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# FULCRUM FEE FUNDS

## The Answer to Active Management's Future?

*By Patrick Newcomb*

INVESTMENTS & WEALTH INSTITUTE®

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Active asset managers face an uncertain future as passive products continue to attract a disproportionate share of flows and ongoing fee pressure chips away at their margins. Although some may find it hard to have sympathy for an industry that has long enjoyed profit margins of 30 percent and more, the current plight of active managers also holds implications for other financial services constituencies, from distributors to clients.

According to a report from PwC,[1] the U.S. mutual and exchange-traded fund (ETF) market is expected to grow 5.6 percent annually from 2018 to 2025, down from an average pace of 8.7 percent each year from 2011 to 2018, and the split between active and passive assets will converge from 64 percent/36 percent in 2018 to 50 percent/50 percent (see figure 1). At the same time, active portfolio total expense ratios will continue to decline from an average of 80 basis points in 2011 to 64 basis points. The result, according to PwC, will be up to a 20-percent decline in the number of management firms, a 14-percent net reduction in the number of products, and a growing concentration of assets in the hands of the five largest managers, from 55 percent in 2018 to 64 percent in 2025.

Active managers are well aware of the deteriorating scenario they face, but given the reverberating effect a change in one segment of the financial services industry can have on the rest, it is worthwhile for distributors and advisors to track how active asset managers are addressing the challenge to stay relevant in a changing marketplace. One of the ways that firms have come up with to boost the credibility of active management is the use of fulcrum fee pricing models, a type of performance-based fee structure through which a mutual fund's management fee increases or decreases in proportion to the fund's level of outperformance or underperformance relative to a benchmark over a specified period of time.

Newcomb (2018) discussed a new crop of fulcrum fee funds that had emerged from AB and AllianzGI that were the first to be marketed around the pricing structure and really moved the needle in terms of what investors pay when the funds underperform or outperform their benchmarks. Since then, we have monitored the industry for new developments related to fulcrum fee funds and have found that, despite a limited supply of products, fulcrum fees are becoming a commonly cited strategy for combating the ill effects of the ongoing migration to passive products and the fee pressure on active managers.

### CHECKING IN WITH FULCRUM FEE FUNDS

Fast-forward 18 months from our initial review of fulcrum fee funds, and the first

Figure 1

**BY THE NUMBERS —ACTIVE FEE PRESSURE WILL REDUCE CHOICE**

U.S. mutual fund and ETF assets grew **8.7%** annually between 2011 and 2018, but are expected to grow only **5.6%** annually between 2018 and 2025.

Though total assets are expected to rise **46%** beween now and 2025, revenues will increase only **10%–15%**.

The split between active and passive assets could reach equilibrium by 2025 from **64%** active ($11.7B)/ **36%** passive ($6.6B) in 2018.

Average weighted total expense ratios for active portfolios will continue to decline, from **80 bps** in 2011 to **64 bps** in 2025.

**Half** of existing funds will disappear by 2025; most will be replaced by new products, but the total number of available products will decrease by **14%** on a net basis.

The five largest managers will control **64%** of assets in 2025, up from **55%** in 2018.

Up to **20%** of firms will be merged away or elminated by 2025.

*Source: "Mutual Fund Outlook: The Time to Act Is Now," PwC, July 2019* question that springs to mind is: How are these funds doing? To determine this, we looked at the returns of the AB FlexFee funds and their benchmarks, as well as the management fee rate paid from inception through December 31, 2018 (see figure 2).

As shown in figure 2, performance and management fees varied widely. For instance, FlexFee Large Cap Growth outperformed its benchmark, the Russell 1000 Index, by 274 basis points over the period, allowing it to collect the full management fee of 1.05 percent, while FlexFee Emerging Markets Growth underperformed its benchmark, the MSCI Emerging Markets Index, by 330 basis points, resulting in the minimum management fee of 5 basis points.

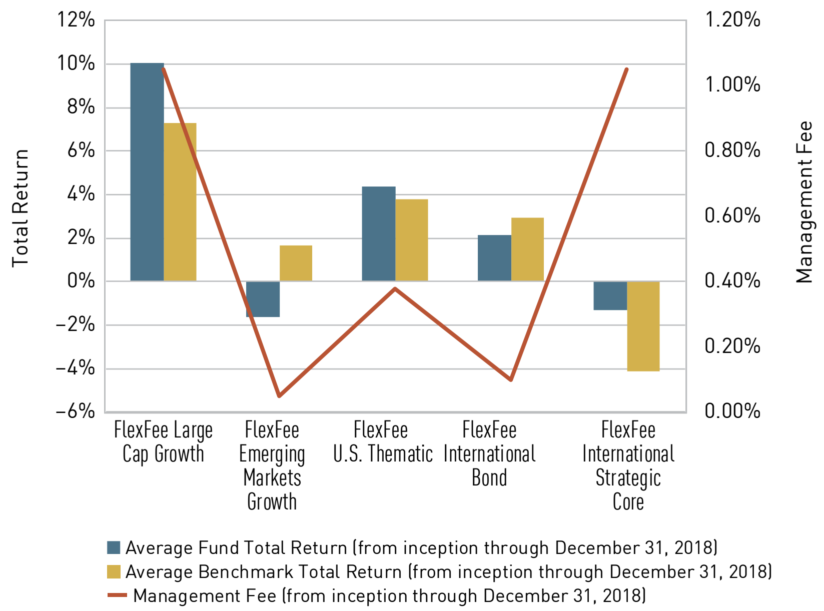
To assess how the funds were performing in 2019, we looked at year-to-date (YTD) performance of the funds and their benchmarks, as well as the net expense ratios through September 30 (due to contractual fee waivers that extend through April 2020, the funds' net expense ratios are nearly equal to their management fees). Over this period, the FlexFee Emerging Markets Growth Fund outperformed the MSCI Emerging Markets Index by 872 basis points, putting the net expense ratio at 1.55 percent as of September 30. On the other hand, FlexFee Large Cap Growth underperformed the Russell 1000 Index by 95 basis points, putting its net expense ratio at 10 basis points (see figure 3). It's likely that AB had hoped to see all of its FlexFee funds significantly outperform their benchmarks on a consistent basis, but in some ways the divergent results are more helpful in promulgating the concept of fulcrum fee pricing in that they illustrate the wide variation in management fees that investors pay for the value (i.e., returns relative to benchmark) they receive.

As with any potentially disruptive trend, the next question is: At what pace is fulcrum fee pricing penetrating the industry, in terms of both product development by asset managers and usage by investors? So far, no other large asset managers have joined AB and AllianzGI in creating a suite of fulcrum fee funds for the retail market. That said, there has been some product development on the margins. For instance, Alger launched the Alger 25 Fund in 2018, a concentrated portfolio with fees that range from a minimum of 30 basis points to a maximum of 80 basis points, which is earned when the portfolio's performance exceeds the S&P 500 Index plus 500 basis points.

Figure 2

## AVERAGE TOTAL RETURNS OF THE AB FLEXFEE FUNDS AND THEIR MANAGEMENT FEES

From inception through December 31, 2018

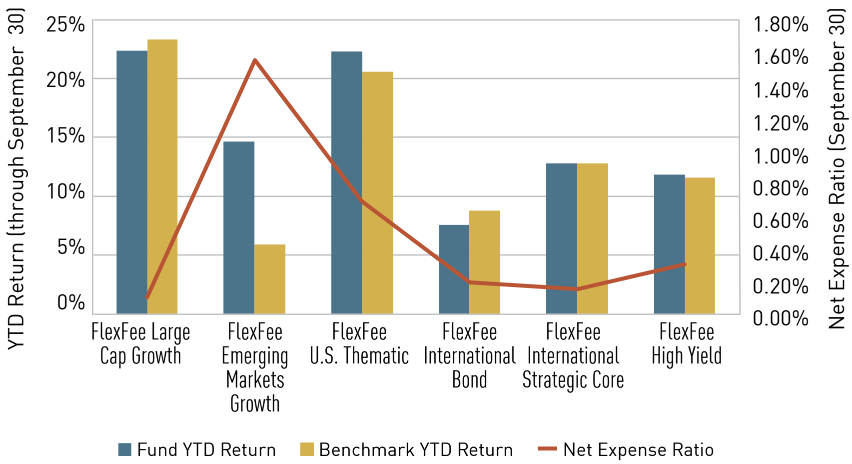



*Source: AB FlexFee fund prospectuses dated April 30, 2019*

Figure 3

## YTD RETURNS OF THE AB FLEXFEE FUNDS AND THEIR NET EXPENSE RATIOS

As of September 30, 2019

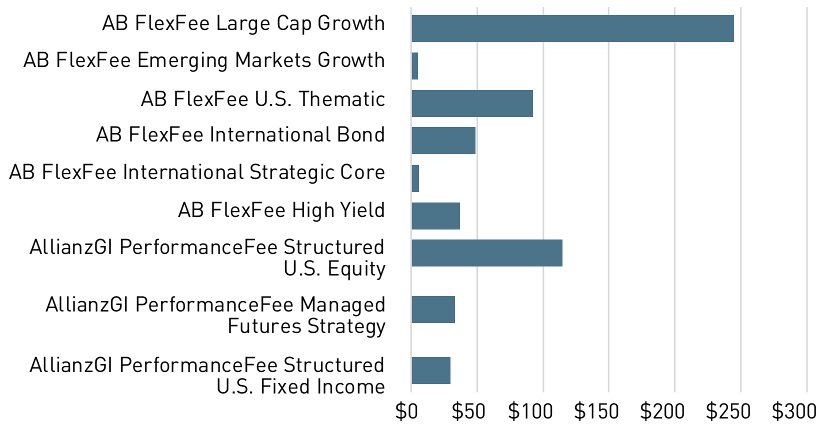



*Source: Q3 2019 Fact Sheets of the AB FlexFee Funds*

Figure 4

## ASSETS OF THE AB AND ALLIANZGI FULCRUM FEE FUNDS

As of September 30, 2019 ($ in millions)




*Source: Q3 2019 Fact Sheets of the AB FlexFee Funds and the AllianzGI PerformanceFee Funds*

Meanwhile, asset-gathering can be described as modest, at best, with just two portfolios exceeding $100 million in assets as of September 30, nearly two years after launch (see figure 4). These results don't signal a strong future for fulcrum fee funds, but it is important to note that much of the headway is likely to occur outside the limelight of the retail investment marketplace. To gauge progress, one also must look to the institutional market, in both in the United States and the rest of the world.

## IT STARTS WITH INSTITUTIONS

Institutional investors have a complicated history with performance fees. In 1986, the U.S. Department of Labor (DOL) approved the use of fulcrum fee structures by private pension funds, and shortly after, a survey of 1,500 pension executives indicated that 43 percent would want all managers to charge performance-based fees.[2] However, because the active asset management industry was at the start of an extraordinary growth cycle, managers had little incentive to offer fulcrum fee products. In other words, there was the suggestion of demand, but almost no supply. In the intervening years, a growing percentage of institutional investors have incorporated hedge funds and other alternative strategies into their portfolios. These strategies typically have a "2 and 20" pricing structure (2 percent of assets managed and 20 percent of profits) that many institutions perceive as being heavily stacked in favor of the manager, perhaps souring their attitude toward performance-based fees in general.

As shown in figure 5 from the Callan 2017 Investment Management Fee Survey, about 80 percent of institutional investors use performance-fee arrangements for hedge funds and private equity always or frequently, but the majority never use these arrangements for traditional asset classes.

Nearly 35 years after passage of the DOL rule allowing the use of performance fees by pension plans (the Securities and Exchange Commission [SEC] passed a similar rule in 1985 for qualified investors), the shoe is on the other foot. The mutual fund is now a mature vehicle, and fee pressure is forcing providers to pursue new pricing strategies in order to continue growing. Meanwhile, institutional investors appear to be of the view that they still possess significant negotiating power to reduce active management fees, and that moving to performance-based fees should be the last arrow in their quiver when it comes to ensuring value-for-money. However, this point may be reached sooner than expected, because even large active managers eventually will begin pushing back on ever-lower fees. Though U.S. institutions have not yet embraced the pricing model, the perspective toward performance-based fees may be changing faster in Europe and Asia.

## BEYOND BORDERS

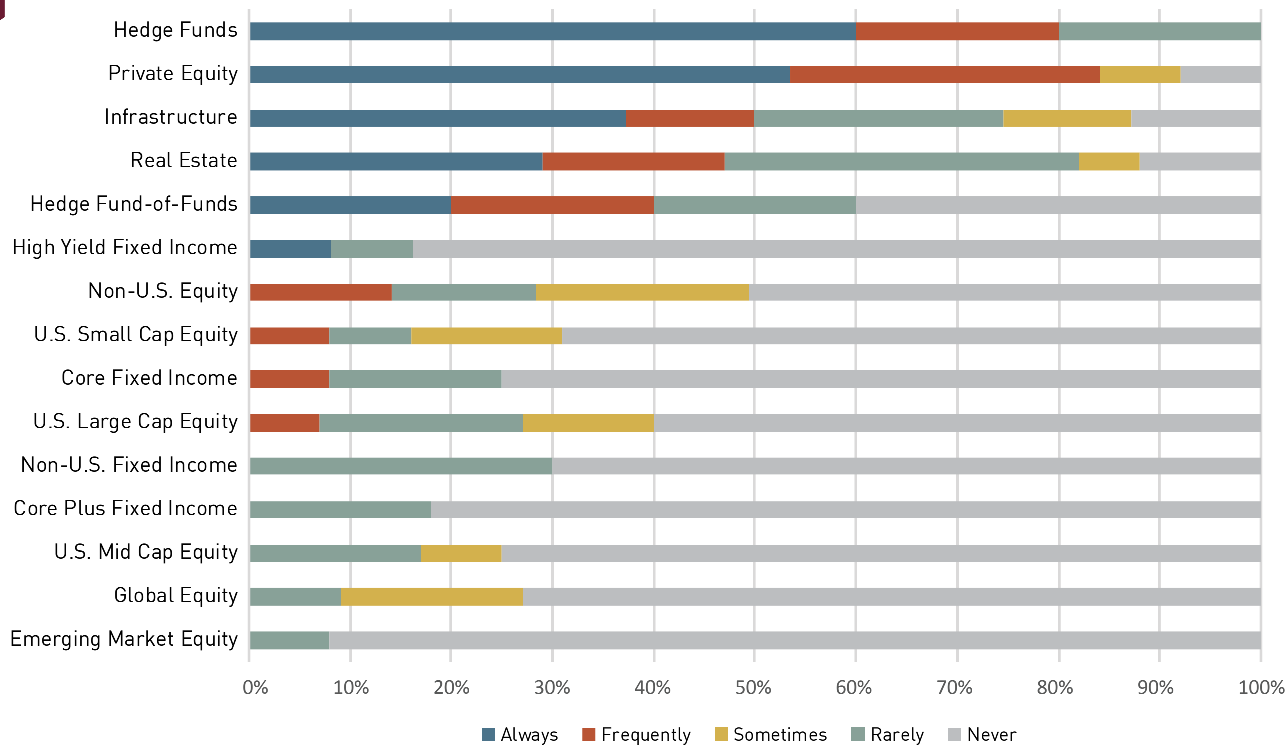
In Europe, much of the discussion regarding fulcrum fees, or performance-based fees in general, is related to implementation of Markets in Financial Instruments Directive II (MiFID II). To understand how this regulation is driving the discussion on fulcrum fees first requires a primer on MiFID II regulation. The original MiFID, which was proposed in 2004 and adopted in 2007, created a legal framework for the operation of financial markets in the European Union, with a primary objective of improving transparency across the marketplace.

However, in the aftermath of the 2008 financial crisis, it was recognized that the original version did not go far enough to protect investors. Enter MiFID II, an ambitious revision of the regulatory framework that was seven years in the making before its eventual debut in January 2018. Although the updated regulation covers virtually all aspects and constituencies of the financial industry, compliance for asset managers has focused mostly on transparency with regard to how they cover research costs.

However, some firms, most notably Fidelity, have pointed out that this is a narrow interpretation of the regulation and more should be done to abide by the spirit of MiFID II to align the interests of product/service providers and investors, which Fidelity believes entails changes to how investors are charged for the value they receive. To address this, Fidelity International implemented a fulcrum fee pricing structure on a range of funds offered in Europe. So far, asset-gathering has been tepid. But as Fidelity's words suggest, the firm's adoption of the pricing

Figure 5

## FREQUENCY OF PERFORMANCE-BASED FEE ARRANGEMENTS BY ASSET CLASS




*Note: Survey of 59 institutional investors, including public funds, corporate funds, and foundations and endowments.*

*Source: Callan 2017 Investment Management Fee Survey*

model is more of an opening salvo in a much larger debate over how to innovate active management pricing versus a move to satisfy current demand for performance-fee funds.

Perhaps the most compelling example of the growing interest in performance-based fees among institutions comes from Japan. In April 2018, the Japanese Government Pension Investment Fund (GPIF), the world's largest retirement portfolio with $1.4 trillion in assets under management, instituted a new system through which it pays active asset managers based on their performance. Under the system, asset managers that fail to beat their benchmarks receive fees equivalent to a passive strategy in the same asset class. In order to earn the previous fixed-fee rate, they must beat the benchmark by a pre-negotiated level, and they must exceed the alpha target in order to earn higher fees. As an indication that the new system may be helping GPIF achieve better value-for-money, payments to money managers fell 40 percent for the fiscal year that ended March 31, 2019, according to GPIF's most recent annual report (Appell 2019). In other words, under an asset-based system, fees would have been substantially higher for the same level of performance.

## ADDRESSING CONCERNS

Although our view is that a material shift in the use of fulcrum fees will begin in the institutional market, fund providers looking to improve receptivity of the structure in the retail market must address the unique concerns of distributors and advisors. Shortly after their launch, the "new" fulcrum fees funds (i.e., the series offered by AB and AllianzGI) started earning placement on distributor platforms, including those of Merrill Lynch, Morgan Stanley, LPL, Schwab, TD Ameritrade, and Pershing. Although this is an accomplishment, especially at the wirehouses where the standards for platform inclusion have risen in recent years, it is far from a guarantee that assets will follow. As Frank McDonnell, managing director and head of global mutual funds at Merrill Lynch, said at the NICSA General Membership meeting in 2018, "Fulcrum fee funds haven't been overwhelmingly successful in terms of sales … I wouldn't call it a gimmick; I would just say it's still really, really early."[3]

In general, feedback from distributors suggests they are open to the idea of fulcrum fee funds, but from a logistical standpoint, some issues need to be cleared up before the products can earn widespread adoption. For instance, speaking at the Securities Industry and Financial Markets Association annual meeting in 2018, Sandy Bolton, the head of managed investments at Merrill Lynch, said (Wenik 2018):

> *I think there's some interesting product development going on. You have the fulcrum fee funds.*

> *AllianceBernstein's FlexFee funds are an interesting concept that hopefully, someday would perform really well and draw a lot of attention and flows … But right now, it kind of just seems like a good idea. I'm not sure how we would ever use that in a model portfolio.*

Gaining the support of the distribution platform is only part of the equation, because advisors have their own concerns about the risks and rewards of fulcrum fee funds. Our research has revealed that advisors have a number of questions when it comes to use of fulcrum fee products in their portfolios:

**How do I explain the fees to clients?** A review of available materials and tools indicates that providers are making a concerted effort to educate advisors about their fulcrum pricing structures. One of the more notable tools so far is AB's FlexFee calculator, which, as the firm says, allows users to "pre-experience" what expenses would be under different investment performance scenarios. Although these educational resources might allow interested advisors to quickly ramp up their understanding of the fees, explaining them to clients is a different matter. On the surface, the concept is fairly straightforward. However, recreating the mathematics behind how a particular fee was determined can be very complicated, and many advisors are disinclined to broach a complex discussion about fees with clients. The client conversation is where asset managers really need to offer support, because advisors will not utilize fulcrum fee funds if they don't feel confident in their ability to explain them to clients.

**What if there is a pricing mistake?** Due to the complexity of the fee calculations, this is a very real concern. Errors can cause reputational damage to both the asset manager and the advisors who placed clients in the products. And, with regard to fulcrum fee funds, this scenario is not without precedent. In 2006, the SEC ordered five mutual fund companies—Dreyfus, Gartmore Mutual Fund Capital Trust, Kensington Investment Group, Numeric Investors, and Putnam Investment Management—to return more than $7 million in miscalculated and overcharged performance-based fees to investors from the period between 1997 and 2004 (Huang 2019). For this reason, mutual fund service providers, such as Broadridge and Citi Custody and Fund Services, are trying to get ahead of the potential product development curve by offering guidance on the back-office systems and processes that need be in place to ensure that performance fees are assessed accurately.

**What would the widespread use of fulcrum fees mean for the price of advice?** This is a salient concern of distributors and advisors, because the use of performance-based fees inevitably will lead some investors to ask why the fees for advice cannot also be tied to the performance of their accounts. Though there are many reasons why the fulcrum fee structure isn't easily applied to advice, foremost of which is the fact that advice and service today go far beyond investment selection, in some cases the question could lead to distrust in the relationship. In fact, the desire to separate the service part of the relationship from investment selection is largely behind the move by a growing number of advisors to flat-rate or service-based pricing models. Although it's difficult to predict how this impediment will be overcome, it's understandable that most advisors don't want to be a test case for how to handle this awkward conversation with clients.

**Do performance-based fees compel managers to take more risk?** The answer to this question comes down to the individual manager; however, research has been done comparing the performance and risk-taking of fulcrum fee funds to their non-incentive fee counterparts in the same category. Elton et al. (2003) tracked the performance and risk levels of fulcrum fee and non-fulcrum fee funds from 1990 to 1999. This study concluded that the fulcrum fee funds exhibited better stock-selection ability than funds without fulcrum fees and achieved better risk-adjusted returns. However, it was also noted that incentive fee funds tended to increase risk after a period of poor performance and decrease it after a period of good performance.

In 2008, Lipper also performed research related to the performance and risk-taking of fulcrum fee funds for the 10-year period through 2007, finding that fulcrum fee funds outperformed their classification medians but exhibited higher standard deviations (Asci 2008). Lipper revisited this research four years later after the financial crisis. This time it found that over the 10-year period from 2003 to 2012, funds with incentive fees underperformed their classification medians over one, three, five, and 10 years and exhibited higher standard deviations over three, five, and 10 years. Additionally, unlike in 2008, the funds posted lower risk-adjusted returns (as measured by the Sharpe ratio) compared to their non-incentive fee counterparts over three, five, and 10 years.[4]

These studies provide a starting point for looking at the historical performance and risk of fulcrum fee funds, but it is important to note that across these time periods fulcrum fee portfolios have accounted for just 3 percent of funds and 6 percent of industry assets, the vast majority of which were managed by Fidelity and Vanguard. Thus, at this point, it's difficult to draw any concrete conclusions about the risk-taking behaviors of fulcrum fee funds managers.

## CHANGING THE CONVERSATION

When it comes to the use of fulcrum fees as a way to revive active management, the concept is still at the top of the first inning, and it is unknown how long the game will last. However, as the conversation continues and more industry players offer their insights, understanding of the potential of fulcrum fee pricing in the retail market will progress. Among those with the greatest conviction in performance-based pricing for active management is Peter Kraus, the former chief executive officer of AB who oversaw the development of the AB FlexFee series. Since leaving AB, Kraus has launched a new firm called Aperture Investors, which directly links management fees and manager compensation to portfolio performance. According to Kraus, the larger the portfolio, the harder it is to outperform, so current asset-based payment models work against performance. Instead, his firm's approach seeks to divide assets between high-conviction active strategies and passive strategies. It is designed for clients who believe that active managers can outperform but that the system is not currently designed to incent them to do so.

In developing the pricing of its funds, Aperture first determined the average fee for an ETF in the same category to use as the base fee, then applied up to a 30-percent performance-linked fee, citing academic literature indicating that the fair price of alpha is about one-third of the excess return. Meanwhile, the firm defers half of manager performance compensation for two years, and the payout only occurs if the fund's performance record remains intact over three years. To launch the firm, Kraus secured $4 billion in seed capital under an agreement that it would be paid back in five years. According to Kraus, if you don't perform in five years, you shouldn't still be in existence.[5]

Perhaps a more surprising advocate of fulcrum fees is SEC Commissioner Hester Peirce. In a 2018 speech at the Financial Planning Association's 2018 Major Firms Symposium, she stated that "allowing funds to experiment with performance fees may be one way to facilitate the continued availability of actively managed funds."[6] This idea ties back to the PwC projections in figure 1, which show that on its current trajectory, the active fund management segment will undergo significant consolidation over the next five years.

Currently, views on fulcrum fees are somewhat polarized. Proponents often cite better alignment of manager and investor interests. Meanwhile opponents argue that they introduce increased complexity, and therefore reduced transparency, to the cost of mutual funds, and that they have the potential to incentivize managers to take on too much risk. Although both perspectives have validity, neither offers a complete assessment of the pricing model's potential in the retail active fund market.

For now, the industry is still benefiting from the longest bull market in history, which has likely stymied adoption of the fulcrum fee structure. However, when this bull market inevitably comes to an end, the impact of lower management fees on active managers' bottom lines will become more pronounced, increasing the urgency to find a solution. This could compel more managers to transition to a fulcrum fee pricing structure, particularly mid-sized firms that will feel the squeeze from all sides. In our view, the move to fulcrum fees will be a slog, not a sprint. Also, the initial goal will not be gathering significant assets. Rather, the goal will be changing the conversation from how much more expensive active management is relative to passive to a dialogue about how both styles can provide good value-for-money depending on the objective of the investor.

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