Why performance fees are a scam

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Special to The Globe and Mail
Published Thursday, Oct. 01, 2015 12:19PM EDT
Last updated Thursday, Oct. 01, 2015 4:17PM EDT

Performance fees, which have predominantly been associated with the hedge fund world, are, unfortunately, becoming increasingly common in the retail fund industry across the globe.

Ostensibly, the purpose of performance fees is to benefit investors by aligning the fund manager's interests with their own. This alignment of interests happens, or so the argument goes, because it ties a manager's compensation to the performance of the fund.

At first glance, this argument sounds pretty convincing. After all, who wants to pay their fund manager just as much when he performs poorly? Many people would prefer to pay more when a fund does well if it means they pay less when the fund underperforms.

The Ruse

The trouble is, it doesn't work that way in practice. In practice, the investor often pays a generous fee of 2 per cent no matter what – even if the fund loses money – and pays an exorbitant fee when the fund performs well. There's often no limit to the fee an investor can be charged if the fund performs well. Therefore, the potential upside to the fund company is multiples of any potential downside. In essence, the fund company has a free call option on the portfolio.

Logical fallacy

More importantly, the logic underpinning the argument isn't sound. Performance fee proponents assume that a fund manager's desire to outperform and the ability to outperform are highly correlated. In other words, if a fund manager wants it bad enough, they can outperform. I can assure you this isn't true. The world is littered with workaholic fund managers who can't beat the benchmark.

Another fallacy of the argument is that it assumes fund managers don't already have enough incentive to perform well. Again, this isn't the case. Fund managers already have an incredible amount of pressure on them to outperform. For instance, strong performance typically leads to a bigger bonus for the individual fund manager and higher revenue for the firm. Furthermore, a manager's track record sticks with her for life and dictates what future career opportunities she has. The better her track record, the more money she can command in the future.

Do the right thing

You have to wonder why the well-paid professionals you've entrusted your hard-earned savings to are asking you for more money when they produce strong returns. Isn't that what they are being paid for in the first place? We don't pay doctors more money if they perform a successful operation; they do everything in their power to save a person's life no matter what. Call me old-fashioned but I'd prefer to steer clear of someone who needs extra financial compensation to do the right thing.

Furthermore, the complexity of performance fee structures allows firms to quietly stack the odds further in their favour by manipulating the fine print. For instance, a firm might choose an inappropriate benchmark, calculate performance fees on gross (not net) returns, or even exclude a hurdle rate or high water mark.

Unintended Consequences

But even when dealing with well-intentioned firms the complexity of performance fee structures leaves the potential for all manner of unintended consequences. For example, imagine you are running a fund and are slightly underperforming. You may be tempted to ratchet up the risk with the hope that you surpass your hurdle and trigger a fat bonus.

Conversely, if you're outperforming, you may be tempted to decline attractive investment opportunities because you are unwilling to risk any bonus you already stand to earn. Not to mention that you have the incentive to take on a lot of risk much of the time because that gives you the best chance of striking it rich. After all, if it doesn't work out and the fund blows up, you can always close it and start another one with a clean slate.

All this said – it is conceivable that a performance fee could be structured in such a manner as to make it benign. But I have yet to see such a performance fee. And the time and effort required to analyze them make them far more trouble than they are worth; especially considering the fact that there's a much more powerful and simple solution.

Eating their own cooking

When you boil it down, performance fees are really just an over-engineered set of rules that attempt to mimic the natural alignment of interests that exists when fund managers become investors in their own funds. This way the fund manager wins when the fund does well and suffers right along with investors when it tanks. So my modest proposal is that fund companies ditch performance fees and simply require their managers to invest alongside their clients. After all, what more incentive could a fund manager need than having their own capital on the line too?

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