

The Right Way

Following on our last post "[The First Step to Regaining Credibility](#)" we wanted to quickly highlight that the difference between the fee structure of a large, diversified, purportedly active fund and a smaller, concentrated, active fund.¹

To be clear, we do not think that paying a skilled hedge fund manager (if he or she exists) a management plus incentive fee is terribly different to paying a skilled mutual fund manager in a management fee only structure. The only question is how to structure the incentive fee.



For those starting from a point that all equity exposure should be passive, that is fine. In that case, the table below shows a rudimentary comparison of two \$30 billion diversified managers, one passive, and one active. In this first example, the market is up 5%, and the active manager generates no alpha. The difference in investor returns is driven by the difference in management fees; and similarly the difference in the fees earned by the manager are driven by the relative difference in the management fee.

5% Market Return, 0% Excess on Active Bet	Diversified Passive Manager	Diversified Active Manager
AUM (\$ Billions)	30.0	30.0
Ideas	150	150
% AUM in Top 20 Active Bets	0.0%	10.0%
% AUM in Closet Benchmark Names	100%	90%
AUM in Top 20 Active Bets (\$B)	0.0	3.0
AUM in All Other Bets (\$B)	30.0	27.0
% Active Bet in Top 20	0.0%	95.0%
% Active Bet in Closet Benchmark	0.0%	0.0%
Alpha (Excess Returns) in Active Bets	0.0%	0.0%
Alpha (Excess Returns) in Closet Bets	0%	0%
Gross Fund Excess Return in Billion \$	-	-
Gross Fund Excess Return in %	0.0%	0.0%
Market Return	5.0%	5.0%
Total Gross Return	5.0%	5.0%
Management Fee	0.1%	0.4%
Total Gross Return Before Performance Fee	4.9%	4.6%
Performance Fee over Hurdle	0.0%	0.0%
Hurdle	0.0%	0.0%
Total Performance Fee	0.0%	0.0%
Total Investor Net Return	4.9%	4.6%
Total Dollars Earned by Passive Investor (millions)	1470.0	0.0
Total Dollars Earned by Active Investor (millions)	0.0	1380.0
Grand Total Dollars Earned by Investor (millions)	1470.0	1380.0
Total Fees Earned by Passive Manager (millions)	30.0	0.0
Total Fees Earned by Active Manager (millions)	0.0	120.0

If you don't believe in manager skill, or in a particular manager's skill, then that is the way to go.

However, if you do believe in a manager's skill, the picture starts to change a bit. Even if the diversified manager is mostly closet benchmarking, his biggest relative bets are impacted if there is indeed skill there, as are the economics for both the manager and investor.

¹ For simplicity's sake, we are assuming this concentrated fund is long-only or – similarly - a "hedge fund" running with a 100% net exposure.

In this scenario, if the active manager was able to generate, say, 10% excess returns (only) in his largest active positions, then the manager would effectively earn that higher management fee, and the net returns to the investor would be commensurately higher too.

5% Market Return, 10% Excess on Active Bet	Diversified Passive Manager	Diversified Active Manager
AUM (\$ Billions)	30.0	30.0
Ideas	150	150
% AUM in Top 20 Active Bets	0.0%	10.0%
% AUM in Closet Benchmark Names	100%	90%
AUM in Top 20 Active Bets (\$B)	0.0	3.0
AUM in All Other Bets (\$B)	30.0	27.0
% Active Bet in Top 20	0.0%	95.0%
% Active Bet in Closet Benchmark	0.0%	0.0%
Alpha (Excess Returns) in Active Bets	10.0%	10.0%
Alpha (Excess Returns) in Closet Bets	0%	0%
Gross Fund Excess Return in Billion \$	-	0.29
Gross Fund Excess Return in %	0.0%	1.0%
Market Return	5.0%	5.0%
Total Gross Return	5.0%	6.0%
Management Fee	0.1%	0.4%
Total Gross Return Before Performance Fee	4.9%	5.6%
Performance Fee over Hurdle	0.0%	0.0%
Hurdle	0.0%	0.0%
Total Performance Fee	0.0%	0.0%
Total Investor Net Return	4.9%	5.6%
Total Dollars Earned by Passive Investor (millions)	1470.0	0.0
Total Dollars Earned by Active Investor (millions)	0.0	1665.0
Grand Total Dollars Earned by Investor (millions)	1470.0	1665.0
Total Fees Earned by Passive Manager (millions)	30.0	0.0
Total Fees Earned by Active Manager (millions)	0.0	120.0

But what if this PM decides he's had enough of the mutual fund life, and wants to strike out on his own. He despises asset-gathering and closet indexing, and decides to launch a concentrated fund consisting only of his top 20 active positions, charging a higher management fee, and an incentive fee as well. You, the investor (in aggregate) then decide to invest 10% of your capital in his fund, and the balance (90%) passively.

5% Market Return, 10% Excess on Active Bet	Diversified Passive Manager	Diversified Active Manager	1.5/20 Abs Manager
AUM (\$ Billions)	30.0	30.0	3.0
Ideas	150	150	20
% AUM in Top 20 Active Bets	0.0%	10.0%	100.0%
% AUM in Closet Benchmark Names	100%	90%	0%
AUM in Top 20 Active Bets (\$B)	0.0	3.0	3.0
AUM in All Other Bets (\$B)	30.0	27.0	0.0
% Active Bet in Top 20	0.0%	95.0%	95.0%
% Active Bet in Closet Benchmark	0.0%	0.0%	0.0%
Alpha (Excess Returns) in Active Bets	10.0%	10.0%	10.0%
Alpha (Excess Returns) in Closet Bets	0%	0%	0%
Gross Fund Excess Return in Billion \$	-	0.29	0.29
Gross Fund Excess Return in %	0.0%	1.0%	9.5%
Market Return	5.0%	5.0%	5.0%
Total Gross Return	5.0%	6.0%	14.5%
Management Fee	0.1%	0.4%	1.5%
Total Gross Return Before Performance Fee	4.9%	5.6%	13.0%
Performance Fee over Hurdle	0.0%	0.0%	20.0%
Hurdle	0.0%	0.0%	0.0%
Total Performance Fee	0.0%	0.0%	2.6%
Total Investor Net Return	4.9%	5.6%	10.4%
Total Dollars Earned by Passive Investor (millions)	1470.0	0.0	1323.0
Total Dollars Earned by Active Investor (millions)	0.0	1665.0	312.0
Grand Total Dollars Earned by Investor (millions)	1470.0	1665.0	1635.0
Total Fees Earned by Passive Manager (millions)	30.0	0.0	27.0
Total Fees Earned by Active Manager (millions)	0.0	120.0	133.1

In this case, the investor that parks a portion of his capital with the concentrated, higher-fee manager, and the balance passively does nearly as well as if he'd invested in the diversified mutual fund. At this level of market return, and of excess return, there just isn't much difference.

However, we're not there yet.

Even in the above-mentioned scenario, the fees paid by the investor are still higher with the “passive + hedge fund” hybrid than in the diversified fund. That’s because the concentrated manager is charging performance fees on the market beta component of fund returns. This was the subject of the piece we referred to further above.

If however the manager wants to align himself, his investor, and his moral compass; he will charge lower management and performance fees, and only charge the performance fee on excess returns, not on total returns. At a 1% management fee, and a 15% performance fee on those excess returns, the investor earns more with the “hedge fund manager plus passive” hybrid than he does in either the diversified mutual fund or the passive only vehicle.

5% Market Return, 10% Excess on Active Bet	Diversified Passive Manager	Diversified Active Manager	1.0/15 Rel Manager	1.5/20 Abs Manager
AUM (\$ Billions)	30.0	30.0	3.0	3.0
Ideas	150	150	20	20
% AUM in Top 20 Active Bets	0.0%	10.0%	100.0%	100.0%
% AUM in Closet Benchmark Names	100%	90%	0%	0%
AUM in Top 20 Active Bets (\$B)	0.0	3.0	3.0	3.0
AUM in All Other Bets (\$B)	30.0	27.0	0.0	0.0
% Active Bet in Top 20	0.0%	95.0%	95.0%	95.0%
% Active Bet in Closet Benchmark	0.0%	0.0%	0.0%	0.0%
Alpha (Excess Returns) in Active Bets	10.0%	10.0%	10.0%	10.0%
Alpha (Excess Returns) in Closet Bets	0%	0%	0%	0%
Gross Fund Excess Return in Billion \$	-	0.29	0.29	0.29
Gross Fund Excess Return in %	0.0%	1.0%	9.5%	9.5%
Market Return	5.0%	5.0%	5.0%	5.0%
Total Gross Return	5.0%	6.0%	14.5%	14.5%
Management Fee	0.1%	0.4%	1.0%	1.5%
Total Gross Return Before Performance Fee	4.9%	5.6%	13.5%	13.0%
Performance Fee over Hurdle	0.0%	0.0%	15.0%	20.0%
Hurdle	0.0%	0.0%	5.0%	0.0%
Total Performance Fee	0.0%	0.0%	1.3%	2.6%
Total Investor Net Return	4.9%	5.6%	12.2%	10.4%
Total Dollars Earned by Passive Investor (millions)	1470.0	0.0	1323.0	1323.0
Total Dollars Earned by Active Investor (millions)	0.0	1665.0	366.8	312.0
Grand Total Dollars Earned by Investor (millions)	1470.0	1665.0	1689.8	1635.0
Total Fees Earned by Passive Manager (millions)	30.0	0.0	27.0	27.0
Total Fees Earned by Active Manager (millions)	0.0	120.0	73.4	133.1

This comparison also depicts just how egregious the hedge fund manager charging performance fees for beta is. He is walking home with \$60 million that shouldn’t be his.

Of course, all of this is predicated on the assumption that there may be alpha out there to capture, and for some that may be the bigger question. But for those that want active exposure, **a combination of the correctly-priced concentrated manager with cheap passive beta exposure can be better and cheaper than paying optically low fees to a diversified active manager.**

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