

PricewaterhouseCoopers

Performance fees:
Some pitfalls and issues

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Performance fees: background

Becoming increasingly popular!

Advantages of performance fees	Disadvantages of performance fees
The most fair way of compensation of investment manager from the point of view of investor	Because return based, may motivate the investment manager to incur higher investment risks
Motivates the investment manager to do his best	Complex and ambiguous calculation methods

Performance fees: historical issues

- Performance fee models not properly described in the asset management agreements → large room for interpretation and lack of transparency to investors
- Difficult to verify whether the implemented performance fee calculations effectively comply with the agreed model
- Performance fee calculations often methodologically questionable
- Lack of guidance / literature on performance fees
- Errors in performance fee calculations materialise in real cash outflows → significant risks for investment managers in case of conflicts with investors



Typical parameters of a performance fee model

- Performance reference point (benchmark, hurdle rate)
- High-water mark
- Performance fee rate
- Accrual schedule
- Payment schedule
- Equalisation methods
- Various model variations exist

	NAV > HWM	NAV < HWM
Outperformance	Performance Fee	0
Under-performance	0	0

Issues

- Explaining the performance calculation methodology to clients (TWR vs. MWR)
- Capital base for calculations
- Frequency of the effective performance fee charge

Date	Cash flow, CHF	Portfolio value, CHF	TWR	MWR	Hurdle rate	Excess return (TWR)	Performance fee (20%)	Perf. Fee (basis WAC), CHF	Perf. Fee (basis end NAV), CHF
01.01.2007	100.0	100.0							
14.01.2007		150.0	50.0%						
15.01.2007	100.0								
31.01.2007		200.0	-20.0%						
January 2007:			20.0%	0.0%	5.0%	15.0%	3.0%	4.50	6.0

Date	Cash flow, CHF	Portfolio value, CHF	TWR	MWR	Hurdle rate	Excess return (TWR)	Performance fee (20%)	Perf. Fee (basis WAC), CHF	Perf. Fee (basis end NAV), CHF
01.01.2007	100.0	100.0							
14.01.2007		150.0	50.0%		2.47%	47.53%	9.51%	9.51	14.26
15.01.2007	100.0								
31.01.2007		200.0	-20.0%		2.47%	-22.47%	0.0%	0.0	0.00
January 2007:			20.0%	0.0%	5.0%	14.4%		9.51	14.26

Example of the impact of a different frequency of the performance fee payments in a mutual fund

Perf. Fee: 20%	Units	NAV	Annual	Quarterly	Monthly
31.12.2004 = HWM	100	100			
31.01.2005	200	101			$=(101-100)*20\%=0.2$ NAV 101 is the new HWM
28.02.2005	150	102			$=(102-101)*20\%=0.2$ NAV 102 is the new HWM
31.03.2005	210	103		$=(103-100)*20\%= 0.6$ NAV 103 is the new HWM	$=(103-102)*20\%=0.2$ NAV 103 is the new HWM
30.04.2005	220	105			$=(105-103)*20\%=0.4$ NAV 105 is the new HWM
31.05.2005	200	102			$=(102-105)<0 \rightarrow 0$
30.06.2005	180	101		$=(101-103)<0 \rightarrow 0$	$=(101-105)<0 \rightarrow 0$
31.07.2005	190	98			$=(98-105)<0 \rightarrow 0$
31.08.2005	210	99			$=(99-105)<0 \rightarrow 0$
30.09.2005	180	104		$=(104-103)*20\%=0.2$ NAV 104 is the new HWM	$=(104-105)<0 \rightarrow 0$
31.10.2005	160	102			$=(102-105)<0 \rightarrow 0$
30.11.2005	200	101			$=(101-105)<0 \rightarrow 0$
31.12.2005	300	103	$=(103-100)*20\% =0.6$	$=(103-104)<0 \rightarrow 0$	$=(103-105)<0 \rightarrow 0$
Total perf. fees			CHF 0.6	CHF 0.8	CHF 1.-

Issues

Collective pooled funds:

- If the frequency of accrual and payment of the performance fee is different (e.g. daily accrual and quarterly charge), on the basis of which number of units should the total amount of performance fees be calculated:
 - At the date of the performance fee charge?
 - At the beginning of the period?
 - Average number of units during the period?
- Equal treatment of unitholders:
 - Daily performance fee accrual?
 - Separate share classes?
 - Separate calculation for each investor?

Issues

Collective pooled funds:

Basis of the performance fee calculation:

- Gross NAV (before deduction of fees)?
- Net NAV (after deduction of fees)?

Advantages of the gross basis	Advantages of the net basis
Reflects the capital effectively available for portfolio management	Understandable for investors
More appropriate for comparison with benchmarks and hurdle rates	No additional gross NAV calculation necessary

Discussion