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22 Year Study Finds Hedge Fund Managers Collect 64% of Investors' Gross Returns

Posted on September 3, 2020 by Yves Smith

No wonder hedge fund investors have finally woken up and started running for the door. And a new study published by NBER confirms that, just like private equity, high fees are the reason for underwhelming results. The level of extraction found in a study of 4000 funds from 1995 to 2016 is eyepopping. From the article:

> After including management fees, investors collected about 36 cents for each dollar of gross excess return generated by funds on their invested capital. The other 64 cents were paid as management and incentive fees. Adding insult to injury, these results are obtained before adjusting fund returns for risk.

We've embedded the paper by Itzhak Ben-David, Justin Birru and Andrea Rossi at the end of the post.

The high fee levels are no doubt a big part of why hedge funds haven't lived up to their return promises. In our very first post in 2006, we pointed out that CalPERS had admitted that hedge funds were underperforming. As it told the New York Times:

> This year "is the third straight year that the global equity markets and long-only managers outperformed hedge funds," said Christy Wood, senior investment officer for global equities at the California Public Employees' Retirement System. "If you threw all these in an index fund net of fees, you would have done better than if you put it in the hedge fund industry."

A key part of the analysis is in the second section, where the authors ferret out why actual fees wind up being so much higher than nominal fees, which is what just about everyone thinks they are paying. The researchers determined that while the nominal incentive payment, aka the "carry fee" averaged 19% (in keeping with 20% in the prototypical "2 and 20"), in reality hedge fund managers took a whopping 49.6% of cumulative gross profits. One of the stunning features of both hedge fund and private equity fund investing is that the fund managers skim off the carry fees, as they decide to calculate them, and pay only the net income to the investors. That puts the investors in the position of having to parse the agreements very carefully (to make sure they haven't agreed to clever clauses that

work to their disadvantage) and then check the amounts remitted against what they think they were owed. Most don't bother, as we can see from carry fee abuses in private equity.

The first is that in private equity, US investors allow the fund managers to take carry fees on each and every deal that show a profit once a hurdle rate is met. The problem with that is that private equity firms sell their good deals early and their dogs later, meaning it's pretty common for investors to have been charged carry fees on early deal profits wiped out by later losses.

There are "clawback" provisions that are supposed to take care of that but they don't. First, the private equity firms pretty much never volunteer to pay a clawback when one is owed; the limited partner has to make a stink. Second, the general partners virtually never cut a check, despite their legal obligation to do so; the cowed and captured limited partners too readily accept the vague promise of getting a "deal" on the next fund…which pre-commits them to invest with someone who underperformed and would not live up to his contact.

But third is that the limited partners have accepted tax language that guarantees they will never get back the full amount they were shortchanged. This 2014 post recapped an analysis by Lee Sheppard at Tax Notes:

> The clawback provisions stipulate that the clawback amount be the lesser of overpayment or the after-tax overpayment. Taxes are assumed to be at the highest conceivable individual rate for someone living in high-tax New York City or San Franscisco. The agreements even assume that the managers cannot benefit from taking capital losses on the dogs. Does anyone believe these men, who typically hire top tax experts to advise them on their personal tax filings, pay the statutory tax rate?

And why should investors be responsible for manager tax problems? Mind you, tjis is just the basic level of chicanery. The post describes additional ruses.

So the short version of the private equity story is that because investors are stuck in private equity funds until the private equity firms return the money, they don't have straightforward ways to recoup overpayments of performance fees resulting from profits on good deals being reduced by losses on bad deals. And the private equity firms play games to take advantage of holding their investors hostage.

So what is the hedge fund version? Because the academics didn't have access to the hedge fund contracts (as we have, and even more so experts like Ludovic Phalippou and Lee Sheppard), there may be ruses in addition to the mechanisms they found. But they identified two.

One was that losses on one hedge fund could not offset gains on a different fund. The authors contend that hedge fund managers take advantage of this by operating like mutual fund families, of offering multiple funds with no offsets across funds run by the same hedge fund manager.

The second is that the greater liquidity of hedge funds works against investors. Many institutional investors are trend-chasers (witness again with CalPERS, dumping its tail risk hedge at the worst possible moment). They exit hedge funds when they are doing badly, even if they showed profits earlier so they give up the opportunity to have the losses offset against later gains:

> ….investor withdrawals and fund exits destroy potential fee credits. The magnitude of this mechanism is exacerbated by the fact that investor withdrawals and fund exits tend to occur after poor aggregate fund performance (and tend to occur for funds that are the worst performers in the cross-section), resulting in the subsequent relatively high returns being experienced by a relatively smaller aggregate AUM relative to the large AUM of the fund industry experiencing losses in the crash.

However, from what I infer, only a minority of hedge funds have fixed terms, as in a pre-set wind-up date. The implication is that most of the rest will shutter after adverse events, like big withdrawals forcing a fund liquidation (as happened to some of the biggest quant funds in 2008). Thus it seem the way most funds wind up or investors decide to depart winds up leaving them shortchanged. It's a reasonable to assume that the fund documents are heavily skewed toward the managers in the event of investor exit or unexpected fund liquidation.

The authors also point out that the efforts of some in the hedge fund industry to change the fee structure from "2 and 20" to "1 and 30" would only make the fee problem worse:

> Our results suggest two reasons for caution [regarding a “1 and 30” fee structure]. First, investors end up paying a signicantly larger fraction of their profits as incentive fees than what the contract species, e.g., the 30% incentive fee rate could be easily doubled ex-post. Second, in the long run, a signicant portion of incentive fees will likely be uncorrelated with actual lifetime fund performance, hence looking more like management fees than incentive fees.

Even though yours truly tends to be cynical, the apparent result that high effective hedge fund fees result more from accidental than intended “heads I win, tails you lose” than in private equity does make a certain amount of sense. Hedge funds, with only limited exceptions, are subject to monthly independent valuations of fund assets and prompt reporting of the resulting AUMs. That level of outside scrutiny, combined with most funds offering liquidity (on a quarterly or annual basis) may well curb the investor chicanery that is prevalent in private equity.

NBER WORKING PAPER SERIES

THE PERFORMANCE OF HEDGE FUND PERFORMANCE FEES

Itzhak Ben-David
Justin Birru
Andrea Rossi

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We thank Berk Sensoy, René Stulz, and Cristian Tiu for helpful comments. Ben-David is with The Ohio State University and the National Bureau of Economic Research, Birru is with The Ohio State University, and Rossi is with the University of Arizona. Ben-David is a co-founder and a partner in an investment advisor that manages a small number of friends-and-family accounts for an incentive fee. Until 2016, the investment advisor was a general partner in a hedge fund. The views expressed herein are those of the authors and do not necessarily reflect the views of the National Bureau of Economic Research.

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This entry was posted in CalPERS, Dubious statistics, Hedge funds, Investment management, Private equity, Ridiculously obvious scams on September 3, 2020 by Yves Smith.

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PlutoniumKun
September 3, 2020 at 4:58 am

I often wonder how much this chicanery is dependant on the simple psychology of high paid professionals being unwilling to say 'I don't understand this' when faced with a mountain of technical documents. Warren Buffet famously said that he didn't invest in the internet in the early days because he simply didn't understand it. I guess only someone as revered as him could get away with that.

Years back I knew some property investment managers for major investment companies well, and I was curious to know the thinking behind some of their (apparently wasteful) investment in empty land – they were responsible for a lot of urban dereliction at the time. Their motto was 'keep things simple'. When you had the firepower of a major pension fund or assurance company behind you, you used that to lower your costs and keep a long focus. They would spend 10 years or more building up a property portfolio in a major urban area, then build a big retail or office development which would then provide the holy grail – a steady stream of annual income with long term capital accumulation. They never invested in a market they didn't understand very well (which is why they kept things close to home). They kept things in-house as much as possible to keep costs down.

Somewhere along the line things seem to have gone very astray. I assume the flood of easy money with lowered long term returns is one reason, but I also wonder if there has been some collective lowering of the ability of professionals to identify BS thanks to modern business practices.

Reply ↓

lyman alpha blob
September 3, 2020 at 9:07 am

I think you are on to something. If I remember right, one of the shorts who profited heavily from the 2008 crisis spoke with a synthetic CDO investor, realized the guy had no idea what he was investing in, and then decided to short the whole lot, taking advantage of the ignorance of the suckers.

There's a reason con men in nice suits make a lot more than street level 3 card monte dealers.

Reply ↓

Zamfir
September 3, 2020 at 10:17 am

Yeah, there is something in that. I am not sure it's just psychology though. Its also a diffusion of responsibility. If it's a simple plan, it's also fairly clear when the plan fails, and whose name is on the plan. If it's complicated (and fashionable), you can coast for years while no one really knows if it's working at all, let alone who should have done better.

Even if you are a well-meaning employee at an institutional investor, it's very hard to choose the simple option. Unless you have hard commitment from above – yes we want the simple plan, yes we understand the plan, yes we understand that the best plans can go wrong. And of course, every higher level is just as hesitant to commit to a simple plan with their name on it. Add in some straight up bribery, and you have a structural force towards complexity.

Perhaps related note: onc upon a time, I worked for a company that sold an expensive product with strong promises about performance, where accurate performance measurement was super tricky. My personal opinion was that our product was good but not as good as promised, that we cut a margin of error that competitors did apply, that many customers where happy anyway that they got a better version than their old crap (even though they could have gotten the same for much cheaper), and in our regular conflicts with customers they could never really make their claims stick due to complexity. Eventually I got in a fight with my boss about this, and I got fired.

My greatest lesson from this experience: once you have sold your complicated product, you do not need to defend yourself. You will be valiantly defended by whoever made the choice for your product, and their bosses, and their bosses. Those people will relish every complication that muddies the water, and they might place repeat orders after a conflict to just to show that they were right.

The difficult part is up front – to get past the bullshit detection. But once it's accepted, it's really hard to throw bullshit out again.

Reply ↓

Ignacio
September 3, 2020 at 5:17 am

PE and HF seem to be financial entities that exist/act mostly on behalf of the financial world when they accrue for the best part of real world benefits and tax incentives as well. It must be such a nice job: let's spoil this, then let's spoil that. It would be unkind for the middle age Vikings to term these as the financial Vikings of today. You may notice I am indulging here on some "Netflix culture" for easy comparisons, but this is the main conclusion I get from the article and the paper. This is one of the best explanations I've seen on modern rent extraction.

Reply ↓

TMoney
September 3, 2020 at 5:18 am

It doesn't do the investor any good if your hedge fund can't beat the market and the vig of the managers.

Just think of the money you could save in an S&P 500 index fund. CALPERS could copy Nevada. The passive route is still working for Nevada.

Reply ↓

vlade
September 3, 2020 at 5:45 am

bear, scatology, woods. What more can I say?

What gets me is that the retail investors woke up to the importance of fees long long time ago.

I get also that the institutional investors are ok to overpay, it's the usual agency problem.

What I don't get (although I believe it's changing) is the family offices etc. I guess part of it was always trying to capture the glamour, rather than the returns.

Reply ↓

rd
September 3, 2020 at 9:56 pm

The family offices know they are special people. Special people have access to special opportunties that the riff-raff can only dream of. These are also brilliant people (in their fields) which means they are also brilliant people in other fields, such as selecting financial managers.

This is Bernie Madoff Marketing 101.

The massive benefits of simple approaches like low-cost target date funds from reputable companies are:

1. Simple investment, but well-diversified portfolio.
2. Virtually eliminates bad investor behavior
3. Very low probability of fraud and/or incompetence on part of managers.
4. Steady investments means a big pile of money at retirement.
5. Glide path means that the money should not have wild fluctuations leading up to retirement
6. Portfolio can be re-positioned easily based on decisions made at retirement
7. Low costs means that most of the returns are in your portfolio, not in the Hamptons.

Reply ↓

chuck roast
September 3, 2020 at 10:17 am

My trusty municipal retirement fund paid PE and HF fees of $75M ($35M in carry fees) last fiscal year out of total fund fees of $99M. For this we got 5.76% and 5.51% returns respectively since inception. Our benchmark has been 7%-8% over that period. They handle 15% of fund assets. Pardon me for mixing annual fees with total average return, but I think you can see what is going on here. The annual financial report gets more and more opaque every year so it's difficult us children of Lake Webegon to sus out the total skankiness which is mixed and matched throughout the 100+ pages. The rich rewards, we are told, will be reaped down the road.

Doubtless their genius strategy is revealed in all its glory to trustees at their regular staff/advisor led resort/getaway/educational seminars.

Reply ↓

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js
September 3, 2020 at 11:50 am

Working in industry periphery: *we know*. What a great study. I didn't see it mentioned, but mature funds will dabble in illiquid investments, distressed debt, and the like. When you decide to pull out, you may well get a NAV statement for an SPV – not 100% cash. So, future extraneous losses not baked into the original 2/20 deal.

Reply ↓

Arizona Slim
September 3, 2020 at 12:54 pm

I'm reminded of what Jack Bogle was fond of saying: In investing, you get what you DON'T pay for.

Reply ↓

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