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PORTFOLIO

Where Performance Fees Don't Work

Researchers from systematic investment firm Dimensional Fund Advisors and MIT make the case against performance fees for factor-based strategies.

Amy Whyte

Paying fees tied to performance could have “unintended consequences” for investors in certain types of strategies, according to researchers from Dimensional Fund Advisors and Massachusetts Institute of Technology.

Such performance fees are often pitched as a solution to the mismatched goals of asset managers and their asset owner clients: They incentivize higher returns and help ensure that allocators pay fewer fees — or even none at all — when their investments underperform.

Historically, these fee structures have been used in alternative investments like hedge funds and private equity. But recent years have seen a push to adopt performance fees for other investments, including more traditional long-only strategies, observed Dimensional researchers Wei Dai and Savina Rizova and MIT finance professor Robert Merton, in a paper they co-authored this month.

“As asset owners contemplate implementing performance-based fee structures across a broader group of managers, it is critical that the resulting implications and tradeoffs are well understood,” they said in the paper. “A fee structure that may be sensible for one type of manager may be less appropriate for another. Indeed, a fee structure that might work well for managers trying to outguess the market might not work well for managers that seek to outperform by using a systematic (factor-based) approach.”

Dimensional is a provider of systematic investment funds. In the paper, the Dimensional researchers and their MIT co-author argue that such strategies are better suited to fixed-fee compensation structures, based on a framework they created to compare costs and analyze how fees impact manager behavior.

Performance fees, they found, can incentivize higher volatility, as well as further deviation from benchmarks — something that could have negative consequences for factor-based strategies, according to Dai, Merton, and Rizova.

“For systematic managers, using more variables to define and



Illustration by II

target a premium can lead to more deviation from the market or factor benchmark,” they wrote. But “adding those variables can introduce more noise into the investment process, impose unnecessary constraints on the portfolio, and increase turnover and costs.”

In addition, they argued that performance fees might motivate systematic managers to avoid factors that are underperforming, as the value factor has over the last decade.

“A performance fee structure in that situation would have left the systematic deep-value managers with very low revenue despite their ongoing efforts and costs, failing to account for the fact that their underperformance was not driven by bad investment decisions but by the underperformance of the premium they were systematically pursuing,” the authors wrote. “Hence performance fees could incentivize systematic managers to derail from their stated mandate.”

While the authors concluded that performance-based fee structures could have negative impacts on systematic managers, they found that other long-only managers, including traditional stock pickers, could benefit from incentive fees.

“Traditional stock pickers tend to run concentrated portfolios with a higher volatility and tracking error,” they wrote. “In those cases, since the value added comes from making bets on individual stocks or market movements, it might make sense to reward correct decisions and make minimal payment if the manager fails to deliver.”

Robert Merton provides consulting services to Dimensional Fund Advisors LP in his capacity as Resident Scientist of Dimensional Holdings Inc.

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