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Congratulations! You got a raise!

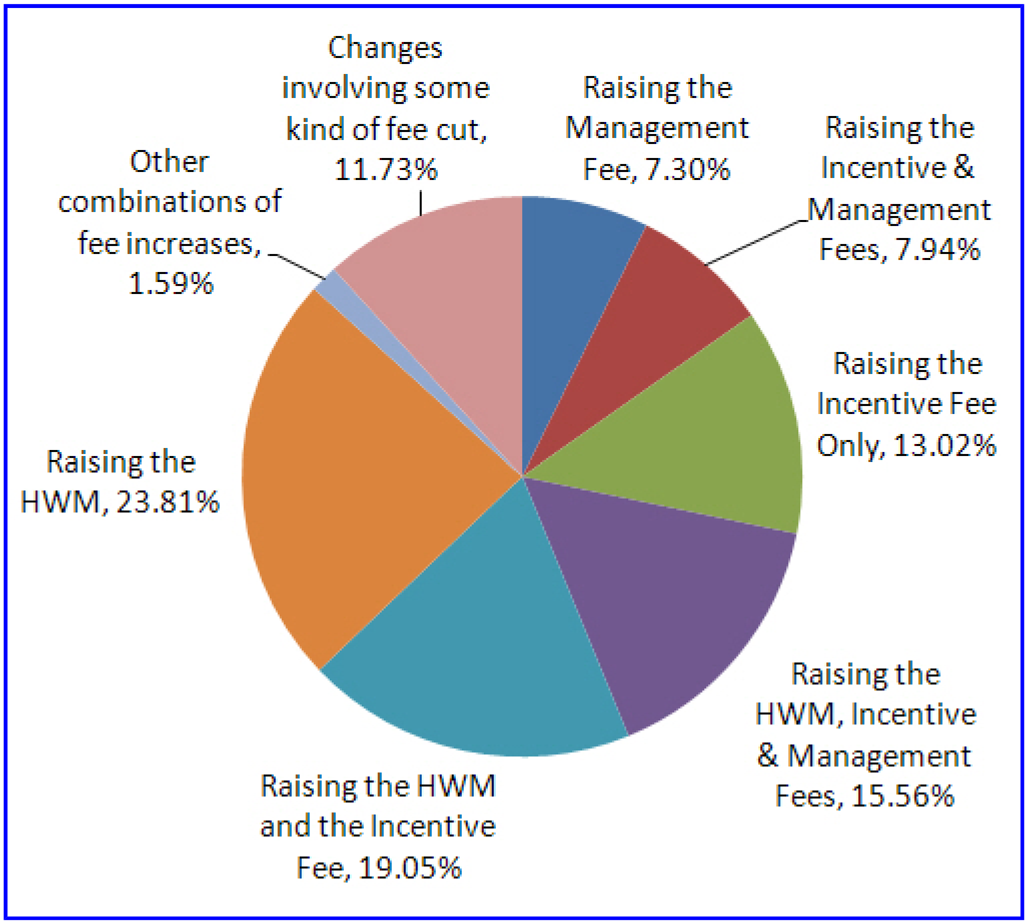
Posted By Alpha Male On April 17, 2011 @ 9:00 pm In Investment Management Fees, Today's Post | No Comments

[1] If you believed everything you read in the media about hedge funds (and why wouldn't you?), you'd surely think that there was a fire sale going on in Hedgistan. Dismayed with 2008's returns and emboldened by their newly found dominance on hedge fund investor roles, institutions are pushing for lower fees. At least, that's the mainstream narrative.

To be sure, some institutions have won fee concessions (and alerted the media of their negotiating victories). But research is still scant on whether fees are really dropping across the hedge fund industry.

However, a new study [2] by Vikas Agarwal of Georgia State University and Sugata Ray of the University of Florida confirms that fees are always changing (i.e. going either up or down) in the hedge fund industry. They figure that hedge fund managers have several incentives to either cut – or raise – their fees. In other words, they wondered about the determinants of a fee change. To what extent did past performance drive fee changes? What about asset inflows or outflows? Or fund size and age?

They examined a "unique" data set of hedge fund fee changes that occurred from April 2008 to November 2010 and counted the occurrence of various types of fee changes (incentive fees, management fees and high water mark provisions). The most prevalent changes were hikes in incentive and management fees as you can see from the chart below made from data in Table 1 of the paper. But note that the most common fee change between 2008 and 2010 was actually a form of fee drop – the addition of a high water mark where there has previously been none.



[3]

However, the rest of the fee changes were all increases (media take note!) and not decreases. In fact, if you added up all the changes that involved some kind of fee drop, it amounts to a paltry 11.73% of fee change occurrences. As the authors wryly observe, "fee changes in hedge funds tend to be asymmetric."

Once fees have been adjusted, Agarwal and Ray wondered what the *effect* of these changes would be. Did the change affect the manager's appetite for risk? Did it help or hinder performance? And how did investors react? Did they actually shun funds which just boosted their fees?

The duo organized their hypotheses in the table below. While these are only hypotheses, not their conclusions, it turns out (as it often does in such studies) that their guesses where pretty accurate anyway. The plus signs denote a positive correlation like when, for example, past performance is high, the likely direction of fee changes is up. The negative signs denote a negative association – like when a fund becomes bigger and older, the direction of any fee change is likely to be down. The "D" factors are the hypothesized determinants of fee changes and the "E" factors are the hypothesized effects of such a change.

Summary of hypothesized determinants and effects of fee changes

Factors and hypotheses	Fees	IF	MF	HWM
Hypothesis 1: Fee changes to adjust incentives				
D: Past performance	+	+	+	
E: Risk shifting		+	–	–
Hypothesis 2: Fees changes to control investor flows to maximize investor returns				
D: Past inflows high	+	+	+	
E: Inflows	–	–	–	
E: Performance		+		
Hypothesis 2A: Fees changes to expropriate surplus				
D: Good past performance	+	+	+	
E: Performance	–	–	–	
E: Inflows	–	–	–	
Hypothesis 3: Fee changes correspond to a "feeling out period"				
D: Fund Age		–	–	
D: Fund Size at Inception		–	–	

[4]

Agarwal and Ray hypothesize that fees respond to – and, in turn, *influence* - changes in manager incentives. After a period of great returns, you might expect the manager to raise fees, while after an awful year, you might expect them to drop fees (which they essentially do since the performance fees after a negative year could amount to 0%). (Check out Hypothesis 1 above.)

In an effort to reduce the flow of new assets into a capacity-limited investment strategy, you might also expect the hedge fund manager to hike fees simply to curb high asset inflows (Hypothesis 2). Similarly, you might expect a manager to not just hike fees in order to curtail inflows, but hike fees simply to make more money for themselves (to "expropriate a surplus," Hypothesis 2A). Agarwal and Ray hypothesize that the string performance which led to the fee hike would likely revert to the mean. Thus, the dual "effects" of such a hike is to reduce inflows and performance.

Finally, one might expect that older and "early blooming" funds might be more agreeable to dropping fees.

An analysis of the "unique" data source used by the duo reveals that these are hypothesize are largely true – even if a little irrational from an investor's perspective. Like many things, a higher fee can sometimes signal higher quality. And in a marketplace where true quality is so difficult to determine and measure, price often sets the tone. As Agarwal and Ray observe (our emphasis added):

> "[Our findings] suggest that fund managers opportunistically increase fund fees following good performance but do not decrease their fees subsequent to poor performance. This raises the question why investors do not participate in downward negotiation of fees. **One possibility is that decrease in fees may not help the managers raise more capital if investors view it is a bad signal about future performance.**"

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[2] a new study: **http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1784545**

[3] Image: **http://allaboutalpha.com/blog/wp-content/uploads/2011/04/Fee-Raises-3.jpg**

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