Investing in hedge funds does not have to be expensive

May 2016

The high cost structures of hedge funds’ fees are in many respects a remnant of days past. In our view, fees can often be structured in a way that better aligns managers’ interests with those of investors. For those hedge fund investors who are sensitive to relatively high TERs, it is possible to construct more fee-efficient investment solutions, while maintaining the desired risk/return profile.

Unigestion has a long history of working with hedge fund managers, and over time we have seen and invested with expert managers who are able to generate consistent genuine, uncorrelated alpha. We think this is a valuable element of any diversified portfolio, and hence worth paying for. However, a material portion of many hedge fund returns can be explained by market factors, and this is an area where we think it is possible to create fee structures that are more aligned with the value-added by a manager and indeed propose solutions that can deliver market factor exposure in a more fee-efficient manner. Our experience in investing with hedge fund managers enables us to advise clients on the performance profiles that are worth having, as well as how best to structure the fees on such strategies.

In this paper, we offer a case study of a TER-reduction exercise we undertook on behalf of one of our client’s through a two-step approach: making use of lower-cost liquid alternative solutions, and fee transformation discussions with our hedge fund managers.

Our two-step approach to tackling fees

Our first step in reducing TERs for the client was to make use of liquid alternative products that are able both to deliver robust returns over time and do so in a more cost-effective manner. The solutions at our disposal included both external as well as internally-created ones, which were purpose-built following an extensive research initiative that drew on investment expertise from across the firm.

Secondly, we redoubled our efforts to engage in fee transformation discussions with new as well as existing underlying hedge fund managers. Fee negotiations are common among hedge fund investors; however, rather than simply asking managers to give us the lowest fee possible, we prefer to seek to transform hedge fund fees, working with a manager to better align their fee structures with the interests of investors.

We believe it is right to pay a manager for performance and by having a fee structure that rewards a manager for good performance, the alignment of interests among investors and managers is improved. Furthermore, we believe a hurdle rate is appropriate where a manager wishes to collect a performance fee as we think investors should earn a minimum positive return prior to the manager taking additional fees for their success. The inclusion of a hurdle is all the more appropriate when some of the manager’s returns can be explained by market factors. By increasing the performance fee participation above a hurdle rate, the manager can potentially earn more than under a typical 2 and 20 fee structure by generating excess returns over the hurdle rate – for example, where a manager has 30% participation in the performance instead of 20%.

The following chart demonstrates the impact of such a transformed fee structure:

Summary

1. The high cost structure for most hedge funds may prevent investors from accessing this useful investment strategy.
2. Today, there are a number of tools that can be used to overcome TER challenges of the past.
3. We still believe an unconstrained hedge fund allocation can deliver the best results over time, but achieving the highest returns is not every investor’s goal. In many cases, attractive return, with strong downside protection and a low TER is all that is needed.
In the chart above, what can be seen is that in the transformed fee structure, the investor in the fund receives a higher net return compared to a 2 and 20 fee structure unless the hedge fund manager strongly performs (in this case, generating a gross return above 15%). Once the manager both delivers a strong gross return and achieves the hurdle rate, then the manager is able to collect premium performance fees. We believe this structure is not only fair, as the investor bears less of the burden of lower performance, while the interests of the investor and manager are more aligned where performance is rewarded.

It is important to note that we do not believe such a transformation of fees makes the investment more risky for an investor by encouraging the manager to take unwarranted risks. The profile of managers that we will invest in is well-defined from the start and any deviation of the risk profile we expect would not be tolerated. We believe that hedge fund managers should not act like asset gatherers in that their compensation should not be materially based on management fees from asset accumulation, but rather from performance fees. All too often, hedge fund managers who earn large fees based on assets under management tend to underperform their relatively smaller peers, who may benefit from being more nimble with smaller fund sizes and being ‘hungrier’ to succeed as the compensation for these smaller peers will be more based on their performance.

The ultimate structure of a transformed fee arrangement will depend on a number of factors, such as the manager’s gross return expectations, investment strategy, operational costs structure (some funds simply require more infrastructure for systems, PhDs, etc.) and other considerations. There cannot be a ‘one size fits all’ when it comes to fees. The challenge for investors is to understand these differences and find out what arrangement would be mutually beneficial for both parties.

Case Study - Reducing TERs in 2015 and action plan for 2016

In this client case study, our goal was to lower the TER for this foundation client, while preserving the risk and return profile of their tailor-made portfolio. In order to achieve this objective, we used the two-step approach described above to deliver our solution.

The first step was to consider how to best make use of liquid alternative solutions. In
the end, in order to be the most fee-efficient as possible, we looked at the use of Unigestion’s internally developed liquid alternative solutions to address the challenge. The reason for this is that while external liquid solutions can be cost effective on a stand-alone basis, in a multi-manager solution, where management of the overall portfolio is needed, an investor’s TER would include both the external liquid alternative solution fee and the fee of the overall portfolio manager. By using Unigestion’s internal solutions, which we believe are equally as robust, the client only pays one fee – at the overall portfolio level. Consider the following:

<table>
<thead>
<tr>
<th>Solution</th>
<th>External funds fee</th>
<th>Unigestion funds fee</th>
<th>Unigestion fee</th>
<th>Total Fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio with Unigestion liquid alternatives funds*</td>
<td>none</td>
<td>0.0%</td>
<td>1.0%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Portfolio with external liquid alternatives funds</td>
<td>0.5%</td>
<td>none</td>
<td>1.0%</td>
<td>1.5%</td>
</tr>
</tbody>
</table>

*Unigestion does not double-charge where internal solutions are used. Only the overall portfolio management fees apply. Fees shown as for indicative purposes only.

As this client’s mandate was focused on Tactical Trading strategies, we limited our scope of liquid alternatives to those in this space.

The first liquid alternative solution we looked at was our trend-following fund, Uni-Global - Cross Asset Trend Follower. Instead of taking a position in an externally-managed CTA/Trend product, Unigestion proposed making an allocation to this internally managed solution. The TER savings from this allocation would be material as the client can avoid paying direct hedge fund fees, which had cost 3.7% a year on average (total manager TER of management fee and performance fee) over the past three years¹. Because Unigestion does not wish to double-charge for this allocation to our internally managed product, the client was invested in a zero-fee share class. We estimate, based on the sizing of the allocation, that the savings benefit will equal an estimated 16 basis points (bps) on the total portfolio TER per year going forward compared to having an allocation to a direct, traditional hedge fund manager.

We also added an allocation to our global macro solution, Uni-Hedge Top Macro. Similarly, instead of taking a position in an external global macro product, Unigestion proposed making an allocation to our internally managed alpha-amplification solution in the global macro strategy. The savings benefit from adding a position in this fund is expected to be around 30 bps.

As a second step, we then looked at managers with whom we had negotiated attractive fee terms that were more aligned with investors and, in particular, where the fixed costs (management fees) were lower – in exchange for potentially higher remuneration in terms of performance fees where the manager delivered strong returns. While the client is TER sensitive, there was an understanding that, subject to strong performance, a higher TER could be justified. This trade-off of having a potentially higher TER if the manager/portfolio did very well is understandable, as defending a low portfolio return with a high TER is harder than defending a high portfolio return with a high TER.

“While the client is TER sensitive, there was an understanding that, subject to strong performance, a higher TER could be justified.”

¹ Based on the arithmetic average total external hedge fund manager TER (management and performance fees) for the hedge funds portfolio over 2013, 2014 and 2015 (last 3 years for which final data has been calculated). Actual TER savings costs may differ, however, this information is provided as an illustration of savings based on actual underlying manager TER data.
For this client’s portfolio, we made allocations to two hedge funds managers who offered an attractive fee structure:

\* Hedge Fund A. In this instance, Unigestion negotiated a fee structure that perfectly reflects our preferred compensation structure with managers. In addition to agreeing to a lower management fee (which would continue to fall as the manager’s fund assets grew), the manager also agreed to include a 5% hurdle rate in the performance fee in exchange for a higher participation rate should the manager perform above the hurdle rate. This allocation in the portfolio is expected to result in savings of 22 bps in 2016 (full year).

\* Hedge Fund B. Through our engagement with this manager during the year, the manager has offered to waive in full the management fees for 2016 (and, of course, does not earn performance fees) until he recovers his high-water mark.

The performance in 2015 was challenging for the manager and we made our future expectations known. The result of this fee reduction in 2016 is expected to result in a savings of 31 bps. Once the manager recovers his drawdown, the original fees may be reinstated. We continue to believe that Hedge Fund B, which is a top emerging markets active manager, can produce attractive returns over time. The fund is up over 4.8% so far in 2016, which has been an extremely difficult period for risk-taking globally, thus demonstrating the manager’s ability to generate alpha.

In total, for 2016 we are expecting to save the client a total of approximately 0.93% compared to the average portfolio TER they paid over the last three years. This figure assumes the inclusion of a performance fee by the underlying managers. However, even if we assume no performance fee is collected by our managers, the savings on management fees alone will equal 0.47% for 2016 based on current AUM levels and underlying manager allocations.

The impact on performance as a result of these moves is naturally a key consideration, as investors are not allocating to hedge funds to achieve a low TER, but rather to get a return on their investment. In a multi-manager solution, the reality is that diversification will limit the ability of a portfolio of managers to achieve extraordinary returns. Outperformance by individual managers will often be diluted by the rest of positions (which is why concentration among manager positions is important, but this is a separate topic). By lowering the TER of the overall hedge funds solution, it is more likely that an investor can achieve their desired net return. Even if liquid alternative solutions deliver a lower gross return, as the alpha contribution from liquid alternatives is expected to be less, by reducing the ‘TER headwinds’, even a lower gross return of the portfolio combined with a lower TER can result in a larger net return, as the chart below shows:

---

2 Performance from 01.01.2016 to 30.04.2016

3 Performance shown above is indicative only and does not represent the performance of any existing portfolio. The Gross return used in the 100% External Managers and 60% External Managers portfolio is 8%. The fees for the external managers are 2% and 20%, while internal managers are assumed to be Unigestion solutions, which carry no fund fee. The overall portfolio management fee is 1%.
In the chart above, the first two bars (from the left) represent the net performance of a portfolio made up of only external hedge fund managers charging 2% and 20%, and a portfolio that only allocates 60% of its assets to external hedge fund managers, with the remaining 40% allocated to Unigestion liquid alternative solutions (which are invested in zero-fee share classes). Both portfolio are also assessed a 1% portfolio management fee. Assuming a gross return of 8% for each of the two portfolios, the external-only portfolio would deliver a net return of 3.8%, while the 60% external manager solution would produce a net return of 5.1%. The move to include liquid alternative solutions has had a strong impact due to their lower fees.

However, as noted above, it is unlikely that over time liquid alternative products will outperform traditional, top-performing hedge fund managers from a gross return basis. A more likely scenario would be that a portfolio based on a combination of external hedge fund managers and liquid alternatives would produce a lower gross return, in this case 7%.

Again, the impact of having lower cost solutions can result in outperformance versus an external-only solution – even at a lower overall gross return. What is far more likely is that the performance per unit of cost will be materially improved when using a blend of external and liquid alternative solutions. If the liquid alternative solutions can produce a return close to or on par with that of external managers, the benefit to investors can be significant.

“The move to include liquid alternative solutions has had a strong impact due to their lower fees.”
Continually innovating

As of today, a lot of work has been done in terms of finding solutions to improve the TER profile of multi-manager hedge fund allocations. This is a constantly evolving and growing project at Unigestion, with additional solutions having already been launched this year and further tools planned going forward.

The pressure that investors have on costs is likely to remain in the current environment. Should the gross return profile improve, it is possible that investors may focus less on fees and more on the overall return. At the same time, we believe that investors today have a good opportunity to impact on the fee structures of hedge funds and better align the interests of managers and investors.

As Oscar Wilde said “What is a cynic? A man who knows the price of everything and the value of nothing”. The key in understanding the right price of a hedge fund manager’s strategy is to be able to truly identify its value. Having been investing with hedge fund managers for over 25 years and today offering our investors both multi-manager as well as single strategy solutions, we believe we are well placed to define and identify the costs that are worth paying and which are not. Where costs are not rewarded, but alternative exposure is desired or needed, there are other solutions to access alternative returns streams in a more cost efficient manner.

Important Information

This document is addressed to professional investors, as described in the MiFID directive and has therefore not been adapted to retail clients. It is a promotional statement of our investment philosophy and services. It constitutes neither investment advice nor an offer or solicitation to subscribe in the strategies or in the investment vehicles it refers to. Some of the investment strategies described or alluded to herein may be construed as high risk and not readily realisable investments, which may experience substantial and sudden losses including total loss of investment. These are not suitable for all types of investors. The views expressed in this document do not purport to be a complete description of the securities, markets and developments referred to in it. To the extent that this report contains statements about the future, such statements are forward-looking and subject to a number of risks and uncertainties, including, but not limited to, the impact of competitive products, market acceptance risks and other risks. Data and graphical information herein are for information only. No separate verification has been made as to the accuracy or completeness of these data which may have been derived from third party sources, such as fund managers, administrators, custodians and other third party sources. As a result, no representation or warranty, express or implied, is or will be made by Unigestion as regards the information contained herein and no responsibility or liability is or will be accepted. All information provided here is subject to change without notice. It should only be considered current as of the date of publication without regard to the date on which you may access the information. Past performance is not a guide to future performance. You should remember that the value of investments and the income from them may fall as well as rise and are not guaranteed. Rates of exchange may cause the value of investments to go up or down. An investment with Unigestion, like all investments, contains risks, including total loss for the investor.

Read more of our publications online: www.unigestion.com/publications/