

ARE HEDGE FUND FEES TOO HIGH?



A comparative analysis of fund fees.

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The fees many hedge funds charge their institutional clients range from between 1% and 2%. On top of that, many hedge funds take 20% of the profits. These fees appear to be much higher than those charged by long-only managers—but are they too high? This article will seek to address this question by demonstrating four key points. First, that an understanding of the information ratio (IR) is crucial in determining true value. Second, that good market-neutral hedge funds (which typically boast high IRs) cost less than traditional active long-only equity funds (which typically have moderate IRs). Third, that market-neutral hedge funds cost more than long-only equity funds with similar IRs and, finally, that among long-only equity funds, those that are risk-controlled are much better value than traditional ones.

For this demonstration, I've made the following assumptions. First, that the equity index manager charges 9 basis points. In addition, that the traditional, long-only equity manager charges 30 basis points and expects to outperform the equity index by 200 basis points with an active risk level of 400 basis points, resulting in an information ratio of 0.5. The risk-controlled equity manager also charges 30 basis points and expects to outperform the equity index by 200 basis points. He does this with an active risk level of 200 basis points and an IR of 1.0. The market-neutral hedge fund manager charges 100 basis points and 20% of returns above the T-bill rate and expects to deliver 5% more than the T-bill rate with an active risk level of 5%. Since the expected alpha from the hedge fund manager is 5%, the expected hedge fund fees are 2%. The T-bill rate is assumed to be 3%, and one can borrow at the T-bill rate by paying a fee of 15 basis points. The annualized volatility of the equity index is 15% and the equity risk premium is 6%.

CAPS Hedge funds versus traditional long-only

The first scenario analyzed is a synthetic active long-only fund: invest \$1 with the index fund manager to

gain full beta exposure to the equity market. Invest \$0.80 in the hedge fund to get some alpha. Use leverage by borrowing \$0.80 to match the level of volatility of the traditional active long-only manager. The expected gross return on the synthetic active long-only strategy is 13% with an annualized volatility of 15.52%. The volatility of the real active manager is the same but his expected gross return is 11%. Net of fees, the expected return on the synthetic active long-only strategy is 11.18%, which beats the 10.70 of the traditional active manager by 48 basis points.

Synthetic Market Neutral

The second scenario analyzed is a synthetic market-neutral hedge fund: invest \$1.25 with the active long-only equity manager, short \$1.25 of the equity index (to remove the equity market beta) and invest \$1 in T-bills to achieve the same level of volatility as the hedge fund. The expected gross return on the synthetic market-neutral hedge fund is 5.5% while the expected gross return on the real hedge fund is 8%. Net of fees, the investor is also better off with the real hedge fund (6%) than with the synthetic hedge fund derived from the active long-only manager (4.81%), an advantage of 1.19%.

A synthetic long-only strategy to mimic the risk-constrained long-only strategy requires \$0.40 in the hedge fund, borrowing \$0.40, and investing \$1.00 with a passive equity manager. The net return is 10.04%, which is 66 basis points lower than the net return of 10.70% expected from the risk-constrained long-only manager.

A synthetic hedge fund with \$2.50 in the risk-constrained long-only strategy, shorting the equity market by \$2.50, and investing \$1.00 in T-bills beats the real hedge fund net of fees by 62 basis points. In conclusion, this confirms that risk-controlled equity funds represent better value than hedge funds and traditional long-only equity funds. ■