Are Fulcrum Fees the Future?

What You Need to Know About These Performance-based Management Fees

INTRODUCTION

Over the past ten years, flows to passive funds have captured 82% of net flows in the US.[1] Over this same period, the proportion of assets under management in passive vehicles has gone from 17% to 36%, and now exceeds $6 trillion, versus $11 trillion for actively managed funds. What is causing this fundamental shift in investor flows?

The rise of index funds has largely been attributed to their lower fees relative to actively managed funds, and an apparent challenge for some active managers to beat their benchmark returns. The ongoing debate on management fees charged by active asset managers has sparked interest in Section 205(B)(2) of the Investment Advisors Act of 1940, which allows registered ('40 Act) funds to charge performance-based management fees. In the US, these fees have typically been associated with hedge funds, private equity funds, or liquid alternative funds in offshore vehicles. Congress approved an exemption to the law in 1970 to allow performance-based fees known as fulcrum fees, but few US managers have taken advantage.

Fulcrum fees accounted for less than 2% of US registered funds in 2016 (194 funds or $790 billion)[2], however we expect this may change now that active managers are facing even more pressure to either reduce fees or substantiate them.

Whether it is the complexity of setting them up, potential fee erosion, or the additional regulatory reviews that may be required, there are many reasons the industry has not yet widely adopted this fund structure. This guide aims to help navigate the complexities of fulcrum fees and highlight important considerations for managers interested in implementing them.

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1 Morningstar Direct, 2017.

2 Noblett, Jackie. "AdvisorShares Brings Fulcrum Fees to ETFs." Ignites, Financial Times, 27 September 2016

INVESTOR SERVICES

LEVELING THE PLAYING FIELD

Several prominent managers have selectively used fulcrum fees: Putnam, Vanguard, Janus, and most recently AllianceBernstein (AB). Peter Kraus, former Chairman and CEO of AB, said it best during his earnings call on May 1, 2017. “Active managers need to level the playing field on fees and be more accountable for our performance if we’re going to compete with exchange-traded funds (ETFs),” he said. “Our new series charges ETF-like management fees and a performance fee only if the fund surpasses benchmarks. If we can succeed with this new structure, and a big if, since it’s early in the game, we think we can improve our competitive positioning and ultimately set a new industry pricing standard for active managers.”[3]

While fulcrum fees aren’t new, the aggressive stance AB took by pitting them against ETF-like fees is an innovative and a proactive strategy aimed at winning back market share from passive fund managers.

NOT JUST US FUNDS

While we’re focusing primarily on US funds in this article, the points remain valid regardless of where a fund or asset manager is based. Indeed, we have recently seen movement in Europe around fulcrum fees due to some regulatory considerations. Fulcrum-based management fees can be a solution not just for US fund managers, but for any active fund manager competing against low-cost passive funds or ETFs.

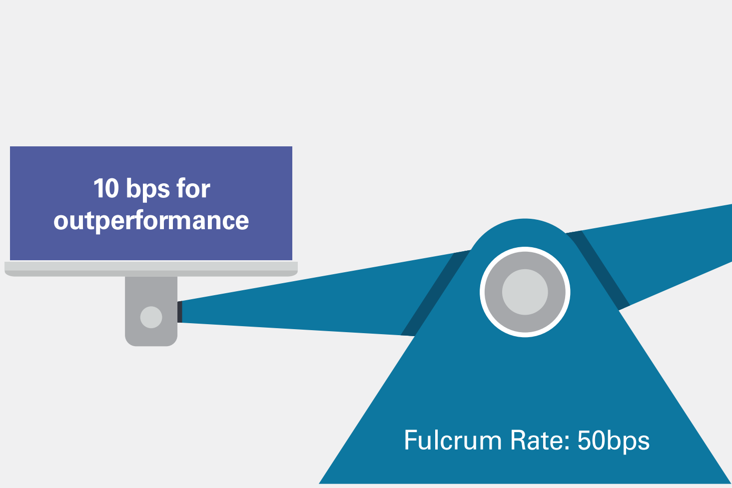
WHAT MAKES A FULCRUM FEE DIFFERENT FROM TYPICAL PERFORMANCE FEES?

The main difference between a fulcrum fee and a typical performance fee is the fulcrum fee can proportionately go up or down based on fund performance.[4]

This approach is markedly different than traditional performance fee arrangements where the manager can collect asymmetrical fees. Hedge funds and private equity funds typically have arrangements where the manager earns a base fee of 2% regardless of performance and then earns 20% of all profits.

This innovative fee structure can serve as a useful tool to justify higher management fees when a fund outperforms. At the same time, if a fund underperforms, a manager can’t charge more than their index-based rivals.

A FEE BALANCING ACT



3 Yahoo Finance, Edited Transcript of AB earnings conference call or presentation 27-Apr-17 12:00pm GMT, May 1, 2017
4 Section 205(b)(2) of the Investment Advisors Act of 1940

HOW TO STRUCTURE A FULCRUM FEE

1. Determine the observation period

The first step to setting up a fulcrum fee is to determine the observation period or performance period. Managers can choose to set up the observation period as rolling or static.

2. To bifurcate or not to bifurcate?

Managers have the option to bifurcate how they accrue their base management fee from their performance adjustment accrual. This means a manager can set up the accrual of their base fee to be different than the performance fee accrual adjustment up or down.

Fulcrum Management Fee =
Base Fee +/- Performance Adjustment

3. Test Your Model

The best advice to any manager is to rigorously test the fulcrum model you want to employ and ensure that stressed scenarios are used. One option to consider is the effective use of a guardrail or expense limit in the fulcrum fee calculation which can protect their investors from outsized impacts of performance adjustment accruals.

KEY CONSIDERATIONS

While there are more challenges with this fee structure than a traditional one, if managers do their due diligence, stress test their method, and ensure a full review by their legal and audit partners, there is likely no reason to be fearful. Here's what you should watch out for.

Base Fee Erosion

The biggest consideration for a manager who has structured their fulcrum fee with a bifurcated method is if they ever experience a period of large redemptions coupled with declining fund performance. Under this stressed scenario, it is theoretically possible that the performance adjustment can erode all the base fees accrued and even cause the manager to owe or have to reimburse the fund.

Determining Fund Performance

When setting up a new fulcrum fee, managers should carefully review the components of calculating fund performance. The SEC allows for fund performance to remove the negative impact of fund distributions, capital gains tax, and withholding tax, to allow the fund to be on even footing with a comparable benchmark index.

Enforcements

Reviewing past SEC enforcement actions is another way to avoid some of the potential pitfalls that managers have faced with fulcrum fees. The most frequent violation has been around the use of the right net asset base on which to apply the fulcrum adjustment. Unlike traditional flat fees which can use current asset levels to apply a fee, a manager can't use the same method for fulcrum fees. Performance adjustments must be applied based on an average in line with their observation period.

Benchmark Availability

The selection and availability of the benchmark index may determine whether the base fee or performance adjustment accrual can be done the same night as the performance comparison to the index.

CONCLUSION

Fulcrum fees can be a challenging concept for managers to adopt due to their construction and various structures. However, when executed correctly, this can be a powerful tool for active managers trying to combat the fees of passive funds. Every active manager should be aware of the potential benefits and pitfalls that come with undertaking such fee structures, especially if the industry were to shift towards this fee structure.