www.HFAlert.com

Hedge Fund ALERT

Upstarts Pioneer New Forms of Incentive Fees

As blue-chip firms including **Brevan Howard, Caxton Associates** and **Tudor Investment** make headlines by marginally trimming their fees, a few smaller managers are experimenting with entirely different approaches to charging investors for performance.

Instead of taking cuts of their clients' profits based on a flat rate — traditionally 20% — **Bluegrass Capital, Marchese Investments** and other managers are structuring their performance fees based on risk-adjusted returns. Marchese, for example, is offering his separate-account clients the option of paying him incentive compensation equal to a multiple of his Sharpe ratio.

"To me, it seems like a no-brainer considering the pushback on fee structures," said the 20-year-old **Julian Marchese,** who is running $5 million following an early departure from **New York University.** "Investors don't care about the absolute return — they care about the risk-adjusted return. It makes it more complicated, but we are supposed to be a sophisticated industry."

John Netto, a futures-and-options trader and author of "The Global Macro Edge," advocates a fee structure based on what he calls the "Netto Number," which takes into account returns, volatility and the amount of capital each investor is willing to lose. "That rewards managers for maximizing returns per unit of risk, while not forcing investors to overpay for natural market performance," Netto said. "Lowering fees doesn't solve that problem — it simply lowers the fees. Managers should be paid high incentive fees when they generate a great risk-adjusted return, and they should get little when they don't."

A survey **Goldman Sachs** published in September highlighted efforts by some fund-management firms to introduce sliding-scale management fees and hurdle rates for performance fees. But investors and industry professionals said they haven't seen anything as innovative as the fee structures being implemented by Marchese, Netto and a few others.

"I've heard a lot of talk about managers doing something interesting with their fees," said an executive at a multi-billion-dollar fund shop. "I haven't seen anything."

Ed Nadel, a senior counsel at law firm **Lowenstein Sandler,** isn't surprised the new ideas are coming from younger managers and smaller firms. "For an emerging manager, it is generally more challenging to raise capital," he said. Big, established firms "can raise capital without having to think as much outside the box."

Netto, who lays out his ideas for structuring fees in his self-published book, runs a Las Vegas trading technology firm called **MPACT Trading.** His concept has inspired several managers including Bluegrass founder **Jason Roney,** who runs $150 million via a commodity-futures vehicle. Netto's ideas also have been adopted by a joint venture between two proprietary-trading firms, **SMB Capital** and **Kershner Trading,** that is devising new ways to compensate its 100-plus traders.

Marchese, who has been trading since he was 11, independently arrived at the idea of basing performance fees on risk-adjusted returns, though Netto now serves as an advisor to Marchese's firm. Among Marchese's clients is **BattleFin,** a Greenwich, Conn., firm that backs new and emerging quant-fund managers.

Netto acknowledges risk-adjusted approaches to performance-fee calculation can be complex, often requiring detailed discussions with investors. But he believes it's exactly the kind of solution investors are looking for at a time when hedge funds are struggling to generate alpha. "Fees are being renegotiated universally," he said. "Not all profits are equal, not all risk is equal. What a lot of investors hate is they are paying for beta and not alpha. The Netto Number prevents you from paying for beta and not alpha."

Chicago-based Bluegrass may hold off on collecting some incentive compensation during periods of low volatility — even if profits are high. The idea, Roney said, would be to wait and see whether his performance holds up when volatility returns to the market. If it does, then investors could feel confident they're getting what they pay for.

"It's the right way to do it for both managers and for investors," he said. "It sounds great on paper to investors and makes total sense to me." ❖

HEDGE FUND ALERT: November 16, 2016, 5 Marine View Plaza, Suite 400, Hoboken NJ 07030. 201-659-1700