

PERFORMANCE FEES FOR FUND DIRECTORS: PERHAPS IT IS TIME?

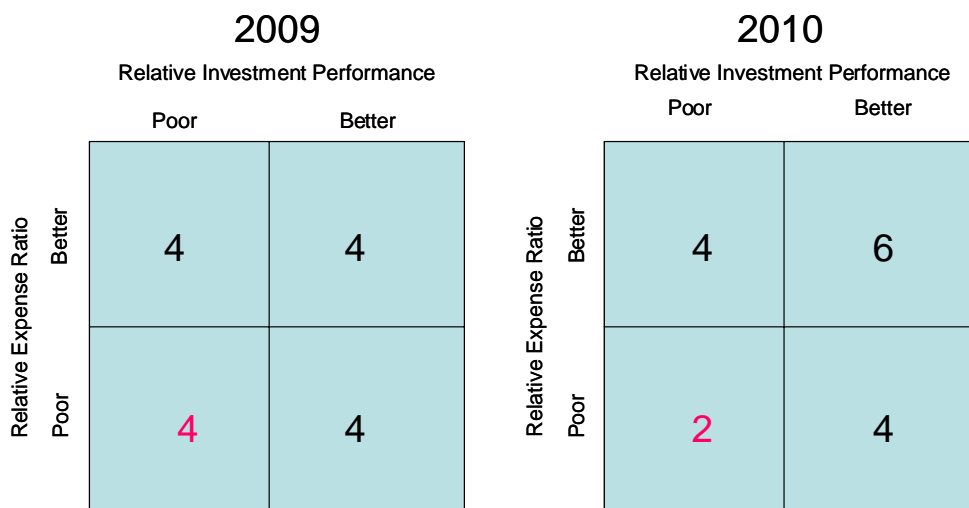
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Every now and then fund directors have a serious discussion about the merits of performance fees for the fund's advisor. Perhaps the debate is incomplete and they should also discuss what it would mean if they decided to integrate a performance fee into their own compensation. Without taking a position on the relative advantages and disadvantages of this proposition, this bulletin explores this concept.

ALIGN SHAREHOLDER INTERESTS

The majority of fund shareholders are interested in longer term results. They love gains but not as much as they hate losses. They recognize that no fund can win all the time, but they want to have the long-term capacity of doing better in their chosen fund than its competitors. They want their fund to stay true to the investment style they chose, and they do not want higher expenses dragging down their fund's performance. One advantage of the introduction of performance-based director compensation would be to indicate to shareholders the dedication the directors have in fulfilling their responsibilities.

Change in 3 Year Relative Investment Performance and Expense Control For a 12 Fund Complex – Number of Funds in Each Quartile



These desires are summarized in the simple quartile chart shown above: good and bad relative long-term performance versus good and bad relative expenses. Indeed many fund boards have adopted variants of this chart in the contract renewal process so as to highlight those funds within a fund family which are likely to require the most attention. Why not adopt this concept for fund director compensation?

The difficulty with fund director compensation today is that (1) it is often arbitrary, (2) it tends to rise in proportion to the aggregate size of the fund complex, measured either by complex assets or number of funds governed, and (3) that director compensation does not reflect the effectiveness of their efforts.

Some fund boards endeavor to measure effort, expertise and exposure as a better basis for director compensation, but no one has yet instituted a performance-based plan. What would be the basis for such a plan?

CRITERIA FOR PERFORMANCE FEE

The criteria for a successful performance fee should include that the basis is easily understood, quantifiable, long term, and focuses on aspects of governance over which the fund directors have some control. Such a performance fee should also reward the achievement of the shareholders' goals and be material in term of amount. A performance fee should not cause unintended consequences – particularly to reward the taking of excessive risk, induced mediocrity on the part of the fund advisor or micro-management on the part of the Board.

A possible basis of calculation might be the year to year change in three year performance as shown in the chart above. In this case the fund directors might receive an additional amount for each fund which moves out of the bottom left quartile. Imagine that the fund directors received a base retainer of \$100,000 for their time and expertise, plus an additional payment of \$5,000 for each of the two funds which have improved their position.

Performance fees for investment managers, by SEC regulation, must be calculated on a fulcrum basis – that is they must have the potential to move up and down equally. In the case of performance fees for fund directors this might not be necessary, as the intent is to avoid relatively poor performance rather than reward relative risk taking. On the other hand, the optics of adopting a performance fee for directors might well be improved if deductions from fees were possible as well as additions.

One of the technical difficulties of a performance fee for fund directors is that it requires the selection of either an index or a peer group against which to compare performance. The fund advisor has long lived with this issue both during contract renewal and when establishing an advisory performance fee for investors. Companies such as Lipper and Morningstar have built their reputations on the reasonable selection of a peer group for each fund in a complex, and fund directors have successfully used peer group comparison for the contract renewal process for many years.

In the next few months, many aspects of the fund director's role and responsibilities will be rethought as the Jones v. Harris awaits the decision of the US Supreme Court. Perhaps how fund directors are paid should be one of them.

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