Lookout Mountain
Hedge Fund
REVIEW
Print edition published Q1 1994 - Q4 1996 © Q2 2023 (Vol. 2.03)

Blindfolded Monkey Fees

Blindfolded monkey fees are the meritless merit pay hedge funds collect on the market's performance.

How much would you pay "a blindfolded monkey throwing darts at the stock page" for delivering, as expected, roughly the same return as the market? Hedge fund investors dutifully pay a standard 20%.

With a nod to Burton Malkiel's 1973 *A Random Walk Down Wall Street*, I call the gratuitous, merit pay for meritless performance that hedge funds collect on the expected returns from their market exposure "blindfolded monkey fees."

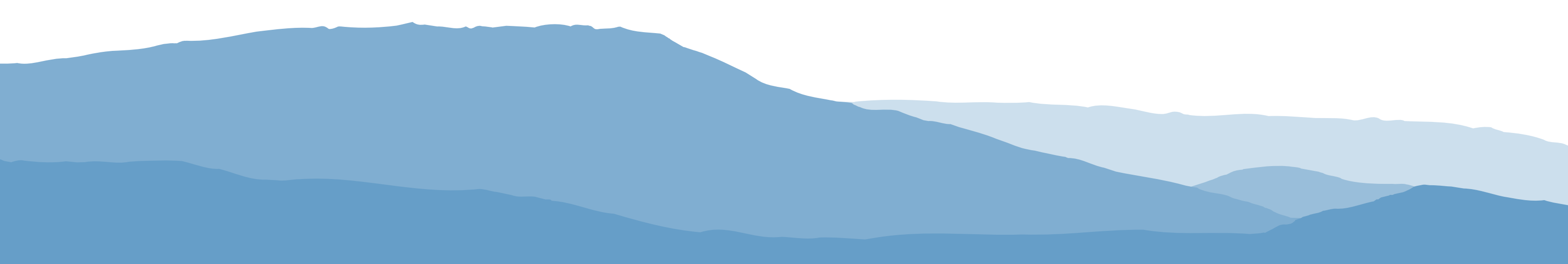
Most hedge funds get most of their performance and performance fees from market exposure, not alpha.

The fact is, most hedge funds get most of their performance and performance fees from market exposure, not alpha, the excess returns that warrant performance fees. While many funds deliver significant alpha, many of those still get most of their performance and performance fees from market exposure.

Since the mid-1990s, I've advocated an alpha-based fee system that grants performance fees for excess returns, but not for the expected returns attributable to market exposure. No manager has ever argued that alpha-based fees are unreasonable or inequitable, but few have agreed to use them. Why should they decline gratuitous fees so long as investors grant them?

Alpha-based fees don't discourage managers from having market exposure, which is usually desirable, but they sensibly deny performance fees on market exposure. The ample base fees charged by hedge funds compensate managers exceedingly well for adjustments made to market exposure. Yet, alpha-based fees astutely reward any portion of negative performance exceeding the appropriate, risk-adjusted benchmark.

The déjá vu lesson of the 2022 bear market is that blindfolded monkey fees taken on temporary but subsequently vanished performance are not



refunded. In many cases, investors never receive the performance for which they paid performance fees.

Prudence dictates that consultants and allocators regularly quantify the attribution of performance fees.

Prudence dictates that allocators regularly quantify *the attribution of performance fees* for both current and prospective investments. Only when large allocators insist on prudent fees will meritless merit pay wane as an industry standard for hedge funds.

Alpha-based fees would only diminish fees to the degree a manager fails to generate alpha for investors.

Alpha-based fees would certainly be disruptive for an industry that thrives on disruption in other industries, yet they would only diminish fees to the degree managers fail to generate alpha for their investors.

ted caldwell

LMC invites managers who consistently generate significant alpha, and thus are good candidates for Superior, Risk-Adjusted Performance (SRAP™) fees, to email introductions to:

Managers@SRAPfees.com

Lookout Mountain
Hedge Fund
REVIEW

Publisher: Lookout Mountain Capital, Inc.

Founder/CEO/Editor: Ted Caldwell
Copyright © 2023, all rights reserved.
Lookout Mountain Capital, Inc.

This digital issue may be quoted or forwarded with clear attribution and without alteration. Other reproduction in part or in whole is not permitted without prior written permission from the publisher.

For reprints, contact the publisher.

Lookout Mountain Capital, Inc.
PO Box 4383
Lookout Mountain, TN 37405

From time to time, LMC publishes articles, reprints, etc. You may register for distribution at: www.LMHFR.com

PLEASE DO NOT PHONE
Email inquiries to:
Feedback@LMHFR.com

Neither the publisher, nor anyone associated with it, accepts "soft dollars," referral fees, advertising or promotion fees, or any other form of consideration for writing about any fund or manager in this newsletter.

Information contained herein has been obtained from sources believed to be reliable, but the publisher makes no representation as to its accuracy.

Nothing herein should be relied upon for investment purposes, nor should it be construed as a solicitation of offers to invest with any manager or in any fund.