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Money managers willing to play ball in SDCERA's fee revamp

The $12bn fund is asking managers to sacrifice the safety of a flat-fee structure, and it is finding takers

Dietrich Knauth | 08 Sep 2017

The $12bn **San Diego County Employees Retirement Association** (SDCERA) is overhauling its fee agreements by asking money managers to take only an index-level base fee when they fail to outperform the market, in exchange for higher upside when they beat the benchmark. For the most part, managers are willing to chase upside in exchange for sacrificing the safety of a flat-fee structure.

Although SDCERA has traditionally paid a flat-percentage fee to its external managers, CIO **Stephen Sexauer** has been working to move toward performance incentives since he took the position in the summer of 2015. With mounting industry-wide pressure on costs, and a major nationwide shift from active management to passive management, asset managers are willing to be more open to non-traditional compensation structures.

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"There's just enormous pressure on management fees – people are using ETFs, they're using index funds – so managers, to maintain their business, are now open-minded about performance fees," Sexauer told *MMR*. "If you randomly called up 20 money managers, they'd all say the same thing. The industry is changing and changing rapidly."

Incentives and alignment

San Diego County has designed new agreements, along with a transparent process for simulating outcomes and controls to discourage excessive risk-taking, which aim to create win-win conditions when managers perform as they say they will. For public markets investments, San Diego wants to pay index-like annual base fees, with a performance fee that is a percentage of manager alpha after the base fee is paid. The performance fee only pays market rate for active management if there is positive alpha, and San Diego typically will allow managers to keep 27% of the excess returns as performance fees. On the flip side, any year of negative alpha must be earned back before an annual performance payment is paid, Sexauer said. For investments that are not tied to an index benchmark, investments like private equity and real estate, San Diego County expects to set a benchmark equal to its annual rate of return assumption, with a base fee somewhere between index fees and standard market rate, to account for the fact that such investments can require more staff and involvement than equities investments.

"All economics can be collapsed into four words: people respond to incentives," Sexauer said. "We created, we believe, investment management agreements where the managers benefit equal to or greater than if they took a fixed-fee contract, if they meet the trust fund objectives. … This is something that's symmetric. If they're good, they will be better off doing this, and so will we."

Getting everyone on the same page

Transparency is an important part of SDCERA's efforts to get buy-in, both from managers and its own board. For the external managers, SDCERA runs simulations based on a range of outcomes and shows the relative likelihood that a manager will meet its target, underperform, or earn bonus

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fees. Sharing those simulations and their underlying assumptions helps managers evaluate their own ability to meet their targets and feel more comfortable with the new fee structure, Sexauer said

"We're completely transparent with how we model these things," Sexauer said, giving an example of a an agreement that has a fixed fee of four basis points, with a 27 basis point bonus for every 1% of overperformance, up to a certain cap. "Over time you'll earn 31 basis points. And if you ring up all the consultants, that's the going rate for this kind of portfolio, 31 basis points. And we share that with the managers, we built the infrastructure to simulate that, they say 'yup that's right, we think we'll make that much' … We now have the infrastructure, in the last year, that allows us to have an open conversation about both sides winning."

SDCERA caps performance fees at about double the market rate for a fixed-fee agreement, typically 60 basis points. The cap on performance fees is part of SDCERA's efforts to minimize risk when incentivizing higher returns.

"We don't want them taking any more risk for our account than for any other account," Sexauer said.

Firms that participate in performance fee agreements must have independent risk management capability, which sends reports directly to SDCERA, and participate in periodic reviews with the pension fund about how much risk they're taking. The cap also prevents SDCERA from paying for performance that is unprecedented and unrepeatable – in other words, luck.

The transparency also helps SDCERA staff explain to the board exactly the fund is getting in return when it pays high fees to a manager. If a manager beats the benchmark by 100 basis points, it will earn 27 cents of every dollar, while SDCERA keeps 73 cents, which is something that boards understand.

"For every dollar we pay them, we get almost three dollars of gain," Sexauer said. "Our board can literally see everything we're doing, and see it in dollar terms."

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The new policy earned support from members of SDCERA's board, including Chairwoman **Dianne Jacob**.

"It's a big change, but a really good change," Jacob said at the fund's August meeting.

Getting buy-in from managers

Managers have largely been receptive to the change, though some firms would rather walk away than adapt, Sexauer said.

"Managers that are good and have confidence in their businesses are completely open to this," Sexauer said. "We've had other managers who want us to hire them … and when we ask them to consider an alignment structure like this they basically say 'no thanks.' It's simpler just to get paid whether you add value or not."

SDCERA is willing to let some managers walk away, and does not believe that the new fee agreements will meaningfully shrink the pool of available investment managers.

"The pool is infinitely large, from our perspective, of good managers who would like to talk to us," Sexauer said.

The new agreements are not being relied on to reduce managers fees paid by SDCERA, Sexauer said. The pension fund has already sharply cut its fees – from $110m a year in 2015 to $65m in 2017 – through a number of previous moves, including allocating 25% of its assets to passive management, moving assets to semi-passive management, eliminating its hedge fund allocation, simplifying its portfolio structure, and reducing the number of consultants from three to two.

"It's not really meant to save lots of money in fees," Sexauer said. "We've already done a lot, so this is more about getting value added going forward."

SDCERA plans to work the performance fee agreements into new contracts with new managers, and over time with existing managers as well.

"We're doing it one manager at a time, and each one takes time," Sexuaer said. "We're talking to our existing managers where this would fit, and for any new manager we're looking at, this is part of the conversation."

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