Lookout Mountain
Hedge Fund
REVIEW
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# Superior Risk Adjusted Performance (SRAP) Fees for Hedge Funds

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Certainly, the standard hedge fund fees have attracted hundreds of exceptional managers who have delivered superior risk adjusted performance to investors. Yet, these fees have attracted and nurtured far more mediocre than superior managers with contractual entitlements that routinely redistribute billions in merit pay for mostly meritless performance.

It's past time to replace today's hedge fund fee standards with a prudent system that will continue to attract superior manager prospects, but afford superior fees to only those who deliver superior performance.

In hindsight, three critical decisions are the source of most that ails hedge fund investors.

In 1949, Alfred W. Jones chose to take fees on total performance for his original hedge fund, though he understood superior risk adjusted performance well.

Two decades later, in the second of her two most influential articles[1] in the history of the industry, Carol J. Loomis chose the compensation system as the primary feature of her enduring definition for hedge funds. As operational insight was unavailable, performance fees were the key feature distinguishing the 1960's generation of Jones model clones from mutual funds.

Finally, institutional gatekeepers and investors acquiesced in droves to the evolving, circular absolution of the fee-based definition echoed by managers with a robust sense of entitlement: "Since I set up my fund based on this fee system, it's a hedge fund. And since it's a hedge fund, I *deserve* these fees!"

Reexamining what Alfred Jones got right, which has been largely overlooked, and what he got wrong, which has been expanded and entrenched, we can arrive at both a precise definition and a prudent fee system for hedge funds.

What Jones got right was his recognition that superior performance is a two-dimensional quantity, return for the risk taken, that can be amplified while reducing the risk from market participation.

Adapting methods from predecessors, Jones systematically combined two risk assumptive strategies, short selling and leverage, into a conservative investing program, telling investors[1], *"[Our] unique hedging operation is merely the means for greater profit with equal risk, or equal*

*profit with less risk than in conventional investment programs.*"

Based on what Jones got right, my definition for true hedge funds is this – and **nothing more: Hedge funds are investing programs designed to amplify alpha from a given capital base in a portfolio constructed to always mitigate risk.**

However, alpha is generated by managers, not the system.

This definition recognizes the diagnostic boundary between risk mitigating and risk assumptive strategies. It's a crucial distinction too often dispensed with by the marketing jargon for nominal hedge funds promoting non-correlation as the primary benefit. Non-correlation is just a collateral benefit from true hedge funds, as they actually mitigate risk.

Yet, recognizing this boundary leads to a heresy in the historical narrative.

What Jones got wrong was his choice of a one-dimensional performance fee rewarding both superior stock selection and performance attributable to the market, which enticed him to bet aggressively on the direction of the market. Indeed, his net market exposure ranged from well over 100% at times, to net short at others. His pursuit of greater profit with *greater* risk cost his investors considerable sums on multiple occasions – for which he expressed regret.

**So, while Jones designed a true hedge fund, he failed to run it as such.**

And while Loomis's fee-based definition remains almost universally accepted (invariably requiring lots of explaining), today's hedge fund fees only remotely resemble Jones's flawed performance fee arrangement that she based her definition on.

Alfred Jones charged no asset based fee whatsoever, and his 20% performance fee applied only to realized gains from closed-out positions. Likewise, the first generation of Jones model clones in the 1960's took performance fees only.

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**…yet leads to a heresy in the historical narrative.**

About 1970, managers began requesting a *draw* of 1% of assets against future performance fees, and by the 1980's, this draw had morphed into a fixed asset-based fee of 1% in addition to the performance fee.

Moreover, taking performance fees on both realized and paper gains became a new standard, rationalized by "high water mark" provisions stipulating that managers would owe investors future performance for fees taken on subsequently vaporized gains. This mutation has facilitated the garnering of billions in fees for performance never delivered.

The flood of institutional investment since the turn of the century increased hedge fund assets about five-fold and brought significant fee enhancements. Asset-based fees more than doubled and numerous structural entitlements such as extended lockups and withdrawal gates were adopted to prolong transfer payments regardless of performance.

Some managers owing performance for fees collected on subsequently vaporized gains began collecting additional (albeit diminished) performance fees before delivering owed performance, which morphed into a brazen new standard.

It's certainly difficult to fault fund managers for demanding greater entitlements when the big money so readily capitulated. Primary culpability accrues to institutional gatekeepers, the esteemed consultants and investment professionals for large allocators who were well positioned to insist on prudent fees.

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**Primary culpability accrues to institutional consultants and gatekeepers.**

The template for our prudent fee standard was also provided by Jones. He was using an intuitive algebraic process for allocating the attribution of performance years before and far more expediently than the Modern Portfolio Theory (MPT) quantities for alpha and beta, later developed to statistically describe the same attributes.

Using daily market exposure, Jones calculated the risk adjusted expected

return from the most appropriate market benchmark. The difference between his actual return and this risk adjusted expected return was his risk adjusted performance. This process is well understood and widely used by good fund managers for internal attribution analysis today.

***SRAP and alpha*****: conceptually interchangeable, as both seek to describe the same thing – excess return over an appropriate, risk adjusted benchmark.**

**SRAP is the only investment performance that warrants merit pay.**

As there is no word in the investment lexicon to describe the algebraic quantity Jones calculated, I use the acronym **SRAP** (**superior risk adjusted performance**) to distinguish it from MPT's statistical alpha. SRAP and alpha are conceptually interchangeable, as both seek to describe the same thing – excess return over an appropriate, risk adjusted benchmark.

**SRAP is the only investment performance that warrants merit pay.**

Disruption for this industry that thrives on disruption in other industries is overdue. Yet, while SRAP fees would be enormously disruptive, they would only impact managers to the degree each fails to generate alpha. And the current system already approximates SRAP fees for market neutral funds. However, SRAP fees reward all alpha, including alpha from negative absolute performance.

There are various paths to adopting SRAP fees as the new standard. My firm has proposed them to managers for two decades, though only a handful have agreed. And such proprietary agreements will not lead expediently to a new industry standard.

As there are other significant flaws in the current system, the most expedient approach might involve a committee of several "800 pound" allocators to outline a SRAP standard that includes other prudent modifications. After wider discussion and agreement, a sensible fee paradigm should be published. New allocations might then be limited to managers adopting the new standard, while current managers may or may not adopt them.

Disruption is regenerative.

Let's get started. *11/23/2016*

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I "The Jones Nobody Keeps Up With" **FORTUNE**, April 1966, p.237 and "Hard Times Come to Hedge Funds" **FORTUNE**, January 1970, p.101.

II "A Basic Report to the Partners of The Fully Committed Fund" by the A.W. Jones and Co. to investors, May 1961.

LMC invites large & small managers who consistently generate significant alpha, and thus are good candidates for SRAP fees, to email introductions to:

Managers@SRAPfees.com

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Old Town Hall
610 N. Bragg Ave
Lookout Mountain, TN 37350

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