The price is right?

The majority of active Africa managers charge hedge fund-like fees for long-only strategies. But are high operating costs on the continent enough to justify the added cost to investors?

By Zaki Abushal

The shape of the fund industry is much altered from its original form. The speed of change can be frightening, teams of lawyers and advisors now necessary to keep CIOs, fund managers and analysts abreast of every new development. Within that evolutionary process, one element has survived; altered, but not significantly different from its early incarnation, mildly draconian, but absolutely necessary to the survival of the industry – fees.

The question will not disappear. In the past it was possible to chart its rise and fall to the success of the fund industry and the performance of funds. The regularity with which fees were raised by the media and investors was metronomic, coinciding with any and all periods of poor performance. The question of fees has again reared its head, only this time, encouraged by uncertain economic growth. Investors are more determined than ever to ensure it remains in the limelight, steeled in their resolve by unspectacular returns and the support of the collective.

In Africa, across frontier markets as well as emerging markets, the fund manager has a different set of challenges to meet than the developed markets fund manager. Chris Derksen, head of frontier markets at Investec, draws a simple equation. "It is

more expensive to run public equity (long-only) Africa funds, especially if you make the effort to see management teams and assets in-country on a regular basis," he says.

Pan-African fund managers are faced with more than just hefty travel expenses as they aim to run a profit in an increasingly cost conscious business environment. Much of that profit will come from fees, management as a given, performance, if you're very good and a little lucky. As such, the majority charge between 1.5-2% management fees and up to 20% for performance, although there are exceptions to the rule, such as Sustainable Capital (*see box-out*), which charges no performance fee.

Of course, this applies to active management. Many of the arguments posed against Africa fund managers relate to active management fee structure against the more passive ETF/Index style of investing, which comes in much cheaper. (For the sake of this article, the focus will be on the processes of active managers, the actions they take to justify their fee structure and not a performance comparison between active and passive investing in Africa).

Higher operating costs offer ample justification for higher fees among active managers, particularly in Africa ex-South Africa, according to Prasheen Singh, head of investment consulting at Riscura. "Brokerage fees might be in the 3-5% range for trades, when in South Africa the high end of trades would be 20-25bps, so there is a vastly different range of costs for dealing in the stocks," she explains.

"The ability to access a particular market and get research out of these markets, get consistent detailed information from the company is also cost intensive. And then there are other issues like language, governance, safety and travel, which are all expensive and alter dramatically depending on where you are in Africa," Singh says.

Investor opinion

Senior fund manager Ramon Tal is in charge of fund manager selection at Blue Sky Group, the €14bn ($18.3bn) pension fund advisor to the likes of Dutch airline KLM. It is allocated to two frontier markets funds totalling 3% of its 45% equities bucket, alongside a 22% allocation to emerging markets. He understands why there are higher fees. "The fees we pay are in the range of 1-1.5% fixed flat. When you're looking at global emerging market active equity managers, you're talking about probably half the fees, but then again frontier markets are pretty illiquid, difficult to invest in, very volatile, difficult to set up new accounts, with all kinds of procedures, so we do understand to some extent where these higher fees come from," he says.

The cost of doing business for a fund

CLAIR MATHE
general manager, investments, BPOPF

A different approach: Sustainable Capital

Africa funds are expensive, but there are exceptions to the rule. Sustainable Capital's managing director Kevin MacDonald explains why the Africa Sustainability Fund charges investors a flat fee of 1.5% with no performance fee

"We believe that this fee is fair to the manager as well as the client, and the most competitive in the market," says MacDonald (*pictured*). "We have seen growing evidence that fee structures are constraining inflows and impairing the growth of the market. During our meetings with institutional investors, it is clear that many of them have held back their investment commitments into Africa due to the high fee structures in the market.

"The introduction of appropriately structured performance fees can align the interests of the investor and the manager. This is especially relevant in the Africa ex-SA listed equity market, where imperfect information provides the potential for material security mis-pricings and meaningful opportunities to generate stock-specific alpha.

"The structure of the performance fee and, in particular, the benchmark against which the manager is rewarded for investment skill is a contentious issue for African investors. Investors are only really interested in true 'active alpha', as this is the best measure of the manager's skill. A performance fee over an inappropriate benchmark gives rise to the potential for 'misfit active return,' which is the portion of a manager's total relative return generated by selecting the wrong benchmark.

"A fund's benchmark should reflect the manager's investment opportunity set. In our opinion, the use of absolute return benchmarks is completely inappropriate in the African investment market.

"There is little doubt that African listed equity markets are likely to deliver significant beta for investors over long-term time horizons. The risk to clients is that their beta may be significantly diluted by performance fees that are unrelated to investment skill."

Due to the flawed nature of most Africa benchmarks, MacDonald says, Sustainable Capital collaborated with S&P to create the S&P Pan Africa ex SA Capped Index to track alpha generation, which Sustainable Capital uses as the benchmark for its own fund. "This is clearly a more demanding hurdle rate than an absolute return benchmark, particularly for clients who are now entering African listed equity markets at close to their all-time lows in valuation terms relative to developed and emerging markets globally."

CHRIS DERKSEN
head of frontier markets, Investec Asset Management

PRASHEEN SINGH
head of investment consulting, Riscura

manager will ultimately filter down to the investor through the fees it charges. "It is the investor that ultimately needs to be happy with paying the fund managers' fees. As such, fees are high on the agenda for asset owners," says Riscura's Singh.

The ability to go off benchmark in search of alpha is integral to the success and perception of active managers – it helps justify higher fees. "I would argue that in South Africa there is a bias to resources. If you're keen on resources then you can go with the index but if you want no-resource stocks then the ability to generate alpha is there. Outside of South Africa we don't have proper indices, so the need for active management is very high, as is the value you could achieve out of that. If you want broader coverage, you have to go down the active route," says Singh.

Paying higher fees to a manager doesn't guarantee benchmark beating returns, or the type of performance storied hedge fund managers are able to charge 4:40 for, although African funds that charge 1.5% (and upwards) management fees with a performance kicker (albeit capped) understand the onus is there to justify its higher fees.

"The universe that you would benchmark Africa investments against is usually a Libor+ kind of benchmark or a cash related benchmark against an equity related benchmark. Nobody is happy if you're paying a performance fee over and above cash when you're actually taking equity risk," says Singh.

"Investors are really looking to get value for money. They're looking to justify the fees. It's actually more relevant now because markets are not performing as they used to and it actually eats into your return over time," says Clair Mathe, general manager of investments at Botswana Public Officers' Pension Fund (BPOPF).

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>
> - ***Ramon Tal***

Under negotiation

In response, she says, investors are negotiating lower fees as over time this can make a big impact on a pension fund's assets. "What does it do to your actual returns over 10 years if you pay 100bps higher? It's actually amazing what it does to the members' returns at the end of the day. I think it's something that the trustees are actively looking at and saying, 'it might seem like one percentage point difference now but cumulatively, over the next 10 years, you see how much difference it actually makes had you negotiated for a lower fee than you got'," Mathe says.

"I think it's quite important, especially when returns from equities remain subdued and you don't get much returns from cash. For those things that you actually have control over, you have to make sure you get a very good deal for your members."

Investors, in particular the large institutional players, are prepared to take the fight on fees to the next level, according to Mathe. She says investors are starting to question whether managers should be penalised for underperformance by reimbursing fees (*see box-out*). Pushing for reimbursements may be a step too far, although it highlights the battle both active and passive managers face over the fees they charge.

"Hopefully, with new active managers entering the space, the fees will come down," says Blue Sky Group's Tal.

Should underperformers be penalised?

Clare Mathe of the BPOPF asks whether reimbursement of fees is justifiable for managers that underperform the markets: "The question trustees are now asking in relation to performance fees is: why is it that you participate on the upside and technically don't participate on the downside? If you don't perform, it's not like you're going to reimburse the investor. The fund manager is only saying that they're not going to take any more. But that is not to say that I have to give something from my pocket in return for the missed opportunities that I actually had for the fund," she argues. "Those are some of the things that investors are now starting to say. Are some of the performance structures really applicable? Are managers really being punished for underperformance?" she says.

Riscura's Prasheen Singh is more phlegmatic when it comes to reimbursement. "Nobody pays anything back. It's not part of the equation really. Managers will say that they budgeted and spent the fee you've paid them and those that earned bonuses have been paid them. From their budget perspective, unless they bolt in that fees reduce if there is negative performance, they won't accommodate anything like that," she says.