Investment Management Fees: Seeking Value for Money

January 2015

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Summary

bfinance’s latest study on investment management fees reveals that reliable alpha does not, necessarily, come with higher charges for investors. Rather, consistent and outperforming managers tend to follow a slightly below average pricing policy, leaving the most sophisticated institutional investors with a significant ability to find the best value for money through negotiation.

Key Points

- Fees diminish significantly as assets increase. Data from mainstream active long-only asset classes indicate that fees on mandates of €400m decrease by 15% compared to €100m mandates

- Active managers showing a genuine capability to outperform their benchmarks over time do not ask for higher fees. In fact, their price positioning is identical to that of managers less able to generate the best performance over the long term

- The level of management fees quoted in the first stages of a tender procedure is not set in stone. Rebates achieved through negotiation represent on average 20% off the initially quoted price

- Alternative methods of remuneration based on performance fees are not only more frequent but also better aligned with the interest of investors than they used to be

Methodology

- The latest bfinance investment management fees study was conducted on a sample of more than 100 tenders relating to the most commonly held investments in institutional investor portfolios. Almost 3,200 replies from over 650 investment managers were examined.

- By analysing the difference between the initial fees, quoted in response to fund management searches conducted by bfinance, and the final fees negotiated, bfinance uncovered key information about the actual level of institutional management fees charged for different asset classes.

Chart 1 – Breakdown of Investment Manager Searches by Asset Class

Source: bfinance, Investment Management Fees: Seeking Value for Money – January 2015

Management Fees Prior to Negotiation

Overall, management fees have remained stable in the three years since our last study. One significant exception concerns low volatility ("low-vol") strategies, for which management fees have decreased as investment product offerings in this asset class have proliferated.

The figures in the table below show the average and median fees demanded by management companies in the main asset classes on initial quotation.

For comparison purposes, mandate sizes differ according to asset class. We have taken €100m as standard for most and €25m as standard in some alternatives assets.

Among the active asset management fees for all-cap equity portfolios, investments in emerging stocks and frontier markets remain the most costly. For a mandate of €100m, initially quoted management fees proposed prior to negotiation have a median of 0.79% and an average of 0.84%. In contrast, credit mandates in the euro zone are the least costly, with a median of 0.24% and an average of 0.25%.

The fees below are quoted prior to negotiation. As we will demonstrate later, it is possible to obtain a 20% rebate if properly negotiation is undertaken.

Table 1 - Investment Management Fees Prior to Negotiation

	Mandate Size (in millions euros)	Average Fees	1st Quartile	Median	3rd Quartile
Actively Managed Equities Core - All-cap & Large-cap					
Global	100	0.57%	0.51%	0.58%	0.65%
Europe	100	0.52%	0.40%	0.51%	0.61%
U.S.	100	0.50%	0.43%	0.50%	0.55%
Japan & Asia-Pacific	100	0.66%	0.50%	0.62%	0.75%
Emerging & Frontier Markets	100	0.84%	0.73%	0.79%	0.91%
Small and medium sized market cap					
Europe, U.S. & Japan	100	0.67%	0.51%	0.64%	0.78%
Fixed Income					
Corporate Investment Grade	100	0.25%	0.19%	0.24%	0.28%
Corporate High Yield	100	0.49%	0.43%	0.48%	0.50%
Convertible Bonds	100	0.65%	0.47%	0.62%	0.84%
Emerging Market Debt	100	0.58%	0.46%	0.56%	0.65%
Alternatives					
Asset Allocation/DAA & GTAA	100	0.63%	0.46%	0.61%	0.77%
Funds of Hedge Funds	25	1.10%	0.92%	1.00%	1.31%
Commodities	25	0.61%	0.41%	0.65%	0.75%
Property/Direct - REITs - Equity (Public)	25	0.73%	0.63%	0.65%	0.72%

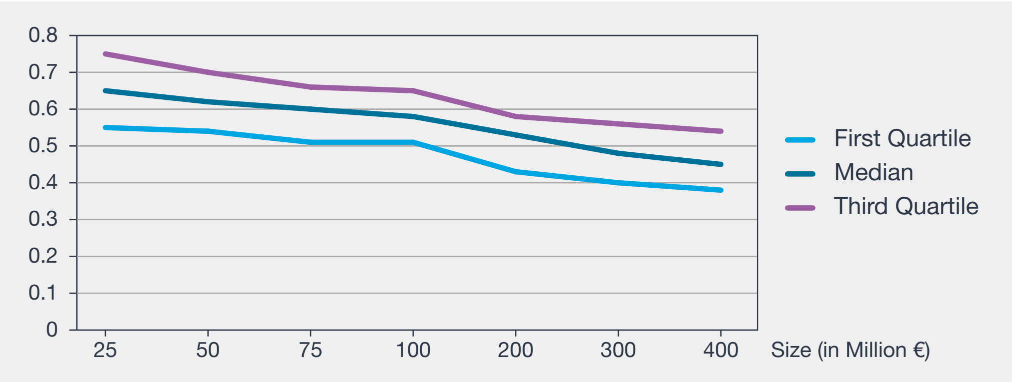
Source: bfinance, Investment Management Fees: Seeking Value for Money – January 2015

Evidence of Economies of Scale

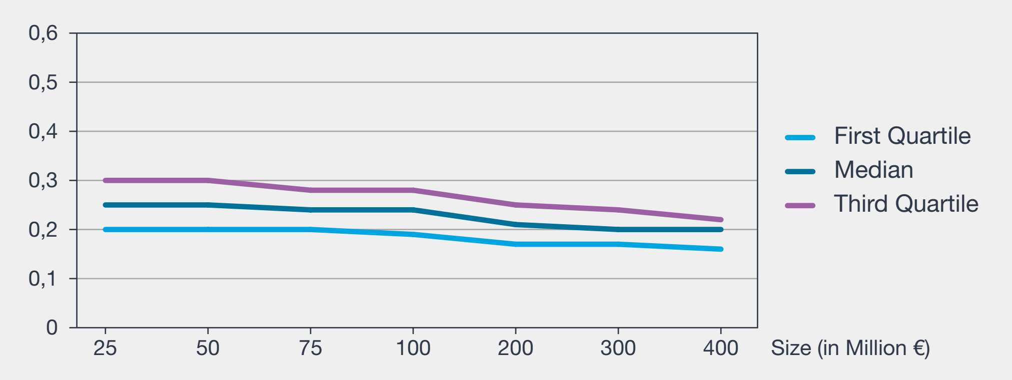
Investment managers responding to RFPs conducted by bfinance have typically quoted sliding scale ad valorem fees based on assets invested. The study shows that fees diminish significantly as assets increase, providing compelling evidence that economies of scale can be achieved through collaborative approaches or "club investments" among institutional investors without changing the distribution of mandates. Data from mainstream, active long-only asset classes indicate that fees on mandates of €400m decrease by 15% compared to €100m mandates.

Charts 2 – Diminishing Institutional Investment Fees Prior to Negotiation for Two Major Sub-Asset Classes

Equity / Active - Core - All-cap & Large-cap - Global



Fixed Income / Active - Corporate Investment Grade



Source: bfinance, Investment Management Fees: Seeking Value for Money - January 2015

Consistent and Significant Outperformance

A significant number of active managers show genuine capabilities to outperform their benchmarks by piloting fund performance in a risk controlled environment over time. As we will demonstrate further, these managers do not differentiate from others by demanding higher management fees. Their price positioning does not significantly differ from the average.

The composites presented in the following table track the performance of all managers recommended to our clients in the respective asset classes since the creation of our firm. It is interesting to note that not only do these composites deliver stronger returns over the long term, they also show a lower risk profile for most asset classes considered.

Table 2 – Illustrative Performance of bfinance Manager Composites versus Underlying Markets – Data as at 31 October 2014

	3m	1Y	3Y (p.a)	Sharpe Ratio 3Y
Global Equity Composite	-2.30%	12.12%	17.83%	1.45
Global Equity Best Performer	0.56%	22.17%	23.42%	1.59
Global Equity Worst Performer	-4.28%	10.16%	7.31%	0.49
MSCI ACWI	-2.30%	11.32%	16.61%	1.37
Composite Outperformance	0.01%	0.80%	1.22%	
Global EM Composite	-3.74%	5.57%	9.19%	0.56
Global EM Best Performer	-4.30%	8.88%	13.25%	0.84
Global EM Worst Performer	-5.67%	5.50%	5.08%	0.24
MSCI EM Index	-3.49%	4.30%	7.19%	0.42
Composite Outperformance	-0.25%	1.27%	2.00%	
Euro Corporate Composite	1.64%	8.72%	8.88%	2.16
Euro Corporate Best Performer	1.57%	9.41%	11.34%	1.89
Euro Corporate Worst Performer	1.49%	7.75%	6.92%	2.13
Barclays Euro Corporate 500MM	1.84%	7.76%	7.95%	2.01
Composite Outperformance	-0.20%	0.96%	0.93%	
US Corporate Composite	-0.01%	7.09%	5.95%	1.48
US Corporate Best Performer	0.03%	8.34%	7.04%	1.59
US Corporate Worst Performer	0.27%	4.74%	3.62%	1.40
Barclays US Corporate IG	-0.08%	6.77%	5.19%	1.16
Composite Outperformance	0.07%	0.32%	0.76%	
EMD Hard Currency Composite	-1.45%	8.47%	8.55%	1.10
EMD Hard Currency Best Performer	-1.04%	11.36%	10.85%	1.24
EMD Hard Currency Worst Performer	-2.22%	6.41%	6.80%	0.80
JPM EMBIG	-1.65%	8.27%	7.69%	0.99
Composite Outperformance	0.19%	0.20%	0.86%	
EMD Local Currency Composite	-5.27%	-0.94%	2.96%	0.25
EMD Local Currency Best Performer	-6.03%	0.40%	4.77%	0.35
EMD Local Currency Worst Performer	-5.89%	-2.92%	1.31%	0.11
JPM GBI-EM GD	-5.66%	-1.54%	2.21%	0.18
Composite Outperformance	0.39%	0.60%	0.75%	
US High Yield Composite	-1.74%	7.28%	11.06%	2.12
US High Yield Best Performer	-1.68%	9.54%	15.28%	2.36
US High Yield Worst Performer	-2.07%	6.41%	9.07%	1.93
ML US High Yield Master II Constrained	-1.92%	7.23%	10.94%	1.97
Composite Outperformance	0.18%	0.05%	0.12%	
Euro High Yield Composite	-0.40%	8.71%	14.26%	2.12
Euro High Yield Best Performer	0.85%	9.87%	15.89%	1.85
Euro High Yield Worst Performer	-1.78%	6.91%	12.66%	2.38
ML European Curr HY Constr. EUR Hedged NON-Fin	-0.58%	8.18%	13.83%	2.04
Composite Outperformance	0.18%	0.53%	0.43%	

Source: bfinance. Each composite tracks the performance of all managers recommended to our clients in their respective asset classes since the creation of our firm[1].

1- All or part of a shortlisted strategy may be removed from a search portfolio if there has been significant turnover in the management team or if bfinance has advised its clients to review the investment for other reasons. When a shortlisted strategy is partially removed from a search portfolio, its weight is redistributed to the remaining shortlisted strategies in that search portfolio in proportion to their weight at the date prior to the removal. The monthly returns used to calculate performance are obtained from the fund managers.

Better Quality, Same Fees

All of the managers included in the composite indices presented in the table on page 8 were selected following a call for tender by bfinance to select institutional managers. In order to identify and recommend the managers best suited to investor requirements, bfinance organises open tenders into which investment managers with the institutional capacity to manage the asset class in question can submit a proposal. This approach helps to avoid the inherent conflicts with the practice of having pre-selected lists of managers, or buy-lists, which are promoted by many investment consultants.

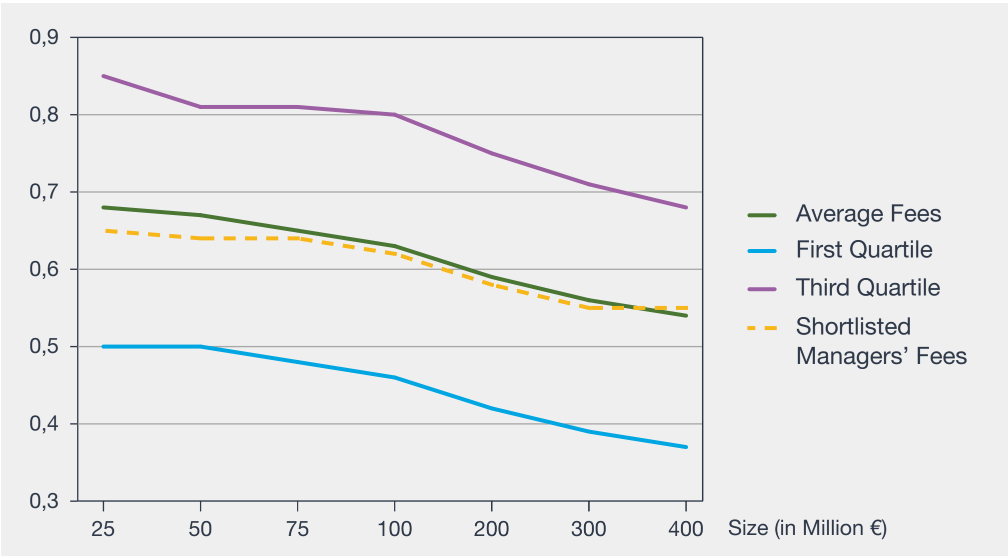
Participants in the tender are invited to present a proposal that conforms to the specifications established by the client and bfinance. Each participant must complete the management fee listing grid, which varies according to the amount invested. The manager's positioning price is not a variable analysed by our research teams in the first round of the process. At this stage, it is vital to single out the proposals that deliver the greatest value to investors over the duration of the mandate.

Discussions relating to price take place only at an advanced stage in the procedure, when a shortlist of managers still in the running is jointly drawn up by the bfinance team and the client.

Having passed bfinance's first quantitative and qualitative analysis, did the emboldened managers demand a higher fee for their greater value creating capacity (as the classic theory of efficient markets would have us believe)? Far from it!

One of the key findings of this investigation is that those managers who pass the first quantitative analysis filter do not ask for higher fees than the average of all participants in the tender. Their price positioning is, in fact, identical to that of managers less able to generate the best performance over the long term.

Chart 3 – Shortlisted Investment Managers' Average Fees (Prior to Negotiation) vs All



Source: bfinance, Investment Management Fees: Seeking Value for Money – January 2015

Seeking Value for Money Through Negotiation

Data from a sample of more than 100 tenders relating to the most commonly held investments in institutional investor portfolios shows an absence of correlation between the managers shortlisted and the level of fees initially quoted. This finding advocates concentrating on finding the best managers during the initial stage of a RFP process, before entering into negotiations on fees at a later stage.

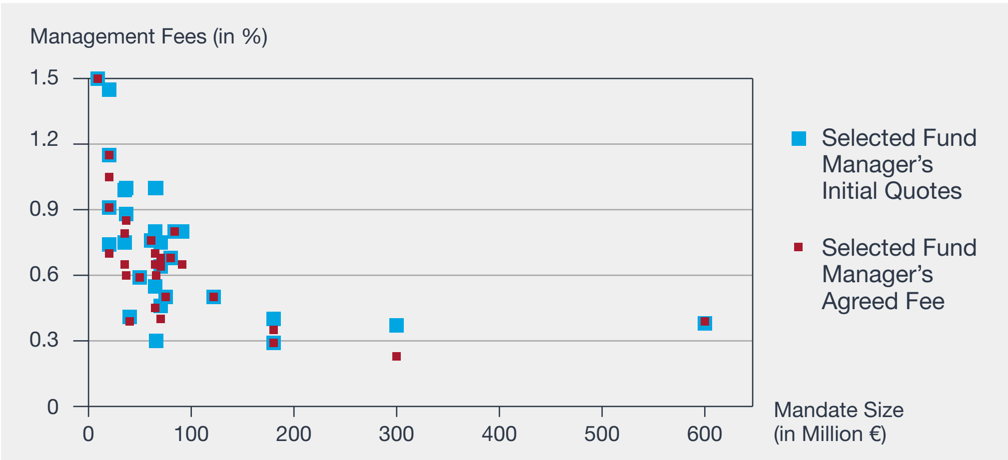
The dynamics of setting management fees depends upon a host of factors that have nothing to do with the functioning of a competitive market, where pricing power would benefit the best managers most efficiently. Some of the scenarios in which investors can benefit from reduced fees include when:

- a new fund is created or a new strategy is implemented;
- management companies with a large base of individual clients can provide additional capacity to the institutional market at a lower cost;
- the investment manager targets a regional expansion;
- the investment manager seeks to diversify its client base.

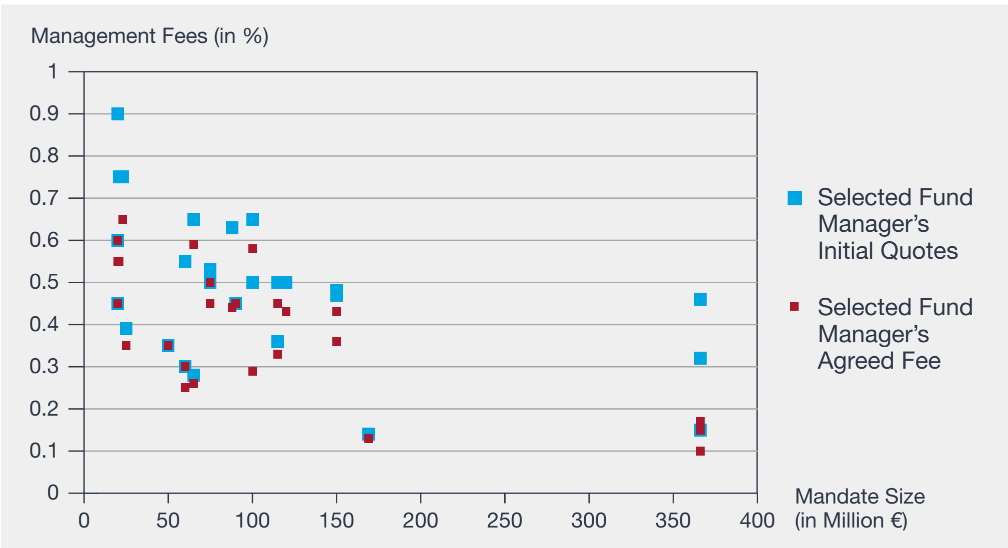
The level of management fees quoted in the first stage of the tender procedure is therefore not set in stone. Even the best managers are prepared to negotiate their fees, and this enables investors to achieve value for money. Experience proves that significant rebates can be achieved, on average representing 20% off the quoted price.

Charts 4 – Fee Rebates Obtained Through Negotiation During the Final Stage of the RFP Process

Equity



Fixed Income



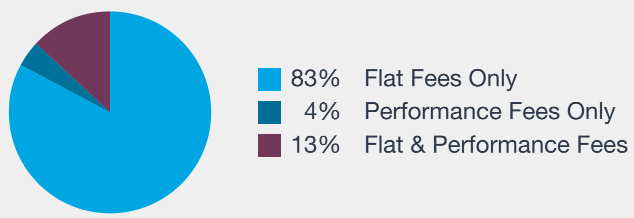
Source: bfinance, Investment Management Fees: Seeking Value for Money – January 2015

Towards a Greater Alignment of Interests between Fund Managers and Institutional Investors

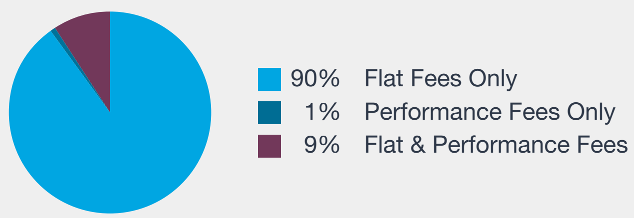
In a growing number of mandates, managers are happy to propose an alternative method of remuneration based on performance fees. Unsurprisingly, this trend mostly concerns equity management, whilst bond management remains immune. The notable exception is convertible bonds which are by nature hybrid products.

Charts 5 – Flat Fees vs Performance Fees in Managers' Initial Quotes

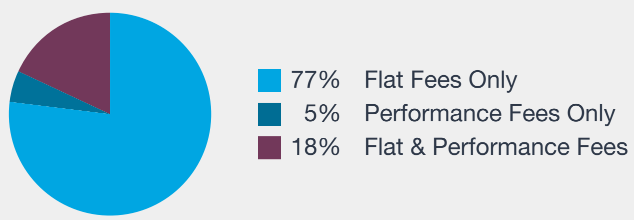
All mandates



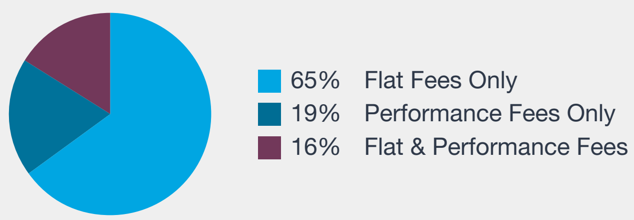
Fixed Income



Equity



Asset Allocation



Source: bfinance, Investment Management Fees: Seeking Value for Money – January 2015

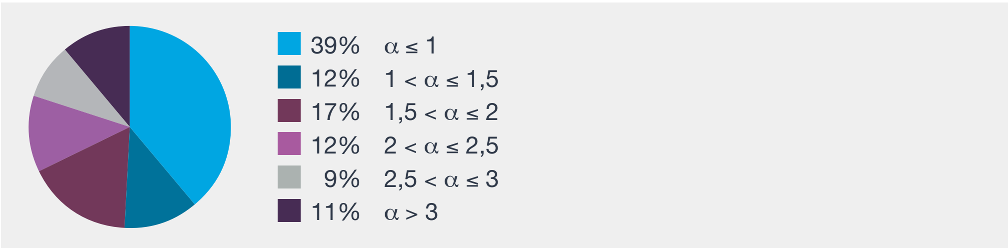
Investors must ensure that the fee structure proposed by a manager is not counterproductive. Investors may set up mechanisms to cap performance fees. Failure to do so could lead to tempting managers to increase risk in the short term. Similarly, it would be worthwhile to include high-water-mark mechanisms or to insist that outperformance fees are calculated over several years.

Of course, a manager's ability to outperform on a regular basis is uncertain. This may be offset by calibrating a modest outperformance target, beyond which the performance fee structure element earns more for the management company. Among equity managers who accept both remuneration formulas, 22% offer a variable structure that automatically adds fees as soon as they outperform the benchmark index by 1%.

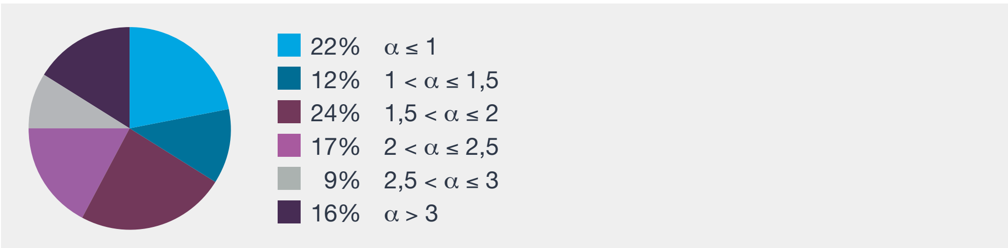
It is, however, interesting to note the significant number of active managers ready to make a trade-off. Almost a third (32%) propose a fee structure with an outperformance element requiring them to exceed the benchmark index by a minimum of 2% before performance fees kick-in. This was not the case when we conducted the same survey three years ago. The alignment of interests between institutional investors and their managers through performance-based fee elements is a trend that bfinance applauds.

Charts 6 – Minimum Alpha Targeted by Active Managers in Performance Fees Structures

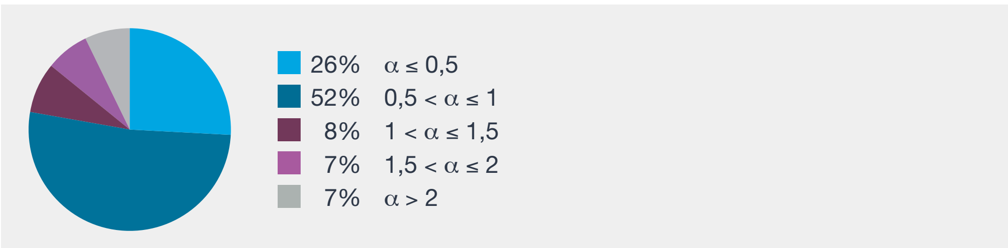
All Asset Class



Equity



Fixed Income



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bfinance's Market Intelligence Group maintains an ongoing and rich dialogue with industry stakeholders around the globe. Designed to share and expand the boundaries of financial industry best practices and developments at the highest level, our team provides a valuable information resource for industry practitioners.

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