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FULCRUM FEES

Leveling the Playing Field between Active and Passive Management

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Though 2017 was a better year for active asset managers relative to the previous few, most are viewing the improved sales environment as a brief reprieve from the onslaught of competitive pressure from passive management. As passively managed exchange-traded funds (ETFs) and index funds continue to chip away at active market share, many active managers are concluding that a more permanent competitive stance is needed if the industry is to sustain itself. Consequently, some managers are turning to performance-based, or fulcrum, fees as a potential solution to help balance the competitive scales.

Fulcrum fees are a type of performance-based fee structure through which a mutual fund's management fee increases or decreases in proportion to the investment performance of the fund over a specified period in relation to a specified index of securities. Despite their long history, fulcrum fees have been used only minimally and are not widely discussed in the mutual fund industry—that is until recently.

This article evaluates the past and potential future positioning of fulcrum fee funds. Along with a look at the history of performance-based fees in the industry, it reviews how an emerging crop of new fulcrum fee funds differ from their predecessors. Many of the arguments for and against the expanded use of fulcrum fees in mutual funds are also discussed.

LOOKING BACK TO SEE FORWARD

Through an exemption to Section 205 of the Investment Advisers Act of 1940, contracts with registered investment companies were permitted to charge incentive-based fees, but little guidance was provided on how those fees should be structured and applied. As a result, when certain provisions of the Act were revisited for the Investment Company Amendments Act of 1970, more specific requirements were laid out for mutual funds that would require them to apply a fulcrum structure. Under a fulcrum structure, incentive fees adjust symmetrically, moving up or down based on outperformance or underperformance relative to the investment record of a specified index over a specified period, with the fulcrum being the point at which the investment performance of the fund and the index are equal.

The U.S. Securities and Exchange Commission (SEC) followed up with a survey in 1972, which showed that many existing performance-fee contracts were not fulcrum structures and were weighted in favor of the fund's advisor. This led the regulator to adopt Rules 205-1 and 205-2, which outlined the following requirements:

All cash contributions must be considered in measuring performance of the fund and the index. To facilitate an apples-to-apples performance comparison, the fund's investment performance must be calculated as the percentage change in net asset value per share over the specified period and adjusted to reflect an assumed reinvestment of any realized capital gains, capital gains taxes per share paid or payable on undistributed realized capital gains, and any dividends paid by the fund. Meanwhile, the investment record of the chosen index must be calculated as the percentage change in the level of the index over the specified period, adjusted to reflect an assumed reinvestment of all cash distributions of the companies whose stocks make up the index.

The specified period over which the fund's net asset value is averaged in determining the base fee must be identical to the period used to compute the investment performance of the fund and the investment record of the index. However, an exemption for arrangements using a moving average or "rolling period" to calculate the advisory fee was included. Although the SEC did not require the use of rolling periods, the practice was recommended to help ensure that fees were related to current fund assets (base fee) and to the assets in which the performance was achieved (performance adjustment).

The SEC also provided further guidance with regard to the chosen index, suggesting that volatility, diversification of holdings, types of securities owned, and objectives of the fund be considered. Additionally, though no specific measurement period was mandated, the regulator advocated choosing a period long enough to minimize the possibility that payments would be based on random or short-term fluctuations, because too short a period (i.e., less than one year) could be influenced heavily by fund sales.

Some firms did implement fulcrum fee contracts. The active mutual fund industry was embarking on a long period of exponential growth, however, and fund managers found little incentive to introduce portfolios that contained this element of uncertainty. In addition, despite the guidance provided by the SEC in the early 1970s, the complexity of these fee structures became apparent in the mid-2000s, when a handful of firms were fined for entering into performance-fee contracts that were in violation of Rule 205. In most cases, they were incorrectly calculating the fees by not basing them on average fund assets over the entire period. Given the limited incentive to launch performance-based funds, combined with the operational challenges they presented, few firms pursued this pricing approach.

NOT YOUR FATHER'S FULCRUM FEE

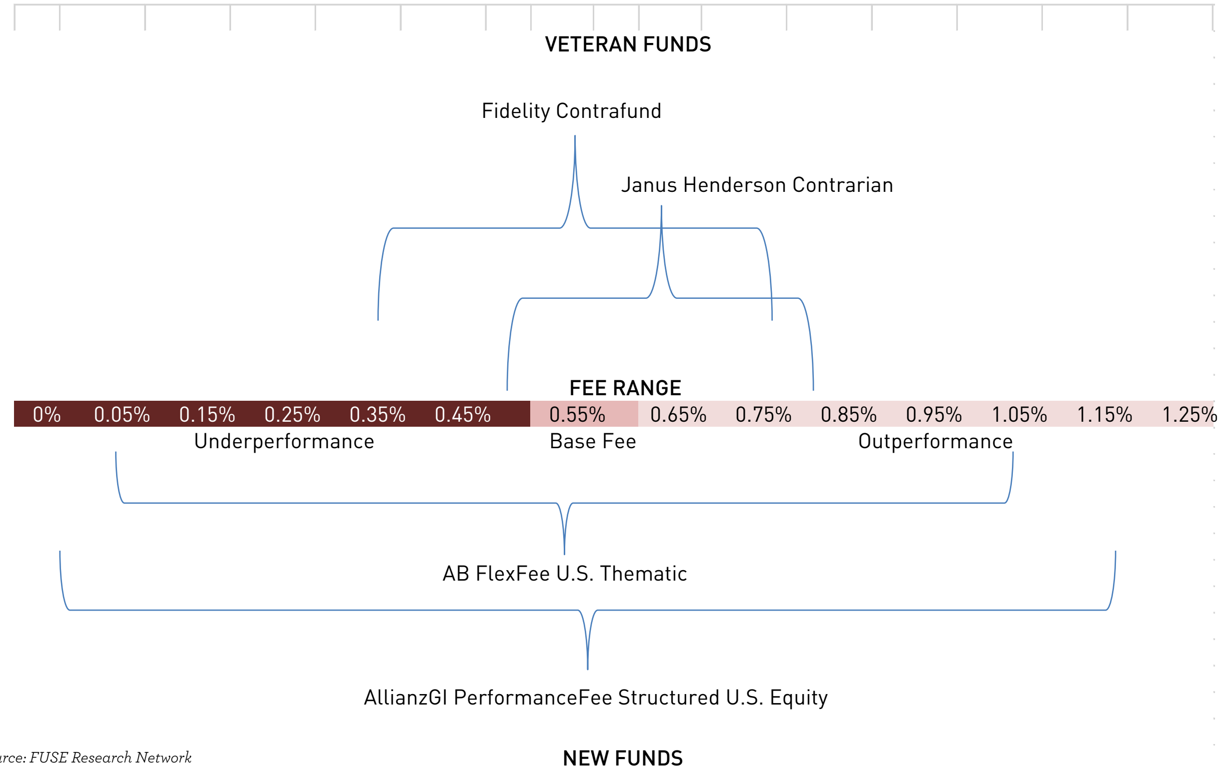
To date, fulcrum fee funds have represented a very small fraction of funds (less than 3 percent), but a notably higher percentage of fund assets (7 percent) given that Fidelity and Vanguard are among the firms utilizing them. Perhaps more interesting, though, is that performance fees have never really been marketed as a differentiator, despite the revenue risk incurred by the asset manager.

Part of the reason performance fee funds have received so little exposure likely has to do with the fact that it can't be proven that they offer the benefit of superior performance. Studies have been done comparing performance fee funds to their flat-fee counterparts, but results have varied. Moreover, with so few firms offering them (Fidelity accounts for more than half of performance fee mutual fund assets), it's difficult to argue that performance differences are due to the fees versus some other factor.

Fast forward 45 years after the SEC provided clarification on how open-end mutual funds can apply performance fees, and the active management industry may now be looking to the structure as a partial solution to its chief marketing problem—how to compete with passive management. Rather than trying to establish a performance case for why investors should choose these funds, firms are focusing on the cost-savings aspect of the structure. In 2017, AB and Allianz Global Investors, two active management companies, introduced performance fee funds. However, unlike predecessor funds, the portfolios from these firms feature wider fee ranges for performance differences relative to the specified index (see figure 1).

Of the mutual fund managers that have utilized performance fees in the past, most applied a relatively conservative fee range that was calculated over a lengthy time period. For instance, as shown in table 1, among veteran funds, performance adjustments fluctuate from

Figure 1 PERFORMANCE FEE RANGES FOR SELECT FULCRUM FEE FUNDS BENCHMARKED TO THE S&P 500



Source: FUSE Research Network

Table 1

COMPARING VETERAN FULCRUM FEE FUNDS WITH THE NEWCOMERS

(A) VETERAN FULCRUM FEE FUNDS

Fund Name	Base Fee*	Fee Range	Index	Period	Adjustment Methodology
Fidelity Contrafund	0.55%	±0.20%	S&P 500	Rolling 36-month period	Adjusts 2 bps for each 1 percentage point of over/underperformance relative to the index, reaching the maximum/minimum fee for over/underperformance of 10.00%.
Fidelity Magellan	0.55%	±0.20%	S&P 500	Rolling 36-month period	Adjusts 2 bps for each 1 percentage point of over/underperformance relative to the index, reaching the maximum/minimum fee for over/underperformance of 10.00%.
Fidelity Low-Priced Stock	0.59%	±0.20%	Russell 2000	Rolling 36-month period	Adjusts 2 bps for each 1 percentage point of over/underperformance relative to the index, reaching the maximum/minimum fee for over/underperformance of 10.00%.
Janus Henderson Research	0.64%	±0.15%	Russell 1000 Growth Index	Rolling 36-month period	Adjusts in even increments for every 50 bps of over/underperformance, reaching the maximum/minimum fee for over/underperformance of 5.00% relative to the index.
Janus Henderson Contrarian	0.64%	±0.15%	S&P 500	Rolling 36-month period	Adjusts in even increments for every 50 bps of over/underperformance, reaching the maximum/minimum fee for over/underperformance of 7.00% relative to the index.
Janus Henderson Emerging Markets	1.00%	±0.15%	MSCI Emerging Markets Index	Rolling 36-month period	Adjusts in even increments for every 50 bps of over/underperformance, reaching the maximum/minimum fee for over/underperformance of 6.00% relative to the index.
USAA Capital Growth	0.75%	±0.04–0.06%	Lipper Global Fund Index	Rolling 36-month period	Adjusts 4 bps for performance that exceeds/trails the index by 1.00%–4.00%, 5 bps for 4.01%–7.00%, and 6 bps for 7.01%+.
Putnam Global Equity	0.85%	±0.15%	MSCI World Index	Rolling 36-month period	Multiplies 0.03 by the difference in performance between the benchmark index and the portfolio.
Putnam International Capital Opportunities	1.08%	±0.21%	S&P Developed Ex-US Small Cap Index	Rolling 36-month period	Multiplies 0.03 by the difference in performance between the benchmark index and the portfolio.

** Base fees, which are calculated based on current assets, may be adjusted due to factors such as breakpoint schedules.*

† First performance period is from inception date through December 31, 2018. The advisor has contractually agreed to waive fees and/or to bear expenses of the fund through December 31, 2018, to the extent necessary to prevent total other expenses from exceeding 0.05 percent of average daily net assets.

‡ First performance period is from inception date through December 31, 2018. The advisor has contractually agreed to waive fees and/or to bear expenses of the fund through December 31, 2018, to the extent necessary to prevent total other expenses from exceeding 0.10 percent of average daily net assets.

§ During the funds' initial performance period (inception through December 31, 2018), the manager has also agreed to waive its management fee in an amount equal to any negative performance adjustment that would otherwise have applied had the funds' performance-based fee arrangement been in effect during such period. As a result of this arrangement, each fund's effective fee with respect to the initial performance period may be no higher than the base fee, but it is subject to downward adjustment in the event the fund underperforms its index hurdle for the initial performance period.

Source: FUSE Research review of most recent Statements of Additional Information

(B) NEW FULCRUM FEE FUNDS					
Fund Name	**Base Fee**	**Fee Range**	**Index**	**Period**	**Adjustment Methodology**
AB FlexFee Large Cap Growth	0.55%	±0.50%	Russell 1000 Growth Index	12-month calendar year†	Adjusts 0.00357% of the fund's average daily net assets for each 0.01% of absolute performance by which the performance of the measuring class exceeds or lags the index plus 1.40% for the period, reaching the maximum/minimum fee for out/underperformance of 2.80% relative to the index.
AB FlexFee U.S. Thematic	0.55%	±0.50%	S&P 500	12-month calendar year†	Adjusts 0.00357% of the fund's average daily net assets for each 0.01% of absolute performance by which the performance of the measuring class exceeds or lags the index plus 1.40% for the period, reaching the maximum/minimum fee for out/underperformance of 2.80% relative to the index.
AB FlexFee Core Opportunities	0.55%	±0.50%	S&P 500	12-month calendar year†	Adjusts 0.00357% of the fund's average daily net assets for each 0.01% of absolute performance by which the performance of the measuring class exceeds or lags the index plus 1.40% for the period, reaching the maximum/minimum fee for out/underperformance of 2.80% relative to the index.
AB FlexFee International Bond	0.40%	±0.30%	Bloomberg Barclays Global Aggregate ex-USD (USD Hedged) Index	12-month calendar year‡	Adjusts 0.00429% of the fund's average daily net assets for each 0.01% of absolute performance by which the performance of the measuring class exceeds or lags the index plus 0.70% for the period, reaching the maximum/minimum fee for out/underperformance of 1.40% relative to the index.
AB FlexFee International Strategic Core	0.55%	±0.50%	MSCI EAFE Index (Net, USD, Unhedged)	12-month calendar year‡	Adjusts 0.00357% of the fund's average daily net assets for each 0.01% of absolute performance by which the performance of the measuring class exceeds or lags the index plus 1.40% for the period, reaching the maximum/minimum fee for out/underperformance of 2.80% relative to the index.
AB FlexFee Emerging Markets Growth	0.75%	±0.70%	MSCI Emerging Markets Index (Net, USD, Unhedged)	12-month calendar year‡	Adjusts 0.004% of the fund's average daily net assets for each 0.01% of absolute performance by which the performance of the measuring class exceeds or lags the index plus 1.75% for the period, reaching the maximum/minimum fee for out/underperformance of 3.50% relative to the index.
AllianzGI PerformanceFee Structured US Equity	0.60%	±0.60%	S&P 500	Rolling 12-month period (following initial performance period ending December 31, 2018)§	Adjusts 0.0048% for each 0.01% by which the fund's investment performance for the performance period exceeds or lags the performance of the index plus 1.25%.
AllianzGI PerformanceFee Managed Futures Strategy	0.75%	±0.75%	ICE BofAML 3-Month U.S. Treasury Bill Index	Rolling 12-month period (following initial performance period ending December 31, 2018)§	Adjusts 0.0015% for each 0.01% by which the fund's investment performance for the performance period exceeds or lags the performance of the index plus 5.00%.
AllianzGI PerformanceFee Structured US Fixed Income	0.30%	±0.30%	Bloomberg Barclays U.S. Aggregate Bond Index	Rolling 12-month period (following initial performance period ending December 31, 2018)§	Adjusts 0.0048% for each 0.01% by which the fund's investment performance for the performance period exceeds or lags the performance of the index plus 0.625%.

the base fee by a maximum of only 15 to 20 basis points (bps). In contrast, the recently launched funds from AB and Allianz Global Investors apply a 50-bps or greater performance adjustment. The result? An older fund might have reduced the management fee from 55 bps to 35 bps due to underperformance, but the new funds reduce it to just 5 bps or less, a level that their providers point out is on par with a passive option covering the same index.

Additionally, older funds typically have used a 36-month rolling period to calculate performance relative to the specified index. Fees for the new funds from AB and Allianz are based on a 12-month period. Some might argue that 12 months is too brief to definitively overcome short-term factors that could affect performance. But from an evaluation standpoint, it is easier for advisors and investors to reconcile the fee change with the performance they have most recently experienced.

In the past, firms have structured their performance fees differently, and understanding exactly how they were calculated often required digging through regulatory documents. By comparison, the structure of the new funds is relatively straightforward. Among the AB FlexFee funds, for performance that does not exceed the index return plus the hurdle rate (e.g., return of the S&P 500 Index plus 1.40 percent for the FlexFee Core Opportunities Fund), the fund's management fee declines incrementally along with underperformance until reaching a low, index-like management fee (e.g., 0.05 percent for FlexFee Core Opportunities). On the other hand, if the fund surpasses the index return plus the hurdle rate, fees grow incrementally along with outperformance until reaching a maximum specified rate (e.g., 1.05 percent for FlexFee Core Opportunities) for performance that meets or exceeds a specified threshold (e.g., S&P 500 Index return plus 2.80 percent for FlexFee Core Opportunities). As an added incentive, for the initial performance period through December 31, 2018, AB is charging only the index-like fee (e.g., 0.05 percent).

The Allianz Global funds follow a similar structure. For performance that does not exceed the index plus the hurdle rate, the funds' management fees incrementally decline, reaching 0.00 percent at a specified level of underperformance. Meanwhile, for performance that surpasses the index plus the hurdle rate, fees incrementally increase until reaching a maximum rate. During the first year of operation, fees will adjust downward for underperformance of the index, but they will not adjust upward and therefore will not exceed the base fee.

The new funds are structured differently from their older peers, but perhaps the biggest difference lies in their positioning. It's probably a safe bet that a sizable percentage of the investing population doesn't realize that such well-known funds as Vanguard Growth and Income, Fidelity Contrafund, and Fidelity Magellan charge performance-based fees. This fact has never been central to their marketing.

On the other hand, the new funds from AB and Allianz Global Investors lead with this aspect of their design, featuring names that group them together based on pricing structure—the AB FlexFee Funds and the AllianzGI PerformanceFee Funds. Both series are new, and it's likely that educating advisors and investors about the pricing structure will be a key element of their marketing strategies, and the level of advisor acceptance will inform future product development plans. Meanwhile, unlike most new product developers, which typically seek to maintain first-mover advantage for as long as possible, the new providers of fulcrum fee funds are encouraging competitors to join them, in the hope that this trend will help stabilize the active management business.

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EVALUATING THE ARGUMENTS

Though nascent, fulcrum fee funds could be on the precipice of a growth trend. And, as for any emerging trend, industry participants and pundits are aligning themselves on one side or the other. Table 2 highlights some of the key arguments for and against the use of performance-based fees in mutual funds. All these arguments have some validity, but they don't necessarily present the whole story. As such, advisors and investors must realistically assess what a future with fulcrum fees might look like for themselves and their clients.

PROPONENT ARGUMENTS

Better alignment of incentives: On the surface, this argument makes a lot of sense. An asset manager whose revenue and profitability are materially impacted by its ability to outperform is significantly incented to deliver superior performance. However, this assertion relies on the assumption that under a flat fee structure, asset managers are not sufficiently motivated to outperform, and clearly this is not the case for most asset managers. According to Morningstar's 2016 Global Asset Flows Report, funds with 5- and 4-star ratings attracted $161 billion and $143 billion, respectively, in net inflows for the year, and those with three or fewer stars suffered net redemptions (see figure 2).[1] This flow pattern has been generally consistent over the past several years. It supports the idea that relative performance significantly impacts fund flows and asset manager profitability, and it is thus already a key incentive to outperform. In other words, switching to a performance-based fee structure is unlikely to cause an asset manager to put forth greater effort to produce better investment results. That said, timing could prove critical. If the market is due for a correction and if one believes that down markets offer more opportunities for active managers to outperform, then the launch of these funds over the near term could prove fortuitous for some active managers by showcasing their skills and demonstrating their confidence in their ability to outperform.

Level the playing field with passive management: For nearly as long as they've existed, active managers have had to combat the argument that, on average, their offerings equate to paying more and receiving less compared to a style-similar index option. However, instead of trying to overcome this value argument with counterpoints about risk management and empirical evidence showing periods of outperformance (which are becoming harder to come by), the application of fulcrum fees gets to the heart of the matter—that cost should be proportionate to performance. And, unlike past performance-based fee funds, the new fulcrum fee structure (i.e., the new AB and AllianzGI funds), might be compelling enough to make them a viable alternative to passive or competing active options.

Increase portfolio manager accountability: This argument assumes that portfolio managers are not accountable, or only marginally so, for the performance of their funds. In most cases, this is not true. If one subscribes to the idea that the compensation structure goes a long way toward motivating employees to carry out their duties to the best of their abilities, then it can be reasonably inferred that the typical portfolio manager compensation arrangement is sufficiently designed to emphasize performance. According to the most recent annual Asset Management Compensation report by Greenwich Associates and Johnson Associates, among equity mutual fund portfolio managers, individual investment performance accounts for more than half of bonus formulas, and bonuses constitute about half of overall compensation.[2]

Table 2

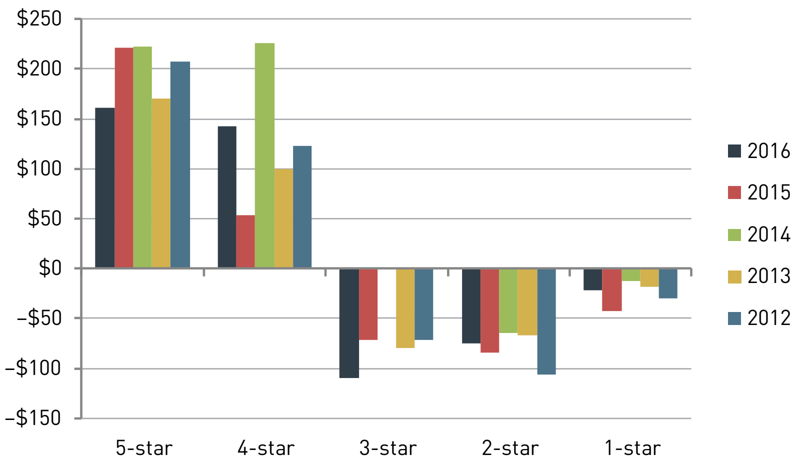
ARGUMENTS FOR AND AGAINST FULCRUM FEE FUNDS

Proponent Arguments	Opponent Arguments
Aligns incentives of managers and investors	Compels managers to take more risks or to deviate from style
Levels the playing field with passive management	Adds complexity, which reduces transparency
Increases portfolio manager accountability	Introduces greater variability to asset manager revenue models

Source: FUSE Research Network

Figure 2

ON AVERAGE ONLY TOP PERFORMERS ENJOY ANNUAL NET INFLOWS ($ IN BILLIONS)



Source: Morningstar Direct US Asset Flows Updates for 2012-2016

OPPONENT ARGUMENTS

Compel managers to take more risk or deviate from style: The concern is that a manager might incur more risk or stray from the portfolio's stated objective in an effort to boost performance relative to the index. For many this might be sufficient reason to steer clear of fulcrum fee funds, but the risk is arguably less now than before the financial crisis. Today, asset managers have more robust risk parameters and stronger oversight procedures in place. Additionally, a growing portion of fund flows can be sourced to models and recommended lists developed by distributor home offices. According to a 2017 survey by WealthManagement.com and FUSE Research Network, the percentage of advisor portfolios influenced by home-office models is expected to increase by 3.3 percent overall and 5.2 percent among wirehouse advisors in 2018.[3] In most cases, obtaining and holding on to these highly valued placements is contingent upon maintaining a consistent investment approach, particularly as it relates to risk.

Add complexity, which reduces transparency: This may be the most salient argument against the use of fulcrum fees, especially given that much of the scrutiny regarding pricing is related to transparency. Fulcrum fees are more complex than flat fees, but the new fulcrum fee funds have simpler structures than their predecessors. Also, the marketing and education strategies of the firms offering them are likely to center around understanding the fee structure and explaining it to clients.

Introduce greater variability to the asset manager's revenue model: For advisors and investors, this can create problems related to service level and consistency if a firm's underperformance leads to insufficient revenue to operate the business. Given this business risk, potential investors should look carefully at the firm in addition to the fund to determine whether it's financially sound enough to endure a period of underperformance and reduced revenue. That said, we believe that the majority of product development in the coming months will be from large firms with sizable flat fee asset bases to support the launch and maintenance of fulcrum fee funds, which are likely to be a cost burden for some time until they reach scale.

So far, industry media coverage has focused mostly on broad generalizations about the advantages and disadvantages that fulcrum fees present. In our view, the potential opportunities and risks they present to investors must be weighed in the context of the current environment and will only be an additional enticement once all other requirements are satisfied, including investment strategy, early performance results, and reputation of the management firm.

THE FUTURE OF FULCRUM FEES

The question of whether fulcrum fee funds will catch on as a product development trend may be answered over the next couple of years and will depend on the success of early adopters of the new structure. In addition, this trend could develop on both sides of the Atlantic. The recent implementation of Markets in Financial Instruments Directive II (MiFID II), with its focus on increasing cost transparency across the financial markets of Europe, is causing firms to adopt pricing structures that demonstrate value for money. One of these structures is fulcrum fees for active management. Fidelity International is leading the charge in this area: It recently implemented fulcrum fees on its actively managed equity funds. Given Fidelity's size and status in the global investment marketplace, other European players likely will follow suit.

The fulcrum fee implementation trend likely will take shape in the near term. However, determining whether these fees are enough to solidify active management's standing in the industry and stem the bleeding to passive options likely will take much longer. Ultimately, it will come down to performance. The significant fee discounts for underperformance may make active management more palatable to some investors and could help with retention during short-term periods of underperformance. But low fees won't be enough to keep investors in the funds in the event of sustained underperformance. The irony is that the most successful users of fulcrum fees will be those firms that rarely have to fulfill the promise upon which they are being marketed—little to no fee for underperformance.

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ENDNOTES

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