Choosing and contracting managers

Performance Measurement

1 A story: the sign on the restaurant door

- A sign on the door is only a claim
- Look in the kitchen: process, people, portfolio
- Ask why the skill should last
- A good result from a poor kitchen is luck

IN THE LESSON

- A restaurant hangs a sign that says every dish is cooked fresh from local farms.
- You walk past the kitchen and see boxes from a wholesaler and a freezer full of ready meals.
- The sign may be sincere, but the kitchen does not match it.
- Judging a manager starts the same way.
- Isla Brenner does not ask first how well the manager did last year.
- She asks what the manager says it is good at, why that skill should last, and whether the kitchen, meaning the process, the people and the portfolio, really looks like the claim.
- A good result from a poor kitchen is luck, and luck does not repeat.

2 The claim and the proof

The claim

Philosophy → Process → People

The proof

Holdings → Attribution → Capacity

IN THE LESSON

- Here is how to hold it in your head.
- The top row is the claim.
- First comes the philosophy: which mistake in the market, or which reward for bearing risk, the manager believes it can collect.
- Then the process, the steps that turn that belief into a portfolio.
- Then the people who run it.
- The bottom row is the proof.
- The holdings should look like the claim.
- The attribution, which splits return into its sources, should show returns coming from the stated edge.
- And the capacity, meaning how much money the strategy can take before it stops working, should be large enough for the assets actually held.
- Philosophy, process, people and portfolio must all agree.

3 What makes a philosophy credible

- Name the mistake or reward collected
- A behavioural, structural or informational cause
- Why does it last once others compete?
- Why can this firm capture it, not others?

IN THE LESSON

- So what makes a philosophy credible?
- First, it must be specific.
- We are good at picking shares is not a philosophy.
- A philosophy names the source of return.
- Perhaps investors overreact to bad news, which is a behavioural reason.
- Perhaps a rule forces some big investors to sell, which is a structural reason.
- Perhaps the firm digs up facts that others miss, which is an informational reason.
- Then comes the hard question.
- Why does the opportunity last, and why can this firm capture it when others cannot?
- An edge that anyone can copy is soon competed away.
- A credible answer survives that competition.

4 Testing the process, stage by stage

Each stage should follow from the claimed edge

Stage	Question to ask
Universe	Where does it look?
Ideas	How do names surface?
Build and risk	How sized and controlled?
Sell	When does a holding go?

IN THE LESSON

- Next, test the process against the philosophy, one stage at a time.
- The universe is the set of securities the manager looks at, and it should be the place where the edge lives.
- Ideas ask how names surface, through screens, meetings or company visits.
- Building the portfolio asks how positions are sized and how risk is controlled, with limits and checks.
- And selling asks the question managers like least, which is when a holding goes.
- Each answer should follow from the edge.
- A manager who claims to exploit overreaction to news, but sells on a fixed calendar, has a process that does not fit its own philosophy.

5 Is the active part worth the fee?

Effective fee on the active part = fee ÷ active share

Fee charged	Percentage of all assets
Active share	Part that differs from the index
Effective fee on the active part	What the active part really costs

IN THE LESSON

- One rough test reads the portfolio against the price.
- Active share is the part of a portfolio that differs from its benchmark.
- A copy of the index has an active share of nought, and a bold portfolio has a high one.
- The fee is charged on all the assets, but only the active part is truly active.
- So divide the fee by the active share.
- The answer is the effective fee on the part of the portfolio that differs from the index.
- The lower the active share, the more the client pays active prices for something close to an index fund.
- Tracking error, the volatility of the gap to the benchmark, tells the same story from the risk side.

6 Example 1: Kestrel's claim against its book

Kestrel Capital charges 0.85% a year (illustrative)

Claimed	high-conviction picker	**30 to 50 names**
Holdings	active share 45%	**300 names**
Tracking error	2.5%	**little active risk**
Fee on the active part	0.85% ÷ 0.45	**1.89%**
Assets	tripled in three years	**capacity?**

IN THE LESSON

- Now the family's shortlist.
- Kestrel Capital says it is a high conviction stock picker, holding thirty to fifty best ideas, for a fee of point eight five per cent a year.
- Isla Brenner reads the latest holdings.
- There are three hundred names and an active share of forty five per cent, so the portfolio sits close to the index.
- Tracking error is two point five per cent, which is little active risk.
- Now divide.
- Point eight five over point four five is one point eight nine per cent, what the family really pays for the part that differs.
- And assets have tripled in three years.
- The portfolio contradicts the philosophy.

7 The people, and what pays them

- Depth: can the process survive one departure?
- Key-person risk: whose exit ends the strategy?
- Incentives: paid on results or on size?
- Capacity: is there room for more money?

IN THE LESSON

- A philosophy and a process are only as good as the people who run them.
- Isla Brenner asks four things.
- First, how deep is the team, so that one departure does not break the process?
- Second, how much rests on a single key person, whose exit could end the strategy?
- Third, how are people paid: do they share in results, or only in the size of the firm?
- Fourth, is there capacity, meaning room for the strategy to take more money?
- On this last point incentives often pull the wrong way.
- A firm paid on assets earns more as it grows, even when the growth hurts the clients it already has.

8 Example 2: has Kestrel outgrown its edge?

Kestrel's fee is 0.85%; capacity is its own estimate

Assets three years ago	$1,200m × 0.85%	**$10.2m fees**
Assets now, tripled	$3,600m × 0.85%	**$30.6m fees**
Capacity, Kestrel's estimate		**$1,500m**
Assets above capacity	3,600 − 1,500	**$2,100m**
Share of assets beyond it	2,100 ÷ 3,600	**58%**

IN THE LESSON

- Back to Kestrel.
- Three years ago it ran twelve hundred million dollars.
- At point eight five per cent, that earned ten point two million in fees.
- Today it runs thirty six hundred million, so fees have tripled to thirty point six million.
- Kestrel's own team says the strategy works up to fifteen hundred million.
- Assets above that figure are twenty one hundred million, which is fifty eight per cent of everything it manages.
- The firm has every reason to keep growing, while the clients' edge is thinning.
- A sound process can weaken once the assets outgrow the opportunity, and the family should ask whether Kestrel will close to new money.

9 Room to add value falls as assets grow

Chart: Room to add value vs Assets managed ($m)

- Capacity $1,500m
- Kestrel now $3,600m
- Level while small

IN THE LESSON

- Here is the same idea as a picture.
- The horizontal axis is assets managed, in millions of dollars.
- The vertical axis is the room to add value, meaning the excess return the strategy can still earn.
- Follow the curve from the left.
- While assets are small, the room to add value stays level, because every good idea can be bought in full size.
- At fifteen hundred million, marked as capacity, the curve starts to bend.
- The manager must now hold more names, or buy smaller companies in bigger size, and the edge dilutes.
- Then the curve slopes down.
- By thirty six hundred million, where Kestrel sits today, little room is left.
- That slope is why capacity matters.

10 A story: the meeting where nobody argued

- Five people can behave like one mind
- A team can multiply a bias, not cancel it
- Spot where each bias shows up
- Structure holds it back, not good intentions

IN THE LESSON

- Picture a committee room.
- The head of the team opens by saying how much they love a certain stock.
- One by one the others nod and add reasons.
- Nobody mentions the bad news they read last week.
- The vote is unanimous, and everyone leaves feeling clever.
- That was not a team of five minds.
- It was one mind, copied by everyone else.
- Teams can compound individual biases instead of cancelling them out.
- Isla Brenner wants to know which biases hurt the Kestrel team, where they show up, and what structure holds them back, because good intentions are not a control.

11 Four biases in the meeting room

Where the team's biases show up in the room

Bias	What it does in the room
Groupthink	Seniors set the view
Confirmation bias	Filters evidence to fit
Anchoring	Stuck on earlier numbers
Herding	Drifts to consensus

IN THE LESSON

- Four biases act in the meeting room.
- Groupthink and conformity come first.
- People go along with the group, especially when a senior member speaks first, so dissent goes quiet.
- Confirmation bias is next: the team notices evidence that supports its view and filters out the rest.
- Then anchoring.
- Forecasts stay tied to an earlier number, such as last year's earnings, and do not move far enough when news arrives.
- Last is herding, where the team drifts toward the consensus position, because being wrong with everyone feels safer than being wrong alone.
- Notice that each one works quietly, and each makes the group feel surer than it should.

12 Biases in the portfolio itself

- Overconfidence: bets sized for false certainty
- Illusion of control: feeling in charge of events
- Loss aversion: a loss hurts more than a gain pleases
- Disposition effect: winners sold early, losers held

IN THE LESSON

- More biases show up in the portfolio itself.
- Overconfidence, with its partner the illusion of control, makes people believe their forecasts are sharper, and their grip on events tighter, than they really are.
- The result is concentrated bets, positions sized for a certainty that does not exist.
- Loss aversion is the feeling that a loss hurts far more than an equal gain pleases.
- Its companion, the disposition effect, is the habit of selling winners too soon and holding losers too long, because selling a loser makes the loss real.
- A team can hold a share for years after the reason for buying it has failed.

13 Break the chain at its start

How a view hardens

Senior speaks first → Others fall in → One view survives

How to break it

Written views first → Juniors speak first → Devil's advocate

IN THE LESSON

- Now see how the fix works.
- The top row shows how a view hardens.
- The senior person speaks first and sets the anchor.
- The others fall in line, and their doubts go unsaid.
- One view survives, with everyone's biases now shared.
- The bottom row breaks that chain at its start.
- First, collect written views from each person, alone, before any discussion.
- Second, let junior members speak first, so that they speak before the anchor is set.
- Third, rotate the role of devil's advocate, a person assigned to argue against the idea, so that disagreement becomes a job and not a risk.
- Order matters more than good manners.

14 Match each bias to a safeguard

Structure beats good intentions

Safeguard	Fights
Written views, juniors first	Groupthink, herding
Devil's advocate	Confirmation bias
Pre-mortem	Overconfidence
Checklist, sell rule, journal	Disposition effect

IN THE LESSON

- Match each bias to its safeguard.
- Written views first, with juniors speaking before seniors, fight groupthink and herding.
- The devil's advocate fights confirmation bias.
- A pre-mortem, where the team imagines the decision has already failed and asks why, fights overconfidence.
- For the disposition effect, use a checklist, an explicit sell rule agreed in advance, and a decision journal reviewed against outcomes.
- Diversity of background and clear accountability help too.
- But when you are choosing a manager, a policy in a binder is not enough.
- Ask for evidence that the safeguards operate in practice, not just on paper.

15 Example 3: Kestrel's safeguards in practice

Policy: juniors first; review any position down 20%

Senior voice spoke first	18 of 20 meetings	**90%**
Juniors spoke first	2 of 20 meetings	**10%**
Dissent recorded	1 of 20 meetings	**5%**
Losses past trigger reviewed	2 of 8 positions	**25%**
Decision journal	kept, never read	**unused**

IN THE LESSON

- Kestrel says it guards against bias.
- Its policy is that juniors speak first, and any position down twenty per cent from cost must be reviewed.
- Isla Brenner reads twenty sets of committee minutes and the sell review log.
- The chief investment officer spoke first in eighteen of the twenty meetings, ninety per cent.
- So juniors spoke first in only two, ten per cent.
- Dissent was recorded in one meeting, five per cent.
- Eight positions breached the loss trigger, and only two were reviewed, twenty five per cent.
- The decision journal is kept but never read.
- The safeguards exist on paper.
- Score the process as weak, and look at Loam Partners instead.

16 A story: the tailor and the shop

- Separate account: tailored, held in your name
- Pooled vehicle: off the peg, shared with others
- Ashdown: $60m, taxable, wants no tobacco
- Size, tax, customisation, liquidity, oversight

IN THE LESSON

- A tailor measures you, cuts the cloth to fit, and the suit is yours alone.
- An off the peg suit costs less, hangs in a shop, and fits whoever is average.
- A separate account is the tailored suit.
- The securities are held directly in the client's name, so the client owns them and sees them.
- A pooled vehicle, such as a mutual fund or a limited partnership, is the off the peg suit: many investors buy units in one shared portfolio.
- Loam Partners offers both, and the Ashdown family must choose.
- The choice turns on size, tax, customisation, liquidity and who will watch over the account.

17 Where each structure wins

Most costs of one are the benefits of the other

Feature	Better fit
Exclusions, tax-lot control	Separate account
Ownership, transparency	Separate account
Insulated from others' flows	Separate account
Small minimum, simple to hold	Pooled vehicle

IN THE LESSON

- Start with the benefits.
- A separate account allows customisation, such as excluding tobacco companies or managing each tax lot, which is a block of shares bought at one price and date, so that losses can be harvested.
- It gives ownership and transparency, because the client sees every holding.
- And it is insulated from other investors' money coming in and going out.
- A pooled vehicle has one big benefit: it is cheap to join and simple to hold.
- It spreads its costs across many investors and accepts small amounts.
- Notice that most of what one structure costs you is what the other structure gives you.

18 What each structure costs

- Separate: high minimum ($10m), more administration
- Separate: the client must oversee it
- Separate: higher fees on a small mandate
- Pooled: little customisation, less transparency
- Pooled: you bear others' subscriptions and redemptions

IN THE LESSON

- Now the costs.
- A separate account has a higher minimum, here ten million dollars.
- It brings more administration, with custody, reporting and monitoring.
- The client must have the capacity to oversee it, either a team or a paid adviser.
- And for a smaller mandate the fees can be higher.
- A pooled vehicle costs you in other ways.
- There is little customisation, and the client may see less.
- Most important, you bear other investors' subscriptions and redemptions.
- When others leave, the fund must sell, which causes trading costs, and in a taxable fund it can realise gains that you are taxed on.

19 How other investors' exits reach you

Other investors leave

Others redeem → Fund sells holdings → Gains realised

What you bear

Shared trading costs → Tax you did not choose

IN THE LESSON

- This flow shows the cost that surprises people.
- On the top row, other investors redeem, so the fund needs cash.
- It sells holdings, paying trading costs.
- Gains are realised, and they are shared among everyone who still holds the units.
- On the bottom row is what you bear.
- The trading costs are spread across all the holders, including you.
- And in a taxable fund you are taxed on gains you never chose to realise.
- Some of that tax is a timing difference, because it raises your cost base, but it still takes money out of the pot that compounds for you.
- In a separate account none of this happens.

20 Example 4: Ashdown's cost this year

$60m; tax 20%; separate minimum $10m; pool distributes gains of 4% (illustrative)

Separate account fee	0.55% × $60m	**$330,000**
Extra oversight	custody, reporting	**$60,000**
Pooled fund fee	0.70% × $60m	**$420,000**
Tax on distributed gains	4% × $60m × 20%	**$480,000**
Cost this year	$390,000 against $900,000	**separate wins**

IN THE LESSON

- Now the numbers for the Ashdown family, taxed at twenty per cent on gains.
- Loam's separate account charges point five five per cent, which on sixty million dollars is three hundred and thirty thousand, with a ten million minimum.
- Add sixty thousand for extra oversight.
- The pooled fund charges point seven zero per cent, four hundred and twenty thousand.
- Heavy redemptions are expected to force the fund to distribute realised gains of four per cent of its value.
- Four per cent of sixty million, taxed at twenty per cent, is four hundred and eighty thousand.
- So the separate account costs three hundred and ninety thousand this year, against nine hundred thousand for the pool.
- The tax decides it.

21 Where the cost comes from

Cost this year ($ thousand)

Separate: fee	**330**
Separate: oversight	**60**
Pool: fee	**420**
Pool: tax	**480**

Totals: 390 against 900

IN THE LESSON

- Here are those costs as bars.
- The vertical axis is cost this year, in thousands of dollars.
- The first bar is the separate account's fee, three hundred and thirty.
- The second is the extra oversight, sixty.
- Together they come to three hundred and ninety.
- The third bar is the pool's fee, four hundred and twenty, and the tall red bar is the tax on distributed gains, four hundred and eighty, which together come to nine hundred.
- The pool's fee is itself higher, but the real difference is the red bar.
- It is a cost the family never chose, triggered by other investors leaving.
- Only the separate account lets Ashdown control that.

22 Which structure for which investor

If the investor ... then lean toward ...

If the investor ...	Then lean toward
Has $4m, under the $10m minimum	Pooled vehicle
Is taxable, wants exclusions	Separate account
Cannot oversee an account	Pooled vehicle
Is taxable with $60m (Ashdown)	Separate account

IN THE LESSON

- Let us turn it into a decision.
- If the investor has only four million dollars, it cannot meet the ten million minimum, and the pooled vehicle is the sensible choice.
- If the investor is taxable and wants exclusions or loss harvesting, lean toward a separate account.
- If the investor cannot oversee an account, lean toward the pool, because someone must watch custody, reporting and compliance.
- Taxable with sixty million, like Ashdown, points to the separate account.
- Also weigh liquidity: how quickly money may be needed, and how the pool lets investors in and out.
- Always tie the answer to the client's size, tax status and capacity to oversee.

23 Mistakes to avoid so far

- Taking a philosophy at its word, not its holdings
- Ignoring capacity while assets keep growing
- Treating a written safeguard as one that works
- Comparing fees but not tax, size and oversight

IN THE LESSON

- Let us collect the common mistakes from the first three topics.
- One: taking a philosophy at its word, instead of testing it against the holdings.
- Two: ignoring capacity while assets keep growing, because the firm is paid to grow.
- Three: treating a written safeguard as one that works, when the minutes and logs say otherwise.
- Four: comparing fees alone when choosing between a separate account and a pool, and forgetting tax, size and oversight.
- A good answer always links the evidence to the client, and names the cost that is easy to miss.

24 A story: paying the builder

- How the manager is paid shapes how it behaves
- A fee on assets rewards size
- A fee on performance rewards results and risk
- The small print decides which incentive wins

IN THE LESSON

- Suppose you hire a builder.
- You can pay by the hour, a fixed price, or a price plus a bonus for finishing early.
- Paid by the hour, the builder is never in a hurry.
- On a fixed price you know the cost, but the builder has little reason to do more.
- A bonus rewards speed, but it may tempt corners.
- Paying a manager is the same.
- How a manager is paid shapes how it behaves.
- A fee on assets rewards growing the business.
- A fee on performance rewards results, but it also rewards risk.
- The small print of the contract decides which incentive wins, so Isla Brenner reads it line by line.

25 The two main forms compared

Strengths and drawbacks of each form

Contract	Main point
Ad valorem: strength	Simple, predictable
Ad valorem: drawback	Paid even if no value added
Performance: strength	Aligned, cheap in poor years
Performance: drawback	Option-like risk taking

IN THE LESSON

- Contracts differ mainly in how the manager is paid.
- An ad valorem fee, meaning according to value, is a percentage of assets, flat or tiered by asset size.
- Its strength is that it is simple and predictable, and it does not reward risk taking.
- Its drawback is that it pays the manager whether or not value is added, and it encourages gathering assets.
- A performance based fee ties pay to results.
- Its strength is alignment, and it costs less in poor years.
- Its drawback is an option like incentive to raise risk, because it can reward luck or plain market exposure, and it makes fees volatile and complex.

26 Example 5: Loam's tiered fee

$60m mandate; rate falls by tier (illustrative)

First $20m	0.60% × $20m	**$120,000**
Next $20m	0.45% × $20m	**$90,000**
Last $20m	0.30% × $20m	**$60,000**
Total fee	120 + 90 + 60 thousand	**$270,000**
Average rate	$270,000 ÷ $60m	**0.45%**

IN THE LESSON

- Take Loam's first offer for the sixty million dollars.
- It is tiered.
- The first twenty million pays point six zero per cent, the next twenty million pays point four five per cent, and the last twenty million pays point three zero per cent.
- The first slice pays one hundred and twenty thousand dollars, the next ninety thousand, and the last sixty thousand.
- Add them up: two hundred and seventy thousand, which is point four five per cent of sixty million.
- The rate falls as the mandate grows, which is fair to a large client.
- But notice what the fee ignores.
- Whether Loam beats the benchmark or trails it, the family pays the same.

27 The performance fee, and its break-even

Fee = base + share × excess, up to the cap
Break-even excess = (flat fee − base) ÷ share

Base fee	Always paid
Share of excess return	Slice of the excess paid out
Excess return	Portfolio less benchmark return
Cap on the fee	Ceiling on the total fee
Flat fee	The fixed fee compared against

IN THE LESSON

- The second offer is a performance fee.
- It has a base fee, always paid, plus a share of any excess return over the benchmark, with a cap on the total.
- Excess return means the portfolio return minus the benchmark return.
- The share applies only when the excess is positive, so the bonus never falls below zero.
- To compare with a flat fee, find the break-even excess return: the flat fee minus the base fee, divided by the share.
- Below that excess the performance contract is cheaper, and above it dearer, until the cap bites.
- The cap is a ceiling on the fee, set as a share of assets.

28 Example 6: the performance fee in three years

Base 0.25% + 15% of excess; cap 1.00%; $60m

Year 3% ahead	0.25% + 15% × 3%	**0.70%, $420,000**
Year 1% behind	base only, no bonus	**0.25%, $150,000**
Year 6% ahead	0.25% + 15% × 6% = 1.15%	**1.00%, $600,000**
Break-even excess return	(0.45 − 0.25) ÷ 0.15	**1.33%**
Tiered fee, any year	$270,000 ÷ $60m	**0.45%**

IN THE LESSON

- Loam's second offer is a base of point two five per cent, plus fifteen per cent of excess return, capped at one per cent.
- In a year three per cent ahead of the benchmark, the fee is point two five plus fifteen per cent of three, which is point seven zero per cent, four hundred and twenty thousand dollars.
- In a year one per cent behind, there is no bonus, only the base, one hundred and fifty thousand.
- In a year six per cent ahead, the formula gives one point one five, but the cap holds it at one per cent, six hundred thousand.
- Break-even against the tiered fee is point four five minus point two five, over point one five, which is one point three three per cent.
- Above that, the tiered fee is the cheaper deal.

29 Two fee shapes against excess return

Chart: Fee, % of assets vs Excess return over benchmark (−2% to +8%)

- Tiered 0.45%
- Base 0.25%
- Break-even 1.33%
- Cap 1.00% at +5%

IN THE LESSON

- Here are the two contracts as a picture.
- The horizontal axis is excess return over the benchmark, from minus two to plus eight per cent.
- The vertical axis is the fee as a share of assets.
- The green line is the tiered fee, flat at point four five per cent whatever happens.
- The other line is the performance fee.
- Left of zero it sits flat at the base, point two five.
- The fee never falls below the base.
- It crosses the green line at the break-even, one point three three per cent, climbs, and flattens at the cap of one per cent, reached at five per cent excess.
- That shape, flat on the downside and rising on the upside, is the payoff of a call option.
- An option holder gains from volatility, so a manager paid this way may be tempted to raise risk.

30 Example 7: the high-water mark

Bonus 15% of cumulative excess above the high-water mark

Year 1: +5%, cumulative 5%	15% × 5%	**0.75%**
Years 2, 3: −4% then +2%	cum. 1%, 3%: under 5% mark	**0%**
Year 4: +4%, cumulative 7%	15% × (7% − 5%)	**0.30%**
Total bonus with the mark	0.75 + 0.30	**1.05%**
Total bonus with no mark	0.75 + 0.30 + 0.60	**1.65%**

IN THE LESSON

- Now a provision that tames the incentive: the high water mark.
- It is the highest cumulative excess return reached so far, and a bonus is paid only on the part above it.
- Suppose the share is fifteen per cent.
- In year one the excess is plus five, so the cumulative is five and the bonus is point seven five per cent.
- In year two the excess is minus four, and in year three plus two, taking the cumulative to one and then three.
- That is under the five per cent mark, so no bonus.
- In year four the excess is plus four and the cumulative reaches seven, two above the mark, so the bonus is fifteen per cent of two, point three zero.
- The total is one point zero five.
- With no mark, every good year pays, and the total is one point six five.
- The mark protects the client.

31 Four provisions to compare

Provisions that decide who bears the risk

Provision	What it does
Benchmark or hurdle	Bar before any bonus
High-water mark	No bonus until recovered
Cap and floor	Limit the fee range
Clawback	Return bonus if results fall

IN THE LESSON

- Here are four provisions to compare, beyond the fee itself.
- A benchmark or hurdle rate sets the bar the manager must clear before any bonus.
- A high water mark, as we just saw, stops the family paying twice for the same recovery.
- A cap and a floor limit the range of the fee.
- The cap protects the client in a lucky year, and the floor protects the manager in a bad one.
- A clawback returns bonus already paid if later results fall back.
- Also compare the base fee and the share of excess return.
- For Ashdown, Isla Brenner proposes a modest base, a share above a hurdle, a high water mark and a cap.

32 Beyond the fee: the rest of the contract

- Measurement period and crystallisation
- Mandate guidelines, including exclusions
- Liquidity and reporting duties
- Termination terms and notice

IN THE LESSON

- A sound contract covers more than money.
- First, the measurement period and crystallisation.
- Over what period is excess return measured, and how often is the fee fixed and paid?
- Annual is common.
- A short period makes fees noisy, and a long one delays pay.
- Second, mandate guidelines set what the manager may hold, with limits on position size and tracking error, and the exclusion of tobacco, which the family wants.
- Third, liquidity and reporting duties say how fast money can be withdrawn and what the manager must report.
- Fourth, termination terms say how either side can end the deal, with what notice, and what happens to fees already earned.

33 Recap: the lesson in five lines

- Philosophy, process, people, portfolio must agree
- Teams compound bias: use structure, check practice
- Account or pool: size, tax, customisation, oversight
- Ad valorem is steady; performance fees reward risk
- Hurdle, high-water mark, cap and clawback decide

IN THE LESSON

- Let us pull the lesson together.
- First, test a manager's philosophy against its process, people and portfolio, and use active share, attribution and capacity as evidence.
- Second, teams compound biases, so use structure: written views first, juniors first, a devil's advocate, a pre-mortem, a sell rule and a journal, and check they work in practice.
- Third, weigh a separate account against a pool by size, tax, customisation and oversight, and count the tax that other investors' redemptions trigger.
- Fourth, an ad valorem fee is simple but pays regardless, while a performance fee aligns interests but creates option like incentives.
- Fifth, read the provisions.

34 Try three quick questions

1. Fee 0.90%, active share 40%. Effective fee on the active part?
   Answer: 0.90 ÷ 0.40 = 2.25%.
2. Flat 0.50%; base 0.20% + 20% of excess. Break-even excess?
   Answer: (0.50 − 0.20) ÷ 0.20 = 1.5%.
3. $10m pool distributes gains of 3%; tax 20%. Tax paid?
   Answer: 3% × $10m × 20% = $60,000.

IN THE LESSON

- Now try three quick questions yourself.
- Pause after each one.
- Question one.
- A manager charges point nine zero per cent and has an active share of forty per cent.
- What is the effective fee on the active part?
- Point nine zero over point four zero is two point two five per cent.
- Question two.
- A flat fee is point five zero per cent.
- The performance contract has a base of point two zero per cent plus twenty per cent of excess return.
- What is the break-even excess return?
- Point five minus point two, over point two, is one point five per cent.
- Question three.
- A taxable client holds ten million dollars in a pool that distributes realised gains of three per cent of its value, and the tax rate is twenty per cent.
- What tax does the client pay?
- Three per cent of ten million, taxed at twenty per cent, is sixty thousand dollars, tax on gains that other investors' redemptions triggered.