



# ARE HEDGE FUNDS OVERPRICED: COST VS. INCENTIVISATION

*“Navigating Uncertainty” is a dynamic finance series designed to demystify the complexities of hedge funds. We provide clarity on intricate concepts, ensuring accessibility to readers of all backgrounds.*



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## ARE HEDGE FUNDS OVERPRICED?

The debate around hedge fund fees often boils down to a complex balancing act between incentivisation and cost.

Hedge fund fees are a contentious topic, with managers finding it challenging to justify them and investors grappling to understand them.

### Specialisation vs. Strategy Capacity

The crux of the argument revolves around two main factors: specialisation and strategy capacity.

#### 1. Specialisation:

Hedge funds often focus on niche strategies,

and managers seek higher compensation to reflect their expertise and the unique nature of their strategies.

These specialised approaches demand significant skill and research, which can justify higher fees.

**1. Strategy Capacity:** Hedge fund strategies may have inherent liquidity limits. For instance, a strategy might only be effective with up to 5 billion rand, whereas a traditional fund might manage 50 billion rand with similar strategies. Hedge funds may charge higher fees to optimise returns from their limited capacity and specialised strategies.

Critics argue that these high fees are not always justified.

However, it's essential to recognise that hedge funds are not suited for everyone.

The real question should be whether the fees are appropriate relative to the value and performance provided.

### Management vs. Performance Fees

While hedge fund management fees have realigned to be more comparable to boutique traditional unit trust managers, the key differentiator is the performance fee.

Performance fees are only earned when hedge fund managers exceed their benchmarks.

This model aligns the manager's interests with those of the investors,



as excessive compensation is only warranted through superior performance.

A significant caveat is that benchmarks must be appropriate. For instance, a fund taking substantial equity risks should be measured against an equity benchmark, not a cash benchmark.

Some older hedge funds still use outdated benchmarks, which can skew performance fee calculations.

### **Managing Strategy Capacity and Fees**

Hedge funds generally avoid asset hoarding due to performance fees. Managers, keen to maximise returns and fees, are incentivised to manage their capacity carefully.

Overloading a strategy with assets can dilute performance, a phenomenon where larger managers often underperform compared to smaller ones.

In summary, the focus should be on ensuring that hedge fund fees align with performance and strategy capacity. Rather than fixating on reducing fees, investors should prioritise incentives that drive managers to deliver strong performance, thus benefiting both parties.

### **Understanding Hedge Fund Fees:**

Investors often encounter high Total Expense Ratios (TER) on hedge fund fact sheets—8%, 12%, or even more—and may be startled by these figures, questioning whether such high costs are justifiable.

### **Key Points to Consider:**

#### **1. Performance Context:**

Fund returns are reported net of fees. High TERs typically reflect significant performance fees, suggesting that the fund has delivered substantial outperformance above its benchmark.

In other words, if a hedge fund is charging high fees, it likely means they have achieved impressive returns that justify those costs.

#### **2. TER Reporting and Fee Timing:**

TERs are historical and can cover various periods, such as 12 or 36 months. These ratios do not represent the fees you will pay when you invest today.

Upon entering a fund, you initially pay only the management fee, which typically ranges from 1% to 1.5%. Performance fees, which accrue based on outperformance, are additional and will only be charged if the fund exceeds its benchmark.

#### **The Value of High Fees:**

If a fund's TER is exceptionally high, it implies significant outperformance.

In hindsight, such high fees could be indicative of extraordinary returns after fees.

Therefore, an 8% or 12% TER could signal impressive net returns above the benchmark.

### **Realities of Hedge Fund Costs:**

High fees are a reality in hedge funds. The fees reported are post-performance, making comparisons across investments more straightforward.

However, hedge funds are not for everyone, and their high costs reflect the specialised strategies and potential returns they offer.

Ultimately, with hedge funds, the principle of "you get what you pay for" applies. If a fund consistently outperforms, the high fees may be justified by the exceptional returns.

It's essential for investors to weigh whether the potential for superior performance is worth the higher costs compared to lower-cost alternatives, which often struggle to deliver similar levels of outperformance.