



COMSTOCK

## Paying for Alpha

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We have long been concerned with establishing a proper alignment of interests and incentives between investment managers and their clients. While common in alternative investment structures, the use of performance based fees is relatively rare in traditional equity management. Recently we developed a performance fee structure that accomplishes this with long-only separate account equity managers. The fee structure is based upon absolute levels of performance and is largely indifferent to benchmarks. The manager receives a percentage of the annual return above a 5% hurdle rate. The total management fee is capped at twice what flat fee that manager would charge for a similar account. If the manager returns less than 5% (approximately what an investor could earn in a money market fund) then they do not get paid for that year. There are some additional provisions that incent preservation of capital in poor market environments. If the S&P 500 is negative in a given year and the manager outperforms the index (even with a smaller loss) then up to 5 percentage points of that performance differential would be subtracted from the hurdle rate the following year. The reverse applies also – if the manager underperformed a negative market then up to 5 percentage points of the underperformance would be added to next year's hurdle rate.

There are several reasons why we chose to base the performance fee on absolute performance rather than outperformance of a benchmark:

- One basic reason was that we did not want our clients to be in the position of paying high fees in a year where their portfolio value declined. To make economic sense for an investment manager, the percentage of outperformance would have to be payable would be 25% or more. For example the applicable benchmark declined 20% and the manager only declined 10%, paying the manager a percentage of the performance differential would only serve to further a drawdown in capital and potentially cause liquidation of assets at distressed prices.
- Secondly, we do not believe that a compensation scheme alone can alter undesirable investment behavior. A manager who appears to be a “closet index” would never be invited to participate in this arrangement. Because the investment remains in a separate account like any typical arrangement, we can easily see if problematic investment decisions are being made and the client has the ability to terminate the account at will.
- Additionally, we want the manager focused on absolute performance. Often the stocks that are driving the performance of a given benchmark are undesirable to own, such as Internet stocks in 1999 or low quality financial stocks in 2006. We want the alignment of interests to focus on long-term growth of capital, not short term tracking error decisions by the manager.

- Finally, we want the manager to share the risk of a low return environment with the client. If 20%+ returns are what the market is offering then this arrangement will be more expensive, but the risks to the client's investment goals will be minimal. Conversely, in a single digit return environment, the client would benefit from a much lower fee.

What does the fee schedule look like over a ten year period? We ran a Monte Carlo simulation of two identical large cap US portfolios. The only difference between the two is the fee schedule – one is a flat 0.80% while the other is the performance fee arrangement – 16% of the annual return above 5%, capped at 1.6% of the year-end portfolio value. The results are shown in the following table:

Table 1: Monte Carlo Results - Large Cap US Stocks:  
10 Year Annualized Return – Net of Fees

	Flat 0.80%	Performance Fee <sup>1</sup>	Difference
95%	-1.50%	-1.20%	0.30%
75%	3.90%	4.10%	0.20%
50%	8.00%	8.00%	0.00%
25%	11.90%	11.70%	-0.20%
5%	17.70%	17.30%	-0.40%

1. Annual performance fee of 16% of the return that is in excess of 5%, capped at 1.6% of the total portfolio value

The median or 50% return level is identical between the two approaches. As one might expect, in high return environments the net returns of the performance fee is lower and in low return environments the opposite is true. The table shows a 20 basis point annualized return difference at the 25<sup>th</sup> and 75<sup>th</sup> percentiles.

Given that our expectations for successful active equity managers project a 150-300 basis point gross outperformance of benchmarks over a ten year period, typical active management fees of 1% comprise from 1/3 to 2/3 of the value added. The problem with paying performance fees on relative returns is that it exposes the client to paying a large fee on top on investment losses in a bear market environment. By selecting an opportunistic, absolute-return focused investment manager and incenting them with the opportunity to potentially earn double their normal fee in our view creates a proper and proportional alignment of interests that is supported by statistical analysis.

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