bfinance

Implementation Insight

Investment Management Fees: Nieuwe Besparingen, Nieuwe Uitdagingen

Inhoudsopgave

03
Waarom verder lezen?

04
The long view

06
Equity

08
Fixed income

10
Hedge funds

12
Investor case study

13
Private markets

15
Three takeaways

bfinance is an independent, award-winning consultant that provides investment implementation advice to institutions around the globe.

With highly customised processes tailored to each individual client, our aim is to empower investors with the resources and information to take key decisions.

The team is drawn from portfolio management, research, consultancy and academia, combining deep specialist expertise with global perspective.

bfinance has conducted more the 800 engagements for over 300 clients in 32 countries. The firm is headquartered in London, with offices in Paris, Amsterdam, Munich, Montreal and Sydney.

Contact details
Kathryn Saklatvala, Global Content Director, ksaklatvala@bfinance.com
Geraint Morgan, Portfolio Monitoring, gmorgan@bfinance.com

© 2017 bfinance. All Rights Reserved.

Waarom verder lezen?

Om de paar weken komt er weer een grote instelling in het nieuws wegens activabeheerskosten, met het aankondigen van prijsbewuste veranderingen of het verdedigen van hun uitgaven.

Vorige maand was de North Carolina Treasury aan de beurt, door Bloomberg beschreven als "de 90 miljard USD-belegger die Wall Street onder handen nam", en de 25 miljard USD Yale-schenking waarvan de fervente pleitbezorging van David Swensen over de uitkeringen van het fonds (nog niet openbaar) binnen enkele dagen viraal ging.

Nieuwe bfinance-gegevens tonen dalende vergoedingen aan in verscheidene sectoren, met name daar waar aanbieders onder druk hebben gestaan van goedkopere concurrenten of de beleggingsomgeving is veranderd.

In de tussentijd hebben veel vermogensbeheerders gebruik gemaakt van de gelegenheid om moderne producten te introduceren naast hun traditionele equivalenten, met bepaalde vormen van "unconstrained", multi-asset- of adviseringsmandaten die deze lijst aanvoeren.

Dit document bevat eveneens inzichten van senior beleggers in de hele wereld, inclusief een gedetailleerde casestudy over hoe BT Pension Scheme de kosten met ongeveer 25% heeft verlaagd en zich tegelijkertijd blijft inzetten voor actief management en alternatieve beleggingen.

Wij hopen dat het publiceren van informatie over de door aanbieders gehanteerde institutionele tarieven tijdens werkelijk uitgevoerde manager selectieopdrachten, evenals daadwerkelijk onderhandelde kortingen, de transparantie over dit vaak-te-ondoorzichtige onderwerp zullen bevorderen en de belangen van institutionele beleggers ten goede zullen komen.

Dit document is momenteel alleen in het Engels beschikbaar. Mocht u echter meer details of extra vertalingen willen ontvangen, neem dan contact op met Frans Verhaar via fverhaar@bfinance.com.

In dit document

Wereldwijde aandelen: actieve beheerskosten wereldwijde aandelen dalen met 8%, low volatility met 25% en smart beta met 24%.

Unconstrained fixed income: nieuwe populariteit creëert verwarring in het hogere prijssegment, met sterk uiteenlopende fees rond een gemiddelde van 48 basispunten (100 miljoen euro) en kosten die verrassend weinig verband houden met de aard van de producten. Achter de schermen maken managers gebruik van zeer afwijkende logica bij de prijsbepaling.

Hedgefondsen: fund of hedge funds verlagen de basisvergoedingen wereldwijd met 20% en bijna 30% in Europa. Daarnaast lijkt het erop dat alternatieve beta fees intussen zijn gedaald, met nieuwe aanbieders die vroegboekkortingen aanbieden (max. 50%).

Private Markets: gaan de kosten na jaren van eenvoudig fondsen werven eindelijk omlaag? De meeste gevestigde sectoren blijven onbuigzaam, waarbij de grote vraag in verhouding tot het aanbod van zeer gewilde institutioneel kwaliteitsproducten in het nadeel werken van de belegger. Toch hebben bepaalde gebieden voor aanzienlijke beperking van de prijsbeweging gezorgd, zoals Private Debt in Europa (> 30% omlaag).

Inzichten van beleggers: senior pensioenfonds beleggers (waaronder Blue Sky Groep en SPF Beheer) delen recente ervaringen, inclusief een gedetailleerde casestudy over hoe BT Pension Scheme de kosten met ongeveer 25% heeft verlaagd en zich tegelijkertijd blijft inzetten voor actief management en alternatieve beleggingen.

The long view

The years following the GFC have been characterised by three fee-pressuring trends.

Trust in financial services providers reached a new low, spurring demands for better alignment. Active managers have faced harsher scrutiny than ever, with greater awareness of risk factors and a reluctance to pay heavily for betas dressed as alpha. Meanwhile, the low rate climate has made every basis point worth fighting for.

Although net performance is always the most important metric, a new mindset holds sway: while returns are hard to predict, small cost reductions translate into guaranteed long-term gains. Every cent saved falls straight to the bottom line, to be compounded for years to come.

A plethora of new providers have sprung up to service the cost reduction mission. Regulators and policy-makers continue to turn the screw. Many investors have sought savings through switching investment strategies, bringing functions in-house or dragging vendors back to the negotiating table. bfinance has been engaged by investors all over the world to review portfolios and ascertain where fee savings could and should be made.

Yet, on average, investors are paying out a higher proportion of their AuM in investment costs each year than they were a decade ago. Data from CEM (above) helps to illustrate the extent of the spree. In short, higher allocations to pricier private markets have outweighed savings achieved elsewhere. It is hard to gain clarity on attribution; the interpretation of such figures often suffers from over-simplification.

We strongly hope that today's institutional portfolios, although apparently more costly than before, will also be more robust and diversified, delivering stronger net performance for stakeholders over the long term. Yet it will take years if not decades to determine success. In the meantime, achieving the greatest possible value for money remains a vital priority.

Expert insight: Mike Heale, CEM Benchmarking

"Average total fund costs in the CEM global database [primarily pension funds] have grown from 37.8 bps to 57.3 bps over the past ten years. The cost increase is primarily due to asset mix changes: combined policy weights for real assets, private equity, and hedge funds (alternatives) increased from 10.6% to 20.6%. Public equity policy weights declined from 56% to 44% over the period."

Latest news

A new paper from Oliver Wyman and Morgan Stanley, "The World Turned Upside Down," reveals the increasing importance of pricing in determining flows: "The correlation between fund performance and flows has weakened, with fee levels becoming the more important driver."

LCP published a study in April 2017 showing a 7% reduction in average fees, according to a survey of asset managers. The authors focus on the "paradox" that investors are paying more in cash terms (as opposed to percentage terms) due to rising equity markets: "For an active global equity mandate of £50m that has matched the return of the index, investors could be paying £260k more in fees than they were six years ago." Of course, that effect also operates in reverse if/when markets fall. We have observed a number of investors introducing flat rates.

The most recent available information from CEM Benchmarking shows that total fund costs (internal and external) of the pension funds and other investors in their database have risen from 37.8 bps to 57.3 bps over the past ten years, thanks in large part to higher allocations to private markets. Expect the next set of data in a few weeks' time.

Through these critical years, bfinance has periodically published data on fees, as have other firms.

Yet visibility can be a double-edged sword. While benchmarking can help to ensure that investors don't over-pay, it may also make managers less likely to offer low prices. Indeed, recent FCA reports have explicitly criticized consultants for facilitating median-hugging. Advisors should seek proactive ways of addressing this challenge going forwards.

That problem may be exacerbated by the reality that much of the "transparency" offered by various industry sources involves rack rates, which are significantly higher than what investors actually pay. The data presented in this paper is derived from asset manager quotes for actual mandates, not rack rates or theoretical advertised pricing, explaining why the numbers here may be somewhat lower than other sources. This data does not represent the final negotiated price: further discounts range from zero to above 50%, averaging 12% in equity and 15% in fixed income.[1]

[1] Average realised discount: 18% in equity, 21% in fixed income. Total average discount: 12% in equity, 15% in fixed income.

Figure 1: Investment Management Fees: Seeking Value for Money, published January 2015

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

Source: www.bfinance.com

Global equity fees fall

Active global equity management fees have dropped by 8% in recent years according to bfinance data, while low volatility active manager fees have fallen 25% and smart beta fees 24%.

Competitive pressures on active managers have been intense while allocations to passive management and smart beta have soared. bfinance data indicates that average fees quoted by global equity managers have decreased from 62bps to 57bps in recent years (Figure 2). This could be viewed as **remarkable resilience** given the circumstances.

Meanwhile, the factor-oriented sub-sectors of the active manager universe show more notable price reductions. According to bfinance data, low volatility manager fees have fallen by **25%** since 2010.

Substantial further savings can be obtained through negotiation. For all bfinance active equity searches since January 2013 the average negotiated discount was **12%**, although there is no standard expectation and cuts have ranged from zero to **46%**.

Investors in certain markets, such as The Netherlands (right), have succeeded in making larger-than-average reductions to their active equity fees. Yet this is not the case for all. Returning to Mike Heale at CEM, whose data suggests what sophisticated institutional investors are paying rather than what managers say they charge: "There is no clear trend for external global active public equity: it has bounced around from 52bps to 59bps over the past 7 years and the most recent data is **54bps**.[2]"

Investor insight:

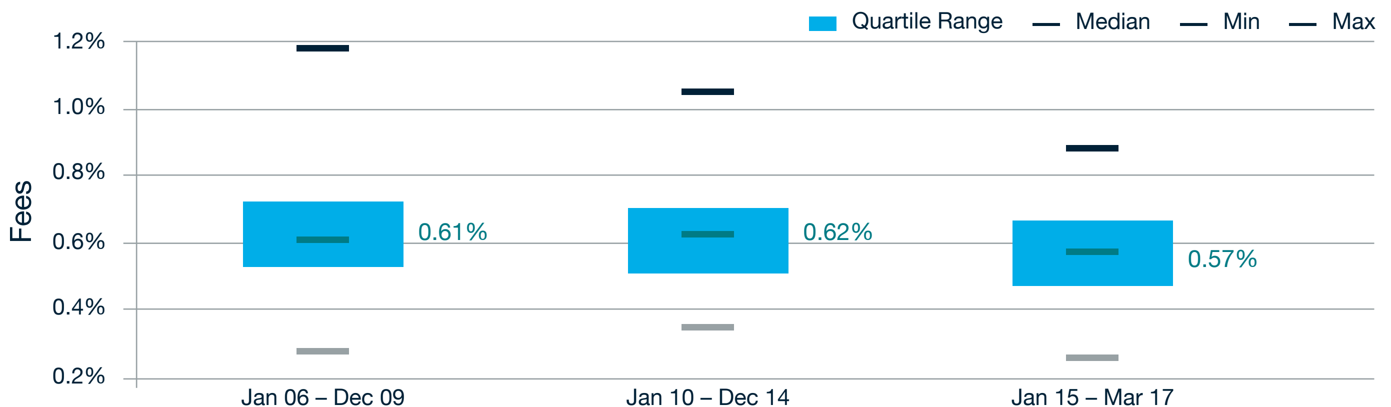
Ramon Tol, Blue Sky Group

"We've compressed our active equity fees by about 20 - 30% in the past few years for some mandates. Disappointing performance of active managers, pressure on costs and regulation have kick-started a huge move into passive in the Dutch market; this has led to lower fees for active mandates." … "We prefer flat fees. Performance fees can create inappropriate incentives. If a manager outperforms in the first couple of years they may dial down the risk to lock in their fee. If managers do poorly early on, they're incentivised to dial up the risk too much in order to improve the chances of getting a fee paid. I also question if a manager will work harder for us for a performance fee, particularly with a partly quantitative-driven process."

Nick van Winsen, SPF Beheer

"The differences between smart beta or factor investing and certain quant strategies have become very slim, while the fee difference is substantial. We're quite fierce on those managers."

Figure 2: Quoted (pre-negotiation) fees for €100m Active Global Equity mandate



Source: bfinance. Data from 168, 163 and 189 managers.

[2] The figure of 54bps is lower than the average quoted fee but higher than the average negotiated fee per bfinance data.

Why have active global equity fees remained relatively stable under extreme pressures?

One driver may be the inclination of managers to cluster around known average fees. Transparency may facilitate this effect, mitigating over-pricing but removing the incentive for under-pricing.

Another antidote to compression is the tendency to position active offerings as complementary to systematic strategies rather than competitive. Managers have focused on metrics such as idiosyncratic (non-factor) risk exposure and active share, to distinguish themselves from smart beta and market cap indices respectively. More are providing unconstrained (as opposed to benchmark-relative) strategies.

In short, clients have clamoured for "real active managers" and providers have marketed themselves accordingly. Yet investors should be wary of gaming.

To apply continuing pressure on fees, we believe that a more open selection process incorporating the widest possible universe of managers can be helpful. We also see certain innovations in terms of performance fee structures, although we note that flat fees remain the "norm" and, if anything, the overall appetite for performance fees in this sector has declined.

In addition, investors may consider introducing other forms of scrutiny. For example, new specialist consultants such as XTP Group (right) have emerged offering services that dig deeper into costs and processes in order to identify possible savings, regardless of how fees compare against peers.

Investor insight:
Superannuation fund, Australia

"Do performance fees actually create better alignment? I have several problems with this argument. First: why are investment managers able to make a case that they are entitled to a share of their work product? It happens in few if any other industries. Service providers are often entitled to a share of profits, not work product (i.e. the thing they make for someone else). Second: managers put the asset owner's capital at risk to enable them to earn a share of the winnings but they do not share in the losses. The risks are unaligned, the pay-off is unaligned."

Expert insight:
Wolfram Klinger, XTP Group

"We don't look at whether managers' fees are higher or lower than average. We look from the bottom up at every cost and process element within the investor's portfolio, from the "other costs and fees" in private equity funds to implicit transaction costs across all security types. …One element that we think investors are not always sufficiently aware of is the relationship between composite size and transaction cost. If a manager has more AuM in a strategy, the marginal cost of additional assets becomes minimal…but there is a massive slippage cost for the investor on the trades, especially in smaller markets."

In smart beta, the maturation of the sector has led to reductions in average pricing.

bfinance data indicates that median quoted fees in smart beta searches have fallen by **24%** since 2011 when the firm began conducting searches in this area. The median on the most recent searches sits around 30bps for a €100m mandate.

Unconstrained fixed income pricing causes confusion

Mandates for "unconstrained" or "absolute return" fixed income have surged in recent years, provoking a wave of product launches. Yet the sector is a pricing shambles.

This style of mandate has become increasingly popular while traditional fixed income returns have remained low and the prospect of rising interest rates has hovered on the horizon, creating fears of capital losses. Nearly **40%** of those vying for recent bfinance mandates had a track record of under five years, while 53% of the "unconstrained" crowd on eVestment were established after 2011.

bfinance frequently receives enquiries from investors wondering what fees they should pay in this space. With an average quote of **48bps**, benchmark-agnostic fixed income strategies are considerably more expensive than their less trendy Global Aggregate counterparts.

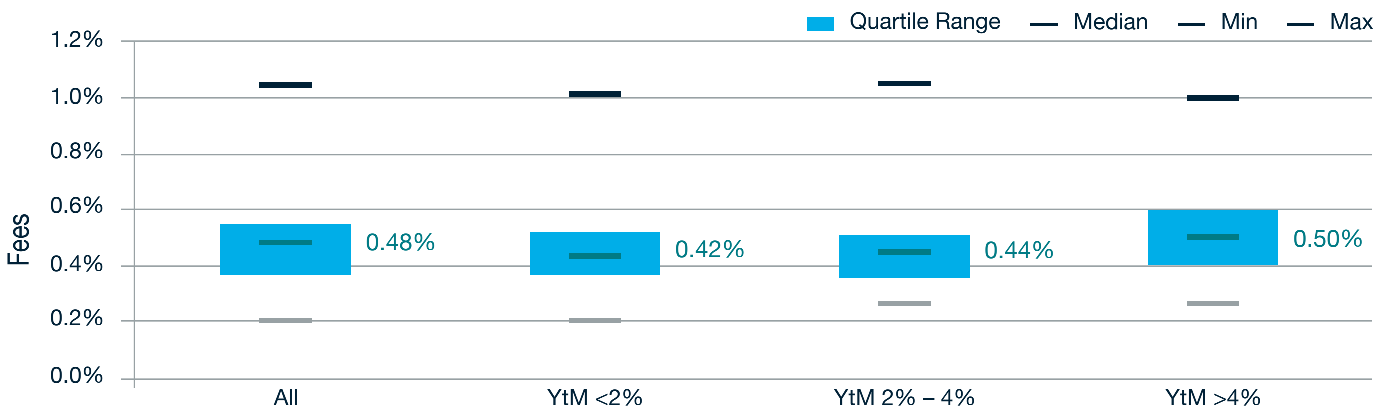
Those quotes precede negotiation: the average discount on all active fixed income searches conducted by bfinance since January 2013 was **15%**, although there is no standard expectation and cuts have ranged from zero to **51%**.

Jargon buster: Unconstrained fixed income

A fixed income strategy permitting investment in a range of instruments, including corporate and government bonds in developed and emerging markets, high yield debt, securitised debt, derivatives and cash. The portfolio usually targets a spread over a money market rate (e.g. LIBOR) rather than being benchmarked against a market index. Sources of alpha include interest rate and currency trades, credit risk management, regional and sector allocation, as well as issuer selection.

The sector is **remarkably diverse and poorly segmented**. It encompasses strategies that are long-only and long-short, derivatives-light and derivatives-heavy, UCITS and non-UCITS, EMD-dominated and EMD-light, to name just a few differences. Risk levels vary considerably, as does the proportion of credit – a variation exacerbated by the fact that distinctions between classic unconstrained fixed income (aka Global Aggregate with an allocation twist) and Multi-Asset Credit are not clear-cut.

Figure 3: Quoted (pre-negotiation) fees for €100m Unconstrained Fixed Income mandate



Source: bfinance. Data from "unconstrained" or "absolute return" fixed income searches 2015-17; includes 95 asset managers.

Fee dispersion is high: the difference between upper and lower quartiles is 19bps, versus 9bps in investment grade credit and 10bps in high yield. Yet the pricing has remarkably little correlation with the major differences in the strategies.

Perhaps surprisingly, there is virtually no relationship between fees and the amount of tracking error, either targeted or realised. There is no correlation between fees and volatility. From a risk perspective, the only faint relationship appeared to be between cost and Yield to Maturity (Figure 3), although it is hardly significant.

Upon examining portfolio composition, we could discover no link between fees and the amount of corporate debt, high yield debt or even structured credit in portfolios. We also could not identify any patterns linking pricing with particular factor exposures.

A correlation is evident between high emerging market debt exposure and cost, although plenty of managers break that pattern. A few EMD-focused managers are evidently offering EMD-heavy strategies re-clothed as unconstrained and these are naturally more expensive, in line with (or, more accurately, at a premium to) their existing EMD products.

The absence of clear relationships naturally begs the question: **how are fees being determined?** Are managers maximising the opportunity to launch a more expensive product based on a relatively opaque alpha-generation process and little previous fee level discovery? We spoke to a handful of managers (anonymously!) to find out how they came up with their prices. Their insights were illuminating. While many have set their fixed fee rates based on "share of target alpha" – a problematic concept at the best of times – there are different approaches, with some identifying a clear resource-related rationale underpinning costing.

Manager insight:
Off the record.

"We wanted to price it **very similarly to our global aggregate product**, with a premium – less than 5bps – to reflect the use of derivatives. It usually comes in around 40bps."

"We looked at eVestment data, **where the major managers seem to set their unconstrained fixed income prices 1.6x higher** than their Global Agg prices. We had originally planned to charge more."

"At my old firm they have a similar product with a **more old fashioned approach to pricing based on share of alpha**: if you were targeting 300bps of alpha then a reasonable share of that would be 20%, or 60bps."

"Our portfolio managers all feed off a large platform of analysts. The unconstrained product and the global agg product **both tap into the same resources**."

"One of our credit teams has been doing very well so **we don't want to use up their capacity with unconstrained clients**…they [unconstrained fixed income] have separate research."

"In areas like global equity and corporate debt we know what fee will be good enough to win us the business, we know what clients will think is cheap or expensive. But here we don't know. We try charging at a certain level and if we're not winning enough business we'll bring it down."

"We looked at Lipper, eVestment, Mercer and LCP reports to help us decide pricing. Although of course we know some of those figures are higher than what managers are actually charging."

We expect prices to come down in this space over the next three years as the product set evolves and managers develop longer track records.

Fund of hedge funds cut fees to regain lost ground

FoHF management fees have fallen by 20% globally and nearly 30% in Europe.

The median quoted fee has dropped from 100bps to 80 since the previous bfinance fee study in January 2015. In Europe, where investors fell out of love with the sector more severely than their counterparts elsewhere, the average is now down to 69bps.

FoHFs have sought to regain investors' favour following the post-GFC rout. This challenge has been made more complicated by the evolution of alternative beta (page 11) and the growing popularity of various multi asset or diversified growth strategies.

On top of these management fees, we currently see underlying hedge fund fees averaging 1.4%+18%. The range is considerable, from under 1+10% on the low end to above 3%+30% at the top.

The past couple of years have also seen the emergence of a new breed of player in the FoHF space: **Funds-of-Sub-Advisors**. These are being offered by larger asset managers with the ability and infrastructure to run managed account platforms.

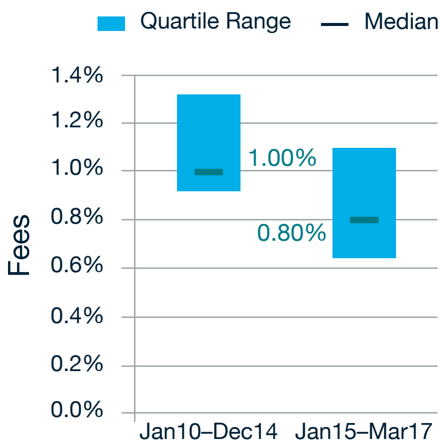
Investor insight:
Daniel Garant, CIO, PSP Investments

"In hedge funds we avoid the typical 2&20. Our trend since 2008 has been a reduction in base fees and an increase in performance fees. We now have fewer relationships and larger amounts allocated to each mandate."

The providers establish arrangements with relevant hedge fund managers such that the latter share trading instructions which the provider then implements themselves, offering one flat fee to the investor.

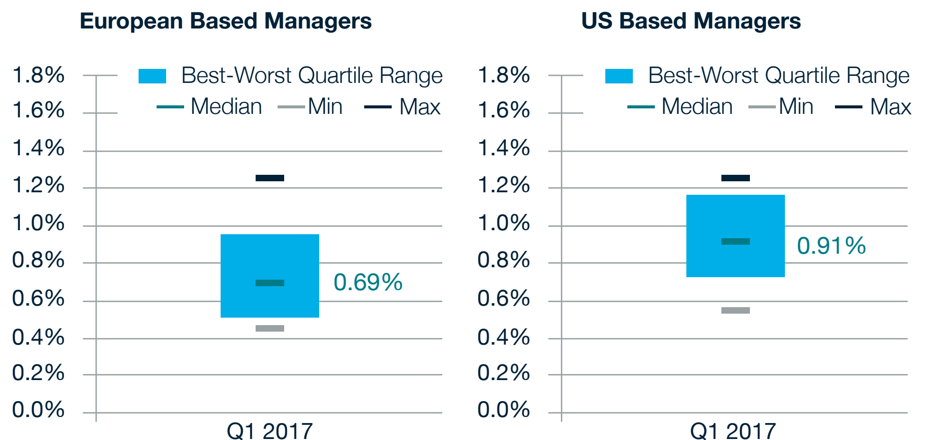
Such products can be seen to represent another interesting response to demands for lower pricing, although there is a lack of transparency on how the economics are shared between the provider and the manager partners.

Figure 4: Quoted (pre-negotiation) management fees for €25m Fund of Hedge Funds mandate



Source: bfinance

Figure 5: Quoted (pre-negotiation) management fees for €50m Fund of Hedge Funds mandate



Source: bfinance

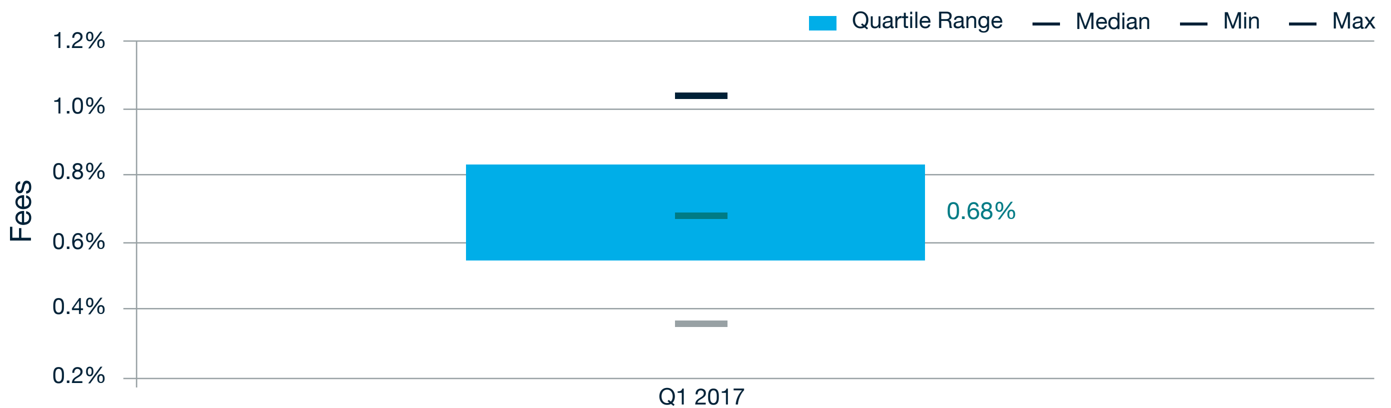
Meanwhile, alternative beta fees appear to have fallen over the past year.

While the 2016 bfinance white paper The *Changing World of Alternative Beta* paper showed fees with a range of 30-150bps and a median of 74-80, the most recent proprietary data from 2017 (Figure 6) indicates a new range of 35-103bps and a median of 68.

Much of this reduction can be attributed to the involvement of new providers, who are offering what tends to be quite competitive pricing as well as early bird discounts of up to 50%. Over 2016 alone the number of providers increased by more than 30%, producing significant sample variation. At the same time, a handful of more established managers have either reduced their fees or closed their doors to new investors. We would be hesitant about calling a trend just yet.

Investors are showing a strong preference for flat fee structures and this, on the whole, is what the industry is now delivering. 94% of managers present flat fees as an option while 29% offer both performance and flat fees. Only 6% insist on a performance fee structure. Most managers don't charge a premium for a managed account versus a pooled fund although others do add 5-10bps. In addition, fund costs typically add 5-15bps on top of quoted figures.

Figure 6: Quoted (pre-negotiation) fees for €100m "Alternative Risk Premia" mandate



Source: bfinance ARP mandates, Q1 2017

Doug Clark
Principal – Portfolio Management

Investor case study: BT Pension Scheme

Over the last few years the Scheme has increased its focus on ensuring it achieves the best value-for-money outcomes from its portfolio of investment managers. Between 2012 and 2015 this has led to a **reduction in fees of approximately 25%**.

Our objective was not simply to reduce fees and costs. That is relatively easy to achieve, for instance by moving from active to passive managers or reducing allocations to alternative asset classes. However, as believers in the benefits of active management as well as the diversification and added value that managers in alternative assets can contribute, our goal was to achieve similar or better outcomes for lower cost. How did we seek to achieve this?

1: What gets monitored gets managed. We have significantly improved the monitoring, oversight and benchmarking of the Scheme's investment fees and costs. For the last five years the Scheme has participated in the CEM benchmarking survey. We have also started regularly reporting our investment costs distinctly to the Trustee Investment Committee. Unquestionably, this enhanced monitoring has sharpened the focus on delivering better value outcomes and contributed to reducing fees.

2: Keep it simple. We have actively sought to reduce the number of investment mandates. The purpose of this was essentially two-fold. One objective was to simplify implementation, which had become relatively complex over time. This enabled greater asset allocation flexibility while also providing a more intuitive understanding of our portfolio and how it would react to different market regimes. A second objective was to reduce cost through larger mandates with fewer managers. By cutting the number of mandates by around a third since 2014 we have made considerable cost savings.

3: Low hanging fruit. We exited or renegotiated fees for fund of fund mandates, which were probably the most significant source of cost relative to the performance delivered. We exited our fund of fund exposure within hedge funds and made changes to the strategy and fee structure for private equity. In the case of the latter, evolving our exposure to a combination of fund and co-investments. This has resulted in reduced cost, better performance net of fees, as well as providing increased flexibility and liquidity from our PE program.

4: A fair alpha share. Since 2014 we have renegotiated fees across mandates that represent around 50% of Scheme assets. We pay close attention to the "alpha share", i.e. what share of the value-added is taken by managers relative to clients. Over time we have targeted fee re-negotiations where we felt this metric was overly generous to managers.

5: Better alignment. The structure of fees has been another focus of activity. In some cases this has meant moving away from performance fee structures to simple management fees, especially in situations where the structure was skewed in the manager's favour and with weak alignment between how we paid the manager and how the actual investment team was paid. In other cases this has resulted in more innovative fee structures benefiting both us and our managers. Another aspect of fee structuring has been to limit paying managers higher fees simply because markets rise. We are happy to pay managers more if they deliver better value for us, however it seems unfair to pay them more simply because asset prices rise in aggregate. As such we have introduced fixed pound or dollar fees for certain mandates, added new fee rate tiers that kick-in if assets rise due to market performance for others, and finally, in one or two cases, put in place fee caps.

Private market fees suffer from years of easy fundraising

Investors have been at a pricing power disadvantage in illiquid investments, with client demand continuing to exceed the supply of desirable institutional-quality opportunities.

Fees have largely remained intransigent in private equity and infrastructure, although the picture is obscured by the increasing usage of other routes to market including co-investments, club deals and separate accounts. Yet there are certain niches where we have observed significant fee compression, for example European private debt (Figure 7) and private equity primary fund-of-funds.

After the GFC, many expected fees in this sector to shift in favour of asset owners. Yet the reality has proven a different story. When surveying investors for this report, there was an overwhelming consensus that high appetite from LPs - many of whom have been increasing their allocations since 2009 - has translated into a lack of meaningful pressure. “If we don’t like the fee, the next person in line will pay it,” explained one exasperated U.S. pension fund official.

In **private equity** there may still be some room to negotiate on hidden costs. For example, certain managers that are including transaction and monitoring expenses in their quoted fees may be willing to reduce them in recognition of the reality that such inclusions no longer represent standard market practice. There may also be more leeway with younger managers on their second or third fund than there is among the established houses, although manager selection for that pool is more challenging. In addition, while it is still conventional to charge management fees on committed capital, we do see some flexibility at the margins with some managers willing to delay fees until the fund’s first investment has been made.

Investor insight:
Nick van Winsen, SPF Beheer

“In private equity and infrastructure the situation has not changed in favour of LPs. I would even say we’ve seen some deterioration in terms, such as lower hurdle rates or no hurdle rates. There is too much money chasing a few good managers. Most PE and infra funds returned so much money in the past three years, as they’ve exited investments, that a lot of LPs are underweight allocations - a lot of us are looking at the same small group of managers.”

Expert insight:
Anne Feuillen, bfinance

“Why have certain very popular private equity managers done away with hurdle rate? The answer is simple: because they could. But this has a meaningful negative impact on net returns and reduces the alignment of interests between GP and LP. It is very hard for investors in this fundraising climate to say: ‘no, that is a step too far.’ It takes a huge amount of discipline, especially when you have to meet an allocation target.”

There have been notable fee reductions in private equity fund-of-funds, particularly those focused on primaries rather than secondaries. It is now quite unusual to find FoFs charging 110-125 basis points, as was relatively commonplace a decade ago, with more managers quoting in the 50-90bps range. This sub-sector has undergone a considerable amount of consolidation, with prominent 2017 mergers already including Schroders/Adveq and Unigestion/Akina. Amid declining margins, scale is proving increasingly important.

There has been fee compression in certain niches that are relatively immature, such as European private debt.

Median quoted management fees for European direct lending fell from 1.5% to 1.0% and the average carry percentage dropped from 15% to 10%. In addition, fewer managers are asking for fees on committed capital - a welcome trend.

That being said, catch-up structures are still prevalent in this space, despite a widespread investor preference for carry-only. In addition, many managers have hurdle rates that appear to be inappropriately low for their strategy.

Investor insight:
Olivier Rousseau, Fonds de réserve pour les retraites

"We started investing in private debt in 2013 and we have seen the fees coming down since that time. This is especially true in cases where we are a return customer, investing in the second fund having been in the first. But it's also a function of a general trend in the market."

Figure 7: Median quoted (pre-negotiation) fees for European Direct Lending, Q1 2017 versus 2014

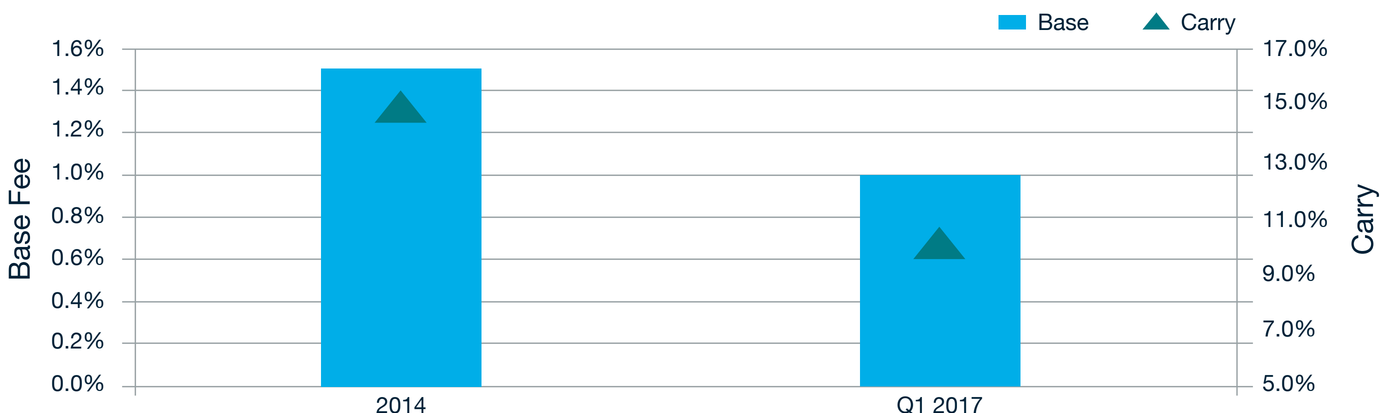


Figure 8: Quoted (pre-negotiation) fees for Direct Lending, Q1 2017

Average (median) senior debt fund manager fees, by geography

	Mgt fee	Carry	Hurdle	Catch-up
Europe only	1.0%	10%	5%	100%
US only	1.3%	15%	6%	100%

Senior debt fund manager fees (ranges and averages)

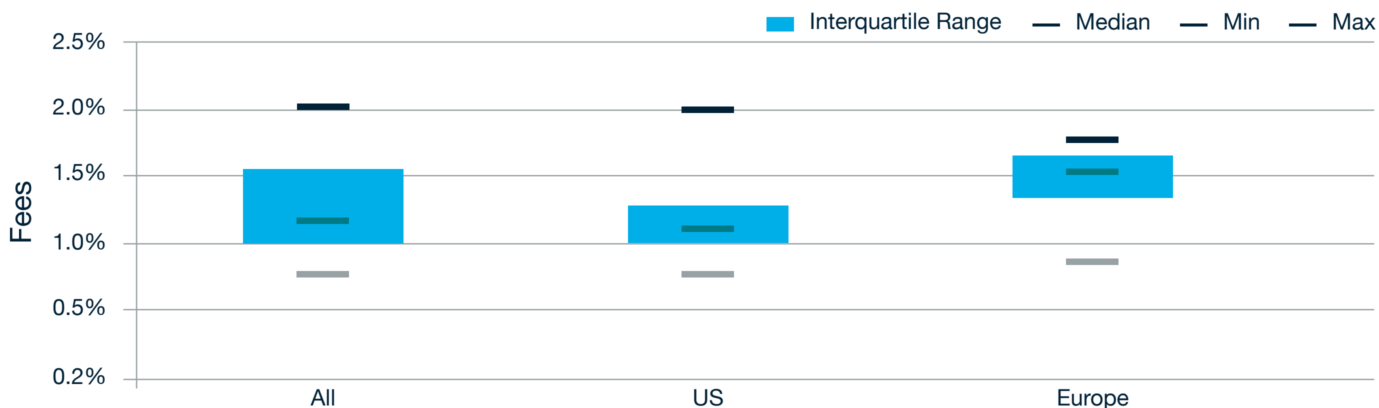
	Mgt fee	Carry	Hurdle	Catch-up
Max	2.0%	20.0%	9.0%	100.0%
Median	1.0%	15.0%	6.0%	100.0%
Min	0.5%	0.0%	0.0%	0.0%

Source: Direct Lending: What's Different Now? bfinance, March 2017

Beyond isolated instances of fee reduction, a more striking feature of the private asset classes is the still-wide dispersion in fees across similar mandates.

The opaque nature of these markets coupled with the specific nuances of individual strategies leads to a wide variation, as shown for a range of funds providing diversified exposure to European and US Core+ and Value Add real estate (Figure 9). Management fees range from 0.8% to 2.0% per year and there are important differences in the performance fee structure. Some of these are relatively attractive to investors, with high hurdles relative to the target returns, while others appear far more aggressive.

Figure 9: Quoted (pre-negotiation) management fees for Core+ / Value Add Real Estate (2016-17)



	Base	Carry	Hurdle
Max	2.0%	25.0%	11.0%
Median	1.2%	20.0%	8.0%
Min	0.8%	10.0%	4.0%

Source: bfinance

Three takeaways

Renegotiate: where significant price reductions have taken place, such as in low vol or smart beta, now may be the time to bring providers back to the table and get fees in line with new practices.

Reassess: if fees proved to be a factor when entering or leaving certain sectors, such as hedge fund-of-funds, investors should be aware that the calculations may prove rather different today.

Reprioritise: stakeholders should remember that, while asset allocation is always preeminent, **implementation risk** is increasingly critical to investor outcomes for today's more illiquid and expensive portfolios. Asset allocation strategy and implementation reality are not always aligned: conflicts between the two should be recognised and governed rather than ignored.

Office locations

Amsterdam
Symphony building – 26th Floor
Gustav Mahlerplein 109-115
1082 MS Amsterdam
The Netherlands
T +31(0)20 794 61 00
www.bfinance.com

London
36 Queen Street
London
EC4R 1BN
England
T +44 20 7747 8600
www.bfinance.co.uk

Montréal
1250 René Lévesque Blvd. W
Suite 2200, Montréal QC
Canada H3B 4W8
T +1 514 393 4899
www.bfinance.ca

München
Promenadeplatz, 8
D-80333 München
Deutschland
T +49 89 55 29 59 00
www.bfinance.de

Paris
49, avenue d'Iéna
75116 Paris
France
T +33 1 45 02 64 00
www.bfinance.fr

Sydney
Level 13
135 King Street, Sydney
Australia
T +61 2 8973 7503
www.bfinance.com