Case Studies:

Is “1 and 10” the new “2 and 20”?*

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“Case Studies” presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

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The standard “2 and 20” (i.e., 2/20) fee structure for hedge funds has long been criticized, but in more recent years, the industry has seen a dramatic shift in fee models. Now, with close to 60 percent of firms charging less than 1.5% in management fees and approximately 20 percent of firms charging less than 10% in performance fees,[1] John must seriously reconsider the 2/20 fee structure for his own fund, Zero Beta Capital Management (ZBCM).

In past years, ZBCM enjoyed an average annual return of 30%, and at its height, held $2 billion in assets under management (AUM). Abstracting away from clawbacks, high-water marks, and hurdle rates, this scenario loosely translates to $40 million in management fees (i.e., 0.02 x $2 billion AUM) and $120 million in performance fees (i.e., 0.20 x $600 million in profits) under a 2/20 fee structure. Under a 1/10 fee structure, this same scenario would translate to $20 million in management fees and $60 million in performance fees.

However, in more recent years, John’s fund has succumbed to the post-2008 trend that has plagued many others in the industry. His average return has lagged that of the S&P 500 Composite, and after repeated outflows, ZBCM is now left with just $1 billion AUM. Although changing to a “1 and 10” model means that John would not only earn a lower management fee but also a lower carry on performance, John’s total earnings may ultimately be greater if he is able to stave off further outflows and possibly even gain additional investor capital as a result of the changes.

Still, John is acutely aware that a 1% management fee is high relative to that set by index funds, many of whom charge only 10 basis points (i.e., 0.10%) and do not earn a carry on performance. At the same time, John is hopeful of several new investment strategies developed by his alternative-data team, and he is further hopeful of the SEC’s latest stance on 13F filing requirements. Specifically, regulators have recently proposed to increase – from $100 million to

[1] https://www.bloomberg.com/graphics/2020-hedge-fund-management-performance-fees/

$3.5 billion – the required amount in equity holdings that would require a fund to file a 13F form.[2] This change would save John from the onerous process of providing a quarterly account of ZBCM's equity positions.

John believes that such filings have adversely impacted returns on his equity positions in the past, and is optimistic that, jointly, his new investment strategies coupled with regulatory changes could bring ZBCM back to consistently outperforming passively managed index funds tracking the S&P Composite. To regain the confidence of existing and potential investors, he decides on a 0/20 fee structure with an 8% hurdle rate (i.e., ZBCM can only levy its performance fee on incremental earnings beyond 8%), based on his observation that the recent 5-year average return on the S&P 500 Composite Index was approximately 10%. With this final decision, John decides to call counsel to begin drafting a letter to investors.

Questions

- Was John extreme in setting a 0/20 structure given his chosen hurdle rate?
- What are key considerations in setting an appropriate fee structure?
- What are some advantages to no longer filing 13F forms?
- What are some potential drawbacks to John if more funds are no longer required to file 13F forms?

[2] https://www.bloomberg.com/news/articles/2020-07-20/goldman-warns-sec-proposal-could-shroud-hedge-fund-crowding