Russell OpenWorld® Russell Investments

Performance Fees: An overview

Funds in OpenWorld® use performance fees to ensure access to innovative managers and to keep base fees highly competitive. This note provides an overview of the key characteristics of the performance fee approach used in OpenWorld®.

Why use performance fees?

While it is difficult to demonstrate conclusively that managers with the incentive of a performance-related fee are likely to outperform managers on traditional annual management fees, performance fees have nonetheless grown in popularity with managers and investors in recent years. We find this is especially true amongst the innovative, high-alpha managers we make available via OpenWorld®.

We include performance linked fees in OpenWorld® for three reasons:

- Performance fees align the interests of clients and managers, as they are paid only if the managers generate performance in line with expectations;
- Performance fees enable us to access managers at attractive and highly competitive base management fees;
- Many of the managers we seek to include in OpenWorld® strictly limit capacity, and wish to maximise the management fees they can extract from this limited investment capacity. Performance fees allow us to gain access to capacity-constrained managers in circumstances where flat fees would be either insufficient or uneconomic.

A single performance-related fee in each fund

While conceptually appealing, actually implementing performance fees in a way that treats investors and managers fairly is a complex task.

Fees for OpenWorld® funds comprise a base annual management fee plus a fee that is earned only if the fund's performance exceeds a target or benchmark return plus an additional amount equal to the base management fee charged on the institutional share class. The performance fee element is split between Russell and the manager in an agreed proportion. The maximum combined participation in any benchmark relative out-performance is 20% (e.g. 10% to the manager, 10% Russell). The precise split is determined through negotiations with the manager.

The Irish regulator has reviewed and approved the performance fee model used in the Russell OpenWorld® range.

Principles and objectives for performance fee implementation

While intuitively appealing, including performance fees in funds that trade regularly, incorporate multiple share classes, have many investors and the ability to change managers is complicated to administer. Given the innovative and unique characteristics of the OpenWorld® funds, we have had to create an innovative and unique approach to implementing performance fees. We sought an approach that would achieve a number of key objectives:

- Treat all customers, managers and Russell in the fairest way possible.

- The performance fee paid should represent as closely as possible the shareholder's experience during the period in which they are invested.
- Russell should be required to make up any historic underperformance before collecting performance fees; but in the event of a manager change, the incoming manager should not have to recover the previous manager's underperformance before earning a performance fee.

The approach we developed is based on a daily accrual of money-weighted performance fees. Rather than a high water mark, we have created a claw-back mechanism to ensure that investors only pay a performance fee if, over the long term, there is good performance. We also use crystallisation on fund redemptions to ensure that redeeming investors pay the performance fee accrual that is due from them, thus protecting the remaining shareholders. These features are described below.

Basis for the fee

Performance fees are earned when the return of the fund's Gross Asset Value exceeds the benchmark return plus the fee on the institutional share class.

Most fund providers using performance fees use Net Asset Value (NAV) as the basis for measuring out-performance. However, OpenWorld® funds have multiple share classes and using NAVs for each share class would be extremely complicated.

Therefore, OpenWorld® funds measure out-performance by comparing the performance of the fund's Gross Asset Value (GAV) with the performance of the benchmark plus a hurdle equal to the Institutional share class fee, which is our standard and most common fee. This hurdle will, however, apply across all share classes. Effectively, therefore, all investors will be paying performance on alpha "net of Russell's standard fees".

Money-weighted fee

Ideally, to avoid the possibility that one investor subsidises another investor due to differences in trading dates, the performance fee would reflect each and every client's experience in the fund based on the precise dates when they bought into and sold out of a fund. However, this is not operationally practical in a daily traded fund with multiple share classes. We have, therefore, adopted a money-weighted approach in which the benchmark-relative performance is multiplied by the fund's opening assets to appropriately weight and accrue the amount of the performance-related fee. This provides a simple yet equitable way to charge the fund.

The "notional negative account" claw-back mechanism

Many funds using performance fees based on "since inception" or "average performance" use a high water mark to ensure that investors recover any historic underperformance before paying a performance fee.

Russell OpenWorld® does not use a high water mark approach because the fee is money-weighted, and as such the fee is recorded as a cumulative dollar-amount.

If the fund is not in a situation in which it is recovering historic underperformance, then performance in excess of the target will result in the generation of an accrual reflecting the fund's liability to pay the performance fee to Russell and the underlying manager. Subsequent underperformance would erode this accrual as the fund's liability to Russell and the manager diminishes.

The performance fee accrual cannot be negative, but historic underperformance must be recovered fully before Russell can collect a performance fee. To account for this, underperformance in a fund that has no performance fee accrual will result in the creation of a “notional negative” account. The value of this account is not reflected in the fund’s price, but the underperformance it represents must be clawed back by future out-performance before any performance fee can be earned again. **This provides the equivalent effect of a high water mark system.**

If a manager is changed, any negative notional amount relating to the exiting manager is eliminated, whilst the negative notional account for Russell remains. Russell’s negative notional account must be clawed back prior to Russell being able to charge its performance fee. In this way Russell is only paid if the fund has added value including any manager changes made along the way, but the separate underlying managers can still earn a fee even if the manager that they replaced was below benchmark. Effectively, this means that Russell and the manager each have a different claw back (or high water mark) requirement.

This solution protects clients’ interests, without compromising the Fund’s abilities to replace managers when necessary.

Crystallisation

Any accrued positive performance fee will be crystallised in full on an annual basis, and also pro-rated on redemptions. When there are redemptions at the fund level the proportion of the accrued fee (or notional negative) applicable to the redemption will crystallise, i.e. become payable (or will be written off) and can not be eroded by future underperformance. As accrued (or notional negative) performance fees are crystallised, the cumulative accrual will adjust by the payable amount without any impact on the NAV. Payable amounts will then be transferred to Russell and the money manager on a quarterly basis.

This approach to crystallisation, in conjunction with money-weighting, ensures that in the event that a fund experiences a decline in assets under management, the claw back is not proportionately too large at a lower asset base. This protects the interests of the funds’ shareholders.

Conclusion

Performance fees are intuitively appealing in that they can align the interests of investors and managers, and can enable investors to access managers on competitive fees that might otherwise be prohibitively expensive. However, as the issues raised in this note suggest, incorporating performance fees in regularly traded funds with multiple share classes, many investors and with the ability to change the underlying manager, is not straightforward.

We believe that the innovative approach we have developed facilitates the use of performance fees, protects the interests of all shareholders in the fund and treats the managers, Russell and shareholders fairly.

If you have any further questions about the performance fee methodology used in OpenWorld®, please contact your usual Russell representative.

For more information:

Call Russell Investments at +44 (**0)20-7024-6000** or
visit **www.openworldinvesting.com**

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