The Performance of Hedge Fund Performance Fees

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One of the tenets of modern economics is that agency conflicts can be mitigated by implementing compensation contracts that align the agents interests with those of the principal. Over the past three decades, compensation contracts in the hedge fund industry have sought to achieve this goal by charging a variable performance fee to complement a fixed annual management fee of 1-2%. Performance fees, often called incentive fees, are typically around 20% of profits over a quarter or year and often are accompanied by provisions meant to ensure that incentive fees are only paid on profits exceeding a predetermined benchmark, which often includes the previous highest portfolio valuation. On its surface, the structure of hedge fund incentive fees appears to closely align the incentives of hedge fund managers and hedge fund investors. But how do these incentive fees fare in practice?

Looking back over a 22 year sample, beginning with 80 funds in 1995 and including nearly 6,000 funds by 2016, we find that incentive fees equaled roughly 50% of hedge fund industry profits in excess of the hurdle rate. Accounting for the annual fixed management fee increases the fraction collected by hedge fund managers over this time period to 64%. That is, for every dollar profit generated by hedge funds, 64 cents of this profit was retained as fees by hedge fund managers and the remaining 36 cents ended up in the pockets of hedge fund investors a seemingly far cry from the stated promise of 2 and 20.

The underlying cause of this large gap between stated nominal incentive fee rate and effective incentive fee rate is the asymmetric structure of incentive fees. Fees are gathered when performance is good, but are not returned in times of poor performance. For a hedge fund that generates steady profits over time, investors indeed may pay a total incentive fee of roughly 20% of profits. Of course, this preferred outcome is not realized by most funds, leading to a number of predictable distortions arising from this asymmetry.

For a typical fund with performance marked by ups and downs, fees will be collected when times are sufficiently good, but are not refunded when returns are poor. Investors of a fund with early profits followed by later losses may find themselves in the position of having paid large aggregate incentive fees for long-term returns that are minimal, or even negative if losses are large enough to eclipse earlier profits.

It is not just funds collecting fees from early gains that are later lost that contribute to the distortions. A second factor becomes apparent when looking across the entire universe of funds. Funds with lifetime losses act as a weight dragging down profits of the aggregate hedge fund investor. For example, if half of hedge funds generate profits and retain 20% of these profits as incentive fees, but the remaining half of hedge funds generate losses of equal magnitude, then investors will in aggregate pay incentive fees despite failing to earn positive returns. While no individual fund earns unjustified or excessive incentive fees, investors as a whole pay incentive fees in excess of 20% of aggregate hedge fund profits.

A third contributor to the 50% effective incentive fee rate is the entrance and exit decisions of hedge fund managers and investors. Because many contracts include provisions specifying that incentive fees are only paid on profits in excess of the previous highest portfolio valuation, a hedge fund investor who is below the previous highest portfolio valuation is exempt from paying performance fees until the portfolio valuation exceeds its previous high. These “fee credits” are only applicable to that fund, and therefore are permanently lost when an investor chooses to exit the fund, or when a fund chooses to exit by liquidating. In practice, investor and fund exit tends to occur after fund losses: precisely when fee credits are likely to be largest.

Do investors understand the implications of asymmetric fees and anticipate the outcomes that we document? Financial markets in general, and hedge fund returns specifically, are known to experience periods of booms and busts. Similarly, it should be common knowledge that in the cross-section of hedge funds, some will be winners and others will be losers. To a sophisticated investor, the various factors that contribute to the observed outcomes should be stylized facts. However, current industry trends suggest that the implications of asymmetric fees that we document are poorly understood. For example, one of the most commonly suggested remedies to better align the interests of investors and managers is to increase the incentive fee rate in exchange for reducing the management fee. Our findings indicate that a movement in this direction could exacerbate the very factors that lead to the disconnect we document between performance and incentive fees in the long run. For example, a higher incentive fee rate is likely to incentivize managers to take on increased volatility, likely exacerbating the first two factors discussed, and to be more willing to liquidate when underwater, likely exacerbating the third factor discussed.

Can the link between fees and performance be tightened? For the reasons discussed above, our findings suggest that suggestions to improve the link between fees and performance by moving toward fee structures with a lower management fee and increased incentive fee may not necessarily yield desired outcomes. Our overall analysis suggests that the most effective way to tighten the link between performance and fees is to make incentive fees more symmetric. Possible ways to do this include clawback of fees for periods much longer than currently considered, or funds providing for offsetting of gains and losses across funds, an agreement known as “performance netting” or “carry netting”.

The complete paper is available for download here.