The Lowdown on Fees
Performance Fees — Part 2

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Performance Fees – Part 2

In The Lowdown on Fees: Investment Management Fees and Costs–Part 1, we explained that Morningstar's Total Cost Ratio helps investors make meaningful comparisons. It is a single figure encompassing the total nondiscretionary fees and costs associated with managing a fund in Australia. It incorporates investment management fees and costs, performance fee costs, and total annual dollar-based charges.

In Part 1, we focused on investment management fees and costs. Now, we'll take a look at performance fee costs and how they work.

Key Takeaways

- Performance fees can align a manager and an investor, but the devil is in the details.
- Performance fees can be charged for beating an index, beating an absolute number, or a combination.
- Check for mechanisms like a high-water mark to ensure underperformance is recouped before a fee is payable.
- Assess the merits of a performance fee in the context of the total fee charged and the performance achieved.

What is a performance fee?

As the name suggests, a performance fee is based on the performance of the fund and is supposed to align the interests of the manager and investors. It's good in theory, but the devil is in the details.

Defining how "well" a fund has performed is typically done using a hurdle rate—the return the manager needs to beat before the fee is payable. Performance fee hurdles come in many forms—a manager may be rewarded for beating the return of an index, an absolute number, or an amount based on some combination of the two (typically, the manager must beat the higher rate).

The basic premise is that the manager needs to generate performance in excess of the hurdle and then share in the rewards with you. That is, you get 100% of the performance (after investment management fees) up to the hurdle rate, and then you pay the manager some of the performance they have generated over this rate. In theory, the more difficult the hurdle, the better for the investor, but note that setting hurdles too high might encourage the manager to take excessive risk in order to have a shot at earning a performance fee.

What is a hurdle rate or benchmark?

Exhibit 1 contains examples of hurdle rates used by some well-known international equity funds—the indexes are relevant to the asset class the manager is investing in. For example, Platinum International Fund is trying to beat the MSCI All Country World Net Index (a well-known international equities index) and not the S&P/ASX 200 Accumulation Index. That's because the fund invests globally and not just in Australian shares. The benchmarks listed are also "total return", "net", or "accumulation" indexes—meaning each index includes returns from share price movements and dividends paid. Some indexes are "price only" and do not include returns from dividends (worth around 3% a year historically for international equities). Using a price index makes the hurdle rate a fair bit lower and easier for the manager to beat—so keep an eye out.

Finally, pay attention to whether the fund needs to beat its benchmark or hurdle *after* investment management fees have been deducted from the return. This is the norm for well-structured performance fees, but again—worth checking.

Exhibit 1 International Equities Funds' Performance Fee Hurdles

Fund	Performance Fee Hurdle
Magellan Global Fund - Open Class Units	The higher of the Index Relative Hurdle (MSCI World Net Total Return Index (AUD)) and the Absolute Return Hurdle (the yield of 10-year Australian government bonds)
Platinum International Fund – P Class Units	MSCI All Country World Net Index in $A
Hyperion Global Growth Companies – B Class Units	MSCI World Accumulation Index (AUD)

Source: Product Disclosure Statements.

There are pros and cons with each hurdle. An index-linked hurdle can result in the investor paying a performance fee when the fund has lost money (in absolute terms) but has outperformed an index that has fallen by more. Psychologically, this can be difficult for investors to accept in falling markets, and it is something to prepare yourself for in the event you choose a fund with this sort of performance fee structure.

On the other hand, an absolute return or cash rate hurdle can be simply too low, or earn a performance fee for a manager purely riding a strongly performing market (not outperforming it). For example, if you are invested in a share fund, you'd typically expect the fund to generate returns far in excess of a cash return over time even if it doesn't outperform the relevant share index.

The idea of combining absolute and relative return hurdles is to make sure the manager both makes money and outperforms the market generally. For this reason, the hurdle is typically defined as being the higher of the absolute or relative return figure (for example, see the hurdle definition for Magellan Global Fund in Exhibit 1).

There are also other ways that hurdles can be made more challenging, with the most common technique being a "high-water mark" mechanism. A high-water mark requires that the manager recover any underperformance (compared with the hurdle) from prior periods before a performance fee can be paid. This mechanism is critical for maximising the alignment of interest between manager and investor.

Performance fee "free kick" for the investor

One thing to keep an eye on when investing in a managed fund is when the manager has underperformed the benchmark for a period of time. If this is the case (and assuming the manager is subject to a high-water-mark hurdle), a new investor could enter the fund at a time when the manager needs to catch up to the high-water mark before qualifying for the performance fee. As a result, a new investor could get a free kick—that is, the benefit of the high-water mark without having experienced the prior underperformance.

The Platinum International Fund – P Class Units is a good case study. As at 31 December 2021, the fund had underperformed its benchmark (MSCI All Country World Net Index in $A) by over 15% for the year and Morningstar's category index (MSCI World Ex Australia NR AUD) by over 19% (Exhibit 2) for the year. The underperformance relative to the benchmark (and any underperformance prior to this point) must be recovered before a performance fee is payable.

Exhibit 2 Platinum International Fund – P Class Units Performance as at 31 December 2021

Trailing Returns (31-Dec-2021)

	6 Mth	1 Yr	3 Yr	5 Yr	10 Yr
Quartile					
Total %	-0.37	10.38	10.13	NAv	NAv
Index %*	11.46	29.58	20.58	NAv	NAv
Category %	7.87	24.43	18.07	NAv	NAv

*MSCI World Ex Australia NR AUD

Source: Morningstar Adviser Workstation.

How often a performance fee is paid matters

The period over which a performance fee is "crystallised" (or paid to the manager) is also worth paying attention to. From an investor's perspective, longer crystallisation periods are better—the manager has to provide a consistent period of outperformance before banking a performance fee. Ideally, the frequency of payment of a performance fee would align with your investment horizon—for example, for a share fund, five to 10 years. However, it doesn't work that way in practice. Most funds investing in liquid, listed investments earn performance fees on a quarterly, semiannual, or annual basis. And managers who are banking performance fees over these shorter-term periods may be tempted to focus on these short-termer gains. They could take a large performance fee for one strong period of good performance and underperform in subsequent periods. Unfortunately, fund investors are not eligible for a refund of the performance fees already paid. Had the manager's fee crystallised over a longer period, the investor would not have paid a fee, as the positive performance accrued early on would have been netted off by the ensuing underperformance.

Morningstar's Total Cost Ratio and Performance Fees

Morningstar's Total Cost Ratios—Prospective and Realised look at performance fees through two different lenses. "Prospective" performance fees are those disclosed in the Product Disclosure Statement (PDS), and "Realised" performance fees are those earned in the last financial year. These performance fees can be very different (Exhibit 3). Prospective fees provide an indication as to what fees investors are likely to be charged over time based on a longer-term history. Performance fees in particular can swing wildly from one year to the next depending on markets and fund performance. As such, the regulatory guidance is that performance fees disclosed in PDSs should take an average of the fund's performance fees generated over the last five financial years. This is designed to smooth the volatile nature of performance fees and hopefully give investors a better idea of the fees they would pay over a longer time period. Realised performance fees, on the other hand, are simply the last financial year's performance fee that was actually earned. While past performance is not a guarantee of future performance, disclosing a five-year average in the PDS is a better guide for investors than disclosing fees earned in one year (which can vary markedly one year to the next).

Let's look at the Platinum International Fund – P Class Units again. The recent poor performance resulted in a Realised performance fee (as at 30 June 2021) of 0%. However, the fund earned a performance fee in financial-year 2018, and as such, the Prospective performance fee disclosed is 0.19% per year, as it considers those historical fees earned.

Exhibit 3 Prospective and Realised Performance Fees as at 30 June 2021

Name	PDS Date (Prospective)	Total Cost Ratio (Prospective)	Investment Management Fees & Costs (Prospective)	Performance Fee Costs (Prospective)	Performance Fee Costs (Realised)	Difference between Realised and Prospective Performance Fees
Hyperion Global Growth Companies B	8/12/2021	3.33	0.70	2.63	2.23	-0.40
Platinum International Fund P	5/10/2021	1.35	1.16	0.19	0.00	-0.19
Magellan Global Open Class	23/12/2021	1.45	1.35	0.10	0.00	-0.10

Source: Morningstar Direct.

Consider the total package—investment fees, performance, and importantly net returns

Performance fees should not be considered in isolation of the fund's net performance or the fund's investment fee. Hyperion Global Growth Companies Fund – B Class Units provides a good example of a fund that has delivered very strong net performance and earned generous fees. The fund discloses a performance fee of 2.63% per year in the PDS. This is an intimidatingly high number. However, Exhibit 4 shows that recent net financial-year returns have been very strong. These strong returns have driven the level of performance fees earned and disclosed in the PDS. It's always important to consider whether the manager will be able to deliver similar levels of outperformance in the future and whether history is an appropriate guide to future outperformance.

Most investors would be happy to pay these higher fees in exchange for this level of outperformance, but investors would clearly be better off with no performance fee component and the same strong returns. So, if you find two managers with similar skill levels but only one charges a performance fee, then (assuming base fees are the same) it should be an easy choice to pick the manager without the performance fee.

Exhibit 4 Hyperion Global Growth Companies Fund – B Class Units Recent Financial-Year Returns

Financial Year Returns

	Jun-19	Jun-20	Jun-21
Fund	17.45	19.17	46.31
+/- Category	4.50	7.20	17.32
+/- Index	5.51	13.99	18.81

Source: Morningstar Adviser Workstation.

The presence of a performance fee often impacts the investment management fee. Many managers with performance fees have lower investment management fees than peers with an investment-management-fee-only structure, so it's important to consider the whole fee package. For example, the Platinum International Fund – P Class Units (performance fee units) charges annual investment management fees and costs of 1.16% compared with the investment-management-fee-only Platinum International Fund, which charges annual investment management fees and costs of 1.41%. Setting aside that the P Class Units will be under their high-water mark because of the recent underperformance as described earlier, if both funds either underperform or produce only moderate levels of outperformance above the index over time, you'd expect the total cost ratio of the P Class Units to be lower. Conversely, in an environment of very strong performance relative to the index over a sustained period of time, P Class Unitholders should expect to pay a higher total cost ratio.

Performance fee structures can be incredibly complex for investors. And the devil is in the details. Investors need to understand the hurdle rate, whether a high-water mark is in place to ensure underperformance is recouped, and if strong historical performance has driven performance fee disclosures in the PDS—and if this is sustainable in the future. Finally, it's important to consider the total fee load in the context of the net returns expected to be delivered by the manager. It's our hope that the Morningstar Total Cost Ratio can make complex fee disclosures easier to understand and assist investors to compare apples with apples across funds.

Stayed tuned for Part 3 of The Lowdown on Fees, where we will bring it all together and compare across a range of funds.

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