Investment outsourcing fee basics

What are the different investment outsourcing fee approaches?

PART ONE OF A TWO-PART SERIES ON INVESTMENT OUTSOURCING FEES

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In recent years, there has been a surge in non-profit organizations’ choosing to outsource the investment management of foundations, endowments and other investment pools. According to aiCIO magazine’s first Investment Outsourcing Survey, conducted in 2012, nearly 56% of the 300-plus asset owners who responded are either currently outsourcing some part of their investment management function or planning to do so. The increased demand has attracted new entrants into the outsourcing market. The numbers of traditional consultants, boutique investment managers, traditional money managers and pure outsourcing multi-managers all add up to a fragmented market; thus, outsourcing as an offering varies across the board, and so do the fees proposed by providers. Institutions considering outsourcing find it challenging to determine what is included in one offering and not in another.

This paper is the first of a two-part series evaluating investment outsourcing fees and determining what is included in them. First, we offer an understanding of how investment management fees are calculated. After we have covered these basics, we will discuss different outsourcing approaches in the second paper. Our goal is to equip you with a list of questions to consider when evaluating the fees charged by your outsourced chief investment officer (OCIO).

Fee structures and investment outsourcing fee approaches

It is important to differentiate between “fee structures” and “investment outsourcing fee approaches.” Fee structures are the basic fee-calculation methods utilized in the asset management industry. Investment outsourcing fee approaches may involve one or more fee structures, depending on which services are included in an OCIO provider’s offering. Below, we list the most common forms of fee structures observed in the investment management industry.
**FEE STRUCTURE** | **DESCRIPTION** | **EXAMPLE**
---|---|---
Flat basis point fee | A fixed percentage of the assets under management (AUM) of a fund or portfolio, usually expressed in basis points or percentage per annum. As assets under management increase, the dollar amount of fees goes up as well. | Example of fees as a percentage of AUM: 
50 bps in fees would be 
= 50 x 0.0001 x AUM 
or 0.50% 
Example of a tiered sliding scale fee schedule: 
- 50 bps – first $50m invested 
- 45 bps – next $50m invested 
- 40 bps – excess of $100m invested 
Total fees incurred will be the sum of fees charged for AUM within all applicable ranges 
Example of a stepped sliding scale fee schedule: 
- 48 bps – $50m-$100m – applies to all assets invested 
- 45 bps – $100m-$150m – ** 
- 43 bps – $150m-$200m – ** 
Total fees incurred will be determined within a single applicable range. 

Sliding asset-based fee | Similar to flat fee in that it is expressed in basis points or a percentage of the assets under management. However, the percentage or basis points vary with the level of AUM. Sliding asset-based fee can be tiered or stepped. 
Tiered fees: Provides fees which (a) decline as assets increase above pre-determined breakpoints, and (b) are applied sequentially to assets within those breakpoints. 
Stepped fees: Provides fees which (a) decline as assets increase above pre-determined breakpoints, and (b) are applied to all assets invested once a breakpoint is reached. | 

Performance fee | Based on the performance of the fund or portfolio outsourced to the provider; i.e., the better the performance, the higher the fees. There is typically a minimum return hurdle and a maximum return cap for the performance fees. | Example of performance fees: 
The 2 and 20 performance fee would be 
= 2% of AUM + 20% of return earned by the investment, in excess of agreed benchmark 

Note: The interests of the OCIO should be aligned with the risk and return objectives of the portfolio.

**Investment outsourcing fee approaches**

The most common forms of outsourcing fee approaches observed in the industry are:

- **Bundled fees**: Typically sliding asset-based fees that include any underlying costs of managers, custody, performance reporting etc. Usually stated as basis points or percentage charged for different levels of aggregate assets at the total portfolio or fund level. If the entire portfolio is being outsourced to a single provider, the fees may be aggregated at the total portfolio level. However, if multiple providers or managers are involved, the assets may be aggregated at the fund level for each provider. On request, the OCIO may provide the proportion of the bundled fees associated with:
  - Strategic planning 
  - Portfolio management 
  - Administrative services 
  - Custody 
  - Underlying Investment managers 

- **Unbundled fees**: Typically broken down separately by individual costs: strategic advice, manager costs, custody, performance reporting, etc. Sometimes, unbundled fees may also include a separate “OCIO fee,” without a disclosure of what is included in this fee. 

- **Hybrid bundled-unbundled fees**: An example of hybrid fees is when the outsourced offering is utilizing mutual funds. Due to the nature of the regulatory requirements around mutual funds prospectuses and reporting, the fees of each mutual fund are available to the investors.
Evaluating different fee approaches: Questions to consider

Given the complexity and variability of the offerings in the outsourcing market, there is no “one-size-fits-all” approach when it comes to fees. There are benefits and limitations with each approach, and there is merit in evaluating each to determine which will give you the best value for your needs (and your money!). Following are some questions you and your committee should ask when determining the fee approach that is right for you.

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<th>CONSIDERATION</th>
<th>QUESTIONS TO ASK YOURSELF</th>
<th>RECOMMENDED FEE APPROACH</th>
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<td>Fee structure</td>
<td>Is a fee structure that is simple and straightforward preferred?</td>
<td>Bundled fees</td>
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<td>Is the fee structure easy to understand?</td>
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<td>Higher certainty</td>
<td>Do you prefer higher certainty as to what your fees will be?</td>
<td>Bundled fees</td>
</tr>
<tr>
<td></td>
<td>Do you need to know up front what you are paying, e.g., for budgeting purposes?</td>
<td></td>
</tr>
<tr>
<td>All-in fees</td>
<td>Do you want to avoid hidden costs or future surprises?</td>
<td>Bundled fees</td>
</tr>
<tr>
<td>Individual components</td>
<td>Do you need transparency on the breakdown of the fees (advisory fees, investment management fees, etc.)?</td>
<td>Unbundled or bundled fees</td>
</tr>
<tr>
<td>Individual manager fees</td>
<td>Do you prefer that individual manager fees be passed directly to you instead of being the responsibility of the OCIO provider?</td>
<td>Unbundled fees</td>
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<td>Are you prepared to deal with expense volatility?</td>
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<tr>
<td>Flexibility</td>
<td>Do you prefer the flexibility of picking and choosing what you want to pay for, even if you end up paying more for individual services?</td>
<td>Unbundled fees</td>
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</table>

In Russell’s experience, the benefits of a bundled fee approach generally outweigh those of an unbundled approach in the context of an investment outsourcing arrangement. A bundled fee approach has the following benefits:

- Up front, you know exactly what your total fees will be for your current and future asset allocations and AUM levels.
- You do not need to negotiate custody costs or individual manager fees separately. The OCIO does it for you.
- You don’t need to worry about unexpected costs over the course of time.
- You can still view a breakdown of the all-in fees while still enjoying the benefits of consolidation.
- You can shift the responsibility of managing underlying manager costs to the OCIO, instead of dealing with them yourself.

Conclusion

Understanding fee calculations and approaches is only one part of determining whether you are paying the right price. The second key component is asking your provider the right questions and determining what best fits your needs. In the second paper in this two-part series, we will discuss the kinds of questions you should be asking your OCIO provider to ensure that you fully understand the fee structure.

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First used: February 2014 (Disclosure revision: December 2014)

USI-18869-02-17