The Price of Active Management – Is the Lowest Fee the Best Deal?

Arthur Grigoryants

There are many interesting aspects of the active versus passive debate that has dominated the investment industry agenda in the past few years. To us one of the most interesting implications of increased availability and popularity of passive products is the effect on the pricing of active management.

Historically the investment industry has provided both the prospect of above market returns (alpha) and offered clients easy access to asset classes. Although some of those assets are still difficult to access effectively without a specialist active manager (private equity, activist, private debt, frontier equities etc.), the real game changer is that investors today no longer need, and therefore should not be expected to pay for, access to the majority of liquid financial assets.

This means that a material segment of what the investment industry traditionally offered to its investors - core benchmark-driven larger capitalisation equity and bond products - is unlikely to survive, irrespective of price. In today's world, these types of strategies are rather difficult to differentiate from passive or semi-passive alternatives (like factor or enhanced beta solutions), and as a result it is challenging to justify pricing that would be materially different from those of passive alternatives.

But what about truly active managers? How should investors approach the question of fees? Is it as simple as trying to get to the lowest charges possible? In this brief article we offer some of our insights into the pricing of active management services and suggest a simple framework that investors could use when considering appointing an active manager.

Fundamentally, in our view there are two approaches to the pricing of investment services; which could be viewed as 'top-down' and 'bottom-up'. The former is primarily focused on paying a manager a fair share of outperformance. It is a very simple and intuitive approach that does not take into account the cost of service element of the equation. The challenge however is that the future outperformance, or alpha, is not known at the outset. Also, there are lots of views as to what that fair share should be. Should an investment manager expect to be paid 20%, 30% or 50% of added value? Some of those investors who are keen to avoid overpaying for outperformance are often tempted to go for incentive fee solutions as they explicitly incorporate an acceptable split rate between them and their investment managers. Incentive fees however bring an additional level of operational, communication and behavioural risk complexity.

The purest expression of this top-down, fair-share approach, in theory, would be an arrangement where an investment manager simply receives, for example, 30% of any outperformance with no base fee charges involved. The practical reality of running an investment business in today's world of increased regulation and compliance costs means that this purist approach is extremely difficult to support. However, the recent rise in popularity of the 1% or 30%, 0% and 50%, and some fulcrum fee price arrangements are all examples of the drive to find a fair-share solution to pricing.

The alternative approach to pricing that we believe investors should think about is a bottom-up or cost-to-capacity method. Although this is likely to require much greater insight into the details of each investment management proposition and business, we would argue that this effort could be extremely important and therefore worth the time required to consider.

Investment management is not a science and successful strategies operating in a similar market segment (asset class, region, sector, even within the same style) could often differ significantly. When viewed from a bottom-up perspective the most important parts of the equation that investors should consider are: 1) the estimated capacity of the strategy, i.e. a level of assets under management at which a combined negative market effect of managing a larger portfolio for investors - mainly due to narrowing of an opportunity set and increased indirect/implicit costs of moving larger amounts of money - do not materially affect the expected alpha of the process; and 2) the resources needed, on a fully costed basis, to deliver the proposition to investors.

For example, within the same global equity universe a predominately screen- or rule-based investment approach that operates in a larger capitalisation end of the equity market is likely to have both a materially greater maximum capacity and lower operational costs to another (manager) that invests across a full spectrum of market capitalisation and relies on ground-level fundamental research. The first manager might only require two people and some relatively inexpensive computing power to effectively manage up to $15bn of investor funds, for example. On the other hand, the second manager is likely to need a much larger team of portfolio managers and analysts and a substantial travel and research budget, whilst being constrained to a maximum AUM of say $3-5bn. The sustainable price for the proposition in this simple example is clearly not the same and, in our view, should not be ignored by investors.

We believe investors should care about these considerations as these reflect the real costs of delivering the promise that the investment manager implicitly makes. Pushing fees below reasonable levels may not be such a good deal as it might appear on the surface. Such behaviour is likely to push an investment manager under unwelcome cost and business pressures. Those pressures in turn are likely to result in investment service providers having to make some sort of sacrifice, like reducing team size below optimum, cutting research budgets, reducing the number of meetings with companies, underinvesting in maintaining the quality and robustness of the process, running more money that they can deploy etc. The likely consequences of all of these is a deterioration of the product/service one pays for. In other words, the quality of a product is most likely to rebalance to the price one pays.

Outside of the investment industry we are overwhelmed by examples of cost pressures, materially impacting the quality of products and services we consume. One simply has to think about the impact that the growth of supermarkets has had on the quality and sustainability of products available. Similar to a grocery business, the more one negotiates the price down the more likely it is that you are going to get what you paid for.

In our industry there are some investment management firms that appear to be more sensitive to fee pressures, and as a result are often willing to undercut the real cost-based pricing. The daily pressures of an asset management business (shareholder expectations, requirement AUM growth, profitability etc.) often push some companies to lead on price even if it means going below a sustainable price level. Having won a new mandate at a low price these businesses then realise that the only way to go back to a required profitability is to compromise on purity of alpha and grow the assets under management. This becomes a rather logical second-best option. This usually manifests itself in allowing an investment team/strategy to gather assets well in excess of what would be deemed optimal. So, as one can see, there is a clear link between the costs of proposition, its investment capacity and price.

Our aim at RWC is to build a sustainable long-term organisation for the benefits of all our stake-holders – people who we work with, our clients and shareholders. Among other things, this ambition requires building high quality self-sufficient and sustainable investment teams that focus on delivering the best investment services possible to their investors. To us this implies a clear commitment to capacity and full appreciation of resources and costs required to service our clients. We engage in dialogue with our existing and potential clients and share insights into what we believe are the important elements of our proposition. Sometimes, where we feel the issues that we are so passionate about are under-appreciated and the lower fee is viewed as a single simple dial by investors, this results in us having to say no to new clients.

The introduction of the MiFID II regulation, despite receiving an overwhelmingly bad press, will in our view deliver at least one welcome change. For the wide range of investors, the new mandatory disclosure rules will allow them to have their own take on capacity of an individual investment strategy/product. One would expect the implicit costs (or market impact) of a strategy that gathered more assets than it should to be higher than that of a provider who is committed to purity of investment service.

We really hope that this new degree of transparency will lead to a greater quality of debate in our industry. Investors can certainly celebrate the reduction in average fees for active management. We do however see a serious risk of taking some of the arguments too far and therefore are concerned about their possible impact on the sustainability of some of the truly dedicated active managers. In this new world for the industry, not all of our customers will be interested in a high quality product/service. But those who are should seriously consider the issues of business sustainability and be prepared to pay the right price for the equivalent of a rare breed, grass-fed organic steak.

EXAMPLE – OUR FRAMEWORK IN ACTION

Let us consider three hypothetical managers who could be viewed for a global equity mandate.

Manager A

- Global all-cap manager, concentrated portfolio, below average level of turnover of 20-40%. Estimated strategy capacity is $5bn. Current AUM $500m. Historic and expected gross alpha over the cycle is 3% p.a.
- Process involves bottom-up stock analysis, model building, company management meetings, trips to industry events, external specialist industry research insights. Run by two senior PMs, supported by 6 career analysts.
- Direct costs of $3-4m plus business overheads of further $1m. Some of the costs, like client management and travel are linked to AUM. Team's expected profitability is linked to profitability of the business through a profit share arrangement.

Manager B

- Global larger cap manager. Diversified portfolios, average portfolio turnover of 50-75%. Estimated strategy capacity is 15bn. Historic and expected alpha is 2%.
- Process is built around exploiting behavioural pitfalls of investors and relies on sophisticated screening and desk research. Access to some specialist data tools and research. Run by two senior PMs and one analyst. No travel.
- Direct costs of $1.5m plus overheads of further $1m. Current AUM is $1 bn. The team operates within a larger company with no profit share arrangement so benefits of froth of AUM are not linearly shared with the team.

Manager C

- Global small cap manager. Concentrated portfolio with medium turnover. Capacity of $2bn. Historic and expected gross alpha of 3%.
- Full DD bottom-up process, involving heavy travelling and site visits in multiple countries around the world. Little analysis coverage requires more time spent on the ground, visiting suppliers, competitors, regulators etc. Sometimes activity involves soft activism and engagement. Access to specialist external research providers, industry experts. Run by the team of 1 lead PM, 2 senior PM and 4 analysts.
- Direct costs of $4.5m plus overheads of $2m. Current AUM is $1 bn. Set up as a dedicated single strategy boutique.

	Manager A	Manager B	Manager C
On current assets	0.55%	0.28%	0.72%
On capacity level, simple*	0.11%	0.02%	0.36%
On capacity, estimated**	0.3%	0.08%	0.4%
On 1/3 of alpha	1.0%	0.67%	1.17%

* a simple ratio of the current costs plus a small required profit margin over the estimated capacity
** a ratio of an estimated future cost base at the capacity level over the estimated capacity

There are several interesting observations one can make here. First of all, a quick look at the summary table above illustrates how different costs could be and how much effect the capacity, costs and organisational structure could have on the issue of pricing.

We would argue that a framework approach to pricing would mean that a fee level that an asset owner should agree with an investment manager should be within a range between a fair-share and cost-to-capacity, with a consideration given to the current AUM and its implication on business stability. In our example of Manager C above this range is 0.4%-1.17% with any fee rates under the 0.72% level today viewed as sub-optimal. There are numerous other important considerations that an investment manager and investors should take into account when agreeing a fee rate. These among other things include the longevity of a commitment, a size of a mandate, a nature of a client (does it offer a diversification to a manager or adds to a client concentration risk), client servicing requirements etc.

Also, in this example pushing Manager A to agree a fee level materially below 0.5%-0.6% would mean that they will run under material constrain, which could limit their ability to reinvest and develop their talent and maintain quality of the proposition. Importantly, if Manager A is too willing to accept extra low fees, then the likely outcome is that it will continue to accept the assets beyond the $5bn level. At $10bn the process would struggle to generate 3% alpha and is more likely to disappoint investors.

Arthur Grigoryants, CFA

Arthur is Head of Investment Strategy. He joined RWC Partners in early 2017 and focuses on a wide range of investment, strategy and management issues.

Arthur started his investment career at the Central Bank of Turkmenistan where he spent five years developing and managing the bank's foreign exchange reserves. He then joined Mercer Investment Consulting in London to focus on advising large UK pension schemes. Prior to joining RWC Partners, Arthur spent twelve years with Stonehage Fleming as a Head of Investments and most recently as a joint CIO. He managed a range of multi asset and global equity strategies and had an overall responsibility for the firm's investment proposition.

Arthur has a BSc in Mechanical Engineering from the State University of Turkmenistan and an MSc in Investment Analysis from the University of Stirling. He is a CFA Charterholder and a member of the CFA Institute.

CONTACT US

Please contact us if you have any questions or would like to discuss any of our strategies.
E invest@rwcpartners.com | W www.rwcpartners.com

RWC London
Verde, 4th Floor
10 Bressenden Place
London SW1E 5DH
T +4420 7227 6000

RWC Miami
2640 South Bayshore Drive
Suite 201
Miami
Florida 33133
T +1 305 602 9501

RWC Singapore
80 Raffles Place
#22-23
UOB Plaza 2
Singapore 048624
T +65 6812 9540

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