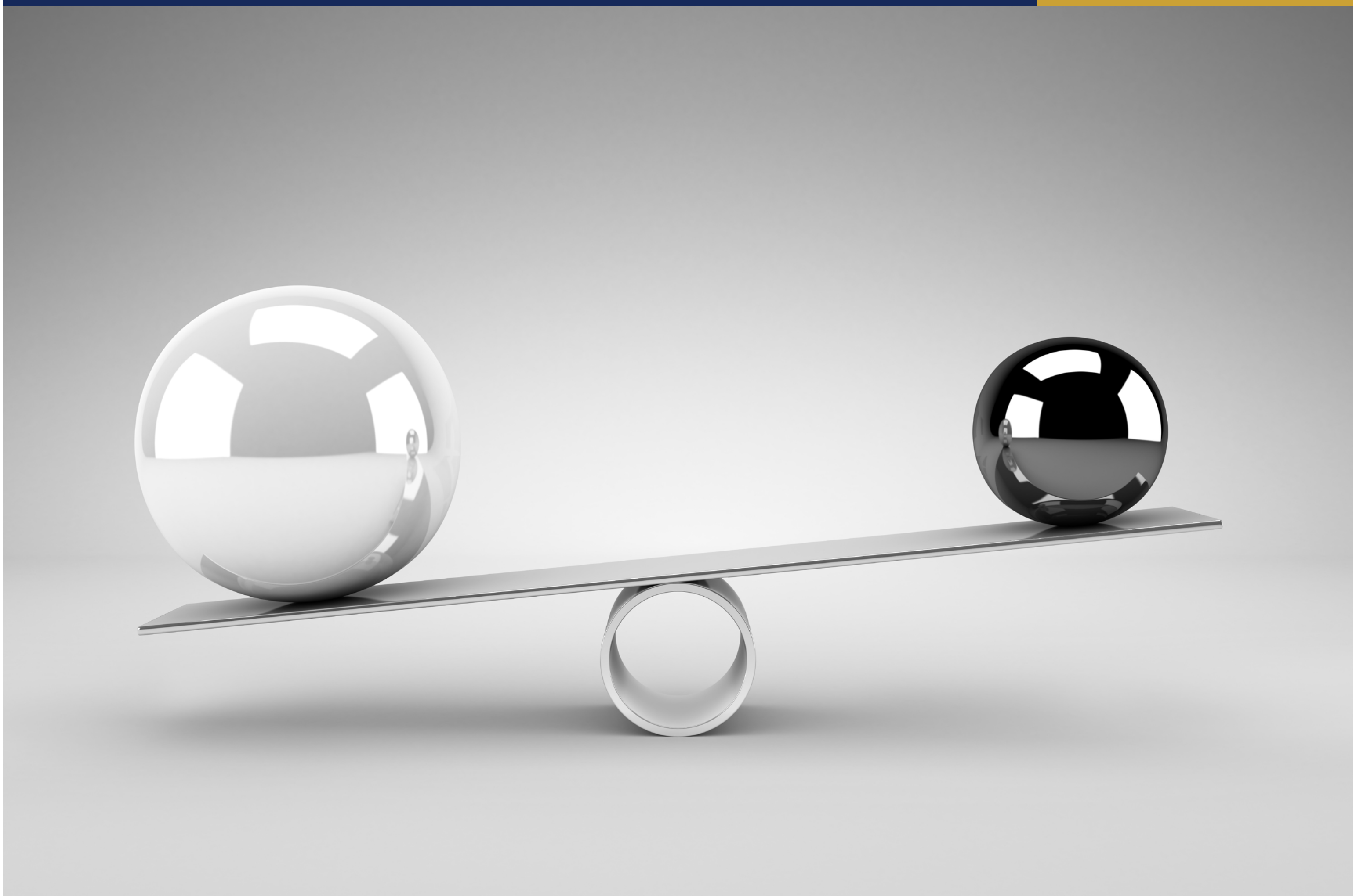
Summit Strategies Group



Putting Fees in Investors' Favor

INSIGHTS

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Executive Summary

An environment characterized by low return expectations and disappointing active manager results in long-only asset classes has put investment management expenses front-and-center for investors. Despite growing pressure on the active management community to deliver net-of-fees alpha and immense flows into cheaper options (passive, ETFs), asset managers as a whole have not responded aggressively to the issue. As an investment consultant that works with a variety of institutional investors, Summit Strategies proactively negotiates on behalf of our clients to garner more favorable fee terms, which in turn drives better investment outcomes over the long term. In this brief, we discuss a few ways in which we accomplish this.

Introduction

Low global yields, tight credit risk premiums and peak equity valuations have reduced future return expectations following an extended bull market. At the same time, cyclical disappointment with active management and a focus on fees have driven investors toward less expensive strategies, e.g., ETFs, smart beta and other passive options. The active management community, however, has been slow to react to the fee pressure and outflows into passive strategies. According to Morningstar, asset-weighted expense ratios have fallen in aggregate for mutual funds, however this decline has been the result of asset growth in low-cost options, where the least expensive funds happen to be the largest. In other words, actively managed funds in particular have not reduced expense ratios.[1]

This lack of wholesale movement on active fees has been detrimental to the active management industry as investors are exerting tangible pressure on managers to perform and justify their fees. With only 19% of active large-cap funds outperforming their stated benchmark in 2016, disappointed investors continue to cast their vote via a substantial rotation from active equity funds to passive equity funds.[2] Over $300 billion moved from active to passive funds (including ETFs) in 2016 and 2017.[3] This trend has kept the active versus passive debate alive and well over the past few years.

While we will not dive into the active vs. passive debate here, Summit believes active management can play a role in a portfolio when balanced with passive strategies that are implemented in certain efficient asset classes. If active management is selected as an approach, we believe it is our duty as a consultant to proactively seek the most fee-efficient portfolio solutions for our clients in order to capture the so-called "shadow alpha" resulting from lower investment management fees.

Fee Negotiation Approaches

To serve our clients' best interests within a fee context, our manager research team proactively negotiates terms with managers pursuing a relationship with our clients. There are a variety of situations that provide a higher level of probability of affecting a favorable fee outcome. The opportunities to do so require constant surveillance of the market and open dialogue with managers to leverage our position to negotiate fees. In no specific order, here are some approaches that have proven successful for us in achieving improved fee terms for our clients.

Seed Investor for New Fund Vehicles

Across the asset class spectrum, managers launch investment vehicles to target new client types or specific asset level ranges. In situations where a proven product exists, managers are heavily incentivized to accommodate lower fees for initial fund investors in order to provide an immediate level of credibility for their fund. This in turn aids in securing other interested parties who may be restricted from serving as an initial investor or require a higher asset base to invest. Several of our most favorable fee structures have resulted from such arrangements and can be highly additive over the course of a relationship as they typically last in perpetuity (e.g., founder share classes).

Summit Case Example

A well-established fixed income manager lacked a pooled fund vehicle to meet the needs of smaller institutional clients. To address this, they launched a Collective Investment Trust for ERISA investors. Given our constant surveillance of the marketplace for opportunities such as these, Summit negotiated a favorable founder's fee for our client who was willing to be a seed investor, dropping the fee to 50% of the median cost in the market.

Emerging Manager Outreach

New investment firms sprout up regularly and identifying them in advance of achieving typical track record or AUM requirements can prove advantageous, even if due diligence is more arduous. Uncovering firms with a competitive track record, seasoned team, investor alignment and durable edge in alpha-generation can create a unique opportunity for long-term investors. In particular, early identification of these managers can reap huge rewards for clients through fee concessions, as many of these firms use discounted investment expenses to attract foundational assets. To be sure, engaging with an upstart manager does have inherent business risks that require additional due diligence to mitigate downside scenarios.

Summit Case Example

Summit's research group identified a successful small-cap equity group who left the confines and pressures of a larger firm to better align themselves with their underlying investors. While an official track record and an experienced team cleared two early hurdles for engagement, their $25 million in total AUM presented business risk that required a heightened level of due diligence. Our conviction in the team and comfort with their business plan enabled us to negotiate a permanent 15% reduction off their rack rate on all asset levels (subject to their stated minimum) that applied to all Summit clients. Since then, the firm has successfully grown to nearly $2 billion in total assets.

Relationship Pricing

Given Summit's sizable advisory asset base, certain managers are willing to aggregate assets across invested clients and charge on the total client assets invested rather than on individual client assets. This "consultant fee" model is a definitive benefit to smaller mandates that fall under the typical investment minimum, allowing them a more favorable fee than the stated rack rate. This is especially appealing when a cliff-fee schedule is offered—as assets cross certain thresholds, the entire fee drops for all client-invested assets.

Summit Case Examples

1) Summit worked with a seasoned investment manager of Master Limited Partnerships (MLPs) to establish a discounted flat fee for their MLP strategy for all Summit clients. This allowed smaller clients to access the strategy at a lower price point typically available for larger mandates only.

2) To help further establish a new emerging markets product by a seasoned team, Summit worked with the manager to create a favorable aggregated fee to be applied to all Summit clients. In addition, the firm offered a limited-capacity fee for the first $200 million in investment, which reduced fees by 50%.

Performance-Based Fees

For asset classes where consistent alpha generation is challenging, the active versus passive debate can loom large on managers and requires a different tact in terms of investment management fees. To provide for better alignment of fees paid and alpha generation, performance-based fees are an option we have found useful. These types of fees allow for the client to pay a reduced annual base fee (even as low as 0 bps) but allows the manager to retain a specific percentage of positive excess return, subject to various parameters and caps. These fees, while not friendly for expense budgeting purposes for managers, can provide a higher degree of alignment between the client's return objectives and the investment manager's ability to consistently generate alpha. Some industry naysayers believe there are disadvantages to performance-based fee structures such as manager incentive to target higher returns, alter risk profile and develop complex or ambiguous calculations.[4] However, when used and applied properly, these fees reward the manager for top performance in efficient asset classes.

Summit Case Example

Given the efficiency in large-cap equity, Summit established a favorable performance-based fee with a quantitative large-cap manager. The negotiated fee provided a 0 bps base fee and 35% share on any excess return produced over the index. The performance fee was capped at 75 bps annually.

What Summit Brings to the Table

Fee negotiations are an integral part of our ongoing efforts to create more efficient portfolios and a net-of-fees valued-added consulting mindset has been embedded in our culture for over 20 years. Keys to our ability to drive fee concessions are as follows:

Firm Size

Our size helps in two ways. First, the level of assets Summit consults on ($160+ billion) provides critical mass to garner regular attention from larger best-in-class firms seeking to work with our client base. Routinely, we serve as a sounding board for appropriate fee levels when new products are launched, which helps guide the industry to a fairer split with investors. Second, our size still allows for nimbleness when engaging emerging managers with relatively small asset bases, a level that larger consulting firms may have trouble implementing.

Independence

Summit's sole source of revenue is the consulting fees paid by our clients, plain and simple. While we view our relationships with managers as a partnership, thus creating a mutual respect and open dialogue, we operate in the sole interest of our clients. A good negotiation starts with knowing who you are serving and while a manager may not always be able to offer concessions in every situation (most favored nation clauses, for example), Summit is always working toward a more favorable outcome for our clients.

Industry Market Position

Given our unique position at the nexus of institutional clients and investment managers, Summit is able to respond to challenges in real time. We are able to consume information from multiple market participants to formulate effective approaches to solve our clients' ever-changing needs.

Conclusion

Creating permanent value through fee negotiations is paramount to our consulting approach, especially in a low-return environment. Asset owners are in the driver's seat as active managers contend with growing use of cheaper passive funds and ETFs, largely due to discontent with active management's record over the last few years. As a result, the willingness and capacity to pay for active management has certainly diminished among investors.

Summit firmly believes certain asset classes have inefficiencies to exploit and active management in those is justified. We use our unique position in the marketplace to garner permanent value for our clients through various fee-reducing approaches, thereby putting clients in a better position to meet their long-term objectives.

About the Author

Chris W. Kamykowski, CFA, is a principal of Summit Strategies. He is a senior member of the firm's Manager Research team and is responsible for traditional manager due diligence, selection and monitoring, with a personal focus on fixed income. Prior to joining Summit in 2008, Chris spent three years at Asset Consulting Group, where he was a research analyst covering fixed income managers. Prior to that, he served as an account administrator at NISA Investment Advisors, assisting on taxable portfolio analysis and management. Chris holds a bachelor's degree in finance from Saint Louis University. He is a member of the CFA Society of St. Louis.

About Summit Strategies Group

Summit Strategies Group is one of the industry's leading investment consultants focused on developing long-term partnerships with institutional investors. Founded in 1995, we have been serving our clients, including endowments and foundations, hospitals and health care systems, public funds and corporations (defined benefit and defined contribution plans), for more than 20 years.

We provide traditional full-service consulting, defined contribution and outsourced CIO services. Our extensive in-house resources and research capabilities enable us to help clients meet their investment objectives. We have highly experienced professionals in the areas of consulting, capital markets and risk management, manager research, operational due diligence, and performance measurement and analytics.

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[1]MorningStar: U.S. Fund Fee Study (5/23/2017). [2]Goldman Sachs: Mutual Fundamentals (11/30/2017). [3]J.P. Morgan: US Equity Strategy Equity Manager Performance, Flows, Positioning (10/27/2017). [4]Dimitri A. Senik: Practical Issues with Performance-Based Fees (March 2011).