



2004 Investment Management Fee Survey

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Executive Summary

Investment management fees get at the heart of the business relationship between fund sponsors and their investment managers. While these fees are always an active topic of discussion, recent business and investment volatility have brought this discussion to the fore. Some fund sponsors are questioning whether their managers are providing sufficient value-added to justify their fees. Managers are faced with balancing these fee pressures against the growing costs for compliance, systems, and other areas of their businesses.

Competition, product demand, size of mandates, and budgetary considerations all play important roles, both when the investment firms set standard fee levels and when fund sponsors negotiate these published fees.

Callan Associates conducted the 2004 Investment Management Fee Survey to provide both fund sponsors and investment managers with an up-to-date report on fee payment practices, uses, and trends in the U.S. institutional investment market.

This report summarizes the survey's results incorporating responses from 166 fund sponsors and 134 managers, and includes important comparisons of the significant changes in the industry since our 2000 Fee Survey. Key findings include:

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- When conducting investment manager due diligence, fund sponsors rank the importance of the managers' fees in the middle of the priority scale, similar to its ranking four years ago. It is Callan's experience that fees become increasingly important as an investment firm advances in the selection process. Once hired, fees often become a point of contention for those firms who have not delivered the value added desired by their fund sponsor clients.
- It is fairly standard industry practice to pay fees quarterly in arrears. One-third of the respondents indicated they calculate these fees based on an average of month-end values, with the remaining respondents calculating fees based upon quarter-end market values.
- Fund sponsors have generally perceived managers' growth rates for profitability and revenues to be lower than they actually are. As a case in point, fund sponsors anticipate managers' revenues to be flat in 2004, while the managers in our survey are more optimistic regarding their growth prospects.



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- Using the compensation analogy of base salary plus bonus for the allocation of fee revenues, approximately half of the fee revenues are allocated to cover base costs of investment management. Less than one-quarter of fee revenues are paid out in the form of a bonus to the portfolio manager or team, with the remaining one-quarter to one-third flowing back to the firm as profit. As a percentage of total revenues, all asset classes contributed less to the firms' bottom lines relative to what the survey respondents reported four years ago.
- Perhaps the most dramatic change in the results of this survey versus the one Callan conducted in 2000 was the increased usage of performance-based fees. More than 60% of the investment manager respondents and 30% of fund sponsor respondents indicate using these fee structures for at least some of their traditional investment mandates; these figures are up from 37% of investment managers and 12% of fund sponsors just four years ago. Callan presents three performance-based fee arrangements in this survey as they characterize a majority of the survey responses to this question.
- More than ever reported before, investment managers indicate they are making some changes to their published fee schedules often by increasing them, a trend that is confirmed in the fee data presented in this survey report.
- Fund sponsors reported that they negotiate fees with more than two-thirds of their investment managers. Unlike four years ago where public funds dominated the fee negotiation discussions, today all client types—corporate, endowment/foundation, multi-employer and public—attempt such negotiation.
- This report includes survey results on published and actual fees for 10 different active and passive asset categories. The degree of the differential between published and actual fees paid to investment managers within individual asset classes is influenced by: (1) an individual product's performance and risk characteristics; (2) the maturity of the product with respect to its historical use by institutional investors; (3) marketplace supply and demand forces; (4) the length of the relationship the manager has with the client; (5) the number of mandates the managers has with the client; and (6) the size of the individual mandate, with larger accounts receiving greater discounts.
- Callan's research has shown that fee differentials across asset classes are influenced by a variety of factors, including: (1) where the product falls on the capital market line; (2) the maturity and/or relative efficiency of the asset class; and (3) supply and demand forces in the marketplace.



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- Callan compared the fee responses in this year's survey with the one conducted in 2000 and found that, overall, the gap between published and actual fees for many of the asset classes has widened. Results show that published fees have risen on the order of 10–20% on average while actual fees have declined by approximately 5% on average. U.S. small cap equity showed the most dramatic increase in the spread between published and actual fees.
- When asked what their biggest issue or concern is regarding fees, the majority of fund sponsors noted one of four areas: (1) fees versus value-added; (2) the use of most favored nations clauses; (3) managers shifting focus from portfolio management to managing the bottom line; and (4) fee transparency.
- Investment managers' most frequently noted concerns about fees include: (1) margin pressure; (2) expanded distribution channels taking a piece of the revenue pie; (3) performance based fees' ability to fund long term business strategies; and (4) the use of most favored nations clauses.

To order the survey please email your contact information to the Callan Investments Institute at institute@callan.com, or call Ray Combs or Gina Falsetto at 415.974.5060.