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Hedge Fund Fees: 2 and 20 or 2 and 50?

By DANIEL TENREIRO | June 22, 2020 2:26 PM

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David Solomon, CEO of Goldman Sachs, speaks during a meeting with bankers and President Trump on coronavirus response at the White House in Washington, D.C., March 11, 2020. (Tom Brenner/Reuters)

"2 and 20" has long been the standard fee structure in the hedge-fund industry. Limited partners (LPs) in hedge funds pay 2 percent of their allocation to management fees, which go to salaries and overhead, and 20 percent of the fund's return as a performance fee. Performance-based compensation attempts to align the interest of the fund manager with the interest of the investor. Since managers make the lion's share of their money on the returns they generate, they only get paid if they do well.

A new academic paper from The Ohio State University finds that the headline fees significantly understate the actual fees paid to hedge-fund managers. Between 1995 and 2016, hedge-fund investors paid roughly half of their total profits as incentive fees, well above the 20 percent figure written in their contracts.

The high "effective incentive fee rate," as the study's authors call it, is attributable to the fact that hedge-fund managers are not liable for fees on losses. The total amount of fees paid to hedge funds is roughly 20 percent of all profits generated, but because a significant portion of funds lose money, fees as a portion of total profits almost always exceeds 20 percent. "A particularly absurd illustration of this mechanism occurred in 2008," the authors point out. "Despite the aggregate loss of $147.1bn before fees, investors still paid incentive fees of $4.4bn in that year."

If a fund loses money, it provides "fee credits" to its LPs, which offset incentive fees on future gains. But a hedge fund that persistently underperforms will never pay back any portion of its losses. Because there is significant dispersion in the hedge-fund industry, with the average fund just barely delivering excess returns, most of those "fee credits" end up being written off when underperforming funds shut down. Hedge funds that shutter after periods of poor performance effectively default on the fees they owe to investors.

Further amplifying the high effective incentive fee is the fact that investors tend to flee funds that underperform. When investors withdraw money from lagging funds, they lose the right to recoup fee credits on the losses they have realized. Effectively, investors subsidize underperforming fund managers to the tune of $7 billion a year.

High fees have played a role in the recent exodus from hedge funds, which have underperformed their benchmark stock indexes every year since 2009. With the unprecedented bull market in stocks showing signs of persisting through the coronavirus pandemic, investors are likely to keep pulling money from active managers.

That's all before accounting for the outsize portion of fees paid as a portion of aggregate hedge-fund profits.

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