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OPINION

Hedge funds need to start making money for their clients, not themselves

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A man looks at a Bloomberg terminal.
BEN FATHERS/AFP/GETTY IMAGES

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Active investment funds have been overcharging investors for decades. Nowhere is this more prominent than in the alternative fund category, colloquially known as hedge funds.

Investment management used to be a profession. Today, it's a business. Traditionally, fund management companies offered but one fund, managed for long-term maximum real return after taxes, in order to increase purchasing power for savers. Today, a typical manager offers hundreds of funds.

And as what used to be a craft devolves into a numbers game, the whole industry has weakened. Assets in the hedge-fund industry have fallen by nearly US$220-billion since the end of 2021, with global economic conditions leading to poor performance, and investors redeeming funds in droves as a result.

Two of the world's richest, most successful investment managers, Warren Buffett and Canada's own Prem Watsa, operate just one vehicle through which they manage the wealth of many investors, but they take it one step further. They are among only a handful of investment leaders who forgo management fees in favour of profit sharing. Hedge-fund managers, even those that don't invest alongside their clients, can mimic this approach by taking fees only when clients make money.

I follow the same principle. In lieu of upfront set fees, I take 25 per cent of profits over a 6-per-cent annualized operating return (this refers to the return after deduction of all fund operating expenses including trading commissions, admin fees, independent audit, tax prep, etc.). This is rare; I know of only three funds in North America, including ROMC, who offer a similar model.

Conversely, almost all hedge funds take a percentage of investors' assets in fixed fees, generally 2 per cent, and then take a percentage, usually 20 per cent, of any profits. It's like the old saying: "My adviser invests my money until it's theirs."

With this structure, managers have no real need to worry about performance. Sure, they risk losing clients if they perform poorly over long periods of time, but if they tread water and eke out modest returns, clients are likely to stick around even if their purchasing power is declining. Why? Because they don't know how to do it themselves.

A November, 2021, survey from Canada Life found that only two out of five Canadians had high confidence in their investment knowledge. An earlier survey by the Investment Industry Regulatory Organization of Canada (IIROC) found that many Canadians do not invest, with half of them giving lack of knowledge as the reason why, and another 60 per cent lacking the confidence to make good investment decisions.

But the odds are distinctly against even professional investors; the average active manager does not outperform the stock market, and given the magnitude of their fee structures are, as a group, assured of underperformance. Yet they continue earning that 2 per cent.

As technology advances and a more knowledgeable and interested generation ages, fund managers are likely to find themselves paying the price for overcharging. One only has to look at the transition from active fund management to passive indexing – where investors are pretty much guaranteed not to underperform the stock market and pay practically nothing in fees for the pleasure – as proof.

Today, with inflation at levels not seen in nearly 50 years, fund managers wage an almost impossibly steep uphill battle to maintain client purchasing power, and yet they continue to take that 2 per cent. In this climate, even 10-per-cent absolute gains turn into relative losses, especially after paying taxes.

What about a fund model that puts investors back where they belong: first? What if managers took no management fees and only shared in the profits they produced? What if managers went even further by handicapping themselves with a pre-profit-share hurdle rate that materially exceeded the long-term rate of inflation? The answer is: We move from a business back to a profession.

Messrs. Buffett and Watsa understand this and have embraced a structure where the risk is on them as managing owners. I subscribe to this.

ROMC Fund is a global equity fund, and like most of the category, is down year to date, although it is outperforming the category by 6 per cent, and its relative performance since inception 15 years ago is almost 8-per-cent annual outperformance. And for my investors, although they are experiencing some losses in the short term, these have not been compounded by unearned fees.

It’s time for the rest of the industry to follow suit.