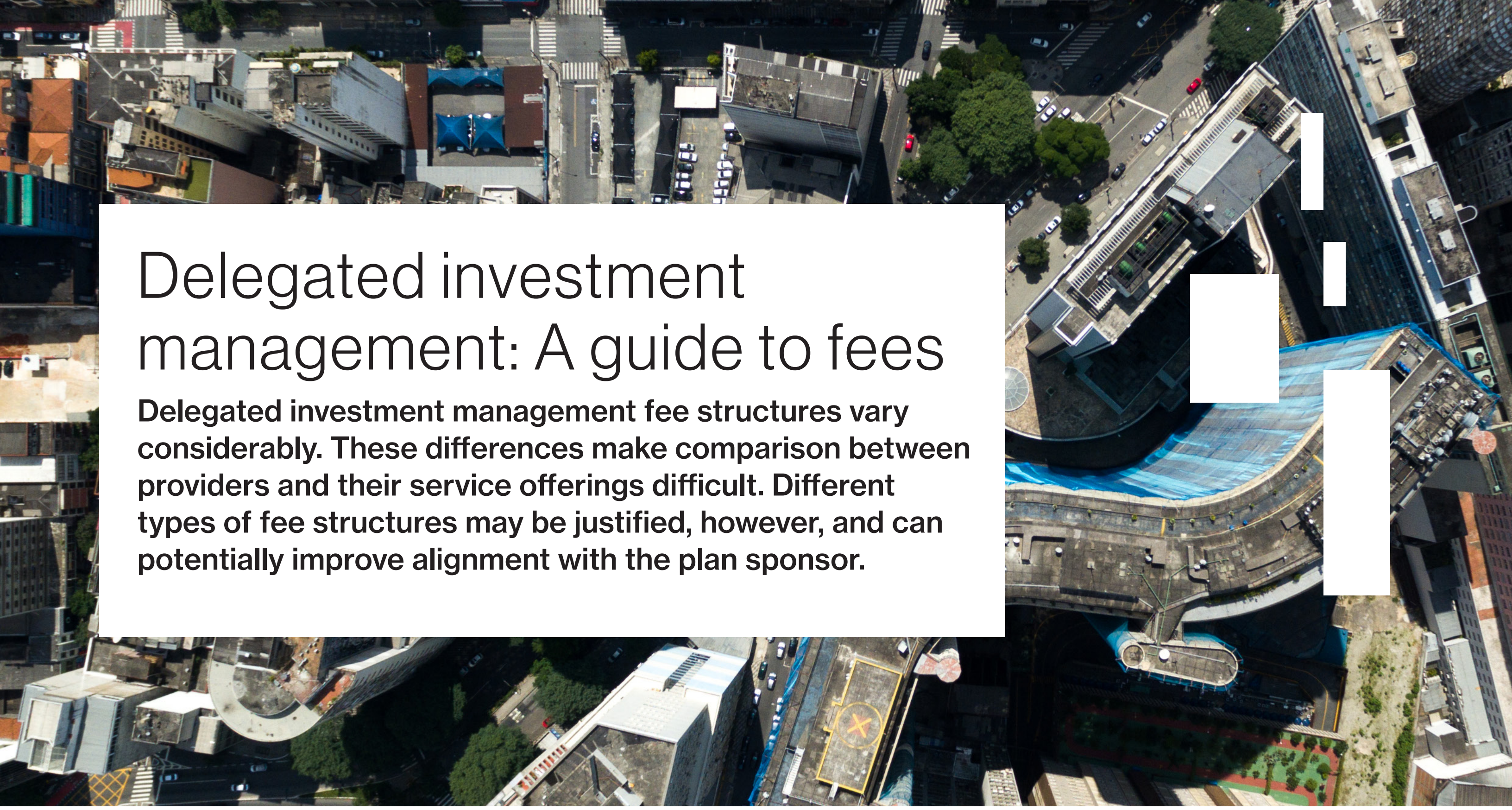

Delegated investment management: A guide to fees

Delegated investment management fee structures vary considerably. These differences make comparison between providers and their service offerings difficult. Different types of fee structures may be justified, however, and can potentially improve alignment with the plan sponsor.

A wide and varied range of activities are included in delegated management, and a broad skill set required, all of which warrants a higher fee than seen in an advisory relationship. However, considering the pension fund's total costs, there is potential for lower overall fees, as delegated managers can often negotiate larger fee reductions with underlying investment managers.

Delegated management fee structures can include base (ad valorem) fees, performance fees or a combination of the two. Mandate specifics and plan sponsor preferences typically dictate the structure selected.

Base fees (ad valorem)

Base fees are charged either as a fixed nominal amount or, more commonly, as a percentage of the assets managed (ad valorem). Delegated managers typically adopt one of two base fee structures:

- A bundled structure that aggregates all of the costs associated with a delegated manager's activities into one fee, which includes any fees paid to the underlying asset managers
- An unbundled structure that splits out the fees for the delegated manager's services and the fees for any underlying service providers (the delegated manager will typically be responsible for paying the underlying manager fees from the pension plan's assets, so full transparency of what each fee relates to is necessary)

We feel a plan sponsor can more fairly assess the value of different delegated investment managers when the fee structures are transparent and activities are identified. This is particularly true when the plan sponsor is potentially transitioning to a different governance approach, such as moving from a traditional advisory model to a delegated solution. An all-inclusive bundled fee structure is simple to understand and may provide more certainty of the pension fund's costs, but it makes it difficult to assign a cost or value to underlying activities and could potentially create an incentive to appoint lower-cost managers.

In contrast, an unbundled fee structure that separates out the fee paid to the delegated manager and the underlying asset managers allows a plan sponsor to see what is charged for each service. In addition, in unbundled fee structures, any fee savings from reduced fees that the delegated manager negotiates will be passed directly onto the pension fund.

Whichever model is adopted, a plan sponsor needs to understand the benefits and drawbacks of each structure to make an informed decision that creates comfort that the value added from appointing a delegated manager justifies its fee.

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Performance fees

Performance fees are commonly charged as a set percentage of the return over a certain performance hurdle. Advocates of performance fees argue that they provide managers with an incentive to perform. However, this can also mean that alignment of interests is more difficult to secure.

Many investors, particularly pension funds, focus on long-term, risk-controlled returns, whereas managers are assessed and remunerated based on shorter-term performance. A performance fee model for a delegated manager needs to be carefully constructed to align interests and provide a long-term focus. In general, we expect pension funds to reduce risk over time as their funding positions improve and as they get closer to their long-term objectives.

We believe plan sponsors should recognize the following performance fee features:

- Performance fees exhibit inherent asymmetry: When performance is good, the manager receives a performance fee, but when performance is poor, the manager does not participate fully in the downside. This can encourage managers to take more risk if performance is poor.
- Short-term performance can be highly volatile, so fee structures should reduce this volatility.
- Performance fees should be paid, where possible, for value added, based on the return generated relative to a predetermined benchmark, and in excess of the base fee and expenses. Unfortunately, however, this is not a perfect measure of value added, and plan sponsors will need to accept that they will be paying for some market returns (beta) inherent in the chosen investment strategy.
- Balance is key in combined performance and base fee structures: In our view, around a third of a manager's total fee should depend on performance. In most cases, the manager's participation rate should not be too large. Performance fees of 15% to 20% that are frequently seen in hedge funds and private market funds are probably inappropriate.

In summary, there are various ways to structure a delegated management fee, some of which are more transparent than others. The plan sponsor needs to understand what activities (and underlying fees, where applicable) are included in the delegated manager's fee. Only then will the plan sponsor be in a position to judge whether this fee represents good value.

Afterword

Delegated investment management could materially benefit pension plans looking to add to their investment decision-making capabilities.

The industry has developed considerably over recent years, presenting pension plans with a variety of credible propositions from competing providers. As with many other professional service selections, details are important, and there are no real short cuts. Please feel free to contact us at investment@willistowerswatson.com to discuss any of the concepts in this guide in greater detail.

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