Looking at Management Fees From a Different Perspective

February 2020

DelMarche

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Management Fees: *fees charged by money managers to cover all expenses and compensation needed to run an investment portfolio*

Point of Discussion

01 Fee Compression and Historical Context

02 Observations on Fees and Performance in Small Cap

03 Key Takeaways

Put Research To Work

with the DeMarche Team

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Fee compression is a widely discussed topic in investment management and has contributed to competition in the industry. DeMarche looks to shed some light on this area with a focus on relative performance from a different point of view.

Historical Perspectives

For over sixty years, opportunities in U.S. Small Cap Equity management has sparked hundreds of institutional investment firms to launch strategies embracing active management techniques. Thanks to an economic growth environment conducive to double-digit returns, where allocations to equities were increasingly embraced, small cap strategies typically carried a management fee that richly rewarded the provider. But over the past two decades, a convergence of factors have powered a fee compression trend where the average management fee has been lowered significantly over time. Passive solutions have steadily become more available, as investors gained access, transparency, and lower cost transactions in accounts including brokerage and 401(k) plans.

Furthermore, the bear markets of 2000-2003 and 2008-2009 were followed by the current era of very accommodative Federal Reserve interest rate policies, supporting small cap returns. The start of the 21st century brought an environment that has reduced forward return expectations for a number of asset classes, resulting in a confluence of drivers of fee compression for investment strategies.

Our Study

For this study, DeMarche set out to observe if there was any relationship between the fees investment managers charge versus their trailing five year performance record. Do managers who charge low fees tend to underperform or outperform their peers? In the top performance quartile, is there a significant portion of managers that charge high fees on a relative basis? What about the bottom performance quartile? In order to answer these questions and others, this study compared managers by fee and by performance against their DeMarche manager style universe. DeMarche's proprietary manager universes are comprised of institutional separate account strategies and sorted based upon Style of the product (Growth, Relative Growth, Relative Value, or Value) and the market capitalization of the portfolio. The focus of this study was the DeMarche small cap universes, which consist of 250+ actively managed products. Measures utilized include the annualized five year return of all products in each universe and the reported management fee (as published by eVestment) on an institutional separate account at mandate sizes of $10 million and $100 million. Performance was split into quartiles

Exhibit 1

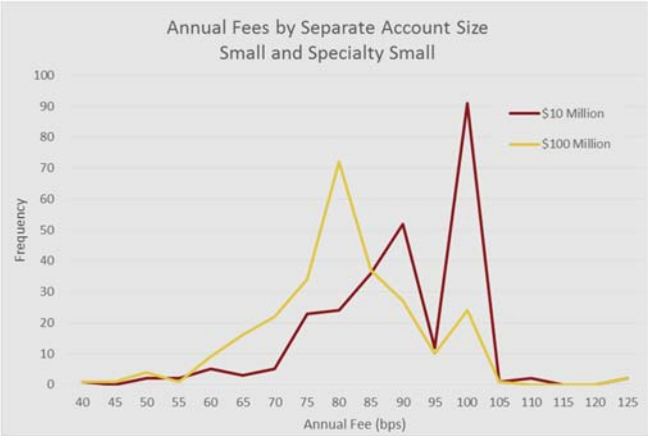


Exhibit 2

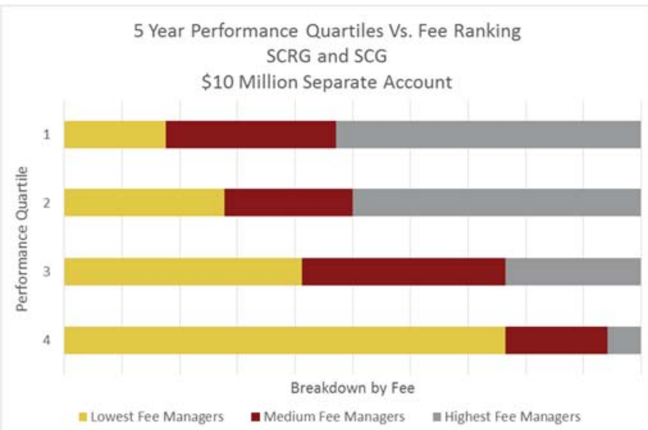
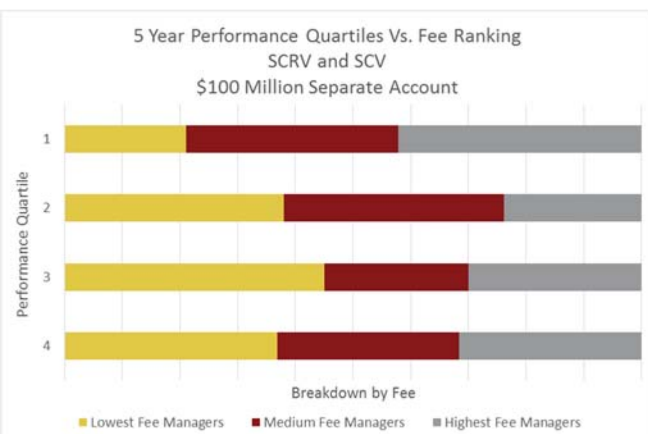


Exhibit 3



What is Specialty Small? *Small cap-focused investment strategies that invest a meaningful portion of their portfolio in companies above the typical maximum market capitalization of Small Cap.*

with 1 representing the best performing strategies in the universe and 4 representing the worst performing strategies. It is important to note that the outcomes of the study are based on observations and not statistical inference or significance.

Observations

Our observations begin by first understanding what fees are being charged by small cap managers across all Styles. It is common practice by many investment managers to use a sliding fee schedule where the fee charged decreases as the size of an account increases. This practice was observed when comparing the management fees of a $10 million account with that of a $100 million account. Fees charged for a $10 million account cluster very tightly at 100 bps, skewing the data so the median fee is actually much closer to the top of the range than the bottom [Exhibit 1]. For a $100 million mandate, the fees charged resemble a more normal distribution with fatter tails centered on 80 bps. The size of a separate account can have a significant influence on the fee charged.

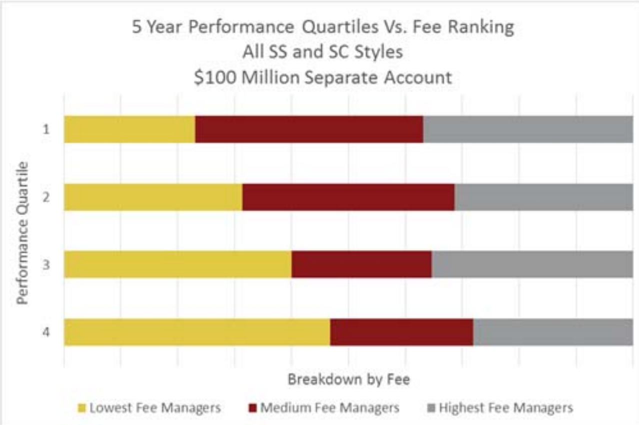
When considering the potential relationship between fees and performance, we start with the DeMarche Small Cap Growth and Small Cap Relative Growth universes [Exhibit 2]. In general, we observed higher and medium fee managers tend to outperform managers who charge the lowest fees. It is also worth noting that the lowest fee managers account for the smallest proportion of the first (best) performance quartile and the largest proportion of the fourth (worst) performance quartile. This observation also holds true for $100 million accounts.

In the Value and Relative Value universes, a similar observation for the first performance quartile can be made, but it is more difficult to make concrete interpretations from the bottom three performance quartiles which generally have similar representation from the three fee groups [Exhibit 3]. The first performance quartile is made up of mostly medium and high fee managers but there is some representation from the lowest fee group. The same observations were made for the Specialty Small value universes (table not shown).

While the distinct breakdown of the first performance quartiles is very clear when utilizing the combined Relative Value and Value universes, we found this relationship between management fees and performance success was not always observable in more narrowly defined areas, such as the DeMarche Value universes. These Styles are more indicative of a 'deep value' investment philosophy and in general, these universes have fewer constituents.

However, in aggregate, we observe that lower fee managers tend to make up a smaller portion of the first performance quartile and their

Exhibit 4



DeFact:

How does the gap between lower and higher fee managers impact the study? The same conclusions are observable on a net performance basis as only 6.5% of products in DeMarche small cap universes shift performance quartile when using net returns.

Summary of DeMarche Styles

Growth: Strategies which mainly consider growth characteristics

Relative Growth: Strategies which consider growth characteristics but will also consider valuation

Relative Value: Strategies which mainly consider value characteristics but may also require growth factors

Value: Strategies which consider mean reversion and value factors reaching historic lows

For more information on this study and the DeMarche universes, please contact your DeMarche Consultant.

Sources Utilized:

- *eVestment Alliance*
- *DeMarche Database*

representation gradually increased with each step down in performance quartile [Exhibit 4]. The gold bars exhibit a 'step like' appearance which makes this observation clear. While the low fee trend in the graphs is worth noting, it is equally noteworthy that every fee group is represented in each performance quartile. This is true for each individual Style and in aggregate across all small cap. Based upon these observations, it seems that a search for a successful manager should not be limited to only include low fee providers, since that would exclude an outsized portion of candidates that have demonstrated success!

Client Search Behaviors May be Shifting

As recently as five years ago, our Consultants observed that client Investment Committees most often selected traditional asset class search winners as the finalist with the highest trailing returns versus peers. In search decisions over the latest few years, DeMarche has witnessed an increase in committee members selecting the strategies with lower, or the lowest, fees as their winner, with less focus on trailing returns. Will this become a longer-term trend that favors lower cost active strategies?

One contributor to this trend may be the ample marketing in support of passive strategies, many of which state they have more consistent performance than active peers. We keep in mind that the past decade has been unlike any in the past, with years of quantitative easing, a decade of modest economic improvement, and the tremendous expansion of passive solutions as a backdrop.

One of the most frequently published pieces of advice is that past performance is no guarantee of future performance (nor much of a predictor, either, we argue). Given our observation of a potential behavioral shift involving investors assuming lower fees offer any guidance to manager selection, DeMarche urges caution in placing too much emphasis on management fees during the decision making process. If neither past performance nor relative fees are strong predictors, what should investors focus on? We encourage emphasis on what we call the "leading indicators" of future performance: stability of the manager's firm, its ownership, and leadership; stability of the investment management team and their resources; continuity of the investment philosophy and process; and an appropriate growth/stability of the strategy's assets under management. Excess volatility in any of these fundamentals weakens the odds of maintaining a winning strategy.