FTfm Hedge funds

Hedge fund titans grab lion's share of industry spoils

Investors end up paying high fees for poor returns while managers accumulate personal fortunes

Chris Flood and **Ortenca Aliaj** 3 HOURS AGO

Paulson & Co and Lansdowne Partners this month decided to shut their flagship hedge funds after periods of disappointing performance that destroyed much of the wealth created by these managers in earlier years.

The erratic performance of many hedge funds means investors can be charged high fees for disappointing returns. But at the same time some hedge fund titans, including John Paulson, still walk away with multibillion-dollar personal fortunes.

US pension schemes earned just 5 per cent a year on average from their hedge fund investments between 1998 and 2017 according to data from more than 200 public and private retirement plans compiled by CEM Benchmarking, a Toronto-based investment consultancy. The pension schemes earned annualised returns of 9 per cent over the same period from S&P 500 stocks, an investment that could be made in a tracker fund costing just a few basis points.

Yet more than half of the profits earned by hedge funds over two decades were taken by their managers, a revenue split that will fuel debate over whether investors are receiving fair value for the performance fees they are being charged.

The debate over profits comes at a difficult time for the hedge fund industry as a growing list of former star managers, such as Silver Ridge, Stone Milliner, Jabre Capital, Omega Advisors and Eton Park, either shut funds or close their doors entirely.

Performance fees traditionally accounted for 20 per cent of any profits created by a hedge fund above an agreed benchmark, an arrangement intended to align the interests of managers with their clients.

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Itzhak Ben-David

But the inconsistent returns delivered by many managers and the early closure of many hedge funds after bad results have resulted in investors often paying substantial fees for mediocre performance.

Investors earned $228bn in aggregate gross profits and paid $133bn in incentive fees in a sample of 6,000 hedge funds (over a third of the hedge fund industry) between 1995 and 2016, according to a study by the finance professors Itzhak Ben-David and Justin Birru from Ohio State university and Andrea Rossi from the University of Arizona.

"There is a considerable disconnect between the returns generated and incentive fees earned across all but the worst-performing 5 per cent of hedge funds," says Mr Ben-David.

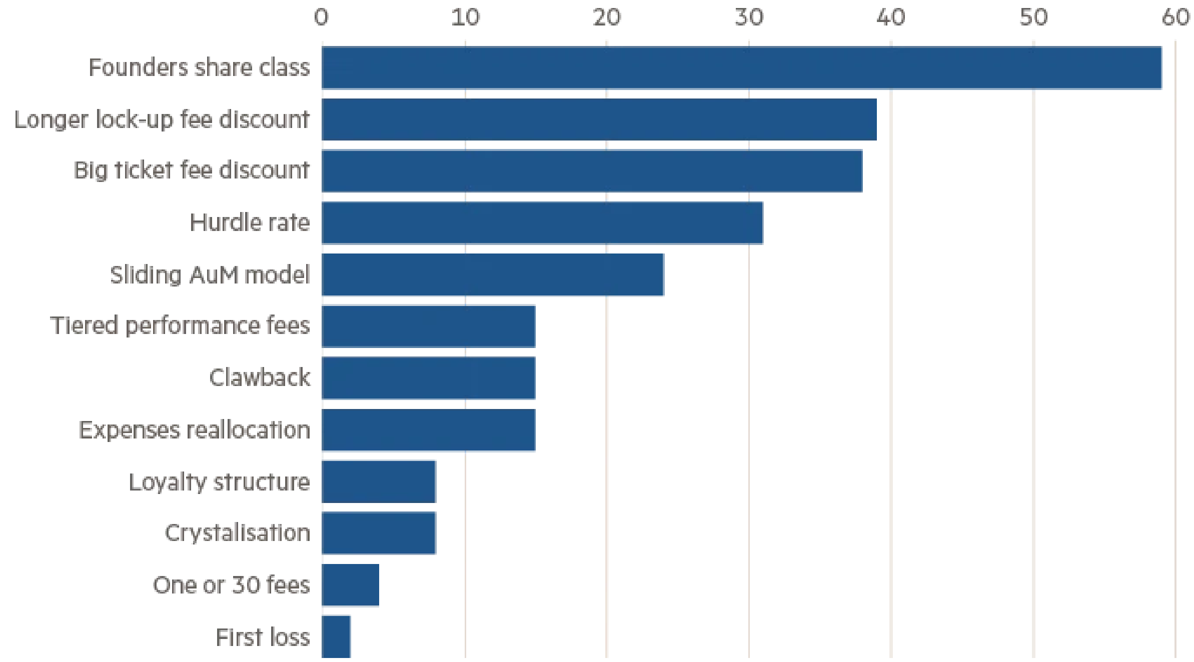
After including annual management fees that are paid regardless of performance, investors earned just 36 cents of each dollar of gross profits generated by the funds above their benchmark. The other 64 cents were collected by hedge fund managers.

"Adding insult to injury, these results are obtained before even adjusting fund returns for the risk embedded in these investments," says Mr Rossi.

A senior executive from a major hedge fund, who did not want to be identified, says ending management fees would make the hedge fund industry much more "robust".

Preferential fees and terms offered by hedge fund managers

% of investors that always or frequently receive improved terms or fees



Source: Credit Suisse

The study concluded that investors would have paid $70bn less if the hedge fund managers had made repayments from their own pockets for any periods of underperformance.

"A clawback provision could drive the effective performance fee down," says Mr Rossi. Yet, only fewer than one-in-six hedge funds offer investors any clawback of past fees in case of poor performance.

More symmetric agreements, known as fulcrum fees, which are designed to ensure that a manager holds real "skin in the game" beside their clients' money, could have saved investors about $194bn over the 22 years if applied across the entire hedge fund industry, according to the academic study.

"Despite the long history of poor outcomes associated with the prevailing fee model, the hedge fund industry does not appear to be moving en masse towards a more symmetrical incentive structure," says Mr Birru.

Tension over fees between clients and managers have risen in recent years, leading to an erosion of the industry's historic "two and 20" fee model. More than half of the respondents in a survey of 227 institutional investors with $706bn in hedge fund assets were renegotiating or looking to renegotiate fees in 2019, according to JPMorgan.

It found that 17 per cent of its respondents had implemented a "one or 30" model. Under this, an investor pays a 1 per cent management fee that switches to a 30 per cent performance fee once an agreed target has been reached.

DE Shaw, one of the world's oldest and most successful hedge funds, increased its fees last year to "three and 30" on the back of strong performance. Steven Cohen, the founder of Point72 Asset Management who opened his family office to outside investors in 2018 following a two-year ban by the Securities and Exchange Commission, now charges a 2.85 per cent management fee and performance fees that can go up to 30 per cent depending on returns.

But loading up incentive fees might not improve the link between long-run performance and fund costs or reduce the total amount paid by investors over a full market cycle, warns Mr Ben-David. "Increasing the incentive fee rate is unlikely to protect investors from paying managers that perform poorly in the long run," he says.

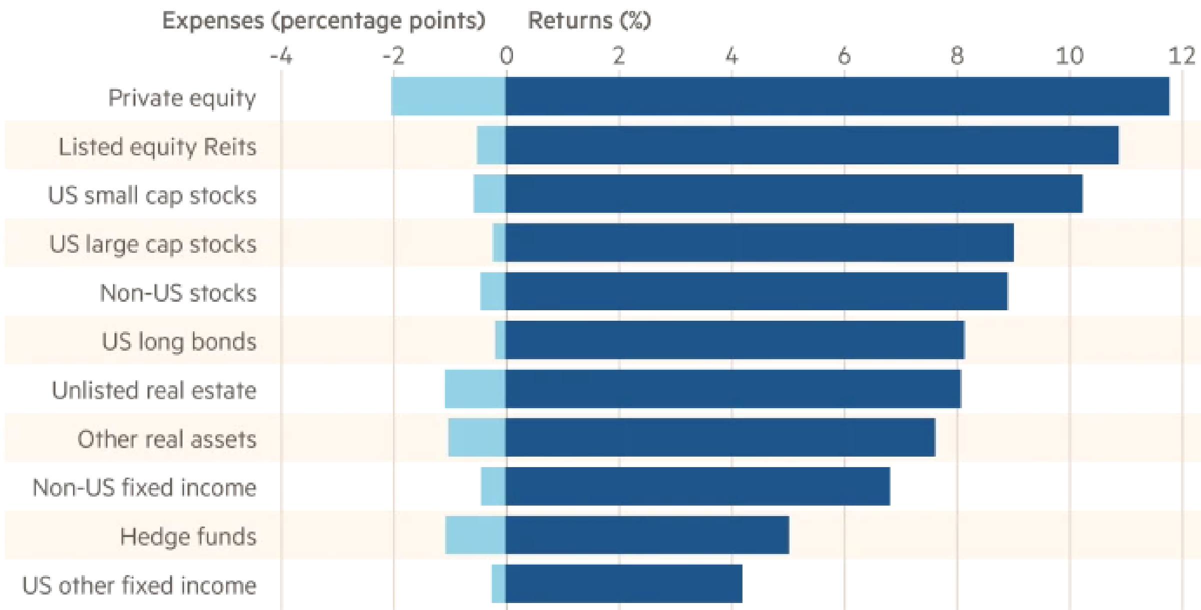
Chris Walvoord, global head of hedge fund portfolio management and research at Aon, the investment consultant, says the academic study paints an unrealistically bleak picture of the fees paid by investors.

"A carefully constructed portfolio of a dozen hedge fund strategies seldom matches the aggregated risk and return of the entire hedge fund industry," says Mr Walvoord.

"There are positives and negatives to hedge fund performance fees that investors need to consider carefully. The lower fees that an investor can negotiate, then the better off they will be. Investors would be better off negotiating a 10 per cent performance fee in return for a slightly higher management fee", he says.

US pension funds net annual returns and expenses

By asset class, 1998-2017



Source: CEM Benchmarking

Aon pays close attention to the capacity limits of hedge fund strategies — maximum effective operating size — when constructing portfolios.

"Funds that attract a lot of assets and exceed the capacity of their strategy can earn high management fees as well as large performance fees in good years. But their returns over time tend to be substandard and they go out of business. So the capacity of a strategy is a very important consideration when constructing a portfolio of hedge funds," says Mr Walvoord.

High fees and lacklustre returns have prompted some investors to look for lower cost alternatives, leading to net withdrawals of $175bn from hedge funds since the start of 2016, according to HFR, the data provider.

But interest from US pension schemes, the hedge fund industry's most important client group, has weakened only slightly. Hedge fund allocations by US pension schemes rose from 1.5 per cent in 1998 to a peak of 8.4 per cent in 2014 before dipping to 6.6 per cent in 2017, according to CEM Benchmarking.

Credit Suisse recently surveyed 160 institutional investors with $450bn invested in hedge funds and found a clear improvement in appetite.

"Hedge funds are the top investment strategy choice for asset allocators moving into the second half of this year. A net 32 per cent of the investors surveyed plan to increase their hedge fund allocations as these strategies performed as well or better than expected during the market turmoil triggered earlier this year by coronavirus," says Vincent Vandenbroucke, head of capital introduction and prime consulting in Europe at Credit Suisse.

Mr Vandenbroucke says there is evidence that hedge fund managers are responding creatively to pressure from investors for a stronger alignment of interest with more customised managed accounts. These products can be better tailored to suit client needs, with a variety of fee discounts and a greater range of enhanced terms.

"More than a third of investors receive fee discounts in return for agreeing to longer lock-up periods or for 'big-ticket' orders," said Mr Vandenbroucke.

But divergences between managers and investors over fees and terms persist. About 57 per cent of investors see hurdle rates — agreed targets that trigger performance fee payments — as valuable. But hurdle rate conditions are agreed with fewer than a third of investors, according to Credit Suisse.

Clawbacks to recover fees after disappointing performance are highly valued by a third of clients but just 15 per cent are provided with such facilities.

"Clawbacks are perceived to be difficult to implement fairly in pooled vehicles where there are regular investor inflows and redemptions. Managers also believe that clawbacks are inconsistent with their fiduciary duty to all clients — past, present and future — in their fund," says Mr Vandenbroucke.

Offering preferential fees and terms might persuade some clients to remain loyal but big improvements in performance will have to be achieved if more of the hedge fund industry's wealthy titans want to avoid following Mr Paulson through the exit door.