Cass Business School
CITY UNIVERSITY LONDON

## Report: UK fund fees skewed in the interest of fund managers

*Study reveals UK's most widespread fee structure does not benefit investors*

**17 November 2014 -** Fund managers should consider adopting a fee structure that better aligns investors' and managers' interests by sharing losses as well as gains, according to a new report by Cass Business School ('Cass').

Academics at Cass are pushing for a sweeping review of fund charges levied across the UK asset management industry after finding the most widespread fee structure is the least appropriate from the perspective of investor welfare, creating an 'incentive mismatch'.

In the most detailed study of its kind, researchers at Cass, part of City University London, discovered that the most prevalent fee structure – a charge fixed as a proportion of assets under management – is best suited to fund managers and rarely suitable for their clients.

In the study titled, '*Heads we win, tails you lose'*, academics compared the effect of three alternative fee structures on the financial well-being of investors and managers. They analysed:

(i) **Fixed fee**: a fee that is fixed as a proportion of assets under management (AUM);

(ii) **Asymmetric fee**: a base fee that is fixed as a proportion of AUM, plus a performance fee where the manager earns a portion of upside performance; and

(iii) **Symmetric fee**: a performance-based fee that is symmetric, meaning investors and managers share both the down and upside of performance.

Using "Monte Carlo" statistical techniques, Professors Andrew Clare, Richard Payne, Nick Motson and Steve Thomas, simulated the performance of thousands of fund managers with varying degrees of skill.

These simulations were conducted using a benchmark return matched to the FTSE-100. At the end of the period, the academics calculated the average financial well-being of investors and fund managers derived from manager performance under the three fee structures.

"*The study identifies a clear incentive mismatch between the best interests of investors and managers. More specifically, there is no single structure that simultaneously maximises both the investors' and the managers' satisfaction.*" said Professor Payne.

"*In fact, our results show that the most prevalent fee structure currently in the UK market (a fixed fee as a proportion of AUM) is generally the best structure for the manager and the worst for the investor!*"

Co-author Professor Clare added: "*It's about time there was a serious debate about fund management fee structures. Our results show that a symmetric fee structure is, on the whole, in the best interest of investors. How long can an industry ignore the best interests of its customers?*"

William Gray, Chief Investment Officer, Orbis Investment Management, which sponsored the research, said:

*"We have always believed in pay for performance—to us, it seems common sense. But few in the industry share our view so we thought it would be useful to hear Professor Clare and his team's perspective on the issue. Of course what really matters is what the investing public thinks, which is how it should be. We can't wait to see what happens."*

To verify the robustness of their results, the team at Cass stress-tested the model by changing the investment horizon over which managers were judged, the level of performance fees, extreme values of investor loss aversion and symmetrical fees starting with an empty reserve

"*None of these model variations changed the base results and our main conclusion,*" added co-author Dr Nick Motson. "*The results in this paper give rise to a natural question: since investors would prefer symmetric, performance-based charges, why don't more fund managers offer such fees?*"

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