The background of the cover is a dark blue and black gradient with various financial data visualizations. On the right side, there is a 3D bar chart with several bars of varying heights. Below it, there are several line graphs with different colored lines (yellow, red, blue) showing trends. Some numbers like '00.01', '-05.22', and '-00' are visible on the graphs. The overall aesthetic is modern and data-driven.

THE Frontier Line

Thought leadership and insights from Frontier Advisors

Issue 119

July 2016

Progressing a New Deal on Fees

Ideas for
institutional investors

▶ *Progressing a New Deal on Fees*

In a previous Frontier Line on the topic of investment management fees, we drew a metaphorical line in the sand and explained our new approach to assessing fee structures within our own Research Program, namely The Frontier Fee Principles.

In this companion piece on the topic, we reiterate again the most challenging and significant of the current fee issues, propose a number of approaches that might assist the institutional investor in getting better value for their fee budget, and also highlight some recent positive outcomes on investment management fees.



AUTHOR

Damian Moloney

Damian has been Frontier CEO since 2011 and has responsibility for the development and implementation of the firm's strategic and operational plans.

Damian is responsible for the management of all business aspects of Frontier, including strategic planning and implementation, company financial matters, operational matters, compliance and all Board and shareholder matters. Prior to joining Frontier in 2011, Damian spent 14 years at Industry Fund Services, joining as an Investment Consultant, and eventually becoming Chief Executive Officer of the key investment management subsidiary, Industry Funds Management, which he lead for 11 years.

A new deal on fees

We know that what matters most to investors is their net return, but net returns are what's left after all fees and costs are paid out of the gross return. Investors can't always control the gross return, but can control investment costs including investment management fees, the most significant of these costs.

In Frontier's view, these particular costs are not only significant but, overall, too high and, in our February 2016 *Frontier Line 111*, entitled *The New Deal: A Fair Day's Pay for a Fair Day's Work*¹, we argued the time had well and truly come for a "new deal" on investment management fees.

The central principle in any new deal on investment management fees and fee structures should be the concept of a "fair share". Investors provide capital to investment managers in order to generate returns and, in exchange, investment managers are entitled to a fair share of those returns as recompense for their ideas, the investment infrastructure provided and their professional labour, commensurate always 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 the last year, Frontier revisited this concept of a fair share in the investment management industry across a variety of dimensions.

As a consequence, we comprehensively revised our own Fee Principles to include a more nuanced and articulated set of five tests to establish whether an investment manager's fee structure does indeed represent a fair share of the value created. Our refined Fee Principles were released in early 2016 and are outlined in detail in the mentioned *Frontier Line*. In essence, the Fee Principles investigate, for any product, two key questions:

- *How does the product represent value for money?; and*
- *How does the product represent a fair share of the economics between the investment manager managing the capital and investors providing that capital?*

In this *Frontier Line*, we aim to progress this discussion by addressing three dimensions of the topic. First, we restate and elaborate on the three most important investment management fee issues present in our industry, and that probably shouldn't be anymore. Second, we attempt the more difficult exercise of proposing some workable and implementable solutions for institutional investors to achieve lower investment management fees, and without sacrificing the value add being targeted. Finally, we briefly outline some recent positive fee outcomes on investment management fees that have resulted in a fairer share for investors.

Why is it so?

So said Professor Julius Sumner Miller repeatedly, and so asks Frontier. We see many different fee proposals and fee structures from the investment management industry through our very extensive research program and via our Global International Research Alliance partners. The variety and creativity of fee structures is mind boggling, as are the sometimes curious reasons behind them.

*Here we revisit the three most important fee related issues identified in *Frontier Line 111*, noting there are many more perplexing, and perennially recurring, issues with investment management fee structures outlined in that research paper. These three issues, however, are the most significant, and reflect both longstanding industry practices, and an industry structure, that have, in our view, reached their use by date.*

1. Authored by my former colleague, and Frontier Legend, Leigh Gavin.

Ad valorem fees

One of the unique and uniquely puzzling features of our industry is the ad valorem fee structure for base investment management fees. The term ad valorem is Latin, translates as “of the value” and refers to management fees calculated as a percentage of the amount of assets allocated to a manager.

Why base management fees are calculated in this way is a bit of mystery but is probably linked to the origins of investment management in broking houses in the 1950s and 1960s, given that broking fees have historically been on an ad valorem basis and this model was likely transferred to ongoing portfolio management contracts.

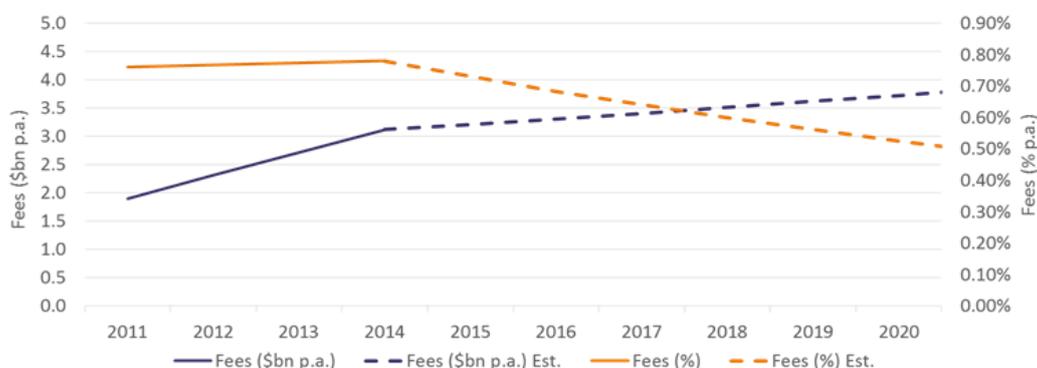
Whatever the history, ad valorem fees are usually a windfall for the recipient as the fee automatically increases as markets rise, and as additional cash is allocated by the client. In Australia, where there is compulsory superannuation contributions, this fee structure has been a revenue bonus for investment managers servicing that sector. What is unique about this fee structure though is the almost total lack of a comparable fee, or cost charging, regime in any other industry. In most other industries, and in most directly negotiated services contracts, fees and costs will typically escalate on a fixed or inflation linked basis.

Whilst this fee structure impacts all investors, one area where the cost to investors of ad valorem fees has been very significant is in our growing retirement system and, correspondingly, savings from removing this fee structure

could be also be significant. By way of example, Rice Warner has calculated that the aggregate management expense ratio for industry superannuation funds increased from 0.76% per annum to 0.78% per annum in the 2011 to 2014 period², despite aggregate funds under management increasing from \$236B to \$358B. Obviously, there are various factors contributing to this outcome, such as asset allocation changes, but the fact is that for this period, industry superannuation funds in aggregate achieved little in the way of scale benefits, principally we would argue due to ad valorem investment management fees.

So, let’s consider an alternative and allow fees to escalate by a modest margin above CPI (say 3% per annum all up) instead of asset growth (say 10% per annum) in the relatively short 2014 to 2020 period. Starting at the Rice Warner 2014 base, this would result in aggregate fees being pared back from 0.78% per annum to 0.53% per annum, although the total dollar fees would still increase due to the CPI-plus escalation which would presumably compensate investment managers for their increasing costs. Overall, a simple idea and a great outcome – scale benefits primarily accrue to the investor.

Chart 1: Fee projections: 2015 to 2020



Perhaps it's time to move on from ad valorem fees.

2. Rice Warner, *Submission to the Financial System Inquiry on MySuper Fees*, November 2014.

2 and 20

Our previous *Frontier Line* also discussed the following question: why the prevalence of the two and twenty fee structure for closed end funds, especially in private equity and hedge fund land? Two and twenty is a fee regime in which part of compensation is intended to be performance based, where a manager charges a flat 2% of total asset value as a base management fee, plus charges an additional 20% of any profits earned (or profits earned over some small hurdle).

Many variations on this now exist, but this basic structure is a hardy stalwart in the closed end product space. Frontier is not sure exactly where this fee structure originated³ in the investment management industry, but the likely original idea of a base fee to cover a manager's costs, plus an incentive, is logical when the manager is a start-up or raising a small fund. When fund sizes stretch into the hundreds of millions, and then billions, the argument is a bit harder to swallow as it is when applying the fee across all industry participants rather than the top tier only.

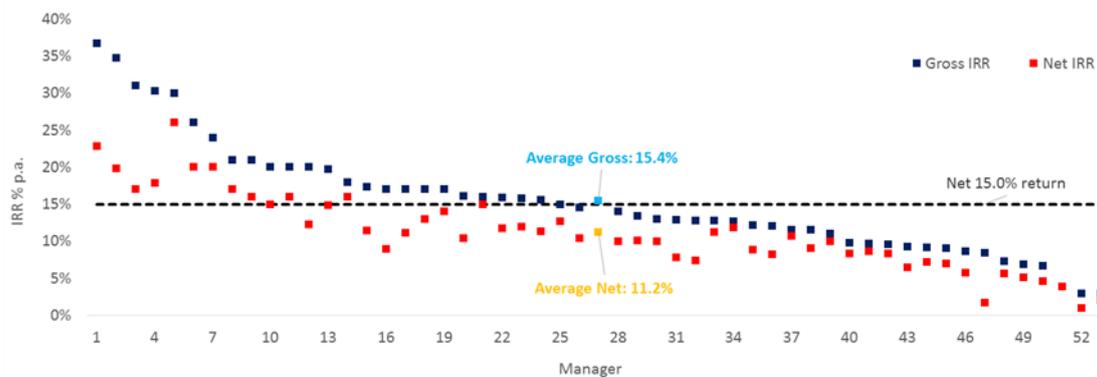
The cost to investors is also hard to swallow. Chart 2 is a graphic of completed, or close to complete, actually invested closed end private equity, property and infrastructure funds in

Frontier's database with vintage dates back to the early 1990s, ordered by gross IRR⁴.

The time period covered is quite lengthy and the sample size is reasonably good. Of interest is the gross to net performance differential of 4.2% per annum, which means that the return on investor's capital was reduced by this amount due to investment manager fees and fund expenses.

This difference is material enough to convert a strong outcome to a more marginal result⁵. Plus, 10% of any portfolio invested in these fund structures would incur an average 0.42% per annum addition to the portfolio's management expense ratio (MER).

Chart 2: Mature and completed closed end funds: gross vs net of fees performance



Maybe it's time to find better closed end fund fee structures too.

3. Henry Kravis of KKR apparently suggested it came from the oil and gas prospecting industry where the management partner received a 25% free carried interest from the silent partners. The two and twenty structure appeared in KKR's first buyout fund in 1978 and quickly spread. PrivateEquitySalaries.com goes further back in history in one of its publications suggesting that the term "carried interest" harks back to the medieval merchants of Genoa, Pisa, Florence and Venice. These traders carried cargo on their ships belonging to other people and earned 20% of the profits on the "carried" product. Note that the merchants still had substantial assets at risk in this arrangement (i.e. their ship).

4. The IRR (internal rate of return) is the cash weighted rate of return to investors in the period since a fund's first draw down of investor capital. The traditional definition of IRR is "...the interest rate (also known as the discount rate) that will bring a series of cash flows (positive and negative) to a net present value (NPV) of zero (or to the current value of cash invested)" (www.investopedia.com).

5. The typical balanced fund return in the last 25 years was in the 8.5% per annum to 9.5% per annum range after tax and fees. The funds in Chart 2 had vintage years across this period.

The incredible non-shrinking margin

The prevalence in the investment industry of ad valorem fee structures, and fee structures like two and twenty that are simply too high (particularly relative to the average value add), is directly reflected in the generous operating margins of investment managers. While many investment managers are private companies and data is therefore hard to come by, some are publicly listed.

Highlighted in Frontier Line 111 were the operating margins of a number of Australia's, and the US's, largest publicly listed investment managers (refer to Chart 3). Note too that most of these public companies spend higher amounts on distribution (particularly in the retail sector), and some are financial conglomerates with investment management margins that are dragged down by lower margin businesses such as custody or trustee services.

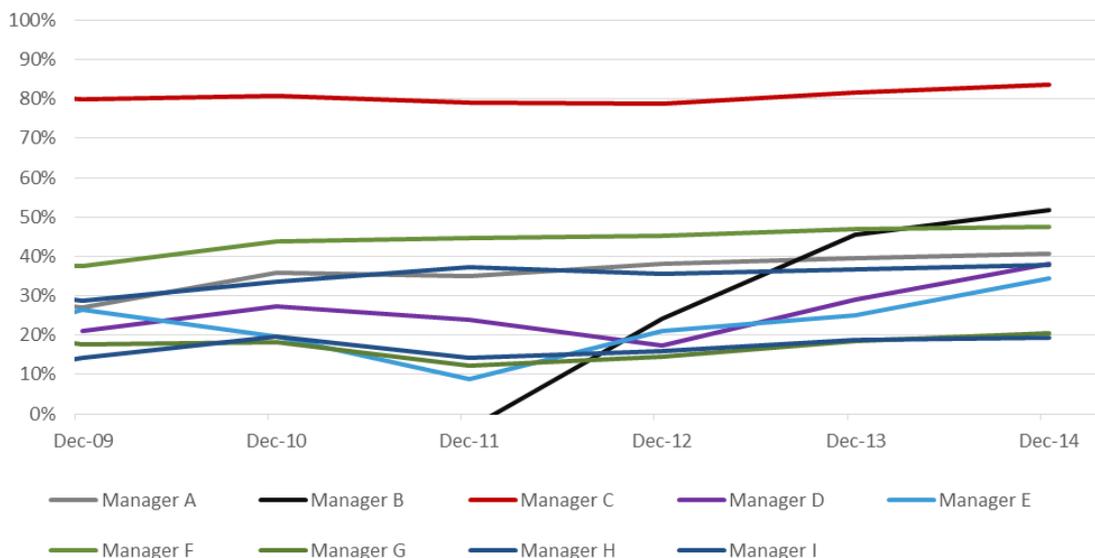
Nevertheless, these margins are, on average, and individually, high and collectively dwarf those of "normal" industries⁶. They have also mostly improved since the global financial crisis in 2008/09, and weathered the Eurozone crisis in 2011/12, showing not only the inextricable link between a rising market and fees, but also the link between a rising market and operating margins⁷.

Frontier believes that these margins are unsustainable. Many industries have been the victim of savage disruption in recent years, particularly those with unsustainable margins and it would surprise us if investment management is immune from these disruptive forces.

This disruption could be "left-field", such as a currently unknown digital disruption, or it could be from a more familiar source, from institutional investors themselves.

The very best investment management firms may be able to sustain operating margins of above 25%. Our view is that most will not, and should not, and it is time that investors redressed this imbalance back in their favour.

Chart 3: Major publicly listed fund managers: operating margins



Source: Bloomberg

6. Data for 7,480 US companies at January 2016 show an average operating margin of 16.3% (New York University Stern School of Business). Data for the S&P ASX 300 at January 2016 show an average operating margin of 15.0% (Bloomberg). An operating margin of "...25% or better is considered favorable by most market analysts" (Investopedia, LLC).

7. The operating leverage in managing listed market portfolios is particularly significant for investment managers. For example, for a manager who charges 0.50% per annum on average for \$10 billion in Australian equity assets under management (AUM), we question whether the costs involved in resourcing, systems, insurance, etc., really amount to \$50 million per annum? In addition, when the market rises 30%, AUM rises to \$13 billion and fees rise to \$65 million: what additional costs if any occur from the additional AUM and \$15 million per annum in fees?

What to do?

It's now crunch time: what solutions and ideas can Frontier suggest to assist institutional investors in lowering their overall fee budget, without comprising the integrity of their investment program to still deliver net returns consistent with investment objectives?



Investment program fee budgets

Many investors now monitor closely the fees they pay as a percentage of assets via their MER or equivalent. However, fewer investors monitor the actual dollar cost of investment management fees, which is at odds with how many of their other expense items are budgeted and monitored.

Our view is that investment management fees should be explicitly budgeted and forecast on a dollar basis, as well as a MER basis. This requires detailed mandate by mandate forecasting, along with assumptions at the individual manager level, but many of these forecasts and assumptions are made to calculate the MER anyway. In performing this analysis, most investors would be surprised at both the overall dollars involved, but also at how quickly this total increases over time. A focus on actual dollars paid makes it easier for an investor to contemplate alternative applications for those fees e.g. for internal staff, additional infrastructure, member engagement programs.

In monitoring and controlling the dollar fees paid, the key overall question to consider is how much such costs should be allowed to increase from year to year. The core question that we ask at this point is: if all other expense lines are rising at CPI/AWOTE or thereabouts, why aren't investment management fees?

In our view, dollar fee budgets are a very important first step in managing investment management fees and is an exercise as important as forecasting MERs. Both should be completed every year as part of the budget process. If you don't measure it, you can't control it.

Managing an investment program fee budget

With both a dollar fee budget and percentage of assets (MER) fee budget in place, the adjunct is a series of basic management disciplines to better control and minimise both measures. Many of these disciplines are already part and parcel of the internal processes of institutional investors, but are nevertheless worth restating here.

- Targets for both measures should be put in place, both short and medium term, with the overall trend identified and agreed. Market comparables should be part of this analysis.
- KPIs should be put in place for investment staff to explicitly meet the agreed targets – the broader and deeper these go across the structure the better. Incentives, or performance assessment criteria, for staff should be linked to achieving the targets.
- Regular reporting against targets should be part of management reporting. Of course, the monitoring should allow flexing over the assessed year as policy settings for asset allocations and sector configurations are adjusted or reset.
- The set of new strategies outlined below should be continually considered for efficacy and usefulness, and included as part of the overall strategy and approach to managing investment management fees, or incorporated in the relevant responsible staff members' approach to managing the outcomes.
- For existing investment management fee arrangements, a regular assessment and renegotiation of contracts is best practice. This may be a business as usual process (say, every three years), or completed as part of a reduction or rework of the manager line-up in a particular sector. In any case, fees paid to existing investment managers should definitely not be set and forget.
- Continually assess and reassess the targets, strategies and tactics used to reduce costs overall. Very few service providers outside a business will voluntarily offer to reduce their fees – it is the investors' responsibility to actively and continuously do this.



Insourcing

Our March 2016 Frontier Line 114, Navigating the Insourcing Trend, extensively canvassed the issues around insourcing (the polite term for disintermediation) investment management by, mostly large scale, institutional investors.

As the paper noted, insourcing drivers cited by executives of investors globally go beyond costs per se and include the general misalignment of interests between the investor and external asset managers, capacity issues with external managers for large mandates or in small markets, increased agency risk, lack of transparency, disappointing returns, the inability to sufficiently leverage economies of scale to reduce costs, and the desire to support a stronger connection with members and the philosophy of the fund.

The paper also cites, on the direct issue of costs, research by CEM Benchmarking which found that, for every 10% increase in internal investment management, there is an increase of 0.041% in net value add, for which “...the reason is almost entirely due to the lower cost of internal asset management”⁸.

Interestingly, the research also showed there was no significant difference in gross value-added performance between internal and external investment management at the asset class level.

Cost reductions can be achieved by insourcing if there are sufficient economies of scale, although these can be easily eroded by the losses incurred by a poorly executed strategy. However, a considered and well executed insourcing strategy has the potential to reduce costs, as well as facilitate a stronger connection between an investor’s philosophy and the way it is invested.

Negotiating techniques and positions

Many of the negotiating techniques and positions outlined below will be familiar, and are standard in other industries, but are nevertheless worth restating. They are likely to be more useful for homogeneous investment strategies or ideas, where the final

- Negotiate hard and be prepared to walk away or deal with the next alternative.
- Use the due diligence process to refine the investment management options for a strategy down to a high quality short list, and then request best offers on price as the differentiator.
- Alternatively, trim the preferred options to a small number and ask for a “best and final offer”.
- Invest early in the life of a strategy, or an investment manager, and negotiate (an ideally permanent) “foundation investor” fee arrangement or a “seed investor” discount.
- Negotiate “loyalty rewards” – a reduced fee for investing with the investment manager over a long period.
- When reconsidering a manager or investment strategy due to a disruption at the investment manager, it is worthwhile inquiring with them as to whether a reconsidered fee may be available to preserve their place in the portfolio.
- Establish a policy position of not recommitting to an investment manager that increases fees in subsequent products, an approach which implicitly penalises (rather than rewards) early investors

8. Miller, Terrie and Flynn, Chris, “Internal Management Does Better After Costs”, CEM Insights, October 2010.

9. An interesting variation on this idea was described to Frontier by an investment manager and is apparently a well tried technique in parts of south-east Asia. This variation involves a beauty parade that reduces the preferred investment manager options from, say, six to three, followed by a negotiation around a table via private offers to the tenderers from the three shortlisted managers. The best offer wins

Fee structures

There are some interesting and peculiar fee practices within the investment management world, some of which are well past their use by date. Additionally, there are also fee structures that could be used to better effect by institutional investors.

- Ad valorem fees should be resisted at every opportunity in favour of a simple CPI/AWOTE type escalation off a flat or fixed dollar fee base.
- Performance fee structures with no minimum level of performance, or the cash rate, generally have no place in today's investment market place.
- By extension, preferred returns should be avoided along with catch up – hard performance hurdles better reflect the minimum return required by an investor before a performance fees should kick in.
- Scale discounts need to scale down harder, reflecting the marginal cost to the investment manager, and ideally be structured as “all in” once a size level is reached.
- Managers that do have favourable and acceptable fee structures, including appropriate economics and margins, should be favoured and rewarded via future cash flow and long term mandates (where continued value add is evident of course).

Implementation

Traditionally, most institutional investors have implemented investment strategies and ideas via investment management intermediaries. These days, implementation options are wider and more varied, and many institutional investors now have the capacity and skills necessary to consider these. We have noted insourcing already as one variation, but other implementation options, and some implementation options to avoid, are as follows.

- Co-investment with managers or alongside managed funds is now a reasonably common implantation method which generally comes with lower fees.
- Alternative beta options are now generally available, particularly in the equities sectors via smart beta type strategies. These are generally lower cost, and can be tailored to suit the exposure desired.
- In addition, synthetics can be used to access beta in many sectors, and are especially worth considering where the position is likely to be unwound in the short to medium term.
- For the more adventurous, bespoke synthetic beta exposure can be negotiated with intermediaries across a range of broad and niche investment opportunities. Obviously, the right skills, processes and internal investment procedures need to be in place to utilise this option.
- One implementation method which we no longer consider appropriate is fund of funds. With an additional layer of fees, and no averaging of the performance fees of underlying funds, this investment structure is designed for disappointment.



New deals post the Frontier Fee Principles

The refined Frontier Fee Principles have been in place for a relatively short time, but we have nevertheless seen some positive responses from investment managers and we are gradually starting to see some proactive thought and creativity.

Some recent positive ideas and outcomes for investors are as follows.

- Frontier assisted in renegotiating the fee structure of an international manager whose first proposal failed all five of the Fee Principles tests. Despite this being a well sought after offering, where the manager was likely to easily meet its fund raising target, pressure from Frontier and the prospective client resulted in a reworked fee structure that included a 0.10% per annum reduction in the base fee and the product was subsequently deemed investable.
- An offshore fund manager is currently offering a fee structure that positively rewards both scale and the early mover. Apart from the traditional scaling for investment size, the investment manager uses cliffs whereby the fee on the whole invested sum drops to that of the next tier if the invested sum increases sufficiently. In addition, the investment manager is offering a nine month period for “foundation investors” to access a permanent 33% reduction in their fee on that initial amount whilst it is invested with the investment manager.
- A domestic manager has agreed a flat dollar fee for a traditional equities mandate, plus a modest escalator and performance fee based on a hard hurdle.
- A second domestic manager has agreed a base fee arrangement that reflects their cost recovery plus a modest profit margin, plus a performance fee based on a hard hurdle.
- Numerous Frontier clients are, with some success, quite simply negotiating harder and revisiting fee regimes more regularly in an effort to ensure fee outcomes are at, or better than, market benchmarks.

The final word

In a previous Frontier Line 111, *The New Deal: A Fair Day's Pay for a Fair Day's Work*, on the topic of investment management fees, we argued that the time had well and truly come for a new deal on investment management fees. We believe that the tide may now be turning on this issue, and that many institutional investors are indeed looking for a new deal.

We have identified and reiterated herein some of the issues we believe have led to our call for a new deal, but also outlined some ideas that will hopefully help push the tide further in investor's favour.

The key is of course implementing ideas in a way that preserves the overall investment objectives of an investor, including that of the net return, but consistently drives

towards better value for money for investors and their stakeholders. Investment management costs are a key drag on the net return, and therefore should be continuously, objectively and specifically assessed for value.

This is a key challenge for all investors, and a particular business challenge for superannuation funds for they face an industry where competition and the regulator are driving harder both value for money outcomes and transparency on fees and costs. It is the latter issue that we will address next in our last Frontier Line on the topic of fees for later in 2016, specifically the likely impact on fees and fee disclosures of Regulatory Guide 97: Disclosing Fees and Costs in PDSs and Periodic Statements (ASIC, November 2015).





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.

Frontier does not warrant the accuracy of any information or projections in this paper and does not undertake to publish any new information that may become available. Investors should seek individual advice prior to taking any action on any issues raised in this paper. While this information is believed to be reliable, no responsibility for errors or omissions is accepted by Frontier or any director or employee of the company.