Kendrick Wakeman, CFA
kwakeman@badonhill.com
203-542-0588

A CASE FOR RELAXING THE LEGISLATIVE RESTRAINTS AROUND PERFORMANCE FEES IN A REGULATED FUND FORMAT

SEI has published a study[i] in conjunction with Strategic Insight as a follow-up to their 2010 report "Exotic to Mainstream: Growth of Alternative Mutual Funds" (see our memo dated June 1, 2010). We feel that the data presented in this study, as well as other studies, strongly support a legislative change in the US to permit managers to charge performance fees in a mutual fund or ETF format.

Our rationale:

1. We feel there is a fairly clear case for the utility of alternative investments in many retail investment portfolios.
    a. SEI states that demand is being driven by investors looking to "bolster performance, protect capital, and lower volatility."
    b. SEI reports that alternative UCITS were only down 7% in 2008 vs a loss of 21% for traditional assets.
    c. A recent paper from the University of California found that large endowments persistently outperform small endowments largely because they use more alternatives in their asset mix.[ii]
    d. There exists an extensive body of research on investing in uncorrelated asset classes from the standpoint of lowering portfolio volatility and/or increasing expected return.

2. We feel that the main obstacle to providing more accessible alternative product to retail is the arbitrary prohibition of performance fees for all but the wealthiest individuals and institutions.[iii]
    a. Our observation is that there are many low-leverage, low-correlation, high-liquidity strategies that would be ideal for a liquid, accessible vehicle.
    b. We feel that these strategies are not being offered in an accessible format because they would not be able to charge a performance fee. This effectively precludes the manager from providing the strategy since the manager's institutional clients would take exception to the fact that the same strategy is being offered to the public with a lower fee structure.
    c. SEI points out that most of the managers offering alternative mutual funds in the US are traditional managers, which typically do not have existing performance-based clients. We believe that many of the managers that have the most experience providing alternative product (hedge funds) are being precluded, which disadvantages the average investor.

3. We feel that the rule prohibiting performance fees is obsolete, decidedly against the interests of the average investor and should be relaxed.

a. This rule was enacted in 1998 to help protect small investors from what was then the new and largely untried "hedge fund" model.
b. Since 1998 there have been considerable advancements in both hedge fund product and the understanding of their benefits.
c. We believe that the payment of a performance fee is a simple enough concept for the average investor to understand and analyze given the appropriate disclosures (the US Tax Code is far more complicated and operates effectively under the same principle).

We would encourage investors and managers alike to contact their legislative representatives and render an opinion on the above. If such a legislative change were to occur, we believe we would see several beneficial effects on the hedge fund industry:

1. Retail investors would be able to structure lower risk/higher return portfolios the same way that institutional investors can.
2. The retail advisory business would become more robust and sophisticated in response to the new investment offerings.
3. Hedge fund managers would be able to broaden their investor base.
4. Traditional mutual fund complexes would be in a more competitive position to offer alternative product.
5. Small institutional investors would be able to access more alternative product in a more liquid format.
6. It would accelerate the convergence of large investment complexes and alternative managers, which we see as a good thing.

Not all managers would choose to market via the retail channel since they may not have a retail marketing arm (requiring a partnership) and retail is highly litigious (probably best left to the larger managers). However, we feel that such changes would drive the accessible alternative industry well in excess of $1 trillion by 2014.

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[i] "Regulated Alternative Funds: The New Conventional" *SEI Knowledge Partnership,* 2011. Link: http://www.seic.com/enUS/about/8378.htm
[ii] Barber and Wang, "Do (Some) University Endowments earn Alpha?" *University of California at Davis,* OCT 2011. See our memo dated 4 JAN 2012.
[iii] 17 CFR Part 275. Link: http://www.sec.gov/rules/final/ia-1731.htm