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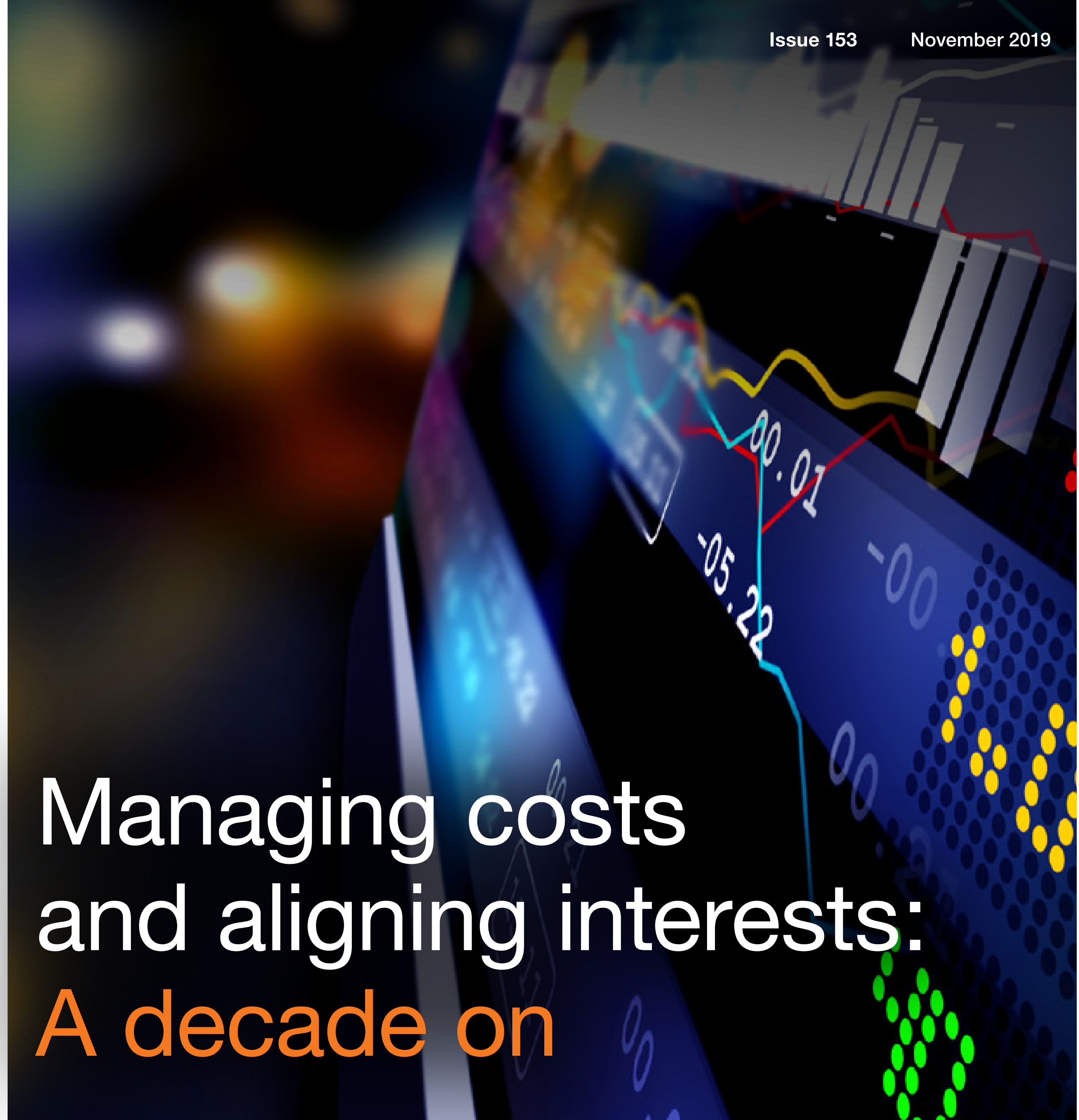

Managing costs and aligning interests: A decade on

FRONTIER ADVISORS

25 years

Frontier Advisors

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over two decades and provides advice over more than $380B in assets across the superannuation, charitable, public sector and higher education sectors.

AUTHOR

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Director

Fiona is one of the world's most respected investment consultants. Fiona started with Frontier/IFS in its inaugural year in 1994 and in 1997 took overall responsibility for the management of the asset consulting business, which became Frontier in 2000 with Fiona as Managing Director. As Director, Fiona provides strategic advice across the Frontier client base and is a member of the Investment Committee. She is also a Non-Executive Director at the Link Group, Prospa Group and the Victorian Funds Management Corporation and a member of the Investment Committee at the Walter and Eliza Hall Institute. In 2013, Fiona was named as the inaugural "Woman of the Year" in the Money Management/Super Review Women in Financial Services Awards, as well as one of the top 10 global Asset Consultants by the US-based CIO Magazine from 2013 to 2016 inclusive, and once again in 2019. She was also announced as a winner in The AFR and Westpac 100 Women of Influence Awards for 2016 in the Board/management category.

In December 2019, Fiona will draw to a close her twenty-five year career with Frontier. This paper aggregates many years of her thinking on how best to align the interests of asset owners with those who manage their capital, and the impact this has on net returns.

Introduction and reflections

It was a decade ago that I took that fateful call from a fund manager trying to be helpful and assuage my fears that the 20% reduction in its workforce during the period of the Global Financial Crisis (GFC) was "ok" because all those staff "had nothing to do with the investment process" (or words to that effect).

My first thought was – how terrible it would be for those people, and the thousands of others across many industries and countries that lost their jobs (and in some cases more than just their jobs) both during and after that time. But my second thought was – then why were our clients paying for them to be employed in the first place? It was this latter thought that led to a conversation with Ken Marshman, then my counterpart at JANA Investment Advisors, about incentive and remuneration models in funds management and why they didn't work that well. In November 2010, Frontier and JANA released a joint paper entitled "Principles for the Establishment of Fees". This paper set out six Fee Principles, which are restated in Attachment 1.

The point of the Fee Principles, and of a separate research report prepared by Frontier at the time, was to propose some alternative fee structures that we thought would better align the interests of the clients with those of the investment managers used. Despite some commentary at that time, our focus was always on the expected net returns to clients (and their beneficiaries), and this was not just a missive to reduce fees in a brute force manner. The intention was always to better align the interests of those that managed the money with those who provided the money (and took the risks). We specifically noted the following in the separate Frontier report.

> *"Readers might think that this is simply a missive aimed at reducing fees. It is not – it is about paying the right amount for performance. In some cases, this may mean higher fees to some firms if they perform well for clients. In others, it is an appropriate mechanism for pushing out the weaker performers and strengthening the investment manager universe over time."*
>
> – Frontier, 2009

Flat dollar fees

One of the key elements of the work we did was to propose some alternative fee models with a specific focus on a combined flat dollar base fee with a performance based fee to reward for targeted performance outcomes.

I had to explain what I meant by flat dollar fee more times than I thought I should (*"you know, where you pay a specific dollar amount for a service, not a percentage of what you manage"*) and it generally was well received by clients but less so by investment managers. We were careful not to suggest a standardised approach to allow for the differences in asset classes and manager styles, and we were careful not to be too prescriptive in the performance based fee component so as not to incentivise the wrong kind of risk taking. We focussed more on the "pay for performance" elements, while suggesting that clients and investment managers needed to agree a commercial relationship that was mutually beneficial.

Despite our enthusiasm, flat dollar fees are not the norm. However, this debate has probably moved on as the role of the active external investment manager has changed in the context of greater internalisation of money management by the large asset owners and greater interest in passive management globally. This trend, explored on the next page, has seen significant shifts in assets from external firms to teams inside superannuation fund businesses and has put considerable pressure on funds management businesses to evolve in response.

Catalysts for change

As I reflected that 10 years had passed since the original paper, I thought to myself that I must be a very patient person, but I also reflected on what we considered the catalysts for change might be.

We had already identified that the number of superannuation funds[1] would decrease and be larger on average. In fact, we noted the following. *"...the superannuation industry will comprise fewer, larger funds over time and this presents challenges for the funds management community, which, to this point at least, has seen considerable proliferation of firms offering funds management services. There will be increased competition for these clients' investments and fund managers who offer innovative solutions on alignment of interest and fees are likely to be in stronger contention for these mandates going forward. This is a material change in the dynamics of the funds management industry and will have profound consequences for some firms."* The trend towards fewer larger funds has been clear and we believe it will accelerate from here with recently announced mergers and takeovers. This has caused a significant change in the dynamics in the domestic funds management industry with a number of business closures or ownership changes (e.g. sales of equity to larger firms or aggregators).

Internalisation of money management – the low hanging cost fruit

Of all the strategies and ideas for reducing investment management fees, the one that ultimately had the biggest bang was the potential for, and subsequent actual internalisation of, money management by large superannuation funds. There was some change in overall investment fees for some funds due to changes in asset allocation and changed use of active management but these were mostly not that significant relative to the step change in fees that is possible due to internal management. At the time of writing the first paper in 2009, some superannuation funds already managed some money internally but it was typically in smaller portfolios or in a relatively low key way. That is, those funds that managed money internally did not really make a big fuss about it so it was not generally seen as any kind of threat to the viability of the funds management community. Then in 2012, AustralianSuper[2] announced that it would be building an internal investment team and ultimately manage as much as 30% of the total assets internally within five years, starting with Australian equities but also including direct infrastructure and property. This was reported in an *Investment Magazine* article[3] that noted *"the fund currently spends about $200 million a year in external investment-management costs, and as the fund grows, that figure continues to rise. [AustralianSuper's Head of Investment Operations] [Peter] Curtis says that if left unchanged, when AustralianSuper reaches $100 billion, its costs will balloon to more than $500 million a year.* ***Switching to internal management will cut costs by about two-thirds, he says.****"* (emphasis added). AustralianSuper also noted at the time that it would fund the internal strategies from cash flow as opposed to redeeming money from its incumbent investment managers. However, plans do naturally change and of the 13 Australian equities managers on the Fund's roster in its 2013/14 Annual Report, only seven remained by the 2017/18 Annual Report and a further three were terminated during 2019,[4] and it has been reported that a further number of managers have been terminated since that time.

The 2017/18 Annual Report states prominently in the CEO report *"We continue to leverage the Fund's size and scale to improve the efficiency and reduce the costs of our investment program. Over the course of 2017-18 total member assets increased by 17%, whilst our total investment costs [as calculated in accordance with RG97] grew by a modest 2%. The most significant driver of these scale efficiencies is the increased internalisation of the Fund's investment management capability, with 31% of the portfolio now managed internally. This has contributed in excess of $100 million in annual savings to members."*

This message is powerful and very clear.

[1] Frontier's client base in 2009 was almost exclusively profit to member superannuation funds and so the paper focussed on that part of the market. In 2019, the business is quite different with superannuation funds remaining as key clients but with additions from the endowment, university, insurance and not for profit sectors. The historical component in this paper therefore reflects the firm's heritage but the crystal ball gazing parts reflect its more diversified future.

[2] AustralianSuper is but one major Australian institutional investor that has made material changes to the way in which it manages money over the last 10 years and we use them as an example here as they have been quite transparent publicly about what their general plans are and their progress against them.

[3] "AustralianSuper brings it in-house", https://www.investmentmagazine.com.au/2012/09/australiansuper-brings-it-in-house/, retrieved 9th July 2019.

[4] "AusSuper dumps three equities managers", https://www.afr.com/chanticleer/aussuper-dumps-three-equities-managers-20190510-p51lyn, retrieved 9th July 2019.

We have since seen other funds publicly talk about increased internalisation of money management and start to build teams to do so. Even the act of thought bubbling about the possibility may well be enough to trigger discussions on fees with investment managers. The transfer of power, responsibility and accountability from investment managers to asset owners is well underway.

It is hard to get much in the way of evidence of the fund managers' and others' views during the early days of the AustralianSuper announcement but the general observations "around the traps" were twofold: (1) that this was an internalisation of (all sorts of) risks that investment managers previously managed (and charged for); and (2) that superannuation funds would not be able to attract and retain the talent they would need to make this successful.

On (1), we still think this is the case but that is not to say that it is an inappropriate thing to do as long as the organisation is properly resourced (including people, systems, technology etc), structured and governed. Done successfully, this will mitigate much of the risk that can exist when any task is conducted internally. This is true for investment managers and superannuation funds.

On (2), this does not seem to have been an issue for those superannuation funds that have gone down this path. Remuneration appears to have been quite competitive although commonly without the same bonus structures that are available in the investment management sector. A number of profit to members superannuation funds have promoted the "for purpose" element of their *raison d'être*, work life balance, no marketing or sales requirements and the long-term investment horizon as key elements of the "talent" attraction and retention strategy and these have resonated strongly with many, particularly post the Hayne Royal Commission.

Further, while it is hard to attribute performance to internalisation as there is no performance data available, the overall returns of the funds that have large internal money management programmes have been very good. Looking ahead, those funds with internal money management could make the underlying performance data available for scrutiny in the same way that investment manager performance data is available. This, in our view, would be the most powerful signal the superannuation funds could send about transparency and accountability.

The growth of passive management

Alongside the increase in Australia in the internalisation of money management (and other previously outsourced functions), one of the other key catalysts for change has been the increase in the use of passive management in mainstream asset classes and the ability to access specific target "betas" or risk factors via what is called "alternative beta". Disappointment with active management outcomes had led a number of institutional investors to question the ongoing usage of active managers and this had led to terminations of some relationships in favour of passive mandates. Anecdotally, this has also assisted with a reduction in fees as managers reduce fees as part of the negotiation to retain a mandate.

The general view now seems to be that investors are no longer willing to pay active management fees for managers who simply deliver index-like returns, which can very easily be obtained via much lower cost passive funds. This trend has made investors generally much more discerning and more sceptical about the use of active management. In developed market equities, for example, a passive investment can be accessed for a very small number of basis points (e.g. sub 0.10% p.a. and likely much lower for very large investors) and in some cases for a zero fee (although this is in exchange for the investor taking counterparty risk that the manager will deliver the required outcome). In contrast, active Australian equities management can be accessed for 0.40% p.a. and active international equities management for 0.50% p.a. While typically a reasonable use of fees to generate good net returns if above median managers can be identified and combined into portfolios, active management generally in equities has experienced a very difficult period with the year to June 2019 being the lowest median net excess returns for many years. Other analysis[5] recently completed by Frontier shows this clearly for Australian equities. This has heightened the interest in passive strategies although there does not appear to be a structural reason for the negative excess returns to persist over the medium term.

Deloitte in the US produces an annual *Investment Management Outlook* and recently released its 2019 version.[6] They note that *"(business) priorities for long-only managers are more acute than those for alternative managers"* (which we explore in more detail in section 4 in the context of innovation in fee structures) and that 16 of the top 20 global funds by net flows were passive mutual funds and ETFs for a net inflow of $US143 billion in the first half of 2018.

[5] Active Management in Australian Equities", Frontier Advisors, August 2019.
[6] https://www2.deloitte.com/us/en/pages/financial-services/articles/investment-management-industry-outlook.html.

Regulatory pressure

The regulatory pressure on fees has been strong although mainly around disclosure as opposed to quantum or structure. A large influence on the awareness and comparison of fees was the introduction of the MySuper product regime in 2014. This will be familiar to most readers but in brief, MySuper products are required to be "simple and cost effective"[7] and there are restrictions on the types of fees that can be charged and a simplification of product features. Part of the MySuper legislation involved the introduction of a Product Dashboard, a standardised template that sets out, amongst other things, fees and costs based on defined criteria for a representative member. This enabled reporting of fees (in dollars per annum) by APRA and others and increased the awareness of the overall cost of MySuper options, although the amount is an aggregate of a range of fees and costs and so it is not possible to determine the proportion that relates to external investment management.

ASIC's *Regulatory Guide (RG) 97: Disclosing fees and costs in PDSs and periodic statements* has been another key development in recent years and while no doubt well motivated (to allow consumers to be able to compare the cost of one superannuation fund with another on a like for like basis), it was poorly drafted, included too many inconsistencies, was too complicated and in the end, took up an enormous amount of the industry's time and money to get to a point where the outcome is largely unusable by the target end users – members of superannuation funds.

ASIC initiated an independent review of RG 97 in November 2017 that appeared to pragmatically identify the pros and cons of the current requirements, and is now in the process of consulting with industry to review several aspects of the Guide. However, no revised date has been proposed at this stage.

Recent APRA guidance to the trustees of superannuation funds has also made its heightened focus on member outcomes, including fees, very clear. In a speech to a Gilbert + Tobin Boardroom Conversation event on 19th September 2019,[8] APRA Chair Wayne Byres noted the following. *"In the past year though, both the Productivity Commission and the Royal Commission have concluded the superannuation system is not delivering sufficiently well. Trustees have not always been focused on their members' best interests, aggregate fees and costs are too high, insurance has not always been good value for money, and there has been too much inefficiency in the system. And they also said – very loudly and clearly – that regulators should do more to hold trustees to account to address those issues."*

Regulators tend to be more reactive than proactive i.e. they regulate against specific actions after something has occurred, preferring to try to allow the "system" or "market forces" to find the right balance ahead of time, and they tend to be "guidelines" rather than "rules" based. Looking ahead, we expect the two main financial markets regulators, ASIC and APRA, to be much tougher in enforcing their objectives, along the lines that we have already observed in the UK with the Financial Conduct Authority (FCA) and we expect there to be more rules with which asset owners will need to comply.

[7] https://www.moneysmart.gov.au/superannuation-and-retirement/how-super-works/choosing-a-super-fund/mysuper, retrieved 10th October 2019.

[8] "APRA Chair Wayne Byres – Speech to the Gilbert + Tobin Conversation Boardroom event", https://www.apra.gov.au/news-and-publications/apra-chair-wayne-byres-speech-to-gilbert-tobin-conversation-boardroom-event, retrieved 14th October 2019

Innovation and other developments in fee models and arrangements

In conferences and other forums where Frontier spoke about fees, we emphasised that innovation in fee models from the investment management community would be well received and in fact would be critical for their future survival.

There were some innovative models around already such as a manager with a refundable reserve mechanism (where the manager returns fees to investors following periods of underperformance); in fact, the manager has been offering this fee option for 15 years. A Director of the manager noted *"revenue for the business can be volatile, but... there is no incentive for corporate considerations to come ahead of our investment considerations. The best thing for the firm as a whole is to focus on maximising our clients' long-term investment returns."* [9]

Global investment behemoth Vanguard has also recently launched a series of actively managed funds in Australia that outsource the active management to other firms and offer a base fee with a symmetrical performance based fee around the base fee.[10] For example, the Vanguard Active Global Growth Fund (outsourced to Baillie Gifford) has a base fee of 0.60% per annum along with a performance fee that increases with outperformance and decreases with underperformance, capped at a premium or discount to the base fee of ± 0.0825% p.a. This is a particularly interesting development given the size of Vanguard's global business, although we would argue that the base fee remains healthy and the performance based fee is comparatively modest. However, it does appear to be a step in the right direction.

Given that there are thousands of investment managers globally, it is impossible to be certain about any and all innovation that might have occurred. However, some notable examples we have identified follow but we note that naturally there are likely to be others. Curiously, the word "symmetric" appears regularly albeit with some unusual definitions of symmetry. So what did we see in terms of developments and innovation?

[9] "Fees & costs: The price worth paying", https://www.ipe.com/reports/special-reports/fees-and-costs/fees-and-costs-the-price-worth-paying/10029260.article, retrieved 9th July 2019.
[10] https://www.vanguardinvestments.com.au/au/portal/articles/insights/mediacentre/vanguard-announces-new-series-of-funds.jsp, retrieved 10th October 2019.

Some positive global developments

The United Kingdom

In the UK, the Financial Conduct Authority (FCA) undertook a significant review into its institutional market in 2015 and ultimately established the Institutional Disclosure Working Group (IDWG) with a focus on improving competition and thereby investor outcomes in the asset management industry. This Group was complemented by the launch of the Cost Transparency Initiative in November 2018 by the UK trade bodies for asset managers (Investment Association), pension funds (PLSA) and the Local Government Pension Scheme (LGPS) Advisory Board. The focus of the latter has been to create cost disclosure templates to be used by asset managers to enable UK institutional investors to better understand all costs and charges incurred during the investment process (including transactions, brokerage, custody, legal services and performance fees). However, as we have noted, most of this change has been around disclosure – still a good thing – as opposed to innovation.

Frontier's global research partner in the UK, LCP, recently released its annual Investment Management Fees Survey for 2019, aptly titled *"Investors are in the Driving Seat"*.[11] LCP concluded that there have been notable fee reductions in the average fees for active global equities, multi-asset diversified growth funds, multi-asset credit, liability driven investment strategies and passive global equity mandates for UK-based investors. It also concluded that there had been an increase in fees for certain fixed interest related mandates, such as corporate bonds, private direct lending, emerging markets debt and absolute return bonds, which it noted could be attributed to pension fund demand for bespoke and more sophisticated fixed interest strategies.

Also in the UK, and from the perspective of an investment manager example, a large global manager offers a range of strategies with performance fees where clients pay *"a low management fee and a 20 performance fee only when the fund outperforms overall at the end of the year"*.[12] That is, no performance fee is paid if the fund underperforms over the year, and the underperformance is carried forward for five years. According to IPE, "*In 2017 the company, which has over €520bn in AUM, generated about 10% of revenues from performance fees. The CEO anticipates the figure will grow steadily over the years.*"[12]

Europe

In Europe, but with broader global ramifications, MiFID II has also had an impact on the behaviour in financial markets. In force from January 2018, MiFID II applies to financial services businesses that operate anywhere in the European Economic Area, creating higher standards on how banks and investment firms conduct their trading and research services businesses. Specifically, MiFID II[13] applies to how and what costs and charges are incurred and subsequently reported to clients on an unbundled basis. These fees were previously packaged as a combined service, with a total commission paid to brokers in return for executing trades and providing research. They were also almost always paid for by the investors in a fund and the client had no visibility on how they were incurred or for what service. The process of unbundling has created greater accountability for the costs incurred and reduced fees as a result. As they say, sunlight is the best disinfectant.

Japan

In Japan, we saw the largest pension fund in the world, the Japanese Government Pension Investment Fund (GPIF), rethink how it contracts with investment managers introducing what it called a "symmetric" performance based fee structure. This involves paying active managers an *ad valorum* fee equivalent to a passive fee as the base fee, along with an uncapped performance fee, that is not paid in full each year but rather partly retained by GPIF and then allocated in the following year. Despite being defined by GPIF as a symmetric performance-based fee structure, it is not evident to us that it is truly symmetrical as it is not clear that the managers ever have their fees reduced.

The Netherlands

In the Netherlands, we saw a continuation of the Dutch focus on overall fee levels although one survey of 10 Dutch pension funds, by LCP Netherlands, noted that by mid June 2018, asset management fees had risen for the first time since 2014 due to "the use of more expensive asset classes, such as infrastructure and residential mortgages, and higher performance fees for asset managers."[14]

The United States and Canada

Anecdotally, it would appear that not too much has changed in the US on the basis of feedback and conversations with investment managers who sell products there, although we have seen some manager terminations and reduction or removal in specific asset classes by some of the large Californian public sector funds such as CalPERS exiting the hedge fund space in 2014.[15] However, it is not clear if this is a systemic change. Canadian institutional investors have typically implemented a more direct investing model for many years but it is difficult to determine the impact that has had on overall fees, or whether this has changed over the last few years.

[11] https://www.lcp.uk.com/pensions-benefits/publications/lcp-investment-management-fees-survey-2019/.

[12] "Fees & costs: The price worth paying", https://www.ipe.com/reports/special-reports/fees-and-costs/fees-and-costs-the-price-worth-paying/10029260.article, retrieved 9th July 2019.

[13] The combination of the first version of Markets in Financial Instruments Directive (MiFID) and Markets in Financial Instruments Regulation (MiFIR).

[14] "Asset management costs at Dutch schemes on the rise", https://www.ipe.com/countries/netherlands/asset-management-costs-at-dutch-schemes-on-the-rise/10025269.fullarticle, retrieved 9th July 2019.

[15] "Why CalPERS Is Exiting The Hedge Fund Space", https://www.forbes.com/sites/jonhartley/2014/09/22/why-calpers-is-exiting-the-hedge-fund-space/#535d2f9f73ea, retrieved 9th September, 2019.

Performance pressures and fee renegotiations – hedge funds and private equity

Clients have had some success renegotiating fees post a period of weaker performance but we would not classify that as genuine "innovation". We did therefore see some movement on fees in some sectors but largely driven by investors reacting to periods of poor performance (e.g. hedge funds and related investments) and cost pressures (e.g. active equity managers losing ground to their passive counterparts).

In 2018, Ernst & Young (EY) published a report that surveyed global investors on their views on alternative investments.[16] While the survey is a much more complete review of the alternative asset categories, there is an interesting section on "innovation in response to fee pressure". Examples of innovation include innovating in the operations area (undefined but likely related to using advanced technology and data based on the full report), using technology to perform tasks more efficiently i.e. with fewer people, outsourcing to better quality providers and offering customised fee models, which differ significantly from the standard "2% and 20%". Maybe it's just me but that does not really look like the definition of innovation. Notwithstanding, 71% of investors indicated that cost management and rationalisation should be in the top three priorities for alternative asset management businesses and 46% said it should be the top priority. Talent management and improved investor reporting were the other two in the top three. At the same time, only 21% of those surveyed are satisfied with fees with the remainder neutral or dissatisfied. So there is some evidence of investors pushing their agenda more with investment managers, which is a positive despite my query of the definition of innovation. When asked to list "non-traditional" fee structures on offer to investors, asset managers provided the following as their top five (although they differed in ranking across hedge funds and private equity):

- Performance fee only charged above a hurdle;
- Tiered management fees based on AUM;
- Negotiated an expense cap;
- No performance fee; and
- Performance fee clawbacks.

In addition, the report notes that margin compression is also affecting the hedge fund and private equity industry, although it seems marginal (pardon the pun) from the data in the report. For example, 33% of hedge fund managers and 28% of private equity managers responded that their margins increased over the last two years, compared with 37% and 33% unchanged and 30% and 39% decreased. What is not obvious is the overall margin at the industry level and it is completely plausible that margins have fallen but businesses remain very profitable. Technological advancements including robotics and artificial intelligence are seen as key to margin protection as well as more efficient operations. It remains to be seen the extent to which any of these improvements are passed on to clients. Positively, there seems to be a clear and strong awareness that "changing investor preferences/needs" (including fees and costs) are assumed to be the greatest risk to alternative asset management organisations (cited by 56% of hedge fund managers, 50% of private equity managers and 44% of investors themselves).

[16] https://www.ey.com/Publication/vwLUAssets/ey-2018-global-alternative-fund-survey/$File/ey-2018-global-alternative-fund-survey.pdf, retrieved 9th July 2019.

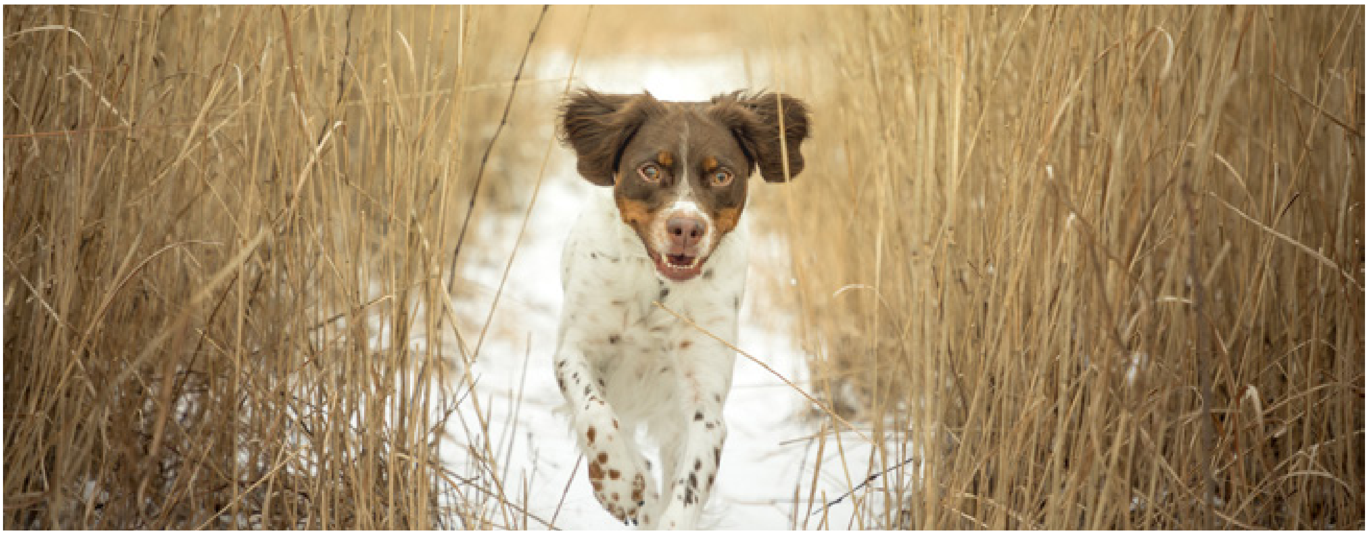
Negative fees – nope, that dog don't hunt

Several investment managers in the US have been experimenting with zero and negative fees. On the zero fee model, these appear to be legitimately at no investment management cost to the investor. For example, in late 2018, Fidelity offered a number of mutual funds at no investment management cost.[17] Presumably this is more of a marketing ploy with Fidelity hoping that these customers will use other paying services such as brokerage or move to other funds where investment management fees are charged. It is also noteworthy that managers can still make money on products where clients pay no fees via, for example, securities lending or from taking active positions and hoping for the value added to be positive, which they then retain. In Australia, a manager offers a range of what it calls "Trust Index" funds that guarantee the investor the index outcome for no total fee, and the manager absorbs any difference (upside and downside) between what it actually earns and what it pays the investor. The risk to the investor is in the manager as the counterparty, as opposed to any active management risk. The negative fee model,[18] where managers pay clients for the privilege of managing their money, raises questions about the triumph of marketing (or, more harshly, perhaps a desperate grab to grow a product or keep one alive) over investment substance and it is hard to see that this is a sustainable business model. From a marketing perspective, it is a logical way to get some attention to a new product, to gather some assets to try to accelerate the growth of a product, or to maintain assets in a poorly performing product. It may also attract clients who then shift to other fee-paying products. Similarly, as noted above, the manager may implement other strategies around the product and retain the benefits of doing so. We still believe that long-term investors and asset owners should want to deal with investment management businesses that are able to be sustainable in the long-term as well, so it is hard to see this as much more than a short-term gimmick.

A new model in private capital

We recently saw the launch of a private equity fund by BlackRock set up by two ex-colleagues at the Canada Pension Plan Investment Board, Mark Wiseman and André Bourbonnais. The challenge is nicely summed up in a May 2019 article in Institutional Investor.[19] Specifically on fees, BlackRock has scrapped the traditional "2% and 20%" model in favour of a budget based approach for the base fee, plus the allocation of units in the fund to the manager as a performance based fee. The fund, known as the "Long-term Private Capital Fund", is different in structure to the common private equity funds in the management buyout space with very long term planned holding periods for investments ("up to forever", according to Wiseman), permanent capital (i.e. not closed end funds), and typically lower leverage. Its goal is to seek less risky investments than traditional management buyouts for a lower gross return but with a better ratio of net to gross return due to lower fees. Investors are expecting returns somewhere in between traditional private equity and public market equities with Wiseman indicating around 15% per annum should be achievable.

The fee model is innovative in that it combines an assessment of the actual cost of running the Fund as the base fee (flat dollar fee anyone?) with the allocation of units to the manager for the incentive-based component. Investors will be asked annually to approve the budget and any variance (including over-runs) will be to BlackRock's account. At face value, this new model looks innovative, more equitable and more transparent – all positive developments – but it remains to be seen the extent to which it will catch on more widely, or the extent to which BlackRock will introduce the model more broadly in its own organisation or to which it will deliver superior net performance for investors. We do, however, believe that this is a very interesting development.



[17] "Zero-fee funds are making some investors even more nervous about 2019", https://qz.com/1494933/2018-the-year-fees-hit-zero/, retrieved 5th August, 2019.

[18] "Fund managers offer to pay investors ... but why, and will it catch on?", https://www.ft.com/content/8f48d470-dcf9-305f-ad3b-2c71d2493459, retrieved 5th August, 2019.

[19] "Private Equity Drove Two Canadians Crazy. At BlackRock, They're Trying to Fix It", https://www.institutionalinvestor.com/article/b1fmb7jbkpysz1/Private-Equity-Drove-Two-Canadians-Crazy-At-BlackRock-They-re-Trying-to-Fix-It, retrieved 5th August, 2019.

Testing the Fee Principles

So, have the Fee Principles stood the test of time?

- ***Principle 1 – Quantum of fees***

This Principle originally stated that investment management fees should normally be limited to a maximum proportion of the expected active returns of 33%, however our experience was that a numerical maximum guide worked well in some circumstances and not as well in others.

- ***Principle 2 – Performance fees***

The use of performance fees is predicated on two simple principles: (1) that the investment manager is "financially aligned" i.e. it does well when the investor does well and poorly when the investor does poorly; and (2) that the manager is financially motivated to limit assets under management to maximise performance fees. It is also argued that higher fees will attract the best talent to a fund manager and thereby deliver better net returns.

There are certainly cases where all these apply. However, in general, the outcome appears to have been that "a bird in the hand has been worth two in the bush" (i.e. investment managers have preferred bigger base fees to uncertain performance fees).

As a result, performance fees are not common in most asset classes, and while we continue to believe that they are an intuitive component within the fee negotiation process to promote alignment of interest, they are more complex than a base fee model and can be a challenge for investors with overall fee or fee budget considerations as well as competitor and regulatory risk constraints. Further, even when properly structured so that there is a sharing of the outcomes, it is not clear that they are as valued by the investment manager as fee certainty and so there is a question about the extent to which they actually influence behaviour and create behavioural alignment.

- ***Principle 3 – Structuring performance fees***

We continue to support the proper structuring of any performance based fees to ensure that there is equity in the fee agreement for each party.

- ***Principle 4 – Unlisted and illiquid investments***

In some circumstances, we continue to accept the use of performance based fees for unlisted and illiquid investments but, as above, we strongly believe that equitable structuring is critical, especially in the context of the much lower ability to transact. We have, however, found in practice that these have been much harder to negotiate and/or change, reflecting the greater complexity in the asset classes and the likely higher bargaining power of the investment managers due to perceived higher skill or scarcity.

- ***Principle 5 – Investment costs***

We continue to believe that there should be full transparency around investment costs and that these should be regularly reported and reviewed.

- ***Principle 6 – Review of fee structures***

We continue to believe that a formal review of the investment management relationship consistent with the mandate type at a pre-agreed point in time makes sense.

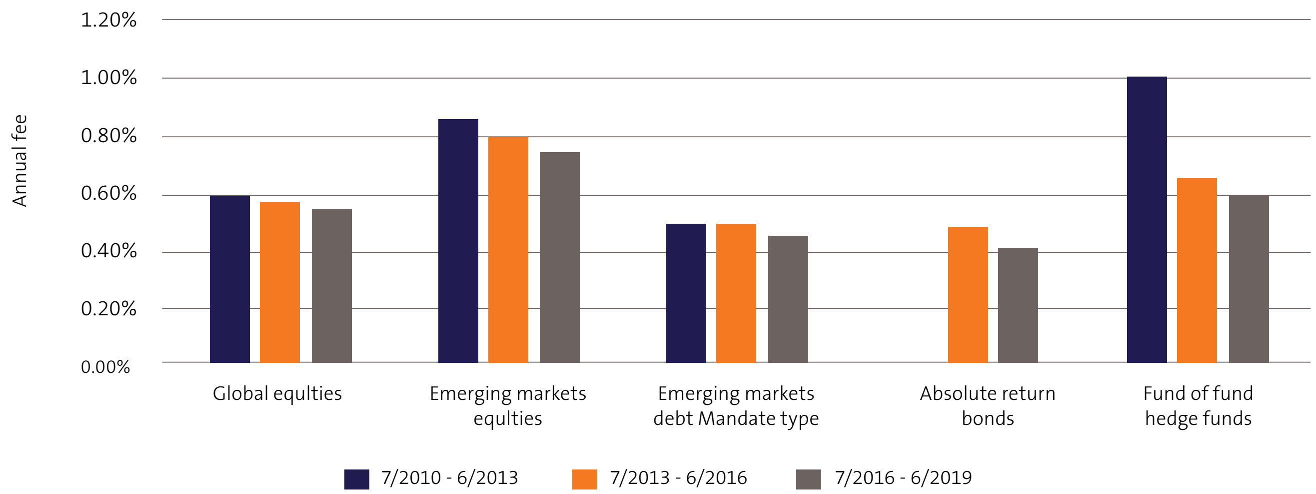
Changes in investment management fees in the last decade

A recent article[20] in the Australian Financial Review (AFR) reported on a Morningstar review of the fees paid in the retail managed funds sector in 26 countries. Morningstar conducts this survey every two years and concluded that fees charged by Australian fund managers are *"amongst the lowest in the world"*, and also that *"the global fee squeeze on the industry shows no signs of abating"*. Morningstar notes that some of this pressure is due to the banning of commissions in countries like Australia and the Netherlands but also increased regulation, the trend towards passive management and the use of exchange traded funds, and the unbundling of fees leading to greater transparency and awareness by the average retail investor have been influential factors. While this survey focuses on the retail market, where fees are much higher than those available to institutions, it is the trend that is most interesting and consistent with what we have observed. bfinance also recently released its biennial study on fees for 2019.[21] This survey has the advantage of focussing on institutional mandates and so is more relevant for Frontier's clients. But equally, bfinance notes that it is not comprehensive as it focusses on a limited number of asset classes, only includes those managers who tendered for the mandates in question and does not discern by investor type or location (so we cannot discern Australian based clients from this analysis). They also note that the fees quoted are typically subsequently discounted by 5-15% in the negotiating process around the final mandate. However, it is the trend we are most interested in even if the absolute numbers are not as relevant. bfinance has been collecting fee data since July 2010, which broadly coincides with the decade that is the subject of this paper. We have used their data in the following charts and all refer to $US100 million actively managed mandates.

We report the actual fees as opposed to the percentage changes as the trends are quite clear. Over the period though, fees have fallen in the categories shown by between 6.8% for global equities and 42% for fund of fund hedge funds.

It is harder to get access to comparable fee data for many private market asset classes such as infrastructure, property and private equity. bfinance, however, notes that there has been fee compression in areas that are less mature or where the manager universe has expanded materially. This will typically be balanced with investor demand and assessments by investors of the likely success of maturing managers and segments. Further, many managers in these asset classes have benefited from strong global demand and so have been able to raise funds at high fees and with weaker terms from an investor perspective.

Chart 1: Changes in median annual investment management fees



[20] "Australian fund manager fees among world's lowest", https://www.afr.com/companies/financial-services/australian-fund-manager-fees-among-world-s-lowest-20190922-p52tqx, retrieved 22nd September, 2019.

[21] https://www.bfinance.com/insights/investment-management-fees/, retrieved 10th October 2019.

The next decade

It is hard to believe that 10 years have passed since we first wrote our paper on managing costs and aligning interests.

It has been a fascinating time to be in markets and to be working with asset owners of all kinds to help them achieve their goals.

Fees remain as important today as they were a decade ago, and potentially moreso when we do (finally) enter the oft cited "lower return environment", where it will be harder to reach investment objectives, so how much asset owners pay for market and excess returns will be even more critical. With lower expected returns, anything that counts against returns such as taxes, costs and fees, needs to be carefully reviewed through the lens of expected net returns.

One of the largest changes in the last decade has been in the asset owner community, specifically in the large superannuation fund segment with which we have long been associated. In our view, it is in fact this change that has completely changed the dynamics in the investment management industry and will continue to do so in the next decade. These changes will not only affect those large superannuation funds themselves but others in the industry for both "free rider" and "collateral damage" reasons, both for smaller superannuation funds and for other institutional investors.

As consolidation in the superannuation industry continues and the industry reshapes, we expect to see the emergence of a small number of very large funds along with the maintenance of a number of niche or specialist funds that appeal to their members for a range of reasons and remain competitive on net returns. These funds will not be distinguished so much for their size but for their member relationships, service and outcomes. Within the very large funds, we will likely see greater internalisation of money management, ideally following a clinical self assessment of comparative and competitive advantage, and this will mean changed use of external money managers in general. External money managers will need to rethink their business models due to the lower number of large mandates available that were previously used to build sustainable money management businesses. The changes in the investment manager landscape will change the offerings of externally managed products to all investors.

At its simplest, this is just how any organisation stays relevant to its current and prospective clients, and so our encouragement to investment managers to be innovative remains as relevant today as it was 10 years ago.

Asset consultants have faced this challenge for many years as many of the functions undertaken for asset owners have slowly but surely moved in-house (or to other providers). Many we were not unhappy about – the drafting of proper instructions, performance reporting, cash flow instructions etc are all tasks that used to be within the remit of the asset consultant but are now invariably undertaken internally or by other providers. This has enabled asset consultants to focus on the best and highest use way to add value to clients. The same has occurred and will continue to occur in the investment management community.

Looking forward, in the same way we believe that there is a role for independent and value adding investment advice, we also believe that there will be a role for external investment managers that are skilled, can add value and where the commercially agreed arrangement allows for an appropriate sharing of the risks assumed, and of both success and failure relative to targeted outcomes. These arrangements need to reward genuine skill and both parties need to think they are fair and transparent.

It is our view that asset owners of all kinds and sizes can benefit from access to external ideas and approaches, whether it is money management or advice. Equally, any organisation that is managing money internally ought to ensure that it is regularly testing its own capability and outcomes against what could be accessed externally after adjusting for fees. After all, it would be a false economy to save on fees but end up worse on a net returns basis.

The fundamental question is: how should investment managers be rewarded for managing money on behalf of others?

It is not possible to reconcile a fee model that works as well for investment managers as it does for investors. Investment managers will mostly always want a certain fee for what investors expect to be an uncertain outcome. An ad valorem fee is the best fee most of the time for investment managers but often the worst for the investor. Investors will always want to pay the least possible for the outcome they think they will get, or at least only pay when the investment manager delivers. And passive management aside, delivery of value added is mostly an uncertain thing – and as they say, hope is not a strategy.

So how can this be resolved? Greater awareness and transparency of fees paid and fee models have made investors question these old approaches and it seems clear that the generic ad valorum model is well past its use by date. However, it remains the most common and so the typical goal of the investor has been to make fees paid as low as possible.

We argue that a pricing philosophy that values transparency and can prove the value of the service, that shares the benefits of scale, that rewards long-term relationships, that balances structure with complexity, and that makes it clear what investors are paying for (investment returns and all the collateral of running the business including risk management) will enable more enduring fee models to emerge. Successful commercial relationships need the organisations on both sides to be sustainable and for both parties to think that it is fair.

Looking ahead to the next decade – the Frontier Fee Philosophy

Frontier is proud to have contributed to the debate about investment management fees over the last decade, and we believe that our Fee Principles from 2009 enabled us to focus on negotiating fees and fee structures that assisted the achievement of strong net returns for our clients.

Looking ahead to what makes most sense for the next decade, we have developed a Frontier Fee Philosophy that includes the key elements of focus on net returns to investors, share of excess returns, alignment of interest, transparency and willingness to share the benefits of scale.

Our Fee Philosophy is set out below.

Frontier continues to believe that net of fees (and tax and other costs) returns are most important for the underlying beneficiaries of the clients we advise. Fundamentally, we believe that our clients are providing the capital and taking the risk and so should retain the bulk of the return, and that the investment manager should not receive an excessive share. Investment returns are uncertain, but fees are always negative.

We acknowledge the differences in our client base, and that some clients will have their own approaches to fees. In determining our view on appropriate fees and fee structures, we take into account the following in our review and rating of investment managers.

- ***The proportion of the expected diversification-adjusted excess returns generated by the investment manager that the client is paying in fees, which may vary by asset class and investment strategy.***
- ***Our level of conviction in the investment manager's skill, and in our view of the prospective net return over a period that is relevant for its investment style and approach.***
- ***The various fee models that are expected to result in an improved alignment of interest between our clients and the investment manager, including properly structured performance based fees if appropriate.***
- ***The willingness and ability of the investment manager to be proactive and transparent in its dealings with our clients and with us, including regular reviews of investment fees and costs.***
- ***The willingness of the investment manager to share the benefits of scale and long-term commitment of capital.***

Attachment 1: Original Fee Principles

- ***Principle 1 – Quantum of fees***

Investment management fees should normally be limited to a maximum of 33% of expected active returns generated by the investment manager.

- ***Principle 2 – Performance fees***

The desirability of performance fee structures depends upon issues such as the willingness of the investor to share the potential upside of outperformance with the manager, the desire of the investor to pay less in the case of manager underperformance, the mechanics of the structure of the performance fee, the alternatives available (e.g. flat fee only) and the impact on the total level of fees to be paid.

- ***Principle 3 – Structuring performance fees***

In the main, performance fees should include deferred payment terms, high water marks, clawbacks and/or caps. Hurdle rates should reflect the risk inherent in the mandate.

- ***Principle 4 – Unlisted and illiquid investments***

Performance fees relating to illiquid investments should preferably be based on realisation of the investments. For open ended funds, where realisations may be detrimental to the investment strategy, the performance fee structure should be based on independent valuations and calculated over periods of three years or longer. These should be calculated on net asset values and should preferably include deferred payment terms/clawback as well as high water marks and/or caps.

- ***Principle 5 – Investment costs***

Other costs intended to be charged to the investor (or through the unit price of the investment) should be clearly identified at the time of initiating the investment, should be reported regularly to the investor and should be regularly reviewed as to their reasonableness and consistency with the terms of the investment agreement.

- ***Principle 6 – Review of fee structures***

At the time of entering a new investment mandate, the Investment Management Agreement should include a provision for the investor and the investment manager to renegotiate fees at a set time. The period should be consistent with the objectives of the mandate. A period of three years for listed investments should be typical. This should not preclude fee reviews at other times should circumstances warrant.

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Frontier Advisors: Frontier Advisors is one of Australia's leading asset consultants. We offer a range of services, solutions and technology to some of the nation's largest institutional investors including superannuation funds, charities, government / sovereign wealth funds and universities. Our services range from asset allocation and portfolio configuration advice; through to fund manager research and rating; governance, risk, decisions and strategy advice; quantitative modelling and analysis; and general investment consulting advice. We have been providing investment advice to clients since 1994. Our advice is fully independent of product, manager, or broker conflicts which means our focus is firmly on tailoring optimal solutions and opportunities for our clients.

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