Once upon a time, there was hope that the real estate meltdown that followed the global financial crisis might prompt an opportunity to develop new and creative fee structures that would better align the interests of investors and investment managers.

But while there has been some tinkering, the market has not seen the development of a breakthrough in fee structures leading to better alignment. What follows are some partially baked ideas — some already kicking around but not widely accepted, and others fairly novel to stimulate some thought and discussion.

### Asset management fees

Asset management fees typically are paid as a percentage of committed capital or a percentage of invested capital during the investment period. From an investor’s perspective, payment on invested capital is often preferred for at least two reasons: First, all else being equal, fees will be lower. Second, because managers are paid to manage invested capital, why should they be paid if they are not actually managing invested capital?

But the first reason, that fees will simply be lower, has nothing to do with increasing alignment unless one believes that better alignment results simply from lower fees. And, as the industry learned in the 2005–2008 period, some of the best investment decisions were made by managers who sat on their hands and invested little or none of their commitments. However, managers paid on invested capital have a significant incentive to do deals. And this incentive is even stronger for newer and smaller managers that may not have an established legacy fee stream to rely upon. That this is not good alignment during a down market is well accepted.

So, here are two hybrid ideas that try to incorporate the better features of both asset management fee approaches: First, pay on committed capital during the investment period but with the fee percentage tied to the pace of investment. The percentage fee would reduce over time to the extent that the pace of investment is slower than anticipated. For example, 100 basis points on committed capital during the investment period, but if a venture is not on track to be fully invested by the end of the investment period, the rate goes down to, say, 75 basis points or even less. Such a structure would probably not have a major impact in today’s market. But tomorrow’s market conditions may be different.

Second, pay an asset management fee that is the greater of a) a fixed-dollar amount scaled to the actual cost of keeping together a team to originate, underwrite and manage investments, or b) a standard asset management fee based on invested capital. This structure might work especially well for smaller or newer managers who need a certain degree of fee income just to keep the lights on.

Either way the concept is to find a middle ground where a) the investor is paying managers to invest capital, but b) the manager is not overly incentivized to invest money just to get their fee stream started irrespective of market conditions.

### Incentive fees

Moving to incentive fees, one area where it is difficult to align the interests of investors and managers is the timing of incentive fee...
payments. Investors, naturally, prefer pooling assets to calculate and pay incentive fees based on overall portfolio performance. Managers prefer a “pay as you go” program with incentive fees paid at individual asset disposition. This tension creates myriad issues.

From an alignment standpoint, there is logic in both options. It is logical to pay on a portfolio basis as the manager is compensated based on what the investor cares about: portfolio performance.

But there is also logic to paying incentive fees on a “per asset” basis. Often different people and different offices are responsible for different investments. Crossing assets at best dilutes any potential alignment, and at worst can create internal discord within a manager’s organization. Also, investments are realized at different times, and it could take many years after the realization of some early assets before a portfolio is “in the money.” This can be an issue because the junior, mid-level and senior people in a management shop will be at very different places in their individual lives and careers.

Two ideas come to mind to deal with this conundrum.

First, evaluate the incentive fee as each asset is realized based on the performance of the accumulated cash flow of all the realized assets to date, not just the individual asset performance. This method would provide some opportunity for early incentive payments for the manager, while lowering, but by no means eliminating, the possibility that the investors will overpay relative to the final portfolio performance or need a clawback.

Second, pay a portion of the incentive fee payment for realized assets to specific mid-level personnel involved in to-date performance. But the remaining fee would be paid at the end of the term based on overall portfolio performance and distributed to the company and senior management. This structure would allow a portion of the incentive fee to be paid early to reward specific people responsible for interim successful performance, while others are compensated only based upon portfolio performance.

Finally, consider how alignment of interests in relation to incentive fees can vary in three potential performance scenarios: poor (below the investment target return), acceptable (near and somewhat above the investment target return) and very good (substantially above the target return).

Generally, investors do not want to pay incentive fees for poor performance. But if the purpose of incentive fees is to align interest, then it makes sense to create a structure where the chances of the manager being in the money are high. This would argue for a relatively lower hurdle rate. This idea has gained some traction during the past few years, although our experience is that investors still prefer higher hurdles and not paying for mediocre performance.

For very good performance, well in excess of the target, some investors do not mind paying a manager a large incentive fee as long as they are also making a lot of money. Fair enough. However, from an alignment standpoint, the manager could be incentivized to embark on strategies that are riskier than originally intended in pursuit of the potentially higher return. And, with the possible exception of some opportunistic investments, in many cases outsized performance simply is due to market lift or other exogenous factors that the manager had little control over.

Finally, for performance near or somewhat above the investment target return, it would seem reasonable for investors to want to reward managers for doing what they said they were going to do. That is, to achieve the target return without incurring risk not intended for the investment strategy.

So, rather than paying the same or even a higher incentive fee rate as returns increase, consider a structure where the percentage incentive fee decreases at higher IRRs. This structure would serve to decrease the propensity to pile on risk and reduce the amount of incentive fee that is paid due to market factors outside a manager’s control. An example of this structure would be: For a value-add strategy with a target return of 10 percent, pay the manager 35 percent above a 7 percent hurdle (target minus 300 basis points), which reduces to 10 percent beyond a 13 percent IRR (target plus 300 basis points).

Not an idea that’s made it to market, but perhaps some food for thought.

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