CHESTNUT ADVISORY GROUP

Grow Your Edge With Investors

Fees and Investors:

Don't Sell Your Firm Short

June 2017

IN THIS ARTICLE

Our latest research among institutional investors reveals that once hired, asset managers go silent on fees; most investors also lose focus on this important topic. Investors' resulting ignorance about their managers' value proposition leaves managers vulnerable to misunderstanding that can lead to termination.

Investors lose focus on fees once managers are hired. We were surprised how many investors we interviewed were unsure of the details about the fees they are paying their managers. This could leave the manager vulnerable should the investor revisit the topic of fees down the road and not fully understand what they are paying for.

Shine light on your value proposition. We strongly recommend asset managers be proactive with investors by holding an annual discussion on their value proposition. This discussion should detail all the services the manager has provided beyond investment returns.

The largest allocators negotiate fees the most. Almost half of large funds say they "always" negotiate fees. Investors who negotiate fees get a 10–15% discount, so set your initial price accordingly.

"On approximately what percentage of your total plan AUM do you pay performance fees?"

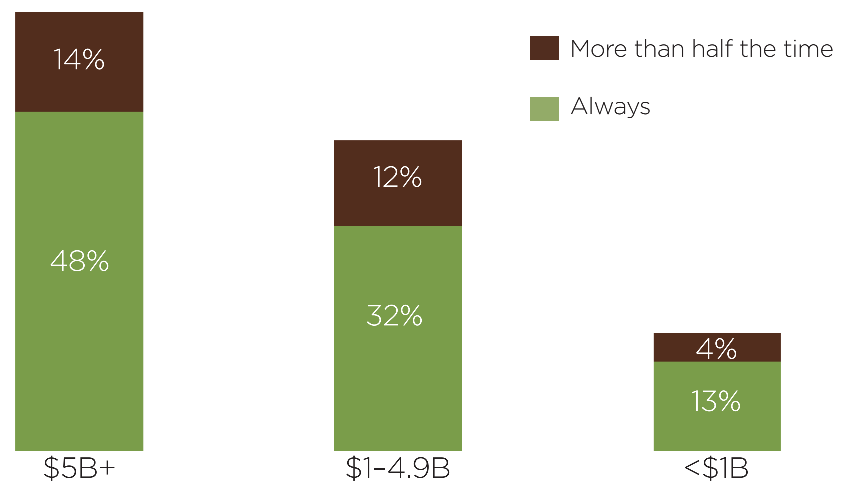
"Not sure."
- *Corporate DB Sponsor*

"That's a hard one."
- *Endowment Manager*

"I don't know the specifics on this."
- *Government Sponsor*

"I don't know; it might be in our annual report."
- *Government Sponsor*

Frequency of Price Negotiation in Hiring an Asset Manager
by Value of Funds Managed



Best Practices Around Fees According to Allocators

We recently asked over 70 institutional investors how informed they were about the fees they pay asset managers and what role (if any) fees play in their decision-making process. What we learned is that most investors don't focus on fees post-hiring and most asset managers drop the topic once hired – leaving the asset manager vulnerable.

Asset Managers Don't Talk About Fees — But They Should

Once managers are hired, most investors don't focus on fees – to the point that many investors we spoke with weren't even sure what their general fee level or structure was for most of their managers. This ignorance about the fees investors pay is compounded by the fact that most asset managers do not regularly talk about fees with their clients once hired.

While this reticence to directly address such a hot topic is emotionally understandable, from a business point of view it leaves the asset manager vulnerable. Without guidance, an investor can start looking into fees in a light that may make an asset manager look bad. This lack of communication also leaves the investor vulnerable to a sudden scramble for information.

It's up to each asset manager to explain their value proposition to investors. We recommend asset managers have this discussion at least once a year with each client. (See our *Elements of a Great Value Proposition Discussion,* opposite)

Value Perception Becomes Reality in the Absence of a Conversation

We found some interesting results in our survey showing that investors are coming to their own conclusions about the value proposition they are receiving from their asset managers. For instance, investors are ambivalent about the efficacy of the performance fees they pay. Although 69% of respondents believe their asset managers who are receiving performance fees outperform those who don't, almost

Elements of a Great Value Proposition Discussion

1) **Remind investors the role your product plays in their portfolio**. Provide data to support you're doing what they hired you to do. Such as:
   - Current income
   - Portfolio diversification
   - Low volatility

2) **Compile all the client service elements you've provided** over the past 12 months, such as:
   - Board presentations
   - PM calls and meetings
   - In-person meetings
   - RFIs
   - Site visits

3) **Remind the investor who is on your team** to provide client service. Include:
   - Names
   - Number of people
   - Experience

4) **Compare what the client is currently paying to a flat fee structure,** especially if you negotiated base fee + performance fee structure

5) **ASK your client what else you can be doing to meet their needs.**

half of all respondents also believe those managers are taking excess risk to deliver performance that triggers those fees. This is exactly the type of potentially dangerous perception that an active dialogue between the asset manager and the investor can address.

Since asset managers often agree to discount their base fee by negotiating an offsetting performance fee, we asked investors whether they believe they end up paying less 'all-in' with the two fee system. The results were evenly split, with about half saying the two fees saved them money, and half saying it didn't. This type of situation is a prime opportunity for the asset manager to circle back to their client and explain how the arrangement has served the client's interest by collectively aligning both the client and the manager's interests, while saving fees during periods of underperformance.

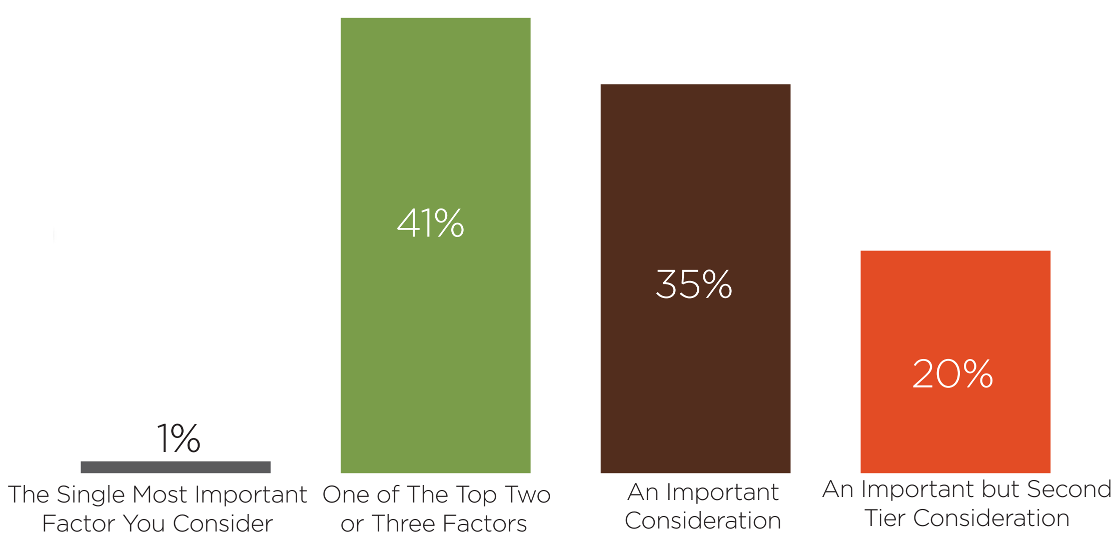
Only 42% of all respondents placed fees among the top three factors in manager selection.

Fees Are Not of Singular Importance in Manager Selection

Hardly anyone we surveyed claims fees are the most important variable when hiring an asset manager. Only 42% of all respondents placed fees among the top three factors in manager selection. Twenty percent put fees even further down the list at the level of a second-tier consideration. Among all respondents, only a quarter said they take fees into account at all during the initial screening process.

Among the different types of investors we spoke with, DC plan sponsors were by far the most price sensitive. Two-thirds of DC respondents ranked price as a top three factor in their hiring decisions. Given the visibility of fees in that space, this answer makes sense to us. DC managers also bring fees into the equation earlier than other managers, with 73% focusing on pricing during their initial screen or the initial interview process, versus an industry average of slightly less than half. Endowments, foundations and government plans are least focused on price in their hiring decisions.

Price as a Factor in Hiring an Asset Manager



Fees Are Negotiable — Everyone Loves a Sale...

The most consistent fee negotiators are government plans and the largest funds. Asked how often fees are negotiated when hiring a new manager, 50% of government funds and 48% of the larger funds (over $5bn) said "always." One government fund manager told us: 'We're [one of the largest funds] in the US, so we throw our weight around."

The ability to negotiate fees seems, not surprisingly, plan-size dependent, with smaller plans negotiating far less frequently - only 13% of the under $1 billion in AUM funds said they "always" negotiate. As most-favored-nation clauses have become more widespread, investors feel less pressure to pursue the best individual deal.

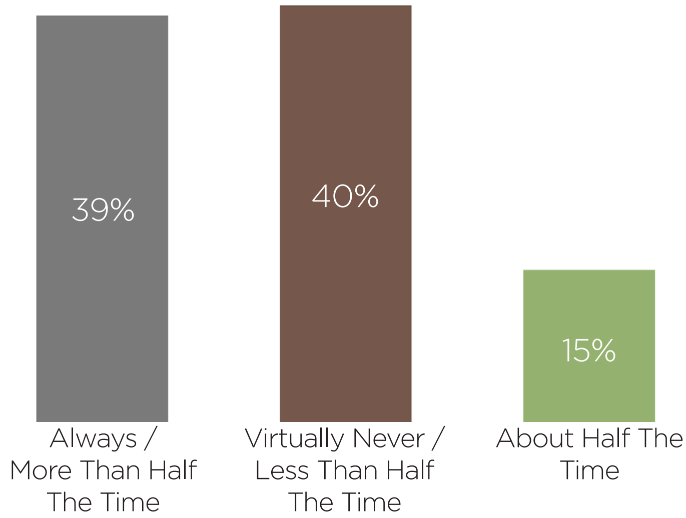
Investors who negotiate are getting increasingly savvy, playing large asset managers with multiple product offerings against themselves to help investors get the fees they want. As one corporate DC manager told us: "I have found that you need to be more proactive on this front to ensure they [the asset managers] retain the business they already have with us."

Investors who negotiate fees generally secure a 10%-15% discount, though some get over 20% off the initial price quote.

...But Not Everyone Negotiates

Almost a quarter of respondents say they "virtually never" negotiate on fees. Endowments and foundations are the least likely to negotiate, followed by family offices. As these types of investors generally manage smaller funds, this result is not surprising.

Frequency of Price Negotiation in Hiring an Asset Manager: All Respondents



Fee Outlook: Hedge Fund Fees Heading Down Gradually, Other Categories Largely Flat

Almost across the board by plan type and size, sponsors believe four to one that fees are more likely to fall than rise, although the decline will likely be a gradual one. Survey respondents have the highest conviction that fees will remain unchanged for long-only equity and fixed income managers, with over 60% of respondents calling for flat base fees in both categories over the next twelve months. While more investors see downside pressure on hedge fund and private equity fees over the next year, the conviction level is not high. For instance, only 41% of respondents expect hedge fund base fees to decrease over the next year, and only 34% expect lower performance fees.

We take this to mean that fee pressure from investors will continue at a moderate level.

Conclusion:
Best Practices Around Fees for Asset Managers

We recommend you address fees with investors head on. Explain your value proposition to them not only from the start, but on an ongoing basis to remind them why they hired you in the first place. See *Elements of a Great Value Proposition Discussion* on pg. 2 for the type of discussion we recommend.

Recommended Action Steps for Asset Managers

Best Practices in Fee Discussions

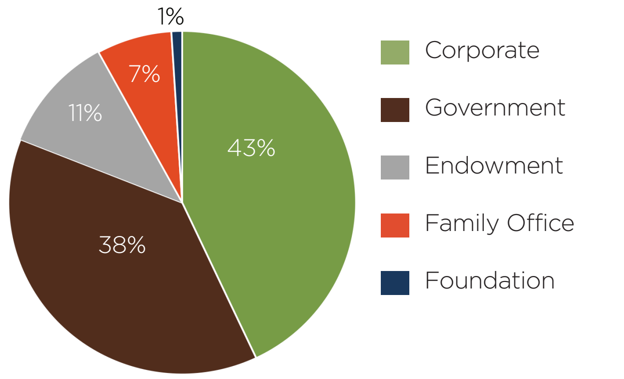
Have an annual discussion about your value proposition with every client.	Once a manager has been hired, most investors quickly forget everything about the fee structure, a situation that makes the asset manager vulnerable. Managers who foster a good understanding of the full value proposition they deliver to their clients will stand out positively against their peers. An informed client is much more likely to remain a long-term client.
Sharpen your pencil when looking for DC assets.	Our research shows that DC plans are by far the most price sensitive segment of institutional investors. When designing a product for that market or taking an existing product to them, it is especially important to have a strong rationale for your price level.
Hedge funds should prepare for continued downward price pressure.	While our research implies this pressure will be gradual, managers who get ahead of this trend in some way are likely to be best positioned. Depending on your market position and growth plans, this may imply that a modest proactive discount, such as offering a limited-time founders' class price level, will be a successful approach.

Methodology

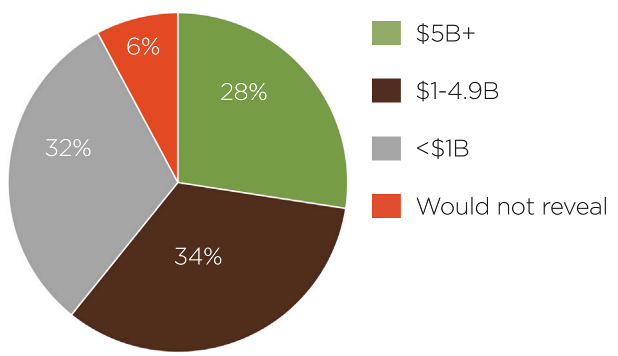
The data referenced in this article is based on a research study conducted by Chestnut Advisory Group. We conducted in-depth phone interviews among 74 institutional investors.

Allocator Respondent Data

Respondent Type



Value of Funds Managed



Years Experience