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INVESTMENT MANAGER FEES
EXPANDING THE FRAMEWORK

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OVERVIEW

This paper expands on the framework set out in Mercer's recent paper[1] on improving the fairness and alignment of investment manager fee structures for active management in traditional asset classes.[2]

In our earlier paper, we set out the arguments for why we believe change is needed in fee structures to address the issues of both fairness (that is, the total percentage of assets paid to asset management firms) and alignment (that is, the influence fee structures have on asset managers' investment and business decisions). Without change, we believe active management will continue to face significant pressure from low-cost passive solutions. Our initial paper also proposed a framework for assessing manager fees across different asset classes based on:

1) A strategy's targeted return
2) The probability of achieving the targeted return
3) The cost of a passive alternative

This follow-up paper applies the same framework to a range of asset class universes to illustrate what we believe are fair and aligned fee levels in common asset classes, giving tangible examples for assessing fee structures for both existing and new mandates. This also provides a consistent framework for investors to develop "fair" fee structures that reflect their individual beliefs based on a clearly articulated set of assumptions.

Although this paper focuses on investment manager fees, we recognize it is only one (albeit significant) element of the total cost of investing. We continue to encourage a focus on the total cost of investing and welcome increased transparency in this area.

[1] Mercer. *Investment Management Fees: Seeking Fairness and Alignment*, October 2017.

[2] This paper focuses on long-only asset classes in benchmark-relative equity and fixed income universes.

EXPANDING THE FRAMEWORK

The framework includes two example fee structures. Each structure is designed to improve fairness and alignment while being similarly attractive. There are other structures that have merit, such as fixed fees (based on a stable "dollar fee" rather than a percentage of assets) or less-constrained performance-based fees (for example, zero base fee performance-based structures with no cap). Such structures can also help improve fairness and alignment and are discussed in our original paper; however, for simplicity, we have not included these structures in the examples below.

The framework has been expanded to include four equity and four fixed-income universe groups. Strategies within each group have broadly similar expectations for the return to active management, with similar costs of access. The approach for each option is set out in the following table:

Table 1: Overview of Fee Framework for Ad Valorem and Performance-Based Fees

Fee structure option	Approach	Management fee	Performance participation rate	Max fee ("cap")
A flat ad valorem fee	A percentage of AUM calculated as the cost of passive plus a "fair share" of the expected outperformance	Indicative cost of passive plus 20%* of the ***realistic expected outperformance***	N/A	N/A
Performance based fee (PBF)	• A very low base fee • A percentage of outperformance such that if the ***realistic expected outperformance*** is achieved, the total fee is comparable to the ad valorem fee • A fee cap to enable ***material fees to be earned*** if performance targets are achieved without incentivizing excessive risk-taking	Indicative cost of passive	20%*	30%* of targeted outperformance

* We have chosen these figures at a level we believe to be fair, based on our own views and the balance of risk between asset owners and asset managers. However, this is a subjective judgment. Defining this value is likely to form a crucial part of the fee discussion for those adopting the framework proposed in this paper.

A key element of this framework is the calculation of a **realistic expected outperformance** in each universe group — that is, the return we believe a well-informed investor can realistically expect to receive from active management.

There are two key inputs to this calculation outlined in the table above:

1. The first key input within this framework is the calculation of a **realistic expected outperformance** in each universe group — that is, the return we believe a well-informed investor can realistically expect to receive from active management (gross of fees). The realistic expected outperformance is estimated using 1) each strategy's return target proportionate to the risk taken and 2) an assessment of the probability of achieving that target in the relevant universe group. The first element of this is setting strategy outperformance targets appropriate for the level of risk taken. We believe this should be agreed upon between the investor and the investment manager and should broadly reflect the level of risk being taken while ensuring the target is not unrealistically high (for example, we would not recommend a target in excess of 3% in large cap equity universes regardless of the level of risk taken). Table 2, on the following page, uses example return targets to illustrate what we believe are appropriate fee ranges. In practice, the return targets will vary by strategy.

2. The second key input of this calculation is the probability of achieving the stated return target. We believe this should vary by universe and asset class but not by strategy within asset classes. The objective here is to treat all highly rated strategies within a given universe equally and to avoid the temptation to place a higher degree of confidence (thus justifying higher fees) in any one favored manager. The probability of achieving the target assumptions used in Table 2 is based on an empirical analysis of success rates across a range of similar universes from a well-informed investor over long time periods and a forward-looking, subjective assessment of the prospects of active management in each area.

The flat fee structure (option 1 in the table above) is what we believe to be a fair ad valorem fee for active management based on a given fair share of the realistic expected outperformance. We have used 20% as a "fair" share of the **realistic expected outperformance**; however, this is a subjective view of fairness and may vary depending on individual investor beliefs.

Option 2 includes a performance-based fee whereby the manager receives approximately the same fee as in option 1 if they achieve the **realistic expected outperformance** and significantly higher if they meet their target outperformance. Option 2 also has a fee cap linked to the strategy's outperformance target (or level of risk taken) to provide some symmetry to the structure with the existence of a "floor" and a "cap." The cap is set as a percentage of the expected outperformance target such that, generally, the maximum management fee is at or higher than the current universe median fee level. This enables investment managers to achieve material financial rewards if they achieve their target objectives but keeps these rewards sufficiently low to ensure excessive risk-taking isn't incentivized.

RECOMMENDED FEE RANGES

The framework described above has been used to calculate what we believe are fair fee structures, which are set out in Table 2, below.

Table 2: Example Fee Structures Assuming a 20% Share of Alpha

						#1	#2 PBF		
	Example strategy return target[3]	Probability of achieving return target	Realistic expected outperformance (REO)	Indicative passive fee[4]	Median universe active fee	Flat fee	Base fee floor	If hits REO	Cap
Equity: US large cap	2.5	33%	0.83	0.08	0.50	0.25	0.08	0.25	0.75
Equity: developed large cap	3.0	50%	1.50	0.10	0.68	0.40	0.10	0.40	0.90
Equity: EM/Asia	3.0	60%	1.80	0.20	0.85	0.56	0.20	0.56	0.90
Equity: small cap	3.0	70%	2.10	0.30	0.90	0.72	0.30	0.72	0.90
FI: credit	1.0	60%	0.60	0.08	0.28	0.20	0.08	0.20	0.30
FI: aggregate	1.25	70%	0.88	0.08	0.35	0.26	0.08	0.26	0.38
FI: high yield	1.5	25%	0.38	0.35	0.50	0.43	0.35	0.43	0.45
FI: EM debt	2.0	30%	0.60	0.35	0.60	0.47	0.35	0.47	0.60

Source: Mercer

[3] This shows common strategy-level return targets. In practice, this will vary by strategy, with the strategy-specific target agreed on between the investor and the investment manager.
[4] Passive fees are indicative of fees paid in each asset class for an average institutional investor.

A NOTE ON PERFORMANCE-BASED FEES

We have outlined two potential fee structures — one with and one without a performance-based element. Although addressing the fairness of flat fee structures is fairly straightforward through the use of a "fair share" of alpha calculation, addressing alignment[5] is more difficult. On the surface, performance-based fees would appear to be an attractive way to increase both fairness and alignment. A minimum payment of a passive-like base fee would seem to improve "fairness," whereas a higher fee reflecting strong performance would appear to improve "alignment." However, the reality of many performance-based fee structures is very different, and they are often neither fair (they are typically skewed in favor of the investment manager due to inappropriate benchmarks and uncapped upside)[6] nor well-aligned (they may incentivize poor behavior, such as a focus on excessive short-term risk-taking).

The core components of performance-based fee structures (base fee, the "share of alpha" and a cap on total fees) are illustrated in the tables above. However, there are other elements of a performance-based fee structure that are critical to consider in order to ensure appropriate alignment, including:

1. **The appropriateness of the benchmark** — Any performance fee should be measured against a benchmark and hurdle that is a fair representation of the objectives of the strategy and the opportunity set available to the investment manager.
2. **High-water marks** should be considered to ensure performance is not rewarded more than once. A structural issue with performance fees is that, if performance is volatile, performance fees can be material despite flat or negative returns. A high-water mark can ensure performance is not paid for twice.
3. **Deferring or retaining performance fees** over a multiyear period to offset against future underperformance can counteract the challenges of "path dependency." A key challenge of performance fees is that the pattern of performance over the period invested can have an impact on the fee paid regardless of the final outcome (that is, the total fee paid is path-dependent). Retaining a proportion of fees to offset future underperformance can help mitigate this issue. The time period over which any fees are deferred will need to be negotiated.

There are additional considerations. For example, investors in mutual funds have specific limitations relating to performance-based fee structures,[7] and we note that smaller, single-product investment firms may face material business risks if a significant proportion of their assets are run against performance-based fees with low base levels.

However, although setting performance-based fee structures can be a complex task, we believe they can be a sensible approach to improving the alignment of many existing fee arrangements and should be considered by investors.[8]

[5] This paper focuses on the use of fee structures to improve alignment. Another approach to improving alignment would be ensuring investment managers have a meaningful proportion of their own wealth invested in the strategies/funds they manage.

[6] For further reading, see Clare et al. *Heads We Win, Tails You Lose: Why Don't More Fund Managers Offer Symmetric Performance Fees?*, London: Cass Business School, October 2014.

[7] For example, mutual funds will have investors joining and leaving the fund at different times, yet the performance fee is charged to all investors simultaneously, causing challenges in creating fair and long-term performance-based fees.

[8] Although we believe in the economics of PBFs as set out in this paper, we do appreciate that in specific situations at least two other issues should be considered. If performance and fees are being allocated to individual participants, there can be intergenerational issues where the person paying the fees may not have earned the performance for which the PBF is being levied. Secondly, if there is strong performance, the consequence of PBFs will be increased fees (fully offset by increased performance), but where there is a heightened attention on the absolute level of fees, the disclosure of higher fees when considered in isolation could be misinterpreted.

CONCLUSIONS AND ACTIONS

We believe investors are currently paying fees that are not fair and aligned given the outcomes active management has delivered.

The topic of appropriate investment manager fees is complex. We believe investors are currently paying fees that are not fair and aligned given the outcomes active management has delivered. Investment managers do provide an important service and can generate returns over those of passive management; if they do that well, they should be rewarded. We do not believe the focus should be solely on identifying the lowest-cost provider but rather on achieving the best net-of-fee outcomes for investors. We also do not believe there is a single right answer that is appropriate for all investors or all investment management firms. However, we do believe many existing fee arrangements are structured poorly, with excessively high fee levels and poorly aligned incentives. We believe there is scope for material improvement in many fee structures, with both lower flat fees and sensible performance-based structures forming part of the solution. This will lead to better net-of-fee returns for investors, a more attractive and sustainable active management proposition and significant rewards for successful investment firms.

The framework discussed in this paper is designed to provide guidance to help investors assess fair fee structures in a consistent and objective way. The key inputs into this framework are highlighted below:

- **The "fair share" of alpha** (for example, 20%)
- **The probability of achieving the return target in a given asset class**
- **The cost of a passive alternative**

The inputs used to calculate the fee levels in Table 2 are subjective, and different investors may well form different views on the key inputs. We recommend investors consider what they believe to be fair and realistic inputs for each of their mandates. The framework described can then be used to calculate a set of fair, consistent and objective fee levels against which to benchmark existing fee structures and to facilitate future fee discussions with asset managers. This framework can also be used to understand and challenge the implicit return assumptions underpinning existing fee arrangements — that is, the current implied assumptions about the share of alpha or probability of achieving success embedded in these arrangements.

Ultimately, we believe change is needed. If investment manager fees do not represent an attractive value proposition, then active management may not be an economically rational decision for many investors.

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