Preqin Research Report

Hedge Funds: The Fee Debate An End to "2 & 20"?

April 2010

Private Equity • Real Estate • Hedge Funds • Infrastructure

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2009 was a turbulent year for the hedge fund industry. The beginning of the year was the most testing time for the asset class as it witnessed the collapse of many funds following the financial crisis that took hold of the markets in 2008. However, in the latter part of 2009, the market started its recovery and the proposals for increased regulation and transparency in the industry, coupled with fund managers' willingness to be more flexible in order to attract investors, helped improve investor confidence.

Preqin carried out a survey of hedge fund managers and fund of hedge funds managers in Q2 2009 and again at the end of Q4 2009. The aim of the initial survey was to assess how the market crisis had resulted in a shift of power from managers to investors and how this in turn affected the terms and conditions of hedge funds and funds of hedge funds. Preqin's survey in December 2009 examined both single hedge fund managers and fund of hedge funds managers across a wide range of strategies and regions. The survey covered data on 900 hedge funds.

Management fees for single manager funds are, on average, considerably lower than the perceived industry standard of 2%. The mean management fee is 1.65%, with the median at 1.5%. This suggests that an increasing number of funds are charging below the standard 2% management fee. Many managers have lowered their management fees in order to attract investors following the market crisis. The mean management fee for funds of hedge funds is 1.44% and the mean performance fee is 11.54%.

The market crisis changed the fundraising environment, and as a result, the traditional "2&20" fee structure has become less common. Today just 38% of single manager hedge funds charge "2 & 20". Hedge fund managers are becoming more flexible with their fee structures by either charging lower management or performance fees or reducing both in an attempt to attract investors and retain a competitive advantage.

Fees

From Fig. 2 we can see that across the sample of funds in the Q2 versus Q4 2009 surveys there was a significant decrease in the proportion of single manager funds charging a management fee of 2% and an increase in the proportion charging 1.5-1.99%. The distribution of hedge fund management fees is shifting towards the lower end of the scale. The highest management fee charged by any survey respondent was 4% and the lowest was 0%.

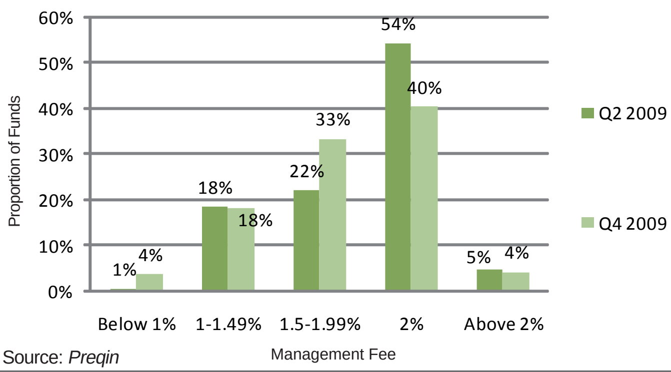
Fig. 1:

Key Statistics: Mean and Median Management Fees				
	HF		FOHF	
	Mean	Median	Mean	Median
Management Fee	1.65%	1.50%	1.44%	1.50%
Performance Fee	18.89%	20.00%	11.54%	10.00%

Source: *Preqin*

Fig. 2:

Management Fee Distribution for Single Manager Hedge Funds



Source: *Preqin*

Funds of funds typically charge a management fee of 1-1.99%. At the beginning of last year, funds of hedge funds were going through what was arguably the worst period in their history. Investor dissatisfaction was at an all-time high following the poor performance of many such vehicles (compared to direct investments) and the gating of assets, which was occurring as a result of liquidity restrictions in underlying funds. However, there was a recovery in the sector towards the end of the year and there was an improvement in the performance of many funds of hedge funds.

As a result, some funds that were launched towards the end of last year were coming to market with management fees that were higher than funds launched in the midst of the market crisis. The average management fee for funds of hedge funds is 1.44%.

In Q2 and Q4 2009, it is clear that performance fees showed

Fig. 3:

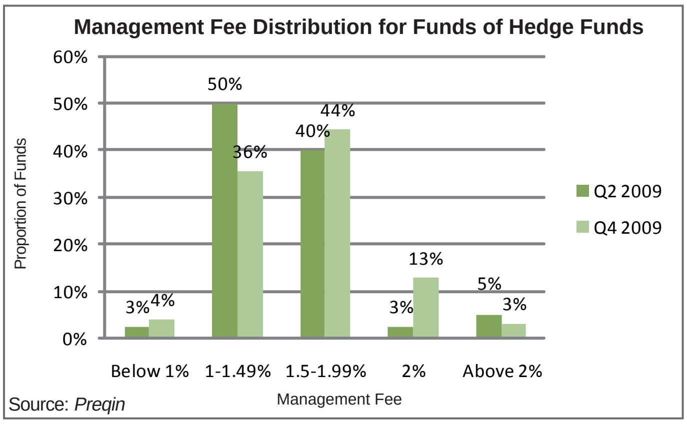
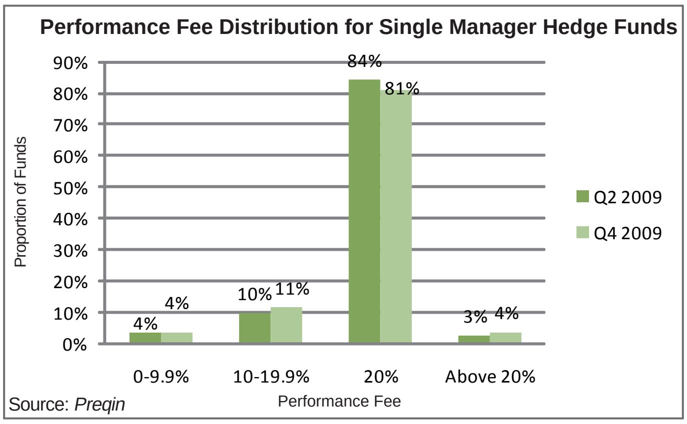


Fig. 4:



less variation than management fees. The mean performance fee charged by single manager hedge funds as of Q4 2009 was 18.89% compared to 18.88% in Q2 2009. This indicates that investors are still prepared to reward good performance despite the market turbulence, and there has been much less pressure for managers to reduce performance incentives. The predominant pressure from investors has been towards a reduction in management fees. Investors believe that such fees should cover "operational, back office and other overhead costs" and should not be used as a profit incentive like performance fees.

There are greater differences in the mean performance fee charged by fund of hedge funds than single manager funds, but the shifts have not been significant. The average performance fee for a fund of funds is 11.58%. Due to the poor performance of hedge funds during the financial crisis, many investors redeemed investments from funds of hedge funds in favour of direct investment, and movement back into funds of hedge funds has been relatively slow in comparison to single manager hedge funds. The performance fees of funds of funds are under more scrutiny from investors with some investors debating whether this type of investment adds value to a portfolio.

Fig. 5:

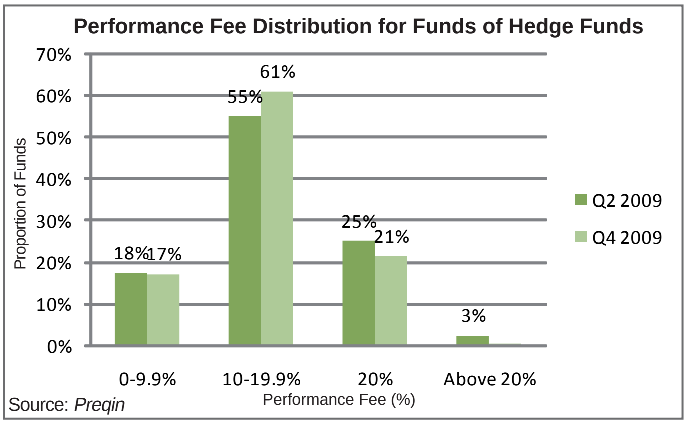


Fig. 6:

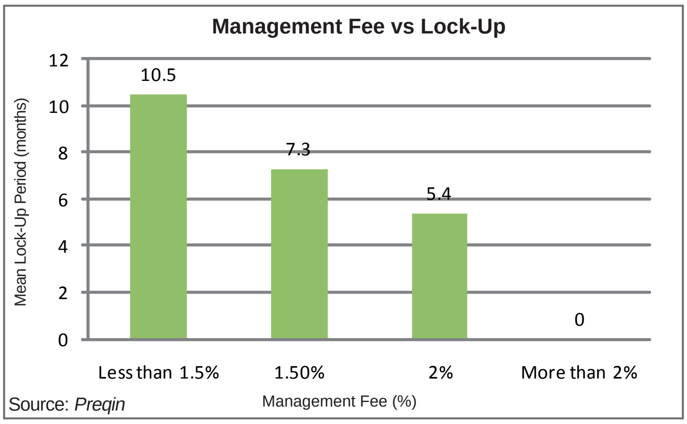
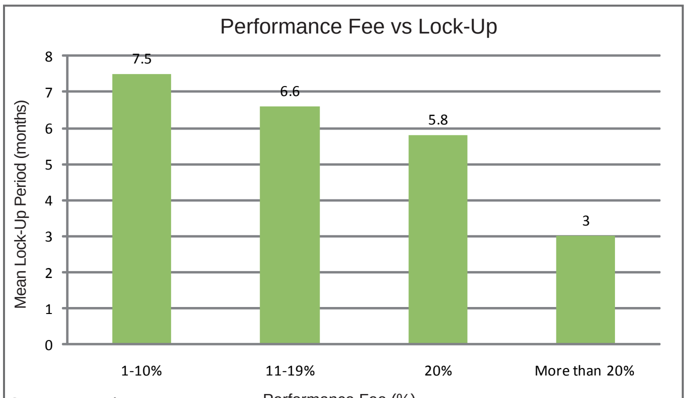
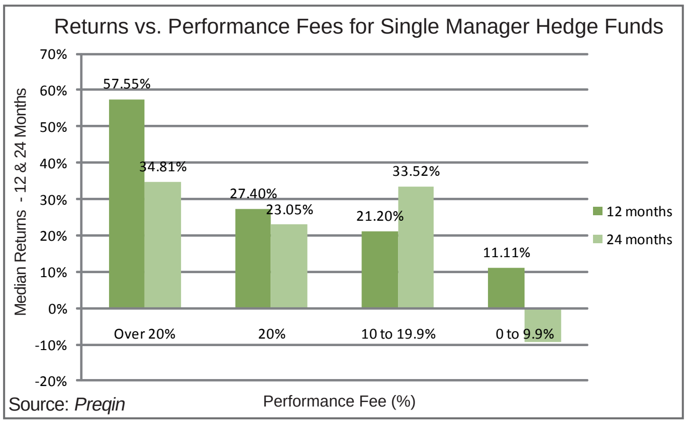


Fig. 7:



Source: *Preqin*

Fig. 8:



Source: *Preqin*

However, as with single manager funds, if performance objectives are met, investors are satisfied to award managers performance fees.

Some investors have called for the implementation of ‘clawback’ procedures in relation to performance fees because of poor performances. This would enable the investor to clawback performance fees charged by the manager in previous years if performance was not sustained. However, many investors feel that performance fees are justified if performance benchmarks are met and as a result “clawbacks” have not become common in the hedge fund industry. Only a limited number of managers have chosen to reduce their performance fees and many of these managers have negotiated other terms alongside this reduction, such as being able to lock investor capital up for longer periods of time.

Manager and investor alignment of interests

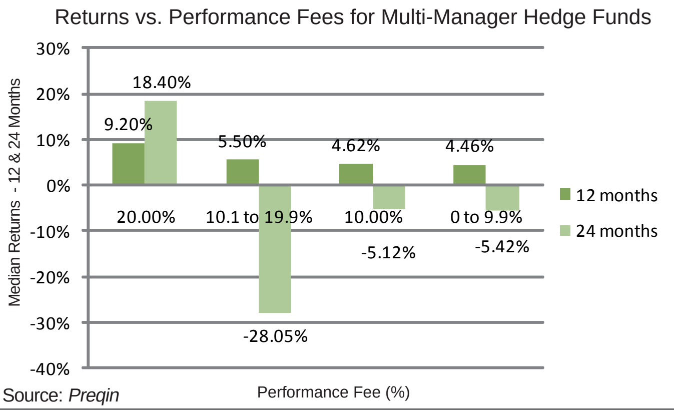
An important topic over the past twelve months has been the notion of a greater alignment of interests between managers and the investors in their funds. As discussed, there has been pressure from institutional investors to reduce management fees, as many investors feel that the current fee structure is not justified. Many managers have answered these calls by launching new funds with lower fees than the “2 & 20” standard or by launching new share classes of existing funds with lower management or performance fees. However, in return, managers have added terms that favour their fund’s structures and can protect against the mass redemption requests which led to many problems at the end of 2008. As a result, many new funds, new share classes or individual negotiations on reduced fees have been coupled with an increased initial lock-up on the fund. This trend is clear in Fig. 6: the funds that charge lower management fees lock up investor capital for longer periods than funds that charge higher management fees. This trend is also evident in performance fees (Fig. 7). Although there has been a power shift in favour of investors over the past two years, investors are also being flexible in the terms they are willing to compromise on with fund managers.

Performance

As part of our survey we collected data for each fund on cumulative 12- and 24-month performance (as of November 30th 2009). We used this data to analyze fund returns through the market crisis and compared this to performance fees.

Fig. 8 shows that there was a strong correlation between performance fees and the returns of single manager hedge funds over the period shown. It can be seen that single manager hedge funds that charged a higher performance fee, produced higher returns for their investors. Conversely the funds that charged the lowest performance fees generated the lowest returns for their investors. It is likely that many of these funds were forced to cut performance incentives following poor performance during the downturn in the markets. Although investors in funds charging a performance fee of 0-9.9% will save money on manager performance incentives, they will in turn have to compromise on the returns their hedge funds are generating for them.

Fig. 9:



Source: *Preqin*

Similarly, there is a clear correlation between the returns generated and the performance fees charged by fund of hedge funds managers. In general, the greater the performance fee, the higher the returns of a fund. For 24-month returns, only the funds of funds charging performance fees of 20% generated positive returns for their investors. These funds were able to keep their performance fees at a high level as they proved they could continue to generate positive returns to their investors even through the downturn.

Differences in Fees by Fund Age and Location

It is not just existing funds that are changing their fee structures and terms. New funds coming to the market are moving away from the standard "2 & 20" structure in order to gain the attention of the institutional market. In order to avoid a replication of the liquidity crunch caused by mass redemptions at the height of the financial crisis, managers are seeking larger and "stickier" investments in their funds: institutional investors can be an ideal source of this capital.

It can be seen from Fig. 10 that when analyzing the difference in management fees based on location, North American managers charged the highest management fees at 1.72% and Asian managers charge the lowest management fees at 1.51%.

Following the financial crisis, many investors have become more conservative when making hedge fund investments and are investing in domestic or developed hedge fund markets.

Fig. 10:

Regional Differences in Fee Structures Charged by Hedge Fund Managers

	Mean	
	Management Fee (%)	Performance Fee (%)
North America	1.72	19.12
Europe	1.59	18.23
Asia	1.51	19.32
ROW	1.68	19.33

Source: *Preqin*

As a result, Asian hedge funds have made their terms more attractive, which alongside good performance will be necessary to tempt potential investors.

The average performance fee charged by North American managers is 19.12%. Managers in different regions have reacted differently to the market crisis and the changes in the hedge fund environment. Managers in some regions, such as Asia, have opted to charge lower management fees and higher performance fees in comparison to other regions.

European managers charge both lower management and performance fees compared to other regions. There have been calls for increased regulation and standardization within Europe, and the industry is currently under the scrutiny of the European Commission. Many new European fund launches have been in the UCITS space or through new share classes of existing funds, with favourable fee terms for investors and liquidity terms for managers.

Conclusions

Hedge fund fees are significantly below the "2 & 20" standard. The mean management fee of single manager hedge funds is 1.65% and the mean performance fee is 18.89%. When setting up new funds, fund managers have deviated from the typical fee structure in order to attract institutional investors back to the asset class following a difficult period of disappointing returns and low investor confidence. Over 2009 an increasing number of investors demanded a greater alignment of interests between themselves and their managers. Many managers answered these calls by changing the terms of their funds and in many cases lowering the fees they charge. In 2009, institutional investors found themselves with much stronger bargaining power than when the hedge fund industry was booming. Prior to the market crisis, fee structures were not questioned and investors were willing to pay more in order to access top-tier funds. However, in the current climate it is vital that managers are flexible with their fees in order to attract more sceptical and increasingly demanding investors.

In order to meet such investor demands, hedge fund managers are introducing new share classes of their funds with lower fees and longer lock-up periods. By limiting the liquidity of the fund, the managers are guaranteed a stable source of capital and in return investors pay lower fees. So if investors are prepared to be flexible with their requirements, many managers will reciprocate with lower fees.

The results of our returns versus performance comparison demonstrated that the funds that were earning the highest performance incentives generated the largest and most consistent returns for their investors. Performance fees have not declined as much from the standard as management fees, which demonstrates that investors are not willing to compromise returns in favour of cost.

About Preqin

Preqin provides hedge fund managers, marketers and others with a database of over 2,500 institutional investors in hedge funds.

Our customers can access this market intelligence in four different ways:

- Hard copy publications
- Online database services
- Consulting and research support
- Tailored data downloads

Preqin's Hedge Investor Profiles Online is a vital resource for all hedge fund managers and marketing professionals seeking backing from institutional investors. Preqin's team of dedicated analysts is constantly contacting institutional investors from around the world in order to ensure that the data we hold is up to date, reliable and complete. To register for a demo, please visit: **www.preqin.com/demo**

Preqin regularly releases research and information on fundraising and all other aspects of the hedge fund industry as both research reports, and as part of our monthly Spotlight newsletter. To register to receive more research and analysis, please visit **www.preqin.com/spotlight**

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