Determinants and Implications of Fee Changes in the Hedge Fund Industry

44 Pages
Posted: 15 Mar 2011
Last revised: 11 Nov 2012

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Date Written: March 13, 2011

Abstract

Using a novel dataset that tracks daily changes in hedge fund fee structure, we examine the determinants and consequences of changes in the three components of the fee structure, namely the management fee, incentive fee, and the high-water mark provision. We find that funds respond symmetrically to past performance by increasing and decreasing their incentive fee following good and poor performance respectively. Further, funds increase their management fee after higher capital flows to mitigate decreasing returns to scale while larger funds decrease their management fee to pass on the economies of scale to the investors. Increase in the incentive fee is typically accompanied by addition of the high-water mark provision to mitigate the risk-taking behavior. Competitive forces in the hedge fund industry also drive the fee changes as funds which deviate from the average fees within their investment style tend to change their fees towards the average. Fee changes affect both future fund performance and investor flows. Future performance is worse subsequent to fee increases but there is no improvement in the future performance for fee decreases. Fund flows tend to be higher after fee decreases, a result driven by the management fee rather than the incentive fee. These findings indicate fees being determined by the bargaining between managers and investors while consequences of fee changes reflect the opportunistic behavior of managers in expropriating surplus from their investors.

Keywords: hedge fund fee changes

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