

Fee structure in agreements with external managers

Background

Norges Bank buys external management expertise in areas where it is not appropriate or realistic for the bank to build the equivalent internal expertise. This will often be specialist expertise in specific industrial sectors or specific emerging markets.

Our goal is to provide the best possible basis for a high long-term return at the lowest possible cost and risk. It is important for the agreements to ensure the closest possible alignment of interests between Norges Bank and external managers. Stringent requirements are therefore made of these managers. They are closely monitored, and their fees are linked to the quality of the service they deliver. Those who deliver a poor service, such as weak investment results, will be paid far less than those who meet or exceed expectations.

Negotiating position

As a large, long-term investor of good standing, NBIM normally has a strong hand when negotiating with external managers. NBIM has built a good reputation, and inclusion in our roster of external managers is a sign of status among management firms. As NBIM has built expertise internally, the proportion of capital managed externally has gradually fallen, and the degree of specialisation in external management has risen. Today's agreements are therefore dominated by specialist expertise in narrowly defined areas. As the investment field is so specialised, there will often be limits on how much capital a manager can handle. Competition for some managers' capacity is therefore stiff.

As a result of this, NBIM cannot simply impose its terms on suppliers and instead finds itself in a negotiating position. Our aim is to obtain the highest possible quality at the lowest possible price – in other words the highest possible expected return after fees. Each year there are instances where NBIM and the manager are unable to reach agreement because the gulf between them is too great.

Our bargaining power will vary from manager to manager and from product to product. We seek to exploit our strengths, such as our long-term approach and our size. This is emphasised in negotiations with managers and is reflected in our fee structure. Fees are based on the return since the very inception of each mandate.

The quality of the products on the market varies considerably, which means that what we are willing to pay also varies considerably. No two sets of negotiations are the same. Different managers have different priorities. As far as possible, we aim to take advantage of the manager's preferences in order to limit the fund's overall expenditure on fees. The result

is a similar fee structure for all agreements, but with context-specific adjustment of its various components.

Fee structure

The basic principle underlying the fee structure is relatively simple. We pay fees based on value added since inception. Value added is defined as the return generated over and above the return on the benchmark index plus a margin. In addition, parts of the fees are held back in the early years to create a better alignment of interests. Finally, there is a ceiling on the fees payable each year.

Although we prefer performance-based fees, as in most cases this reduces our expected costs and, according to research, increases the expected return, for various reasons we will also have mandates with only a flat fee.

Agreements that include performance fees will have the following components:

- **A base fee**, which is a fixed percentage of assets under management. This is paid whatever the results and is intended to cover the costs associated with the specific mandate. The level of this fee is generally much lower than the market standard for the mandate and well below what a flat fee would have been without a performance-based component. In recent years base fees have averaged around 0.12 percent of assets under management. We do not want managers to make a profit unless they are creating value for us as a client.
- **A performance fee**, which is earned and paid on the basis of the system described in the following section.

Performance fees

The value added by external management is defined here as the difference between the return achieved by the manager and the return on the benchmark index plus a margin of 1-2 percentage points.

The most important measure of the quality of the service supplied by a manager is the value added delivered to the client. It is therefore natural for the bulk of the fee to be linked to this. It is also natural that a small part of this value added goes to the supplier, and that results are measured over a long period. Until a manager has produced good results over a long period, parts of the fees accrued are held back in order to avoid a situation where we are rewarding high levels of risk-taking or short-term luck. In addition, it is natural to cap the payments made to a manager in any one year.

Our fee structure takes account of these factors. Performance fees are calculated in the following stepwise manner:

- 1) Value added is calculated each month.
- 2) The monthly values since the start of the mandate are added together.

- 3) If positive, the value from step 2 is multiplied by the share of value added due to the manager.
- 4) The value from step 3 is multiplied by the retention rate.
- 5) All fees paid since the inception of the mandate are subtracted.
- 6) The value from step 5 is capped to the ceiling.

1 and 2 – Calculation of value added

The calculation of performance fees is based on cumulative value added – in other words the total value added since the agreement with the manager was concluded. Value added is defined in the agreements as the return over and above a benchmark index plus a margin of 1-2 percentage points.

Short-term results can be the result of both luck and skill, while long-term results are more likely to be dominated by skill. In terms of fees, the long-term focus on value added since inception means that a high-water mark structure is built into the fees. If a manager has a period of lower returns than the benchmark, it must make up all of this underperformance before any performance fee begins to accrue again. This reduces the fees. It also means that the ceiling limits the payment of fees, not the accrual of fees.

3 – Calculation of fee accrued

The agreement lays down how much of this value added goes to the manager and how much to the fund. The fund's share is normally 80-90 percent, while the manager normally receives 10-20 percent. At the end of each year, the fee accrued is calculated by multiplying the cumulative value added by this percentage.

4 – Retention

Parts of the performance fee are held back during the first five years that a manager has an agreement with NBIM. (*NB: Not rolling*). NBIM's standard is to pay 50 percent in the first year, 60 percent in the second year and so on until full payment is made from the sixth year onwards. After six years of daily data for holdings, transactions and returns, we can say with greater certainty that the value added is a result of expertise, processes and skill. At the same time, the long period since inception means that the value of the high-water mark at this point is much higher.

The idea of holding back payments is partly to provide insurance against possible reversal of previous years' results. This is often referred to as clawback or downside protection. Fees can be retained permanently if value added in subsequent years is negative or in case of breach of agreement. It is worth noting that if the manager goes on to deliver only the same return as the market – in other words less than the hurdle rate – the fees accrued (but not the fees paid) will gradually be reduced. If the hurdle rate for the manager is the market return plus 2.0 percent, retained fees will not be paid if the manager only achieves the

market return plus 0.5 percent. The retention of fees therefore entails a strong element of downside protection.

5 – Subtraction of fees already paid

Previously paid fees are then subtracted from the value calculated in step 4. These fees include the base fee, which means that another margin is built into the agreements. Value added multiplied by the manager's share of value added must be high enough to cover the base fee paid before any performance fee is accrued. The result is that the expected fee is reduced substantially, and that the manager needs to deliver a higher percentage return before a performance fee is earned.

6 – Ceiling

All agreements now contain a ceiling for the fee payable in any one year. The ceiling is formulated as the lower of a set percentage of assets under management and an absolute amount. If the manager delivers an excess return so large that its share exceeds the ceiling, only the amount up to the ceiling is paid out in that particular year.

The amount held back is not just a deferral of payment, as there are various circumstances in which fees accrued over and above the ceiling may not come to be paid out:

- The fee held back is reduced if future returns are below the hurdle rate (benchmark index plus margin).
- Retained fees are forfeited in case of breach of agreement.
- If the agreement is terminated, payments are limited to the ceiling. The manager does not have a right to accrued unpaid fees above the ceiling. If NBIM terminates the agreement in December, the manager will not be paid fees later, even if there are accrued unpaid fees. This might, for example, happen if there are substantial accrued but unpaid fees and we do not expect strong future outperformance.