All you need to know about: Management Fees

Introduction

Shareholders want to make money and a good manager can make an enormous difference to your long-term returns. Persistent outperformance can dwarf even the most expensive fees, however, compounded, high fees can really eat into a fund.

Is your manager paid too much?

You want your managers to be motivated to do their best but it is true that some managers get paid too much. You might be right to be suspicious of a manager who can make multi-millions just by turning up to work and collecting the annual management charge. Where is their incentive to add value? Remember though that your fees are paying for a lot more than just the fund manager.

Ongoing charges

The ongoing charges ratio is a measure of all the ongoing running costs of a fund expressed as a percentage of average net assets. This includes bank charges, lawyer's fees, directors' fees, marketing costs, custodian's fees, stock exchange listing fees and all sorts of day-to-day expenses. This is the measure that we display within the sector data tables.

Unless an investment company manages its own investments (and there are quite a few that do – these are called self-managed funds), the fund will need to hire an external manager and these want paying. There is no standard way of working out the management fee but here we have tried to explain some of the most common ones

Flat fees

The simplest fee is a flat one - £250,000 per year say – there is a good argument for saying that a large fund does not require much more effort to run than a small one – why not pay the manager just for the effort he or she puts in. In practice though the only funds that tend to work this way are the self-managed funds. Managers would argue that by basing the fee on the size of the fund, they are incentivised to make it bigger by performing and penalised for losing money.

Size-based fees

In practice, most fees are charged as a percentage of the size of the fund but "size" can be measured in different ways.

Fees on market cap.

The best of these fees are based on market capitalisation. Using market capitalisation rewards the manager on the size of the fund and how well its shares are rated by investors so the manager has an incentive to keep the discount tight and get the fund trading at a premium if possible.

Fees on net assets

Most fees are based on net assets.

Fees on gross assets Some fees are based on gross assets, i.e. net assets plus debt. This has the potential to be bad news for shareholders as it gives the investment manager an incentive to borrow money, increasing risk.

Tiered fees Some fees are tiered so that higher fees are charged on the first £xm of assets, a lower fee on the next £xm and so on. This is a welcome thing for larger funds.

Performance fees

Performance fees need to be well designed Performance fees often attract bad press because many have been badly thought out. Whether by accident or design some managers have walked away with enormous sums of money just for having one good year, sometimes without even beating any benchmark. Designing a good performance fee is all about aligning the manager's interests with the shareholder.

Benchmarks and hurdles First you need a benchmark or a hurdle; whether this is an index or a peer group average or a return based on outperforming the risk free rate depends on the fund. Some funds (mainly hedge funds and private equity funds) get performance fees just for making profits; some people think this is setting the bar too low.

High watermarks Then you need a high watermark so that fees only accrue if the net asset value has risen since the last time a fee was paid. Funds that invest in volatile assets can alternate between very good and bad years. If they manage to earn a performance fee every time the assets go up, over the long term shareholders can end up seeing money being paid out while the net asset value drifts sideways or even falls.

Good motivation You need to ensure that the right people are being motivated. Ideally Boards should ensure that the majority, or even maybe all, of a performance fee gets paid to the people that generated the outperformance.

Long-term thinking Good performance fees should encourage long-term thinking. One of the easiest ways to do that is to insist that performance fees are paid in shares in the fund that cannot be sold for a number of years. More complicated fees use claw-backs or only vest over multi-year periods.

Caps Ideally earning a performance fee should not be like winning the lottery. You want your manager to be delivering long term outperformance not considering early retirement; so capping the fee makes sense. Some managers will argue that this means that if they hit their cap early in a year, they will batten down the hatches and take no risk until it crystallises. However, assuming the cap has been set at a reasonably ambitious level, shareholders should be quite happy with that.