Everybody Wins

Why management fees linked to investment results are the only way to truly align clients, portfolio managers, and firm owners.

At most investment management firms, three primary stakeholders exist: clients, portfolio managers, and firm owners. The policies in place at the investment manager impact the degree to which the interests of these parties are aligned or in conflict with each other. A common structural flaw within the investment management industry is the linkage of revenue and compensation to assets under management (AUM). In the most recent Berkshire Hathaway annual letter to shareholders, Warren Buffett highlights this issue:

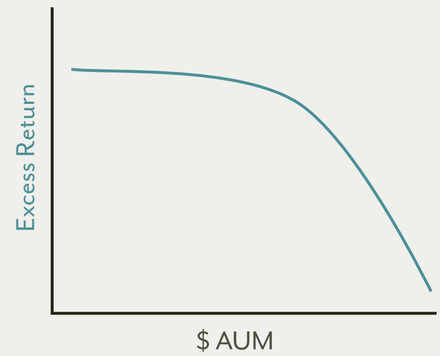
> *There are three connected realities that cause investing success to breed failure. First, a good record quickly attracts a torrent of money. Second, huge sums invariably act as an anchor on investment performance… Third, most managers will nevertheless seek new money because of their personal equation – namely, the more funds they have under management, the more their fees.*[1]

An incentive structure tied to assets under management creates friction among the various stakeholders – that which benefits firm owners and portfolio managers may not be in the best interest of clients. Is it possible for investment managers to align the interests of clients, portfolio managers, and firm owners so that everybody wins? We believe the answer is 'yes' and that the best way to do this is by offering our clients a variable fee that links our compensation to the value we add as an active manager.

We agree, as Buffett points out, that if a strategy is allowed to grow without consideration for the capacity of the strategy, the portfolio managers' ability to generate excess return for the client will diminish, as depicted in Graph 1.

Thus, a portfolio manager who is rewarded for growing AUM may focus his or her attention on attracting new clients rather than delivering outstanding investment results for existing clients.

GRAPH 1



As we have written previously[2], at Diamond Hill we have adopted policies that align our interests with those of our clients. We do not compensate portfolio managers based on assets under management, but rather based on investment results over rolling five-year periods. Importantly, the capacity for each strategy is determined by the portfolio manager, and each portfolio manager has sole discretion in deciding when to close a strategy. Our portfolio managers are incented to limit the size of their strategies so they can achieve strong absolute returns, meaningful outperformance over passive alternatives, and top quartile investment results over rolling five-year periods.

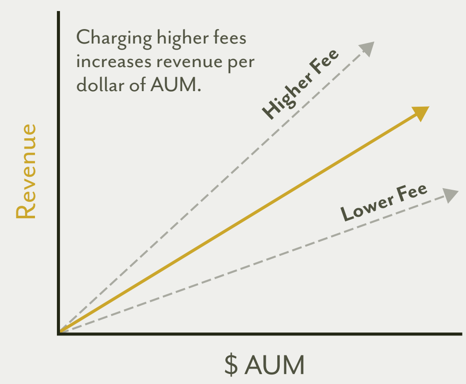
To further strengthen the alignment between our portfolio managers and our clients, each Diamond Hill portfolio manager has significant personal investments in the strategies they manage. By investing heavily alongside our clients, our portfolio managers treat their strategies as though they are managing their own money – because they are.

We have taken steps to align our portfolio managers and clients, but what about the third stakeholder in the equation – the firm owners? At Diamond Hill, not only are associates and portfolio managers significant investors in our strategies, they are also firm owners. Although achieving alignment between managers and shareholders is generally considered a worthy objective, one could argue that in the investment management business this introduces a conflict of interest. Under a standard fixed management fee arrangement, revenue earned is a function of the management fee multiplied by assets under management. Thus, one could argue that firm owners are economically best served by maximizing assets under management and charging higher fees (thus maximizing revenue).

[1] Berkshire Hathaway 2016 Annual Shareholder Letter

[2] For more detail, read our 2011 investment letter "Active Management Fees and Alignment of Interests."

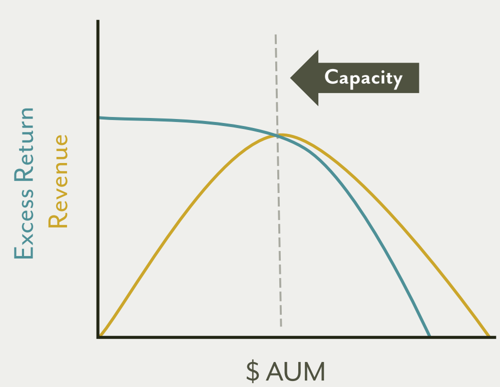
GRAPH 2



As depicted in Graph 2, as AUM increases, revenue increases. When management fees aren't tied to investment results, firms have less incentive to close strategies and investment returns will be increasingly pressured by growing assets under management[3] (as shown in Graph 1). As a result, the firm owners' interests are in conflict with the interests of clients invested in the strategy who benefit from value created in the form of the highest net of fee returns.

The introduction of a variable management fee[4] offers an elegant solution for clients, portfolio managers, and firm owners to be aligned by tying revenue to the value added by the investment manager. If the fee is based on the excess return generated, the relationship between revenue and assets under management changes such that revenue maximization is not necessarily achieved by growing assets under management, but rather by optimizing the tradeoff between performance and assets under management. Under the variable fee arrangement, revenue could actually decline if assets under management were allowed to grow unchecked due to the pressure on excess return caused by additional assets, as depicted in Graph 3.

GRAPH 3



In theory, if all revenue was derived from a variable management fee, the intersection of the two lines would represent the maximum revenue and thus the logical point at which to close a strategy from new asset flows, protecting the best interests of clients, portfolio managers, and firm owners.

In an ideal world, we would have the ability to offer our variable management fee to all clients regardless of investment vehicle. Unfortunately, this is nearly impossible in today's mutual funds where both fulcrum and performance-based fee arrangements adjust based on a fund's past results rather than on results achieved by the individual fund holders.

That said, there is a case to be made that Diamond Hill's variable fee option still benefits our fixed fee clients in two ways. First, capacity limits are set based on the combined fixed and variable fee assets. Second, our portfolios are managed in the same manner regardless of investment vehicle[5], so our fixed fee clients indirectly benefit from the alignment created by the variable fee.

In a perfect world, fees charged by all active managers would be tied to the value they add. Diamond Hill seeks to lead by example in this area by offering clients the ability to link our management fee to the value we add through active portfolio management, aligning the interests of our portfolio managers, firm owners, and clients.

Everybody wins.

[3] See our 2001 investment letter "Why Does 'Closet Indexing' Exist."
[4] More detail on our variable fee option can be found in our 2016 investment letter "Variable Equity Management Fees and Alignment of Interests."
[5] Except clients with specific SRI, ESG, or other client-directed restrictions.