PERFORMANCE FEES HARDLY WORTH IT

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There is no appreciable difference in the returns of asset owners that do pay performance fees and those that don't, so what's the point of these fees?

That's the question to ask, based on a research paper from Maastricht University and De Nederlasche Bank, in the Netherlands. The researchers looked at 218 Dutch pension funds between 2012 and 2015. They found no difference between the investment performance of those that paid performance fees and those that didn't.

The paper, *Does it pay to pay performance fees? Empirical evidence from Dutch pension funds*, claims to be the first that examines the relationship between performance fees and the net investment performance of a pension fund and, in doing so, shows whether it pays for pension funds to pay performance fees at all.

The research looks at total returns, excess return and performance fees for the total portfolio and six major asset classes, and finds that those investors that paid performance fees do not produce higher, or lower, returns than those that don't.

(There is one minor exception. Pension funds that pay performance fees for hedge funds report a net excess return 3 basis points higher, on average, but that disappears when the authors correct for risk.)

In 2015, the funds, whose combined assets are €985 billion ($1.1 billion), paid €1.5 billion ($1.7 billion) in performance fees, across a variety of asset classes but most commonly in private equity and hedge funds. These fees represented a 36 per cent increase from 2012, when the funds paid €1.1 billion ($1.25 billion) in performance fees.

Paying performance fees could be "economically rational", the paper states, if they enable pension funds to enhance their overall net performance by recovering these costs with superior returns or higher diversification benefits. The findings show this isn't necessarily what happens.

The authors observed that "performance fees primarily relate to gross excess returns for equities and hedge funds where investors pay 2.1 basis points and 30.5 basis points, respectively, for every 100 basis points of gross excess return".

The 218 Dutch funds' total return over the period studied was 9.72 per cent, with a 0.11 per cent excess return over the benchmark, after costs. For private equity, the total return was 11.54 per cent, with an excess return of 1.4 per cent, and for hedge funds it was 2.64 per cent, with an excess return of 0.12 per cent.

The paper further calls into question the relevance of performance fees by showing that pension fund size and specialisation are "economically more important for net returns than paying performance fees".

Specialisation is positively correlated with net returns for private equity and hedge funds, the paper demonstrates; pension funds with an allocation to these asset classes 1 percentage point higher than their peers' reported a 1.31 and 1.37 basis point, respectively, higher net total return.

As for size, the research also supports the notion that bigger is better. It finds empirical evidence that larger and more specialised pension funds pay less in performance fees for a given level of excess return in alternative asset classes, possibly as a result of their better negotiating power. Larger funds also apply performance fees more often, and pay significantly less for the same performance by asset managers.

The authors did recognise that, in theory, performance fees could be a valuable tool to minimise the principal-agent conflict between pension funds and asset managers.

The research paper cites academic studies outlining the benefits of performance fees, including aligning the managers' incentives with the pension fund's interests, and linking the manager's reward to performance. Ideally, this should increase the effort from the manager and translate into higher investment returns.

The drawbacks are that the manager receives the same performance fee whether the performance comes from skill or luck, and the payments create a skewed incentive structure, as the manager benefits from excess returns but does not suffer from losses.

"We find no statistical evidence that paying fees for most asset classes adds or subtracts value," the authors conclude.

The paper is by Dirk Broeders, Arco van Oord, and David Rijsbergen.

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