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The mavericks disrupting funds management titans

Eternal Growth Partners portfolio manager Tony Hansen has a plan to ensure he will not take undue risks to earn performance fees. **Brook Mitchell**

by **James Frost**

Bobby Axelrod, billionaire founder of Axe Capital, sounded a warning for fund managers everywhere in February when he said that the model that had delivered him and his staff vast wealth was broken and would not survive.

Axelrod said the "shitty returns" produced by the industry had led to an outflow of institutional money and new competitors would chip away at their market share until the industry changed the way it did business.

Axelrod is a character from the Showtime series *Billions* and the speech is from the new season which started two weeks ago and airs locally on video streaming site Stan. While Axelrod and Axe Capital are works of fiction, the pressures on the funds management industry are not.

According to a report from S&P Dow Jones Indices released this week, Australian fund managers delivered the worst performances last year since the ratings agency began the report in 2009.

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Fundies hail a special CAB

Fund managers are typically well compensated even if they fail to perform. **Supplied**

Only 24 per cent of large cap Australian equity funds beat their respective benchmarks in 2017, while only 14 per cent of large cap International equity managers were able to the same.

Even the mid and small cap managers – who typically do much better – struggled, with only 18 per cent beating the benchmark.

There is no telling whether calendar 2017 will prove to be the tipping point for investors who are sick and tired of paying for underperformance. Fees charged by fund managers have long been a source of contention with investors.

But at least some of those investors are doing something about it, using their scale to force change upon the industry. For smaller investors, alternatives to entrenched fee models are also emerging.

Falling by the wayside

"The hedge fund industry is under siege. We deserve it. We've acted as if it would go on forever," Bobby Axelrod.

From the 5 per cent loading fees charged in the 1950s and 1960s to the "two and 20" model charged by hedge funds in the pre-GFC glory days – 2 per cent management fee and a 20 per cent outperformance fee – all manner of fees have been tried on.

While the above examples have mostly been eliminated, the small annual management fee of between 50 and 150 basis points a year has survived and is charged by the vast majority of funds – even when they lose money.

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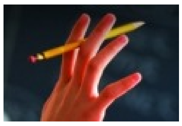

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Some say that the days of charging management fees based on a percentage of assets are over.

They range from maverick stock pickers running just a couple of million to powerful asset consultants who act as gatekeepers for the billions of dollars in superannuation.

"As the big funds internalise we have a lot of managers asking what this means for my business, and guess what, it might mean you don't have a business," Trafford Walker says. **Michael Clayton-Jones**

Fiona Trafford-Walker is a director of consulting at Frontier Advisers, which provides institutions with recommendations on where and how to invest. Frontier's clients manage $235 billion collectively.

She has railed against management fees for several years now and says they should be a flat dollar figure. Trafford-Walker argues the difference between managing $1 billion and $2 billion is negligible and the fees should reflect that.

"They ought to be $200,000 or $500,000, and then the manager could be rewarded with a performance fee. The problem is that the base fees can be enormous. We want fund managers to be viable but they have to take some risk," she says.

Managers' struggles

Massive industry super funds are squeezing many managers on fees. **James Davies**

While Bobby Axelrod is under siege from regulators and quant funds, domestic fund managers are being crunched by the forces of scale. As industry super fund balances swell, funds have been able to negotiate sharper deals with fund managers.

Others, such as the $100 billion AustralianSuper behemoth have been stripping funds of mandates and choosing to run the money in house instead. This trend has removed a large pool of money from the funds management eco-system.

"As the big funds internalise we have a lot of managers asking what this means for my business, and guess what, it might mean you don't have a business," Trafford Walker says.

"Managers who can be innovative with their fee structures have a better chance of keeping their mandates. By innovative, we mean that in some cases they might even give money back when they lose money."

Fund manager Allan Gray is one of the few to innovate with fee structures. **Brook Mitchell**

Allan Gray is a well known Australian deep value or contrarian fund manager. One of the fee structures it offers clients is a zero management fee and 35 per cent of outperformance above the benchmark S&P/ASX 300 Accumulation Index.

According to the Mercer tables to January 31, Allan Gray's flagship was Australia's best performing fund with a 46.5 per cent return. Over three years it was the fourth best performing fund and over five years it was the fifth best.

At the smaller end of the stock-picking universe, a small band of outsiders are looking to shake things up. Eternal Growth Partners, Castlereagh Equity and Collins St Value are three firms which have also done away with management fees.

About 10 years ago Eternal Growth Partners (EGP) portfolio manager Tony Hansen was looking for a fund that charged little or no management fee and where the portfolio manager's own capital was invested alongside their investors.

He couldn't find a fund that met his criteria – so he started his own.

Hansen charges zero management fee and 20 per cent above the S&P/ASX 200 franking credit adjusted annual total return index (tax exempt) which includes the benefits of franking.

"You actually start around 1.4 to 1.5 per cent behind on day one when they add the franking, so people think I'm an idiot. But I think it's the most intellectually honest way of doing it," Hansen says.

EGP has beaten the benchmark by 10.71 per cent since inception on April 2011.

Industry veteran Chris Cuffe is another supporter prepared to put his own capital on the line. **Pat Scala**

"I honestly believe that over the next 20 years the industry will follow this model, maybe not mine which is a little bit insane, but pay a fee of 20 bps or whatever it takes to keep the lights on, with a fee for performance making up the rest."

'An admirable concept'

Hansen has all of his personal wealth outside the family home invested in the fund. He says this ensures that he will not be encouraged to take undue risks to earn performance fees.

"I know a few examples where people manage their client's money one way and do something else with theirs. I think that's morally reprehensible."

Hansen might sound like a renegade but he has chalked up some early wins.

While the majority of the money has come from family, friends and acquaintances, one of those investors is Chris Cuffe, former chief executive of Colonial First State and chairman of the $55 billion industry fund UniSuper.

Cuffe says that EGP has a good track record and the concept is sound.

"As an investor I know that he only does well when the fund does well. Tony walks the talk, he doesn't get to eat unless it performs. It's an admirable concept," he says.

But not everybody is convinced that zero management fee funds are the way forward.

Mercer's Claire Armstrong says that while they look good on paper the lumpy nature of earnings would lead her to question whether corners were being cut.

"Our clients are prepared to discuss all manner of fee structures for their portfolios. They are looking to deliver good performance for their investors at the best possible cost, however, none of our clients currently have performance-only structures in place."

'The devil is in the detail'

That scepticism, however, hasn't stopped players such as Peter Phan of Castlereagh Equity from striking out with the model. Phan charges his investors 25 per cent of returns above 6 per cent with any shortfalls carried forward.

He says he got the idea from Warren Buffett, who employed a similar model before he started Berkshire Hathaway.

He was inspired to put it into practise when he realised a family member was being charged an annual platform fee of one per cent on top of the management fees charged by the underlying funds.

"It was a no-brainer," Phan says. "If I don't do well I don't get paid. Six per cent is the expected long-term return from passive investing so to justify our existence we have to beat that hurdle."

Further south in Melbourne, the Collins St Value Fund operated by Vas Piperoglou and Michael Goldberg is also seeking to do away with management fees. They see the structure as ensuring they remain accountable to clients.

The founders say they got the idea after managing private client money during the GFC where they felt uncomfortable charging fees for returns that were above the benchmark but still in the red.

Their new fund is up 25.85 per cent since inception on February 5, 2016.

"The question isn't so much for us – can we make money at all after paying for operations – but rather how lumpy will it be?" portfolio manager and co-founder Michael Goldberg says.

The fund charges a management fee of 25 per cent of performance above the 10-year Australian Government Bond rate and a buy-sell spread of 50 basis points.

The team Collins St Value say that while the hurdle appears low it will get harder as yields rise and that the higher buy-sell spread reflects the cost of doing business.

Willis Towers Watson asset consultant Ben Griffiths is another consultant that has suspicions about the inherent volatility in the model. He cautions any potential investor to do careful due diligence before investing.

"You often find that the devil is in the detail with these things."

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