ADVISOR PERSPECTIVES

Cultivating Wealthy Clients with Performance-Based Fees

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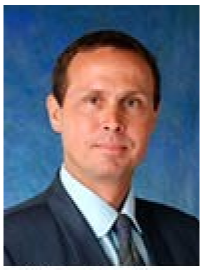
Jeffrey Dunham was one of the featured speakers at the Tiburon CEO Summit XIV, held in New York on April 10-11, 2008.



Jeffrey Dunham

"At the end of the day, clients do not hire and fire advisors based on fees. It is about whether they trust you," says Jeffrey Dunham, Founder and CEO of Dunham & Associates Investment Counsel, (DAIC), a San Diego-based Registered Investment Advisor.

Dunham's firm occupies a unique niche in the advisory business. They offer a series of funds with fees pegged to performance, and allow investment advisors to base their own fees on performance.

"If the fee is fair, clients have no problem with it," says Dunham. Performance-based fees embrace Dunham's concept of fairness, because the manager's, advisor's and investor's incentives are all perfectly aligned. "Fairness engenders trust, and trust is how advisors should compete," says Dunham, adding "Once clients trust you, they become evangelists - on the golf course, at cocktail parties, and elsewhere."

Background and History

Dunham conceived of performance-based fees in the early 1980s, and initially approached several established leaders in the industry, who uniformly questioned his business plan. One former boss told him performance-based fees were "noble but stupid." He persevered, establishing an RIA in 1985 and forming a trust company in 1999. After initially offering private funds, he converted to public mutual funds, and became one of the first to offer performance-based fees for advisors.

"My goal was simply to find a way to differentiate myself," says Dunham.

Dunham identifies an industry trend where managers' fees have eroded from approximately 100 to 30 basis points for many products. Efficiencies and competition in custodial services, account administration, compliance, and other back-office functions have accelerated this trend. Dunham sees performance-based fees as a way for truly skillful managers to earn a fair fee for the value they add, stemming the tide of fee erosion.

Today, DAIC manages approximately $600 million through its sub-advised funds, all of which employ a performance-based fee structure.

Fulcrum Fees for the Dunham Funds

DAIC offers a series of 10 sub-advised public mutual funds, representing unique asset classes and sub-classes, each utilizing a performance-based fee structure called fulcrum fees. Five of these sub-advisers do not offer public mutual funds.

As an example of the fulcrum fee arrangement, the sub-adviser of the Dunham Small Cap Growth Fund receives a base fee of 50 basis points. If the sub-adviser hits its benchmark, it earns 50 basis points. In addition, if performance is within 20 basis points of the benchmark (termed the "null zone") the sub-adviser still earns just the 50 basis points. Performance over or under this band (either exceeding the benchmark by more the 20 basis points, or underperforming the benchmark by more than 20 basis points) is rewarded or penalized. For over-performance, the sub-adviser can earn a maximum fee of 100 basis points (50 basis points of base fees plus 50 basis points of incentive fees), which occurs if performance exceeds the benchmark by 200 or more basis points. For under-performance, the sub-adviser will receive no fees if the fund trails its benchmark by 200 or more basis points.

Fulcrum fees are perfectly symmetrical – incentives for over-performance mirror the penalties for underperformance.

Fees are calculated on a daily basis using the prior 12 months trailing returns. Each of the 10 funds has an industry standard benchmark for fulcrum fee calculations. For example, the Dunham Large Cap Growth Fund (sub-advised by Rigel Management) is pegged to the Russell 1000 Growth Index.

Dunham is not unique in its use of fulcrum fees, but is unique in that it is the only fund company that uses fulcrum fees exclusively. Fidelity, Vanguard, USAA RiverSource and Janus also offer funds with fulcrum fees, but their fees are typically based on 3-year trailing returns. Dunham's Chief Sales & marketing Officer, Sal Capizzi, believes Dunham's 12-month structure incents sub-advisers to deliver more consistent returns over time.

As with any sub-advised fund, there is an additional fee of up to 65 basis points which is charged by Dunham. This fee is based on asset class.

Sal Capizzi

Capizzi explains that many advisors are initially put off by the counter-intuitive nature of Dunham's fee structure. "When our performance is strong, our fees go up," says Capizzi. For advisors scanning for funds based on expense ratios, Dunham's funds may be filtered out, especially when performance is good. "But once we educate advisors about our approach, this ceases to be a problem," according to Capizzi.

"Our belief is that you get paid for performance and not for attendance," says Capizzi. "That is part of the culture that Jeffrey Dunham has created here, and it extends throughout our organization, including our internal compensation systems."

Dunham's public funds are only three years old, and Capizzi says that between 60% and 70% of them are outperforming their benchmarks. Perhaps because of the relative newness of performance-based fees, we are not aware of academic studies analyzing their performance.

Performance-based Fees for Advisors

Dunham's true distinction is the performance-based fee structure they offer for advisors.

Advisors utilizing Dunham's funds can have their client fees set to 10% of absolute returns for each client's portfolio. For example, if a client's portfolio earns $10,000 in a given quarter, the fee charged to the client will be $1,000. If the portfolio breaks-even or loses money, the client will not be charged a fee.

These performance-based fees are modeled after hedge-fund fees, but they do not contain the fixed fee component. The typical hedge fund fee is "2 and 20," but Dunham's structure is "0 and 10." As with hedge funds, performance-based fees incorporate a high water mark. If a portfolio incurs losses, no fees are due until the portfolio value reaches its previous highest value.

Advisors utilizing performance-based fees must ensure clients meet the compliance guidelines of qualified investors, as is the case with hedge fund clients.

Dunham is one of the only firms offering performance-based fees for advisors utilizing underlying public mutual funds.

Approximately 285 advisory firms offer the Dunham funds, and two-thirds use Dunham's performance-based fee structure for advisors. Capizzi finds larger advisory firms make greater use of performance-based fees, and is seeing an uptick in usage in the current bear market. “Ultra-wealthy clients are going through an especially painful experience today, paying big fees on portfolios that are losing large amounts of money,” says Capizzi. “These clients are switching to advisors that offer performance-based fees.”

“Most clients do not care about performance versus a benchmark. They care about the bottom line – whether they can fund retirement, college education, and the like,” says Dunham. “This is why performance-based fees have caught on with advisors – particularly those with ultra-wealthy clients - and why these advisors are building a greater level of trust with their clients.”

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