Making Portfolios More Fee-Efficient

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Investment advice and consulting services provided by Aon Hewitt Investment Consulting, Inc., an Aon plc company.
Executive Summary

- Investment management fees are highly relevant to portfolio performance.
- Making portfolios more fee-efficient is not necessarily about reducing fees. Rather, it is about paying for things that add value, and not paying for things that don’t.
- While efforts often focus on asset allocation and manager selection, it is also important to negotiate aggressively and combine skilled managers in the most fee-efficient way.
- We describe a toolkit of approaches for making portfolios more fee-efficient based on four principles:
  - Get beta cheaply.
  - Pay fees commensurate with expected value added.
  - Optimize the structures and vehicles used.
  - Negotiate hard.

Introduction

Investment management fees are a controversial and polarizing topic, with discussions often marked by ideological sound bites. At one extreme, a common view is to avoid everything but the lowest-fee products, as fees enrich managers while destroying wealth for investors. At the other extreme is the belief that since only net-of-fee returns matter, there’s no reason to shy away from high-fee products if you are paying for skill. Unfortunately, this type of oversimplified, extreme rhetoric gets in the way of more thoughtful discussions about how investors can make their portfolios more fee-efficient.

This paper is not intended to address the debate of active versus passive management.¹ That is an important topic, and investors' views on it tie strongly to their investment beliefs. This paper is applicable to investors with a variety of different investment beliefs, helping them build portfolios that express their beliefs in a fee-efficient way.

Making portfolios more fee-efficient is not simply about reducing fees. Reducing fees is simple: Replace higher-fee managers with lower-fee ones or negotiate lower fees with your current managers. These steps may make portfolios more fee-efficient, but they are not the only approaches and may not even be the best approaches in a particular situation. Most notably, investors who believe in active management or alternative investments are not exclusively trying to minimize fees, but rather trying to earn strong returns with these strategies without paying more than necessary.

¹ For a discussion of active versus passive management in public equities, see Sebastian and Attaluri [2014]. For a discussion around fixed income, see Friedman and Zink [2015].
To do this in a way that is applicable to investors with a variety of investment beliefs and circumstances, we use the following four-factor framework:

1. Get beta cheaply.

This means that investors should not pay high fees for market returns that can be attained at a lower cost. The simplest example of doing so, of course, is indexing those segments of the portfolio that have poor odds of success with active management. This is one of at least three strategies that can be employed.

Implement traditional passive or factor-based (“smart beta”) mandates.

Traditional passive management has obvious appeal when investors don’t expect active returns to meaningfully outpace fees. For decades, our firm has been an advocate for passive investing in many situations, and we continue to believe it is appropriate for most (but not all) equity investors.

In many cases, factor exposures may be the dominant driver of performance for active equity portfolios. Factor-based investing can be a lower-cost way to access many of the exposures active managers seek.

These strategies have lower fees both because they have lower operational costs and because they are priced more cheaply due to competition with very similar strategies. For investors trying to manage within a fee budget or active risk constraint, either traditional passive or factor-based mandates can be blended with high-conviction active managers to create an aggregate portfolio meeting the fee/risk parameters desired. This is often preferable to using predominantly active managers who closely track their benchmarks.

Restructure performance-based fees to avoid paying for beta.

Performance-based fees offer asset managers an incentive to exceed a hurdle rate, and setting the right hurdle rate is critical. Some structures, such as the “2-and-20” fee level common for hedge funds, have a hurdle rate of 0%. When the investment manager’s returns are influenced by the general market, the manager might be getting performance fees without demonstrating skill. For example, many hedge fund managers have positive performance when the stock market increases and negative performance when it decreases. Should they get incentive fees for the component of their performance that is related to passive market returns?

One way to address this issue is to design the performance-based component to exclude “beta” factors. For example, a fee structure would be designed so a hedge fund whose performance is highly correlated with the equity market would not get performance fees because equities increased, but only because of
true outperformance based on their active decisions. To do this, investors could simply change the hurdle so it is related to market returns rather than absolute returns. For example, the hurdle rate might be 30% of the stock market return. Of course, some strategies don’t track specific market indices, in which case it may be more appropriate for the performance hurdle to be 0%, LIBOR, or LIBOR plus an alpha hurdle. The specific details would need to be customized to each manager’s specific approach, and this would require careful attention.

We should note that there are downsides to this approach. It would be more complex, and it may be difficult to communicate with outside stakeholders. For example, if the stock market declined significantly and a manager’s performance was 0%, the manager might earn performance fees. These fees might be well-earned for the manager that avoided losses, but the optics could be damaging—especially for investment programs in the public eye.

While this approach isn’t right for every investor or every mandate, it may be worth considering. Alternative fee schedules can result in higher returns for investors, better incentive alignment, and an increased ability to match fee costs to each investor’s objectives and preferences.

2. Pay fees commensurate with expected value added.

Clearly, investors who believe in active management and alternative assets will have different portfolios from those who do not. Investors should thoughtfully consider their beliefs about what types of mandates have the best prospects for superior returns or risk management, and they should be willing to pay fees if necessary. Further, investors should focus on the amount of active management or diversification per unit of fee.

Use high-conviction mandates.

Aon Hewitt’s research, "Conviction in Equity Investing," found that equity managers who significantly deviated from their benchmarks significantly tended to perform better than active managers who stayed closer to their benchmarks. There are several theories for this, one of which is that the active bets must overcome the managers’ fees, so managers making larger active bets have greater potential to outperform than closet indexers. We call these “high-conviction” active mandates. It is noteworthy that using such mandates may not reduce fees—in some cases, it may even increase fees. However, it may allow investors to get more value from the fees paid.

Many active managers over-diversify, not recognizing that they can take more active risk because their mandates are a small slice of the investor’s overall portfolio. This may be caused by a divergence of interests between investors and managers: Investors have multiple managers, but managers have only one business. The resulting over-diversification can resemble the market portfolio and thus become an expensive index-like portfolio. Investors can diversify away their alpha while still paying fees for active management. Investors may want to use high-conviction managers and possibly ask managers to implement customized, higher-conviction variations of their standard products.
3. Optimize the structures and vehicles used.

A well-constructed implementation plan can help investors avoid overpaying for their returns. There are a number of strategies that fall in this category of managing fee efficiency.

Reduce the number of investment managers.

Having fewer managers with larger mandates creates economies of scale that may drive lower fees. As a simple illustration, Kurniadja [2017] shows the total fees for a $1 billion active global equity portfolio based on different numbers of managers, using standard fee scales for global equity.

<table>
<thead>
<tr>
<th>Number of Managers</th>
<th>Fees (%)</th>
<th>Fees ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>0.57%</td>
<td>$5,700,000</td>
</tr>
<tr>
<td>10</td>
<td>0.61%</td>
<td>$6,100,000</td>
</tr>
<tr>
<td>15</td>
<td>0.68%</td>
<td>$6,800,000</td>
</tr>
</tbody>
</table>

A smaller manager roster also has benefits unrelated to fees. First, it concentrates assets with investment managers believed to have the best opportunities for excess returns. Second, having fewer managers may better exploit manager skill by driving investors to combine niche mandates by region, capitalization, and style (e.g., U.S. small cap value) into broader mandates (e.g., global equities). In addition, fewer managers are easier to monitor, reducing custody and operational costs, in addition to the time and effort required to monitor the portfolio. As demonstrated in our recent white paper, “Optimal Number of Managers in an Equity Portfolio,” there is little incremental benefit from diversification beyond five investment managers in public equities. While there are reasons to have more managers, such as to address capacity constraints and key man risks, we still believe many institutional investors have opportunities to streamline their manager lineups.

Reducing the number of managers presents a prime opportunity to negotiate fees. Even when an investor already has sliding fee schedules with breakpoints for higher asset levels, there may be opportunities to improve those schedules. Notifying managers of an initiative to streamline the portfolio and consolidate assets with the best managers may result in proposals to reduce fees.

Consider share classes with longer liquidity lockups.

Among hedge funds, it is common for investment managers to offer multiple share classes with different terms for fees and lockups. For example, an investor willing to lock up assets for three years might get a lower base fee. The investor may still be able to “break” the lockup, but with a penalty. We see this as potentially attractive, even beyond hedge funds, depending on the specific terms of the deal. We see this as most viable in situations when the manager would have a particularly strong business desire for long-term agreements and thus willing to negotiate down base fees. Emerging managers might be good candidates for such an approach.

Special Application to DC Plans

Much of the framework outlined in this paper can apply broadly across institutional investors, though there are some differences across investor types. For defined contribution plans, there may be a special advantage to reducing the number of investment managers. Our research has found that DC participants build better portfolios when offered streamlined lineups, as they often struggle when faced with many choices [Ryan 2015].
In addition to providing better fees, this lockup approach would reduce the temptation to terminate a manager after short-term underperformance. From a practical perspective, very few allocators fire or consider firing managers in the first few years of a mandate, so the practical limitation of an initial lockup may be small.

Further, from a business perspective, our manager research team generally would look favorably on investment managers with significant levels of assets in such agreements. Longer lockups create “patient” capital, so the manager would be less likely to need to cut staff or infrastructure due to revenue lost in periods of underperformance.

Evaluate alternative fees structures.

Mandates in public markets typically have fees based on asset levels, while alternative assets such as hedge funds and private equity usually have a combination of management fees and incentives, with 2-and-20 being the common fee package. It doesn’t have to be that way. Public market mandates could have performance fees, while alternatives could have either fixed fees or some other combination of management and incentive fees. There is no one-size-fits-all approach to fee structure, so we’ll offer some guiding principles:

- One common philosophy for developing performance-based fees is for the management fee component to cover the manager’s operational costs for staff and infrastructure, while the incentive fee offers the manager meaningful upside for good performance.
- In order for investment managers to agree to the additional risk associated with incentive fees, the expected fee level may need to be higher than for a purely asset-based fee. Quantitative modeling can be used to evaluate the expected tradeoffs between different fee structures.
- For capacity-constrained strategies, putting more weight on performance fees can make managers more mindful of diluting returns.
- Investment managers may not need incentive fees to have interests aligned with investors. Investors are known for hiring and firing managers based on performance; thus, even managers without incentive fees may still be aligned with investors. Further, too much revenue at risk from poor performance may be disadvantageous for an investment manager, as it could make it difficult to maintain staff and infrastructure through down periods.
- Performance fees may not just be about aligning incentives, but also about aligning outcomes. Investors could tell their stakeholders that they didn’t have to pay full fees for underperforming managers.
- Investors with little tolerance for short-term underperformance may reap fewer benefits from performance-based fees, as they may terminate underperforming managers rather than maintaining them through the low-fee, potential performance recovery.
- The most appropriate design of the performance-based component would exclude “beta” factors. For example, a hedge fund whose performance is highly correlated with the equity market should not get performance fees simply because equities increased, but only because of true outperformance based on its active decisions.
- The 2-and-20 fee structure may be used by many investment managers, but it need not be. For example, some investors and investment managers are now considering fee structures of 1-or-30 (30% of performance, but not less than 1%).
Use the same managers in multiple asset pools.

Investors with multiple asset pools—such as defined contribution plans, defined benefit plans, and/or endowments or foundations—often can negotiate better fees by using the same investment managers in both plans. If there is overlap in the fiduciaries for these plans, such a strategy would also be making better use of the managers viewed most favorably. For defined contribution plans in particular, custom target date funds allow plan sponsors to use the same funds in the core lineup and target date funds, providing better economies of scale for negotiating fees. Further, custom target date funds facilitate better use of passive and skilled high-conviction active mandates.

Offer vehicle choice.

Many investment products are offered in multiple vehicles, such as mutual funds (with several share classes), collective investment trusts, and separate accounts. Though the investment strategies may be nearly identical across vehicles, the fees can be very different—the vehicles with the highest fees can cost more than double those with the lowest cost.

As an example, in 401(k) plans in the U.S, some investment managers offer mutual funds and collective investment trust for the same strategies. The mutual funds are typically more expensive because of additional regulatory requirements, so plan sponsors should consider the lower-cost vehicles when available.

There may be good reasons why an investor is not in the lowest-fee vehicle, such as an asset minimum that the investor can’t meet, but investors should carefully review each situation to make sure the vehicles they are in best meet their needs.


Investors sometimes pay different amounts for identical mandates, simply because some are better negotiators. There are many strategies for negotiating harder.

Negotiate with multiple managers.

We often find that investors can be relatively indifferent among the finalist candidates for a manager search,
and fees are the differentiator. Once managers get to the point where they know they are very close to winning the mandate and primarily competing on price, they can be nudged to sharpen their offers again in competition against each other.

This can be even more effective by including managers that have experienced recent underperformance, as they may be more willing to price aggressively. If nothing else, this can provide leverage with the other managers being considered, who can be nudged to match fees with lower bidders.

The potential improvement from this strategy may vary by manager, and it may be difficult for some investment managers that use “most favored nations” clauses with other investors, limiting their flexibility to give you a better deal. Even where most-favored-nation clauses exist, it could be worth investigating further because they may not apply to your situation.

**Negotiate fees when you have leverage.**

Some opportunities are better than others for negotiating fees, and investors should be aware of when they have the most leverage to bargain successfully. There may be some situations when negotiating seems obvious and natural, such as when hiring a new manager. There also are other, less obvious situations that may present good opportunities for negotiation, as shown below:

- Negotiation is advisable when a manager has been in place for a long time without changing the fee structure, especially if the average fee level for similar mandates has declined or the mandate size has increased.
- If the manager charges a premium fee over peers but has not delivered premium returns, this may be an opportunity to negotiate down to more typical fee levels.
- If the consultant downgrades the manager’s rating, it may warrant immediate termination. However, in some cases, the manager may be okay to retain—not good enough for the consultant to recommend for new mandates, but also not bad enough to be an obvious case for forced termination. Possibly a lower fee could be negotiated.
- In addition, when changing the size of a mandate, it may be a good opportunity to renegotiate fees. Even if the fees already include a tiered scale based on asset size, the entire fee scale could be renegotiated. This can be a particularly strong approach for pension plans on de-risking glide paths, as they can negotiate with asset managers whenever the asset allocation changes.

**Consider OCIO and other forms of consultant aggregation.**

While there are many ways to implement outsourced CIO (also known as “OCIO” or “delegated”) arrangements, a common approach is to allow the OCIO provider to aggregate assets with other investors when selecting asset managers. This allows greater economies of scale for negotiating fees. So, for example, an investor with $250 million in assets might get the negotiating power of one with $25 billion in assets. Some investors use OCIO arrangements for their entire portfolios, while others use OCIO arrangements only for specific funds where they believe the OCIO has a particular advantage. OCIO arrangements may have other benefits beyond fee aggregation, such as risk management, portfolio construction, or reducing the effort required from the investor. Of course, the potential savings from the underlying assets may be offset by the additional program fee from the OCIO provider; the net impact will vary by situation.

Consultant aggregation can also happen without OCIO arrangements, though this is less common. It can occur when investment managers offer fee breakpoints based on total assets from all clients advised by
the same investment consultant. For investment managers, they think of this block of assets as a single mandate in some respects, as they may not need to go through the deep due diligence and monitoring processes with every investor independently—they are leveraging the due diligence done by the consultant. This reduces their operational costs of marketing and running portfolios. It offers an advantage to clients of consulting firms that are larger and better coordinated. Outside OCIO arrangements, consultant aggregation is most common with private assets, but we see it as a growing trend for public markets.

Conclusion

Making portfolios more fee-efficient is not necessarily about reducing fees. Rather, it is about paying for things that add value, and not paying for things that don’t. At the same time that investors should be unwilling to pay much for things such as market beta and factor exposures, they should be willing to pay for beneficial mandates that cannot be replicated cheaply. The total fee budget should depend on the investor’s belief in—and use of—strategies such as these:

- Skill-based mandates such as active management
- Illiquid assets
- Diversifiers and complex mandates
- Dynamic strategies such as de-risking glide paths

In their effort to create portfolios generating strong returns, investors often focus on identifying the most skilled managers. While this is clearly important, it is also valuable to put the portfolios together in a fee-efficient way. Investors have many tools to do this and should consider each in relation to the specific situation. Investors should continuously review their fees to make sure they are getting beta cheap, paying fees commensurate with expected value added, optimizing the structures and vehicles used, and negotiating hard. Anything less may be wasting money.
### Appendix 1: When to Use Each Tool in the Toolkit

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Most Effective Situations</th>
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</table>
| Implement traditional passive or factor-based (“smart beta”) mandates | - When active equity mandates are viewed as unlikely to perform well  
- When active equity mandates have low-to-moderate tracking error relative to the benchmark  
- When there are more than five active equity managers |
| Restructure performance-based fees to avoid paying for beta | - Hedge fund portfolios with performance-based fees, when returns are correlated with passive indices |
| Use high-conviction mandates | - When equity mandates have low-to-moderate tracking error relative to the benchmark (e.g., below 5% tracking error) |
| Reduce the number of investment managers | - When there are more than five investment managers in a single asset class  
- When equity managers have narrow mandates that can be combined (e.g., large/mid/small cap, U.S./non-U.S., grow/value) |
| Share classes with liquidity lockups | - Hedge funds  
- High-conviction managers  
- Managers open to being creative with fee structures or with a particularly strong business desire for long-term agreements, possibly such as emerging managers |
| Evaluate alternative fee structures | - When there are performance-based fees  
- When managers are open to being creative with fee structures  
- When engaging with managers who are truly confident in their ability to generate strong returns |
| Use the same managers in multiple asset pools | - When investors have multiple asset pools, such as DB and DC plans, or endowments, foundations, or operating asset pools |
| Offer vehicle choice | - When investors use products with different vehicle options  
- 401(k) plans using mutual funds |
| Negotiate with multiple managers | - When selecting a new manager, and there are multiple finalist candidates that are equally good |
| Negotiate fees when you have leverage | - When there has been fee compression for similar mandates  
- When considering changing the size of a mandate or asset class  
- When a manager has a poor performance, turmoil, or consultant rating downgrade  
- When a manager is susceptible to termination or outflows |
| Use consultant aggregation | - When working with a large investment consultant who mentions this is available for a specific product  
- When the consultant can credibly influence asset flows  
- When alternative assets are used |
| Consider outsourced CIO solutions | - Institutional investors with more than $25 million in assets  
- When price quotes from OCIO providers unveil opportunities  
- Partial OCIO arrangements may be advantageous for specific sleeves when the investor believes the OCIO has a particular advantage. |
## Appendix 2: Will Fee Negotiation Work for a Product?

<table>
<thead>
<tr>
<th>High Likelihood</th>
<th>Low Likelihood</th>
</tr>
</thead>
<tbody>
<tr>
<td>Far from capacity</td>
<td>Capacity-constrained</td>
</tr>
<tr>
<td>Experiencing outflows</td>
<td>Strong inflows</td>
</tr>
<tr>
<td>Managers in asset-gathering mode</td>
<td>Managers with a stable client base</td>
</tr>
<tr>
<td>Managers that routinely negotiate</td>
<td>Managers that rarely/never negotiate</td>
</tr>
<tr>
<td>Emerging managers trying to get into the institutional market</td>
<td>Established managers with strong track records</td>
</tr>
<tr>
<td>Strategies where fees are trending down or flows are going passive</td>
<td>Strategies with positive flows</td>
</tr>
<tr>
<td>Products needing seed money or first capital calls</td>
<td>Final capital calls and products near closing</td>
</tr>
<tr>
<td>Managers with high profit margins</td>
<td>Managers with low profit margins</td>
</tr>
<tr>
<td>Products with low expected returns</td>
<td>Products with high expected returns</td>
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References


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