



Fresh Lemonade from Old Lemons

October 2018

Genuine novelties in our industry are rare, whereas imitation is more than readily available given the surfeit of asset managers. However just because an idea is not new does not mean it cannot or should not be revisited in the light of current industry thinking (or current market conditions for that matter).

This juxtaposition of new and old comes firmly to mind when I consider recent market noise around performance fees. Indeed, to those who think launching non-hedge fund businesses based around performance fees is a novelty, I would point out that Stewart Newton did just that back in the 1970s! Now, I have actually been an advocate of performance fees for 25 years. As my consulting clients in the 1990s may recall (if any of my then clients have not by now retired!), as a consultant I virtually always asked active managers to quote for new business on both a flat and performance basis. My rationale was firstly that it was always beneficial for a client to be able to have a choice. Secondly, since what should concern a client is the potential share of their net of fee return stream, a structure where the fee was taken out of the gross return proportionately was actually helpful on a net of fee basis. Thirdly, the Achilles heel of active managers in our industry has long been a failure to maintain discipline on capacity, and so a structure that hardwired a commercial preference for performance over AUM would (or certainly should!) reinforce a strong capacity mindset.

Of course, not every client was comfortable, sometimes for good reasons. For example, the risk of having to pay a performance fee for good relative performance even if absolute performance was negative was legitimately a client concern in some settings, even though it would still be an indicator that the manager was being rewarded for adding value. Often the reasons for rejecting them were less good ones as well. Moreover, there were good and bad performance fee structures too –although I hope I only ever recommended good ones! – but those things are better known now than they were in the 90s. Nevertheless, generally I personally thought the arguments were typically very favorable and I recollect that the majority of my clients tended to agree with me.

Thus performance fees are definitely far from a novelty. However, I do believe they could and arguably should be central to other key debates that our industry now faces, and moreover they should actually influence the answers to some of those questions. These arguments don't seem to get the air time they deserve, and so I want to try and remedy that.

The first of those I have in mind is the constant struggle between active and passive, and what weight should a client give to each. Given the column inches devoted to this, it's hard to imagine there is an angle that is underexplored, yet performance fees often fail to even enter the discussion even though the availability and nature of an active performance fee approach should be highly relevant to a client who is considering this debate in a balanced way. For purposes of analysis, I am going to assume that a client has available a performance fee that involves the same amount of fixed cost as would be charged for passive management, and that they then pay a proportion of any excess return over the index to a manager (in a way that minimizes adverse optionality for both sides over the lifetime of the mandate).

Of course, if you don't believe in the possibility of investment skill, then a performance fee is not likely to change your mind very much. For everyone else, however, I would stereotype the arguments against active along the following lines:

- The fees are disproportionate relative to the expected added value.
- While skill exists, diagnosing it successfully is not automatic, and there is a risk of picking a bad active manager.
- The governance burdens of selection and monitoring are not justified by the expected reward.

The presence of a performance fee option of the type above materially impacts all three. By design, the first point is of course addressed directly: the client will pay the passive fee unless there is outperformance, and then only in direct proportion to that outperformance. In fact, this argument can be extended because whatever your probabilistic belief about the manager's future gross return stream, the resultant net of fee return stream in the presence of this performance fee design will have less volatility to the client.

So as a good quant, I thought we should build a model to illustrate this! Specifically I conceived of a two-state model to demonstrate how performance fees would lower the level of conviction required to appoint an active manager. As I was describing this to our head of research, Joshua Livnat, eager to hear his reaction, Joshua pointed out a very different construction, based on a separate old idea, which was applying George Akerlof's famous "The Market for Lemons" paper ... written in 1970.

In Akerlof's version (which helped win him the 2001 Nobel Prize, shared with Michael Spence and Joseph Stiglitz) the argument goes loosely as follows. In any market characterized by asymmetric information, where the seller has a large information advantage over the buyer, the pricing has to be set in such a way as to protect the buyer from unwittingly getting stuck with what is popularly referred to as a lemon. The classic example is the used car market. Although the buyer can seek to lower the information asymmetry (having a mechanic look over the car; buying market data reports, etc.), ultimately only the seller really knows whether it is a good car or not. As a result, the price must typically reflect the price of an average vehicle, as the only potentially mutually acceptable way to protect both buyer and seller.

In the asymmetric market for active equity strategies, using Akerlof's construct, performance fees conceivably offer a way to bridge the information gap that no amount of backward-looking checking under the hood provides. Rather than simply accept the average fee, the manager, by offering an index base fee plus performance percentage, is implicitly communicating to the client a high level of confidence that its skills are highly above average. The client, in turn, requires a lower level of conviction to ensure that the manager isn't pulling a fast one or simply misguided about its abilities.

Extending Akerlof's "Lemon" analysis may provide a further elegant refinement of the significance of performance fees in the active-passive discussion. But for the rest of this letter, I consider another novel angle which is where the availability of performance fees should be considered in the whole investment strategy process.

Our industry – maybe because of the principal agent nature of its relationships – typically approaches decision making in a hierarchical fashion. For example, we consider first how much should be allocated to equity, then how much to each market, then whether to use active or passive, then which manager, and finally which fee scale (if you embrace my choice at the start). In fact, given the arguments above, as a client or advisor, you should actually bring the availability of a performance fee of this sort into the earlier decisions. In almost any statistical framework – given the better overall net of fee return shape, the lower cost of being wrong and the lower governance threshold theoretically

required – the presence of the performance fee will have a bearing on the optimal weighting to active vs passive, and indeed may well tip the scales on a yes-no question.

So what's the message here? Performance fees are not a new concept; in fact, they are probably much older than most industry commentators realize. However, don't let the lack of novelty put you off. They potentially have new relevance to our current industry debates, whether through genuinely fresh thinking around how they apply and where they apply, or looking at them through a different lens.



Andrew Dyson

NOTES TO DISCLOSURE

The comments, opinions and estimates contained herein are based on and/or derived from publicly available information from sources that QMA believes to be reliable. We do not guarantee the accuracy of such sources of information and have no obligation to provide updates or changes to these materials. This material is for informational purposes and sets forth our views as of the date of this presentation. The underlying assumptions and our views are subject to change.

This is intended for Professional Investors only. All investments involve risk, including the possible loss of capital. Past performance is not a guarantee or reliable indicator of future results.