

Commentary: The management fee charade

What's lost is what's unrecovered, not what's paid

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Hardly a day goes by without someone expressing unbridled indignation about the “outrageous” management fees collected by fund advisors. Such indignation seems to suggest that the management fees paid (typically, 2% per year on committed capital) are never recovered, which is not the usual case. While it is certainly important for institutional investors to understand what fees they are paying to access private investments, it is simply wrong to imply that the fees paid are money thrown down the toilet, for in the usual case, such fees are fully recaptured during the course of the investment and returned to the investor with interest. In other words, in the typical case where a private investment returns all capital invested plus a preference return on top of that invested capital, all fees paid have actually been recovered, and this occurs regardless of whether any carried interest is also paid the manager.



As a result, is it really appropriate to characterize management fees in general as “lost expense?” Isn’t it more appropriate to visualize management fees as capital that is expected to be fully recovered and in the usual case, is recovered except in those unusual instances where the capital invested is not even returned? And if this is a more accurate picture of what role management fees play in a private investment, wouldn’t it be better to

only treat those management fees never recovered as uncollectible expense, and treat those fees actually recovered as invested capital? Thus, it is wholly inappropriate to decry the total management fees paid by an institution, as so many are wont to do. Instead, only those fees that are never recovered are the true measure of what management fees actually cost the investor. In the scheme of things, this is a much smaller number indeed.

For example, for our clients, the percentage of fees paid but unrecovered by maturity of private equity investments is typically 0%. Put another way, our clients typically recover 100% of the management fees they paid. And that percentage is based upon actual distributions received, without regard to any additional value attributable to increases in remaining portfolio assets. This means that in general, and on the basis of distributions alone, our clients expect to recover their management fees, although in unusual cases, they might not recover them at all because distributions are insufficient to repay all contributed capital.

In our experience, between 1% and 11% of private equity investments fail to return management fees upon fund liquidation. Of course, the range of unrecovered fees will be dependent upon the skill used to select the particular investments in question, but we suspect that most professionally-managed alternative investment portfolios will have recovery experience similar to our clients.

Given the foregoing, the investment community should readily contest the notion that generally, management fees are lost expense. In actuality, they are usually recovered with interest, and only in those instances where invested capital is not recovered can it truly be said that the management fees are money down the drain.

The bottom line is this: It is perfectly fine for institutions to track total management fees paid. However, the true measure of which of these fees are actually lost expenses is the relatively small portion thereof which are never recovered. Only by tracking unrecovered management fees can we really understand the actual out-of-pocket cost of such fees to the investor. Investors interested in their actual bottom line will do no less. Those who seek to discourage investment in private equity by heralding total management fees paid instead only that portion of such fees which are never recovered are being duplicitous, at best.