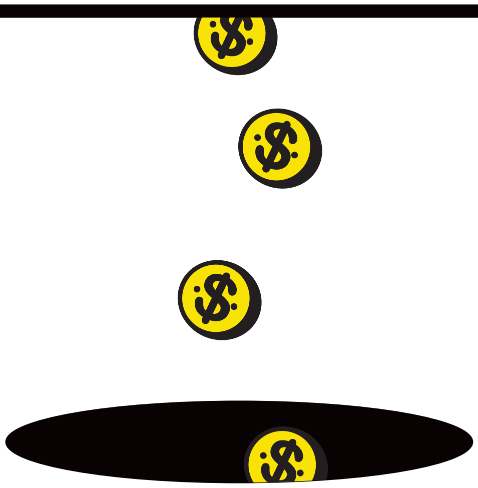

Paying to play

Hedge fund fees may not be as expensive as they seem, especially compared to banks

›BY ARTHUR SALZER

THE TOPIC OF INVESTMENT FEES and management expense ratios has become front and centre as of late. However, as when comparing apples to oranges, not all fees and expense ratios are created equal. This realization became even clearer to me five years ago while I was in Chicago meeting with one of the world's leading hedge-fund managers. I asked what I thought was a simple and standard due diligence question, "What is your management expense ratio or annual fee for your fund"? The answer surprised me.

"We don't have a management fee per se," the head of investor relations told me. "Did you know we have supercomputers we use to trade more stock everyday than the New York Stock Exchange? Did you know our firm has line-of-sight microwave towers from Chicago to Jersey City (where the computers of the NYSE reside) so that we can trade milliseconds quicker than if we used fibre-optic cables? Did you know that our team of analysts meets with 11,000 companies face to face each year to gain precious insight? We also have a $20-billion base, which we leverage six-seven times, which effectively increases our funds capital to $120-$140 billion."

I asked, "What does it cost to run your firm?"

He replied, "$900 million per year."

"What does that amount to as a percentage of assets under management for your fund?"

"Approximately 4.5% on the base capital of the fund," he said. "But that doesn't include our 20% performance fee on the gains for that year."

"On average, what is the 20% performance fee as a percentage of total return?"

"Given that we have been averaging 30% gross returns, that amounts to 20% of 30% or 6%," he said.

I started to run the math in my head: 4.5 + 6% = 10.5%. This fund has a management expense ratio of almost 11%. It must be one of the most expensive investment funds in the world. Why would anyone, especially sophisticated investors such as university endowments, pension plans or billionaire families, invest in something where 35% of the return goes to the manager?

Then it dawned on me. Given how this fund invests and the leverage employed, what if the fund (which is a limited partnership (LP) structure) was a pubic company, such as a Canadian bank? Banks routinely employ high levels of leverage (10x is the norm, with 40x at some U.S. banks just before the Great Financial Crisis) and invest in similar financial securities that this hedge fund did. In essence, banks, in many ways are public versions of hedge funds.

The question then became, if a bank was an LP, what would its expense-to-income ratio be and how would that compare to hedge funds? How much do investors take home after a bank's non-interest expenses are subtracted from the total income?

For starters, a bank's total income is the combination of net interest income (net of loss provisions) and non-interest income such as fees, service charges and trading income. Non-interest expenses are everything that is not interest and include almost all operating and overhead expenses such as salaries and employee benefits, unemployment tax, insurance, and the operation and maintenance of facilities, equipment, furniture and vehicles.

To create this comparison, we used public information on the five largest Canadian banks' ratios of expenses compared to total income. We then assessed different return scenarios and fee arrangements that hedge funds employ to determine what percentage of gains a fund manager would take from the total return (this is the return gross of fees). Using the popular 2% annual management fee and 20% of the total return (with no high water mark), we observed a range of results. When a fund earned a total return of 5%, the manager received 60% of the return. When a fund earned a total return of 10%, the manager earned 40% of the return. Lastly, when a fund generated a total return of 20%, the manager only received 30%.

> "In some cases, hedge funds may be significantly less expensive than public options

When we reviewed the banks over a five-year time frame (2014-2018), the results were astonishing. During this period, the average bank had an expense-to-income ratio of 64%, with a high of 69% to a low of 60% across the banks. In other words, investors received only 36% of the total income from their investment.

There are obvious challenges to investing in hedge funds that publicly traded stocks don't have — such as the requirement to be an accredited investor, the very high minimum investment (which can be up to $5 million for the best managers) and reduced liquidity (lock-ups of one year or longer and quarterly redemptions) — but this study showed that hedge funds, in some cases, may indeed be significantly less expensive than the public investing options.

All fees are not created equal and it takes some keen understanding of accounting and financial reporting to normalize and compare the true costs of investing. As always, caveat emptor. **FPM**

Arthur Salzer is CEO and chief investment officer at Northland Wealth Management.