appropriate cost escalators that still ensure investors benefit most from an increase in scale).

We feel the time has come to draw such a line in the sand and state that, going forward, a product must satisfy at least one of these five tests. If it does not, we cannot give it an investment grade rating and cannot recommend it to clients.

Top-down pressure on fees

This will come as no surprise to any Australian superannuation fund reader, but the pressure on fees continues to also come from on high and arguably with good reason. Australians (unlike most) are able to make heavily tax advantaged contributions to a savings vehicle of their own choice.

In this context, it is perhaps not surprising that every Treasurer or Superannuation Minister has noted the impact of fees on superannuation since the GFC. For instance, back in October 2009:

"A very small reduction in fees can make a very large difference to people's retirement income. I see that as possibly the key role of the Cooper review in terms of getting as efficient a system as possible."

Superannuation Minister, Chris Bowen, 14 October 2009

Through to the current Treasurer, who spoke about fees in late-2015.

"Greater choice in the superannuation system means funds are more competitive and downward pressure is placed on fees - a good outcome for consumers [...]

Competition will drive greater efficiencies through downward pressure on fees, as well as improving the quality of products and services for members. The Government is committed to doing more to reduce fees and improve after-fee returns for members."

Treasurer Scott Morrison, speech to ASFA Conference, 27 November 2015

To all regulators and governments, high fees are simply "bad". Lowering fees without changing asset allocation and lowering net returns should be a priority of all participants in the market, before knee-jerk reactions become almost unavoidable.

The private equity "nightclub theory"

In recent years, more than one market participant (and more than one client) has noted to us that private equity's success owes a lot to the "nightclub theory", or the theory asset management is a luxury good. The theory goes *"you see the red rope outside the nightclub and the queue to get in, and you think 'it must be good in there'."*

The comment resonates with us, although we would also wryly note that, often after the long queue, you get in to the supposedly exclusive nightclub and realise you pay a lot to get in, the drinks are overpriced and, on a value for money assessment, it was hardly worth it. (You also note that there's a bunch of seemingly very important people sitting in a special area in the corner of the club and you presume they've been coming here for a while).

As you grow up (perhaps) you come to realise that the pub next door has no queue, cheaper drinks, and you invariably have a better time there anyway.

The observation is acute to us, as the Australian superannuation industry is approaching its 24th birthday (at least since the introduction of SG contributions in 1992). At the age of 24, most of us have realised the queue outside the club is probably not worth it, especially compared to the pub next door. As our industry matures, maybe its tastes do too?

At this point, our paper becomes quite technical as we explore "value for money across multiple dimensions". Those who are interested in the detail, please read on.

For those who aren't, feel free to move straight to our final word on page 12.

Value for money across multiple dimensions

"Allocation Alpha" and quantifying diversification benefits

"Fees Eat Diversification's Lunch" was a 2014 paper authored by William Jennings and Brian Payne, two Professors from the US Air Force Academy, which examine the relationship tween fees of diversifying asset classes and their diversifying benefits. The paper finds that, in many cases, extra fees completely overwhelm the diversification benefit or "Allocation Alpha" of that investment.

The concept of "Allocation Alpha" was earlier introduced in a paper by Leibowitz and Bova (2005) and reiterated by Jennings and Payne. The formula (for those so inclined) is:

$$\tilde{\alpha}_j = \check{r}_j - \beta_j\,(\check{r}_{us} - r_f) - r_f$$

Where $\check{r}_j$ is the return on asset j, whereas $\check{r}_{us}$ is the return on US stocks, and r_f is the risk-free rate. For the rest of us, a simple comparison of two funds and their respective "Allocation Alpha" is shown in table 1.

Clearly investors want to pay more for higher risk-adjusted returns, rather than just returns per se. Assessing risk-adjusted returns is difficult in many asset classes, as a low standard deviation may arise from a lack of revaluation frequency (common in private equity, property and infrastructure).

"Allocation Alpha" is not perfect, but to us, it is a reasonable proxy for risk-adjusted returns, as the majority of a total Fund's risk comes from listed equities. A number of academic studies have also looked at the "true beta" of unlisted assets, by assessing cash flow models[3], rather than simply assessing the monthly or daily returns of a private equity, private real estate or private debt fund regressed against listed equities. In the previous example, Allocation Alpha highlights how Fund A has delivered far less risk-adjusted returns than Fund B. Hence, Fund B is clearly "worth more" from a total portfolio perspective.

Jennings and Payne's paper then uses the asset class betas calculated by Leibowitz and Bova and applies them to JPMorgan's Long-term Capital Market Return Assumptions. For instance, diversified hedge funds have a Beta of 0.28 to US equities. Based on the assumptions, this gives rise to a projected Allocation Alpha of 1.63% p.a. after underlying manager fees but before fund of fund fees. For smaller US endowment funds, who coincidentally pay an average fund of fund fee of 1.63% p.a., they found that the Allocation Alpha from hedge funds was consumed entirely by underlying and fund of fund fees. Even larger US foundations who pay an average fund of fund fee of 0.97%p.a. have the majority of their Allocation Alpha consumed in fees. For private equity, the Allocation Alpha (again, after underlying manager fees but before fund of fund fees) was just 0.68% p.a., more than consumed by fund of fund fees for all investor types.

Table 1: Allocation Alpha comparison between two 15.0% gross return products

Fund	Fund A	Fund B
Hypothetical Fund Gross Return *(20 years to Dec-15)*	15.0% p.a.	15.0% p.a.
Risk-Free Return *(US Cash return, 20 years to Dec-15)*	2.5% p.a.	2.5% p.a.
Excess Return	12.5% p.a.	12.5% p.a.
Return on US stocks *(S&P 500 return, 20 years to Dec-15)*	8.2% p.a.	8.2% p.a.
Hypothetical Beta to US stocks *(20 years to Dec-15)*	1.4	-0.1
"Allocation Alpha"	4.6% p.a.	13.0% p.a.

Source: Bloomberg

3. For instance, see Ang, Chen, Goetzmann, and Phalippou (2013), *Estimating Private Equity Returns from Limited Partner Cash Flows.*

Playing (and paying) catch-up

The concept of catch-up has been synonymous with private equity and other closed-end funds (e.g. closed-end real estate, infrastructure and private debt funds) for many years. Wachtell, Lipton, Rosen & Katz (the notable US law firm) define the concept as follows.

"Catch-up is also known as a "disappearing preferred return" because the initial preferred return of a specified hurdle to the investors disappears as profits in excess of the hurdle are allocated 100% to the general partner until they reach the standard 20% carried interest. The second, and less common, technique is to allocate profits in excess of the hurdle as 20% carried interest to the general partner and 80% to the limited partners according to contributed capital. This profit allocation is known as a "permanent preferred return" because the general partner is not permitted to catch up with respect to the hurdle distributions."

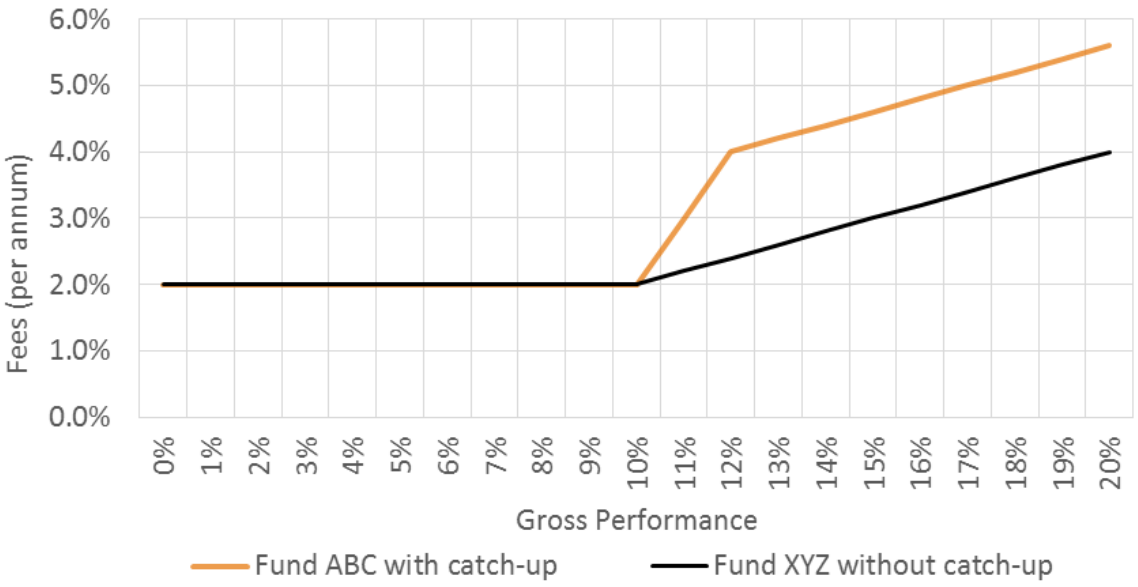
The concept of a preferred return is a concept that applies to preferred equity – i.e. where an investor provides equity with preferred terms and an accelerated share of profits up until a hurdle return or between certain return hurdles (for instance, half of all profits in between 10% and 20%).

In private equity, the manager – or the General Partner (GP) – effectively provides preferred equity, generally via a small investment in the fund (typically 1% to 3%), which in turn gives it an accelerated share of profits between return thresholds. The investors, or "Limited Partners" (LPs) have a position that is akin to subordinate equity, which sits in behind the GP's preferred equity (once the targeted return has been achieved), despite generally contributing 97% to 99% of the equity to the Fund.

Although its origins are unclear, there is a general consensus that catch-up and the "disappearing preferred return" became the norm in the US throughout the 1980s and 1990s as hedge funds began to raise funds with a preferred return of zero. The argument went that, once a GP had reached an appropriate rate of return, it deserved to be paid 20% of all returns, in order to bring the compensation structure in line with the then-emerging hedge fund universe.

The pay-off chart of a typical "2&20"[4] private equity fund with catch-up (or a "disappearing preferred return") versus no catch-up (or a "permanent preferred return"), both with a return hurdle of 8% p.a. after base fees (so effectively 10% p.a. before base fees) is shown as follows.

Chart 2: Fees paid to manager at various gross IRR figures



4. Often the base management fee in private equity is less than 2% p.a. (for instance, 1.5% p.a.), but is charged on commitments during the investment period (and then invested capital). Hence, the fees on invested capital (or "money in the ground") typically work out to be at least 2% p.a. on average.

Viewing this another way, let's look at how the total returns are split between GP and LP at various gross performance outcomes. Comparing the fees at a 12% p.a. gross return, for Fund ABC with catch-up, **the GP takes 33.3% of the total return**, compared to 66.7% for the LPs. This is compared to Fund XYZ without catch-up, where total returns are split 80/20 between the LPs and GP once the base fees are recouped and the fund moves into performance territory (after 10% p.a. gross returns).

Taking this analysis to the concept of "Fees as a percentage of Allocation Alpha", the analysis takes on a new complexion. **At a 12% p.a. gross return, the investor pays away a whopping 86.8% of Allocation Alpha in fees.** Without catch-up, this figure would be 39.4% at a 15% p.a. and 52.1% at 12% p.a.

Chart 3
Share of total returns between GP and LP:
Fund ABC with catch-up

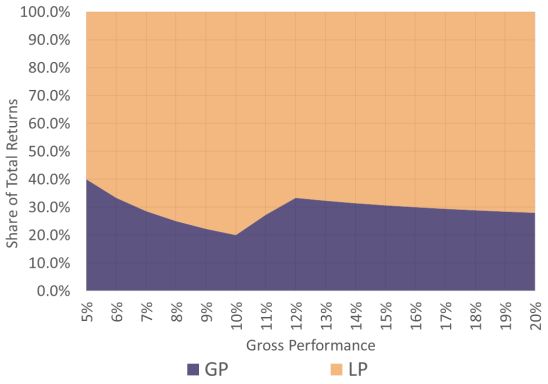


Chart 4
Share of total returns between GP and LP:
Fund XYZ without catch-up

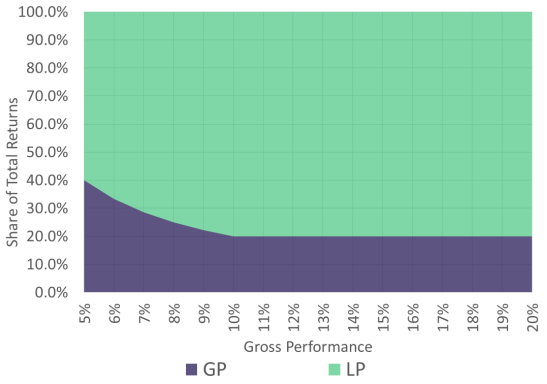


Chart 5
Share of Allocation Alpha between GP and LP:
Fund ABC with catch-up

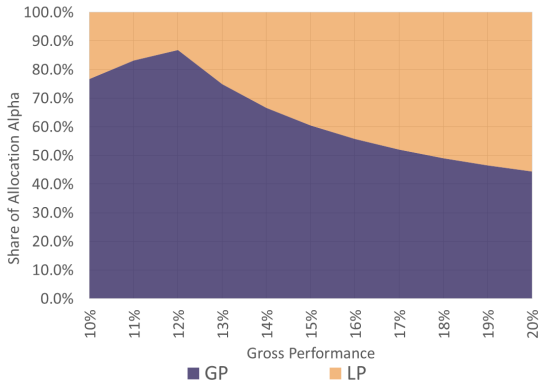
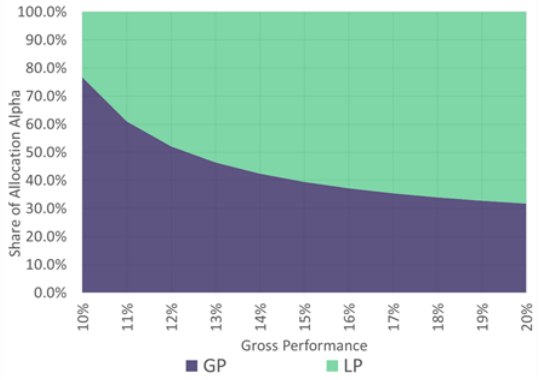


Chart 6
Share of Allocation Alpha between GP and LP:
Fund XYZ without catch-up



The impact of catch-up is most stark in the low to mid-teens and begins to diminish (as a percentage) as returns exceed the high-teens. It is useful to determine the point at which the performance fee structure reaches "escape velocity"[5], or in other words, when the catch-up period ends and distributions are shared 80/20 between the LPs and GP. For a standard 2&20 fund above 8% p.a. (net of base fees), with catch-up, "escape velocity" occurs at a 12% p.a. gross return.

This is particularly important in a potential low return environment, as funds that may have had reasonable prospects of mid-high-teens gross returns in the last vintage may now be looking at low-mid teens for the next vintage. In terms of fees as a percentage of "allocation alpha", this may be somewhat offset by lower hurdle returns in the medium term (e.g. cash and listed equity returns). However, from the perspective of absolute returns, it seems clear that the GP's "take" will be higher as a percentage of lower absolute returns. In order to maintain the economics between investor and manager, the terms and fees of the fund should be lowered in parallel with a lower return world (for instance, a 15% p.a. to 12% p.a. gross return assumption would imply base fees should reduce from 2% p.a. to 1.6% p.a. to maintain the economics).

Where catch-up does not exist, lower gross returns are likely to be offset by lower performance fees for the manager. However, where catch-up does exist, the performance fee take may be little changed for the manager, particularly if the lower gross return takes the fund from "just out of escape velocity" to "just before escape velocity". For instance, using the previous 2&20 example, the manager's total fee take reduces from 4.6% p.a. at 15% p.a. to 4.0% p.a. at a 12% p.a. gross return.

5. "Escape velocity" being the point when the catch-up period ends. We can't find any reference to the term elsewhere, so acknowledgements to my colleague, Michael Sofer, who has applied his First Class Honours Degree in Aeronautical and Aerospace Engineering to performance fee modelling!

Disappearing preferred return versus no preferred return

At this point, it's reasonable to ask "what about hedge funds", which typically have a performance fee hurdle of zero, or more commonly these days, a cash return (albeit the difference between cash and zero is somewhat of a moot point in most of the developed world at present). Therefore, not only do they have a "disappearing preferred return", but the preferred return never existed in the first place!

We would agree with most market participants that performance fees above a zero hurdle are egregious for most strategies and even a cash return hurdle is generous. However, it is worth considering what the return would be on any given strategy without any allocation alpha. Drawing on our previous examples, **if a product had a Beta to listed equities of zero, a performance fee hurdle of cash is somewhat defendable,** because any additional return generated by the manager is allocation alpha (based on the previously stated equation). **Alternatively, if a product had a Beta to listed equities of 1.0, a performance fee hurdle of cash would be hard to defend.**

In some rare cases, a performance fee hurdle of less than cash may be defendable. For instance, for certain short-biased hedge fund strategies (e.g. specialist short-selling equities strategies and long volatility strategies), delivering a cash return over the long-term may be a reasonable outcome, given the headwind of a negative Beta to equities (on the basis that equities outperform cash over the long-term). Even if cash is not a "reasonable return", the "negative Beta manager" has to deliver allocation alpha in order to achieve a cash return when equities outperforms cash.

Regardless, when considering a performance fee hurdle, it is imperative to consider the risk-adjusted returns, or Beta to listed equities, of the strategy. **For strategies with a Beta of 1.0 or more** (and most private equity strategies have a "true Beta" of at least 1.0), **a performance fee hurdle of cash or zero is entirely inappropriate**. Given the nature of catch-up, the performance fee hurdle effectively becomes zero when the manager achieves a return in-line with listed equities, which seems almost as inappropriate to us.

Lastly, the asymmetric performance fee structure of closed-end funds mean that those managers enjoy the success of high performing funds but do not repay some of those successes in underperforming funds. In a properly structured performance fee in an open-ended fund (for instance, with clawbacks and/or a high watermark), underperformance must be recouped before outperformance is subsequently rewarded. The difference in performance fees paid (and therefore in net returns to investors) between the two is commonly overlooked, but can be very material over the long term.

Case study: bank loans versus direct Lending

An example in the current environment is the prospective return on private debt, or "direct lending" (closed-end funds) versus open-ended investments in the more liquid bank loans or high yield market.

Bank loans (also commonly known as leveraged loans) have provided a good risk-adjusted return in recent years for investors, with relatively good liquidity. However, in the current low return environment, a number of investors are looking to earn slightly higher returns via direct lending strategies. This is not dissimilar to investors who have sought private equity to earn a slightly higher return over listed equities for a number of years.

We believe direct lending strategies makes sense for institutional investors to take advantage of an illiquidity premium that continues to exist. However, it is important to stress that the illiquidity premium belongs to the investor, not the manager. In other words, locking up capital for five to ten years is not worth paying any additional fee for (if anything, the fee should be lower for patient capital).

The investor also benefits from a "complexity premium", as loans in the direct lending space are often more complex and time-consuming to arrange and manage than the comparatively vanilla leveraged loans market. They also generally need to be sourced by the Manager, which adds significant labour to the process. An investor can also take advantage of an additional "skill premium", due to the manager's outperformance of an admittedly opaque universe. The complexity premium is worth paying a small amount for (above bank loans), generally via a slightly higher base fee.

The skill premium is worth paying an additional amount for when "skill" is achieved, via a performance fee. However, it is pointless to pay away the bulk of the complexity and skill premium in additional fees.

The all-in running yield on a bank loan fund (US or European based) has been in the vicinity of 5% p.a. in local currencies in recent quarters. Additional returns can and are being earned for hedged Australian dollar investors, via forward points on currency hedging, but this is clearly not manager alpha and not worth paying for. We continue to believe that a return premium above bank loans of circa 3% to 7% p.a. can be earned in a closed-end direct lending fund, via the illiquidity, complexity and skill premium. Therefore, it is worth comparing the comparative fees and net returns from two similar, competing choices for capital at present, as follows:

i. a hypothetical bank loan fund – an open-ended fund (for instance with monthly liquidity[6]), with an assumed base fee of 0.40% p.a. (the typical range for institutional investors is 0.3% to 0.5% p.a.) and no performance fee; versus

ii. a hypothetical direct lending fund – a closed-end fund with an average base fee over the life of the fund of 1.0% p.a. on invested capital plus a performance fee of 15% p.a. over a preferred return of 6% p.a. after base fees (i.e. effectively above a 7% p.a. gross return) with full-catch-up.

Table 2: Hypothetical bank loan fund vs hypothetical direct lending fund

Returns (% p.a.)	Hypothetical bank loan fund	Hypothetical direct lending fund		
		Low case	Mid case	High case
Gross return	5%	8%	10%	12%
Fees	0.40%	2.00%	2.35%	2.65%
Net return	4.60%	6.00%	7.65%	9.35%
Share of total returns				
Manager	8.0%	25.0%	23.5%	22.1%
Investor	92.0%	75.0%	76.5%	77.9%
Share of (before fees) returns above bank loans				
Manager	n.a.	66.7%	55.0%	37.9%
Investor	n.a.	33.3%	45.0%	62.1%

6. Bank loan funds typically have monthly liquidity, with buy/sell spreads typically ±0.30% to 0.50% (although this is not a fee, as the proceeds go back into the fund).

Most would agree that the "high case" for the hypothetical direct lending fund represents a reasonable return (9.35% net) for the fee involved (2.65%), particularly in the current environment. However, in the "low case" and "mid case" for the hypothetical direct lending fund, one can see that more than half of the return premium above bank loans is consumed in fees. Another way to look at the impact of "additional fees for additional return" is to break up the additional return into assumed premia, as outlined on the previous page. Let us assume that the illiquidity premium makes up 2% p.a. of any return premium; and the complexity premium makes up 1% p.a. That then leaves the residual to be attributed to "skill", which ranges from zero (low case) to 4% p.a. (high case).

Therefore, in the low case, the additional fees (1.6% p.a.) more than consume any assumed skill and indeed the assumed complexity/skill premium in aggregate. The additional complexity of direct lending is worth some additional fee, but in the mid case for instance, the fee differential (1.95%) consumes circa two-thirds of the assumed complexity/skill premium in aggregate. At a fee of "1&15", it is only in the "high case" (12% p.a. gross return) that we feel the economics begin to be shared appropriately between investor and manager.

Therefore, although we accept that direct lending is complex, requires specialist skills and additional resourcing compared to bank loans, and therefore deserves higher fees to some extent, we do not accept that the complexity/skill premium should be consumed in additional fees and "a fair share" is certainly not more than 50% of this combined premium going to the manager. In addition, **the illiquidity premium belongs entirely to the investor** and is not worth any additional fee whatsoever. As such, negotiating fair and equitable fees and a fair share of the economics is vital before including these strategies in a portfolio.

By now, one may have realised that the above example also shows the stark impact of catch-up on performance fees. If the fees on the hypothetical direct lending fund were 1% p.a. and 15% performance fee **without catch-up**, the fees in the "low case" above would have been just 1.15% p.a. and the net return a comparatively healthy 6.85% p.a. It would also mean that just **40.3%** of the additional return above bank loans is consumed in fees, compared to **66.7%** in the example above. In our experience in recent quarters, several direct lending managers do not have (or have been willing to remove), catch-up in their performance fee terms and this examples shows the power of doing so.

Table 3: Assumed composition of returns in hypothetical funds

Returns (% p.a.)	Hypothetical bank loan fund	Hypothetical direct lending fund		
		Low case	Mid case	High case
Additional fee above bank loans				
Fee differential	n.a.	**1.60%**	**1.95%**	**2.25%**
Return premium (before fees) above bank loans and assumed composition				
Illiquidity premium	n.a.	2.00%	2.00%	2.00%
Complexity premium	n.a.	1.00%	1.00%	1.00%
Skill premium	n.a.	0.00%	2.00%	4.00%
Total premium	n.a.	**3.00%**	**5.00%**	**7.00%**

Performance fees and MySuper legislation

As part of the 2012 Stronger Super reforms, APRA now requires superannuation funds to ensure that any performance fee arrangements meet new guidelines. Section 29VD (1) (3) of the Superannuation Legislation Amendment (Further MySuper and Transparency Measures) Act 2012 reads as follows:

"If, under the arrangement, a fee is or fees are payable to the investment manager in addition to the performance-based fee, the other fee or fees must be set or adjusted so that they are lower than they would be if the arrangement did not include the performance-based fee."

The challenge with many closed-end funds is that a structure without performance fees has never existed, so considering what the arrangement "would be" without performance fees is a moot point. However, based on our previous example of a 0.40% p.a. bank loan fee versus a "1&15" direct lending fund, one has to consider whether the base fee is set appropriately low enough to compensate for the existence of performance fees, particularly with catch-up.

A fair day's pay for a fair day's work

Up until this point, the traditional sectors (such as long-only active listed equities) have largely escaped the attention of this research. In some circumstances, a 2% base fee may be an appropriate fee structure for a private equity or hedge fund, for example if the firm is new and a 2% p.a. base fee ensures there are enough resources and systems in place, especially if the manager is covering a complex sector.

Conversely, a 0.50% p.a. fee (even with no performance fee) may be egregious for long-only active Australian equities. Think of a manager who charges 0.50% p.a. on average for $10 billion in Australian equities institutional assets under management (AUM). Whilst there are costs involved in resourcing, rent, systems, insurance, etc., do those costs really amount to $50 million per annum? If so, many other industries would like to operate under such hardship. In addition, when the market rises 30%, AUM rises to $13 billion and fees rise to $65 million p.a., what additional costs necessitated the additional $15 million p.a. in fees?

Frontier has been a long-outspoken critic of percentage-based (or *ad valorem*) fees in asset management and we won't repeat those arguments here. The *ad valorem* fee structure and fees that are simply too high (particularly relative to the value added, on average) is borne out in the operating margins of fund managers.

Whilst most are private companies and data is hard to come by, some are publicly listed and a handful of Australia's and the US's largest publicly listed asset managers are shown in Chart 7 below. Most of these public companies spend high amounts on distribution (particularly in the retail sector) and some are financial conglomerates, where asset management margins are dragged down by lower margin businesses such as custody or trustee services. The more "pure play" asset managers generally enjoy higher margins.

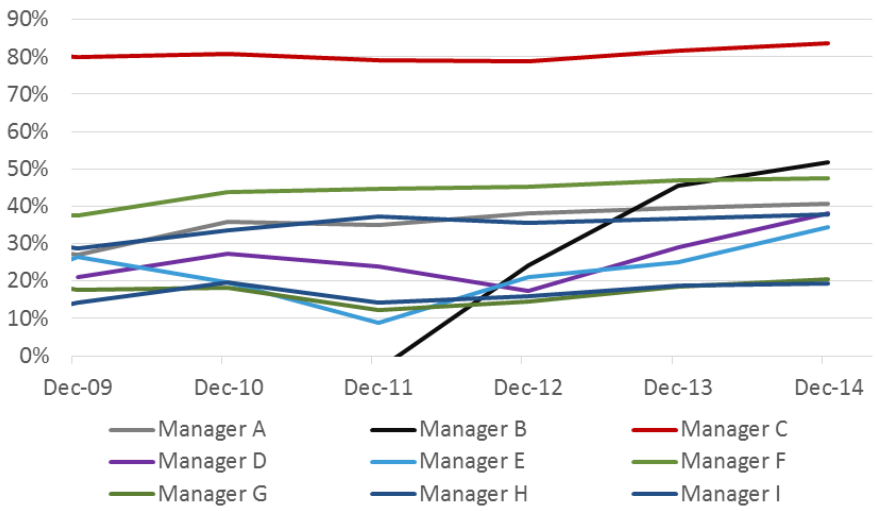
Quite simply, these margins are unsustainably high and dwarf most "normal" industries. They have also grown almost in unison since the GFC in 2008/09 and Eurozone crisis in 2011/12, showing not only the inextricable link between a rising market and fees, but also the link between a rising market and operating margins.

We believe that these margins are unsustainable. Many industries have been the victim of savage disruption in recent years, particularly those with unsustainable margins (for Australian readers, think of Cabcharge and its credit card fees for instance – supposedly an unavoidable monopoly until the arrival of Uber) and it would surprise if asset management is immune from these disruptive forces. This disruption could be "left-field", such as an unknown digital disruption (Graham Hand has written about the possibility of an Uber or Amazon of wealth management), or it could be more familiar, from institutional investors themselves. Ailman again:

"We have the ability to manage money internally at one tenth of the cost and with more control, so we are constantly looking at it. We've looked at our global peers with more than $200 billion, and they have 58 per cent of assets internally."[7]

The global pension fund industry is consolidating, Australia more than most. Whilst $200 billion superannuation funds are still some way off, it seems likely there'll be at least a handful by 2030 (particularly if the industry continues to consolidate). Whilst the very best investment management firms may be able to sustain operating margins of 40% to 60%, our view is that many won't. **The potential for disruption is obvious and the ball is in the asset management industry's court.**

Chart 7: Major publicly listed fund managers – operating margins (%)



7. White, Amanda. "We Don't Have To Be Friends", *Top 1000 Funds,* 11 December 2015.

Niche funds for niche demand

In the hedge fund landscape, managers who wish to maintain those margins have largely withdrawn themselves from the institutional landscape – for instance, BlueCrest and Renaissance Technologies have effectively privatised and going forward, manage money for exclusively for staff and friends. Mike Platt (the founder of Bluecrest) recently noted:

"It is no longer a particularly profitable business to run a multi-manager hedge fund on 2 and 20 per cent fees."

This seems likely to continue in the years to come and some very talented high net worth individuals will simply manage money for other high net worth individuals.

Given the lack of scalability in many of these strategies anyway, this shouldn't overly concern most institutional investors.

A handful of hedge funds with scalable business models may be able to keep commanding "2&20" fees for institutional investors. But of the 11,000 hedge funds in the world, not many can unilaterally dictate their terms and not many are successful enough to take themselves private, like Bluecrest and Renaissance. The vast majority should not be capable of commanding "2&20". They only do so because the investor community allows them to do so.

The final word

With all the talk about investment management fees, it seems the debate gets polarised in some strange division between "those who focus on fees" and "those who focus on net returns", as if the two are mutually exclusive. Frontier has always been focused on net returns. But net returns have two components – gross returns (which the investor cannot control) and the fees (which the investor can control). Funnily enough, getting the same product (or a substitutable product) for a lower cost increases net returns to members.

Analysing how the economics of an investment are shared between investment managers and investors is entirely reasonable in this context, as fees are a leakage from net returns. In the same way that any prudent investor should analyse the prospective tax leakage at prospective return levels, the prudent investor should analyse the fee leakage at prospective return levels. In a very likely lower return environment looking forward, anything that detracts from those returns needs to be examined.

"Value for money" is an inherently subjective concept and what is value for money to me, may not be to you. However, in 2016, Frontier will draw a line in the sand and define what value for money means to us and what is a fair share of the economics between the investment manager and the investors providing the capital. To us, a product that has the following three factors does not represent value for money:

1. the manager keeps more than a fair share of expected active returns above a common market benchmark (which includes the listed alternative – e.g. listed equities instead of private equity);
2. the manager keeps more than a fair share of the expected total returns; and
3. the manager keeps more than a fair share of the diversification benefit or the "Allocation Alpha" (Jennings and Payne, 2014).

Put this another way… If a manager takes more than a fair share of the returns from a product on these three measures, ask yourself (and indeed ask the manager) how this represents value for money? How does it represent a fair share of the economics between the investment manager managing the capital and investors providing that capital?

However, any attempt to define "value for money" in a consistent manner across all asset classes will invariably disfavour those asset classes that are more labour intensive and less scalable, such as private equity, private debt and infrastructure. It will also give a free kick to those asset classes that are comparably less labour intensive – such as long-only large cap Australian equities, which is more scalable than private equity, the universe (of 300 stocks at most) is pre-defined and generally well-researched by the sell-side community.

Just because a long-only Australian equities product has defined "value for money" on the same basis that a private equity fund is not "value for money", we do not mistake this for the best that can be done for investors.

So, for alternative assets and generally high-fee sectors, "drawing a line in the sand" becomes more crucial. However, so much more needs to be done in traditional sectors (via negotiation), such as further exploiting scale and ensuring that economies of scale flow to the principals, not the agents, in the system.

Remember, in the words of Midnight Oil, "it belongs to them".

8. Johnson, Miles. "BlueCrest to turn private as fee model wanes", *Financial Times,* 2 December 2015.

FRONTIER ADVISORS

About Frontier Advisors: Frontier Advisors is one of Australia's leading asset consultants. We offer a range of services and solutions to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice, through to fund manager research and rating, investment auditing and assurance, quantitative modelling and analysis and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

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