Active Management Fees and Alignment of Interests

By Ric Dillon, CFA and Chris Welch, CFA
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The Diamond Hill Mission Statement calls on us “To serve our clients through a disciplined, intrinsic value-based approach to investing, while maintaining a long-term perspective and aligning our interests with those of our clients.” Our mission permeates the way we manage our business, including our consideration of the appropriate management fees for our strategies. To ensure that we properly align our interests with those of our clients, our management fees are derived in part from our investment management goals. In this piece, we explain our fee philosophy and the related ways in which we seek to align our interests with those of our clients.

Active management costs are higher than passive management costs, reflecting higher management fees and higher market impact costs, which are influenced by portfolio size, number of positions, and turnover. At Diamond Hill, our goal is to achieve net of fee returns that exceed passive alternatives over time, despite higher active management costs.

Like many mature businesses, investment management is very competitive, and the market for large cap strategies tends to be more competitive than small cap strategies, reflecting the capacity constraints inherent in small cap. As a result, the level of outperformance necessary to achieve a certain peer ranking for a small cap strategy is typically greater than the outperformance necessary to achieve the same ranking for a large cap strategy. Additionally, active management fees are greater for strategies where the opportunity to outperform is greatest, primary research efforts are highest, and capacity constraints limit the amount of revenue that can be generated to support the strategy. Thus, small cap strategy fees are higher than large cap fee.

Similarly, as strategies grow in terms of assets under management, the aforementioned market impact costs impede a manager’s ability to outperform a passive alternative. The paradox is clear: if a manager has too few assets under management, the economics may limit the internal resources necessary to beat the relevant benchmark; in contrast, too many assets under management may cause a strategy to resemble the benchmark (closet indexing). Conceptually, an ideal size exists for every strategy. While the ideal size is unknowable in exact terms, a measure known as active share illustrates to what degree a manager differs from the benchmark, while subsequent investment results demonstrate the degree of outperformance achieved.

At Diamond Hill, the capacity for each strategy is determined by the portfolio manager. Since a majority of our portfolio managers’ incentive compensation is based on investment results, each manager is incented to ensure that the strategy remains at a size that will allow strong absolute returns, meaningful outperformance of a passive alternative, and achievement of top quartile investment results.

In determining our goals and capacity for each strategy, we are always driven by a desire to properly align our interests with those of our clients. With this in mind, we first deduce goals for each of our strategies. From these goals, we then determine our fee schedules. Clients are best served by a fee that is low enough to allow us to achieve meaningful outperformance relative to a passive alternative; yet at the same time, a fee that is high enough to allow us to build and maintain an investment team capable of achieving such results. Likewise, clients are best served by goals that are not only high enough to inspire outstanding performance, but also realistic enough to allow us to pay and retain top investment talent. In addition to creating appropriate quantitative incentive structures, we also recognize that the proper alignment of interests cannot be achieved unless we are diligent about hiring only individuals with high integrity and a fiduciary mindset.

Quantitative Goals for Investment Results

The majority of incentive compensation potential for our portfolio managers is based on quantitative, pre-determined goals for investment results. These goals, measured over rolling five-year periods, include:

1. An absolute return sufficient for the risk involved in investing in the asset class.

The absolute return goal is important because it is most closely aligned with our intrinsic value investing philosophy. Each investment decision is driven by a desire to generate absolute returns by exploiting a difference between the current market price and our estimate of intrinsic value, with an appropriate margin of safety, rather than an interest in overweighting or underweighting a given security relative to a benchmark.
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2. **Sufficient outperformance over a relevant passive benchmark.**

The absolute goal alone is imperfect in implementation because absolute returns are necessarily constrained by the market environment. An absolute goal of 10% per annum is much more realistic in an environment when the relevant market segment generates 8% per annum as opposed to 3% per annum. We understand there are passive alternatives available, and we seek to add value through active management.

3. **Top quartile results in the relevant peer group.**

Absolute and relative goals alone are still deficient because the difficulty of achieving relative outperformance can vary widely depending on the time period. While five years generally is sufficient to remove most of the idiosyncratic nature of investment returns, there are times where idiosyncratic forces overwhelm expected returns. Extreme examples of this would include two five-year periods: 1995-1999 and 2000-2004. During the 1995-1999 period, strong market returns (especially for technology-related and mega cap stocks) made outperformance very difficult with few active managers beating passive alternatives. In contrast, in the 2000-2004 period, most active managers outperformed passive alternatives. Thus, our third goal is critical as it requires that we not only perform well on an absolute and relative basis, but also that our results compare favorably to our relevant peer groups.

Importantly, we measure these goals over rolling five-year periods which is consistent with the manner in which we assess the efficacy of our efforts across all aspects of our business, knowing that periods less than five years lack statistical significance. Evaluating our investment returns over rolling five-year periods also minimizes the portfolio manager’s incentive to adopt a more or less risky strategy as year-end approaches, because each year’s investment results will be included in five rolling five-year periods.

Alignment of Goals and Determination of Fees

When we formed Diamond Hill in 2000, we believed that the definition of active management had been altered by a large percentage of managers utilizing low tracking error relative to the benchmark in order to reduce the business risk of underperforming their relevant benchmark (see our 2001 white paper “Why Does ‘Closet Indexing’ Exist”). Because of that trend and the growing popularity of index funds, we believed that goals and fees must be considered collectively and should be aligned with one another. Specifically goals two (relative) and three (peer group) are directly linked as the relative goal, net of fees, is set at a level which we expect will yield top quartile peer group results over a typical rolling five-year period. Next, in the context of these goals, the management fee must be both competitive and reasonable. Marketplace fees are considered to determine competitiveness; whereas reasonableness is evaluated in terms of the firm’s share of profits generated by expected gross outperformance. Our initial value-add goals were set by looking at our expectations for the coming decade, rather than looking at the previous decade. In general, we were confident in our ability to achieve outperformance for each of our strategies partly due to our belief in the existence of an extreme valuation discrepancy at the beginning of the decade.

In keeping with the on-going analysis of our business, we recently reviewed the alignment of our goals as well as the competitiveness and reasonableness of our fees using two decades of history, rather forward-looking estimates of expected value-add. While we are pleased that our estimates at the beginning of the decade were approximately right, we concluded that in many ways the past decade was somewhat anomalous. Our other conclusions follow.

First we examined whether our relative return and peer group goals were aligned with one another. After reviewing historical top quartile peer results over rolling five-year periods from 1990 through 2010, we determined that our relative performance goals have been too aggressive in relation to our top quartile peer group goal. To properly align these goals, the relative return goals should be revised to the levels reflected in the table below.

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Value-Add Gross</th>
<th>Management Fee</th>
<th>Value-Add Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategic Income</td>
<td>200</td>
<td>50</td>
<td>150</td>
</tr>
<tr>
<td>Large Cap</td>
<td>220</td>
<td>55</td>
<td>165</td>
</tr>
<tr>
<td>Select</td>
<td>280</td>
<td>70</td>
<td>210</td>
</tr>
<tr>
<td>Small-Mid Cap</td>
<td>300</td>
<td>75</td>
<td>225</td>
</tr>
<tr>
<td>Small Cap</td>
<td>320</td>
<td>80</td>
<td>240</td>
</tr>
<tr>
<td>Long-Short</td>
<td>360</td>
<td>90</td>
<td>270</td>
</tr>
</tbody>
</table>
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Next we considered whether our management fees are competitive. After evaluating our management fees relative to other active managers’ fees in the marketplace, we concluded that our management fees are competitive. No change would be required unless these fees violate the next test (reasonableness relative to our value-add goals).

Finally, we considered the reasonableness of our management fee and concluded that it is appropriate to reduce the management fee for our Large Cap strategy by five basis points from 60 to 55 basis points. This reduction reflects the lower margin of outperformance necessary to achieve top quartile peer group results for the Large Cap strategy. The management fees for all other strategies will remain the same. Based upon the table above, our share represents 25% of the Value-Add Gross goal, which we believe is reasonable.

Performance Fees

Because future results are uncertain, we also offer our clients a performance-based fee alternative to our standard, fixed fee schedule that shares similarly in the outperformance over time. Under this performance fee schedule, the annual base fee is 20 basis points. At the end of a five-year period, we will assess our relative performance over that period and receive 25% of any return greater than the benchmark (after deducting the 20 basis points base fee). We believe that waiting until the end of five years to assess outperformance demonstrates our conviction in our long-term investment philosophy and further differentiates us from our competitors.

For example, with a standard, fixed base management fee of 55 basis points, our Large Cap strategy’s outperformance goal is 220 basis points, gross of fees, or 165 basis points, net of fees. For a client that chooses the performance fee, at the end of year five we will examine our results and calculate the fee based upon 25% of the outperformance. With the 20 basis point base fee acting as the floor, we impose a ceiling of 90 basis points, such that our standard fee of 55 basis points falls precisely in the middle of the performance fee floor and ceiling.

We Eat Our Own Cooking

Each of our portfolio managers has a significant personal investment in the strategy they manage. By investing heavily alongside our clients, we ensure that portfolio managers will treat their strategies as though it were their own money – because it is.

In addition, all Diamond Hill associates, including portfolio managers and research analysts, are prohibited from investing in individual securities or competing firms’ funds in asset classes in which Diamond Hill has an investment strategy (domestic stocks, corporate bonds). This policy ensures that we are always focused on finding the best ideas for client portfolios, avoiding the conflicts of interest inherent in managing personal accounts.

The goal of this letter is to illustrate the ways in which we are working to meet our mission to serve our clients through a disciplined intrinsic value approach to investing, while maintaining our long-term perspective and aligning our interests with those of our clients. We remain thankful for the trust and confidence our clients have shown in us, and we are committed to rewarding that trust by striving to achieve superior investment returns while maintaining the highest integrity.
“Our goal is to achieve net of fee returns that exceed passive alternatives over time, despite higher active management costs.”

– Ric Dillon, CFA
Co-Chief Investment Officer

ABOUT THE AUTHOR
Ric serves as Chief Executive Officer and Portfolio Manager for Diamond Hill Capital Management, Inc. He joined Diamond Hill in 2000. From 1997 to 2000, Ric was a Portfolio Manager at Loomis Sayles & Co., an investment advisory firm. From 1993 to 1997, Ric was the President and Chief Investment Officer of Dillon Capital Management, an investment advisory firm. Ric has a Bachelor of Science in Finance and a Master of Arts in Finance from The Ohio State University, a Master of Business Administration from the University of Dayton, and holds the CFA designation.

Ric Dillon, CFA
Diamond Hill Capital Management, Inc.

“By investing heavily alongside our clients, we ensure that portfolio managers will treat their strategies as though it were their own money”

– Chris Welch, CFA
Co-Chief Investment Officer

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Chris serves as Co-Chief Investment Officer and Portfolio Manager for Diamond Hill Capital Management, Inc. He joined Diamond Hill in 2005. From 2004 to 2005, Chris was a Portfolio Manager with Fiduciary Trust Company International. From 2002 to 2004, Chris was a private investor. From 1995 to 2002, Chris was a Portfolio Manager and Senior Equity Analyst for Nationwide Insurance and affiliates. Chris has a Bachelor of Arts in Economics from Yale University (summa cum laude) and holds the CFA designation.

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