



Performance-Based Fees

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Asset-based fees, under which managers are compensated with a percentage of assets under management, have long been the dominant compensation structure used in the investment management industry. An alternative approach links a portion of manager compensation to investment results. Performance-based fee arrangements may be found in both traditional and alternative asset classes. Adoption has historically been highest within alternative investments, where incentive-based compensation is often a core component of manager economics. These fee structures attempt to better align the economic interests of managers and institutional investors by creating a relationship between what investors pay and the performance they actually receive.

This paper examines performance-based fee arrangements, with a focus on how they relate to traditional long-only investment managers. It reviews the strengths and weaknesses of both asset-based and performance-based compensation structures, discusses common fee arrangements used across traditional and alternative asset classes, and outlines key considerations for investors evaluating performance-based fee structures.

Key Takeaways

- › **Asset-based fees remain the dominant compensation structure in investment management, but they are not perfectly aligned with investor outcomes.** Manager compensation can increase as markets rise or assets grow, even when little or no alpha is generated, creating ongoing interest in alternatives that more directly link fees to performance.

- › **The effectiveness of any performance-based fee arrangement depends heavily on its design.** Symmetrical (“fulcrum”) fee structures are the most common performance-based fee approach within traditional long-only strategies because they reward outperformance and penalize underperformance.
- › **Alternative asset classes commonly rely on asymmetrical fee structures, including hedge fund incentive fees and private equity carried interest.** While these arrangements link a portion of compensation to investment outcomes, they generally allow managers to participate more in gains than in losses and may create incentives that differ from investor objectives.
- › **Implementation is critical to the success of any performance-based fee arrangement.** Benchmark selection, performance measurement periods, fee caps and floors, the treatment of risk factors, and the handling of cash flows can materially influence whether a performance-based fee arrangement rewards genuine alpha generation or simply compensates managers for market exposure.
- › **The decision between asset-based and performance-based compensation is ultimately a question of alignment, cost, and manager access.** Performance-based fee arrangements may be more prevalent among highly sought-after managers and strategies where access and fee negotiability are limited.

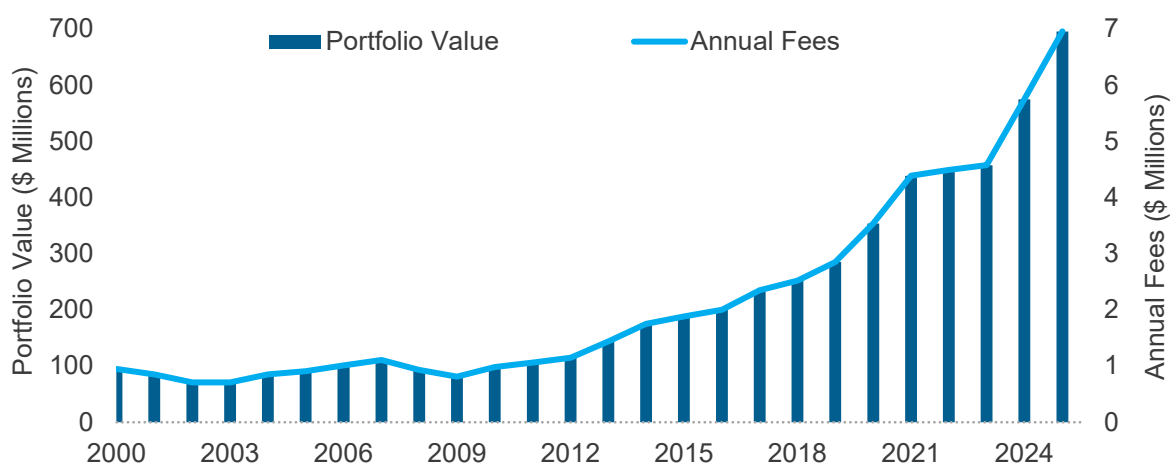
Asset-Based Fees

Asset-based fees have been the dominant compensation structure in investment management for decades. Their widespread adoption reflects a practical balance between investor and manager needs. Investors receive a fee arrangement that is relatively transparent and easy to understand, while managers receive a predictable source of revenue that can support personnel, research, and other operating expenses.

Despite these advantages, asset-based fees are not without shortcomings, and valid arguments can be made against them. For example, a manager who simply matched the calendar-year returns of the S&P 500 index from 2000 through 2025 would have received a 629% increase in their asset-based fees, while adding no excess return over the period (see Figure 1). This increase in dollar fees was directly the result of asset price increases driven by market forces, not alpha. In other words, the manager's total compensation increased through their beta (market) exposure rather than through their ability to add incremental value over their stated benchmark.

Additionally, asset-based fees create an incentive for investment managers to gather assets beyond what might be considered optimal levels. In less liquid and capacity-constrained asset classes, such as small cap and microcap equities, asset growth can make it more difficult for managers to maintain their investment process and add value.¹ Coupled with the fact that managers are often not fired for mediocre or slightly trailing performance over the medium term, managers have strong incentives to gather assets above what might be considered an optimal level, to the detriment of investors.²

Figure 1
Growth in
Portfolio Value and
Fee Revenue in a
Zero-Alpha
S&P 500 Mandate



Assumes a hypothetical \$100 million mandate tracking the S&P 500 Index from 2000–2025 with no alpha. Annual fees are calculated at 1.00% of estimated average assets, and cumulative fee increases are measured relative to 2000 annual fees.

Performance-Based Fees

Performance-based fees compensate managers based on their relative performance: if they perform well, they receive higher fees, whereas if they perform poorly, they receive lower (or potentially no) fees.

The concept is not new. Performance-based compensation has been permitted under the Investment Advisers Act of 1940 for decades.³ For investors subject to the Employee Retirement Income Security Act (ERISA), the structure of performance-based fee arrangements also warrants careful evaluation.⁴ In a 1989 advisory opinion, the Department of Labor (DOL) identified several factors that support the use of performance-based fees, including independent fiduciary oversight, objective valuation procedures, performance calculations that include both realized and unrealized gains and losses, and compensation that is reasonable relative to the services provided. More broadly, the opinion emphasized the importance of a prudent fiduciary process when evaluating such arrangements.⁵

Performance-based fees may have either “symmetrical” or “asymmetrical” fee structures. Asymmetrical fee structures are most prevalent in alternative asset classes such as hedge funds, real estate, and private equity. Symmetrical fee structures are more commonly used by traditional, long-only asset managers.

Symmetrical (“Fulcrum”) Fee Structures

The fulcrum fee is the performance-based fee structure most associated with traditional long-only investment strategies. Under a fulcrum fee structure, manager fees increase for performance above that of a pre-determined benchmark and decrease for performance below that of the benchmark, creating a more symmetrical relationship between manager compensation and investor outcomes.

Initially, a flat (base) fee is determined, which is generally equivalent to a manager’s standard asset-based fee. A minimum fee is then typically established that is roughly equivalent to similar passive index strategies, while a maximum fee may be established to dissuade a manager from taking on unwanted levels of risk in order to obtain higher fees.

When structured appropriately, performance-based fees can align manager compensation more closely with investor outcomes. Investors pay lower fees over periods of underperformance and managers receive additional revenue during periods of outperformance. Additionally, performance-based fees are designed to reduce the principal-agent conflict whereby agents (i.e., managers) seek to maximize profits with little regard to the principals’ overall wealth. Performance-based fees may be more likely to encourage managers to run strategies at optimal asset levels in areas where large base levels can impair their ability to add alpha due to liquidity constraints. Finally, if performance-based fees can be structured with a base fee below a manager’s normal asset-based fee, the arrangement may result in lower fees for the investor over the long term. This will likely be the case if the manager matches or underperforms its benchmark.

The benefits of fulcrum fees, however, depend heavily on implementation. When paired with an appropriate benchmark and a sufficiently long evaluation period, a fulcrum fee structure can improve alignment while potentially reducing long-term costs for investors when managers fail to consistently outperform their benchmarks.

Caveats

Performance-based fees are not without some downsides. First, if structured improperly, performance-based fees can encourage managers to take on excessive risk in their portfolios.

Even under a fulcrum fee structure, the manager’s downside is generally limited to reduced fee revenue rather than shared investment losses. Managers never lose money; they just earn less than they otherwise would. Arguably, true alignment of interests requires sharing symmetrically in the downside as well as the upside. As a result, performance-based fees can be viewed as call options (even under fulcrum constructs) for the managers.

As noted earlier, benchmark selection is also critical. If the benchmark is poorly matched to the strategy, investors may end up paying for results that do not reflect true alpha generation.

Additionally, performance-based fees create uncertain cash flows for investment managers and can create business risks for poorly capitalized firms, though this is less of a problem for larger management firms. Small differences in how performance is measured can have a meaningful impact on the fees investors ultimately pay. Factors such as the benchmark used, the length of the measurement period, and the treatment of cash flows can all influence the final outcome.

Implementation

The decision to use a performance-based fee should be viewed as a fee and alignment decision rather than a substitute for manager conviction. Investors should first determine whether they believe the manager can generate alpha. If so, they should compare the expected cost of a performance-based arrangement with the lowest available flat fee. If not, the more important question may be whether the manager belongs in the portfolio in the first place.

Ensuring a symmetrical fee structure that discourages excessive risk-taking behavior is essential when implementing performance-based fees. Initially, a flat fee (i.e., fulcrum) should be established along with an associated required rate of excess return (i.e., alpha). The fulcrum should be set so that the manager’s expected level of outperformance yields a fee that is typical for

active managers in that asset class and that both parties feel is fair.⁶ The manager will receive this flat fee if it outperforms its benchmark by the required rate of excess return. Performance above (below) the required rate of excess return will increase (decrease) the management fee until the maximum (minimum) fee is reached. Ideally, the excess return calculation should be adjusted for any risk factors that the investor could obtain on its own at a lower cost. In other words, the investor should pay for alpha, not beta they could achieve on their own far more cheaply.

Achieving that objective depends heavily on benchmark selection. The benchmark should accurately reflect the manager’s investment opportunity set and be specified in advance. For example, a value manager evaluated against a broad equity index may appear to outperform during periods when value stocks outperform the broader market, causing investors to pay for style exposure rather than manager skill. A core bond manager may outperform the benchmark by taking on greater credit risk than the benchmark. Careful benchmark design can help improve the fairness and effectiveness of the fee structure.

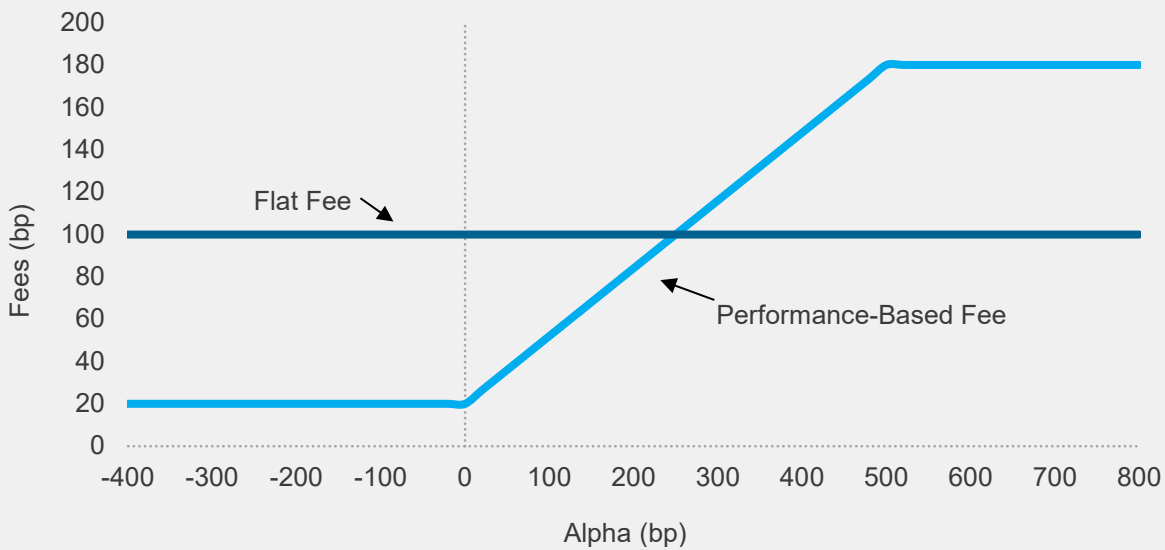
The use of a maximum fee discourages managers from taking imprudent risks in order to increase fees. The minimum (or base) fee should be informed by the cost of a comparable passive strategy. The maximum fee should

be the same distance from the flat fee as the minimum fee. The minimum fee, flat fee, and required rate of excess return will define a slope that can be used, along with the maximum fee, to calculate the value of alpha at which the maximum fee will be realized. Using these rules, the resulting fee structure will resemble that shown for the performance-based fee in Figure 2.

Typically, a negotiated base fee will be charged for the first twelve months of the strategy, given that this is too short a timeframe to make a fair assessment of performance in most cases. Following the twelve-month period, a since-inception performance fee is calculated until a pre-determined longer-term rolling period is established. The rolling period is typically three or five years in duration to discourage managers from jeopardizing long-term performance for potential short-term revenue generation. These structures can also encourage investors to retain a manager for a longer period, which may benefit investors, particularly if it reduces performance-chasing behavior (e.g., terminating a manager after they have underperformed and replacing them with a manager who just outperformed).

The treatment of cash flows and mandate termination should also be established in advance because both can materially affect performance-based fee calculations. For example, a large contribution shortly before a period of strong performance may increase the dollar value

Figure 2
Illustrative
Symmetrical
(Fulcrum)
Fee Structure



The fee schedule shown is intended only as an illustration. Assumes a 20 basis point minimum fee, a 100 basis point fulcrum fee at 250 basis points of excess return, and a 180 basis point maximum fee at 500 basis points of excess return. Actual terms should be negotiated based on the strategy, benchmark, expected alpha, and investor objectives.

of excess returns and resulting fees, while a significant withdrawal before a period of weak performance may reduce them. Similarly, investors and managers should agree on how performance fees will be calculated if the relationship terminates before a rolling measurement period has been completed. Clearly documenting these procedures can reduce disputes, improve transparency, and help ensure that performance fees accurately reflect the manager's results.

Independent calculation or verification can be an important element of a performance-based fee arrangement. Using a third party, such as an investor's custodial bank, may help reduce potential conflicts of interest and provide greater transparency around performance calculations and fee determinations.

Asymmetrical Fee Structures

An asymmetrical fee structure allows a manager to earn additional compensation when performance is strong without reducing the manager's base fee by a comparable amount when performance is weak. Typically, the manager receives a standard asset-based fee plus a share of profits, while investors bear the investment losses. By contrast, under a symmetrical fee structure, the manager's fee rises with outperformance and falls by a corresponding amount with underperformance.

Some fee structures include a clawback feature that requires the manager to return previously distributed carried interest if later losses or the fund's final results show that the manager received more than its agreed share of cumulative profits. By reconciling compensation over the full life of the fund, a clawback can protect investors from overpaying carry based on early gains, strengthen accountability for subsequent losses, and better align the manager's ultimate compensation with investors' realized outcomes.

While these features can improve alignment, they do not eliminate the underlying asymmetry of the arrangement. The structure tends to favor investment managers by allowing them to share in the upside potential while generally preserving their base fee revenue if performance disappoints. In effect, managers participate more in gains than in losses.⁷ This creates incentives that may not always align with investor interests. A manager who is behind a performance hurdle may be tempted to increase portfolio risk in an effort to earn incentive

compensation, while a manager who has already generated strong returns may reduce risk to preserve accrued fees.

Incentive fees, however, are only one of several forces shaping manager behavior. Strong performance can attract additional investor capital, increase future fee revenue, and strengthen a manager's competitive position, while poor performance can lead to client withdrawals or termination. This means that managers are often motivated by the prospect of future business opportunities as much as by current incentive compensation. As a result, portfolio decisions may reflect a desire to retain clients and grow assets under management in addition to maximizing performance under the existing fee arrangement.⁸

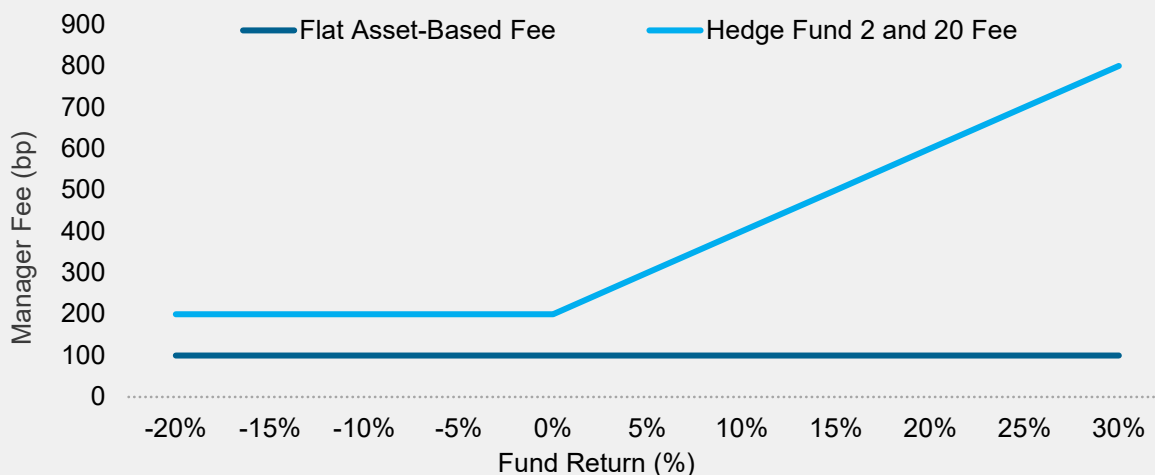
Hedge Fund Fee Structures

Hedge funds typically charge two types of fees: a management fee based on assets under management and an incentive fee based on investment profits. The traditional structure is often described as "2 and 20," referring to a 2% annual management fee and a 20% incentive fee, although actual terms vary and institutional investors frequently negotiate lower rates. The management fee is generally paid regardless of performance and supports the manager's operating costs, while the incentive fee gives the manager a share of gains. Because the incentive fee increases compensation for positive results without requiring the manager to absorb a corresponding share of investment losses, the arrangement is asymmetrical (see Figure 3).

Most hedge fund incentive-fee arrangements include a "high-water mark," which is generally the highest net asset value previously achieved after fees. If the fund subsequently incurs losses, the manager cannot earn another incentive fee until those losses have been recovered and the fund exceeds its prior peak. For example, if a fund rises from \$100 to \$120 and then falls to \$105, the manager would not earn an incentive fee on the recovery from \$105 back to \$120; incentive compensation would resume only on gains above \$120. The high-water mark therefore helps prevent investors from paying performance fees more than once on the same economic gain, although the management fee typically continues to be charged while the fund remains below its prior peak.

Figure 3

Illustrative
Hedge Fund
Asymmetrical Fee
Structure



The fee schedules shown are intended only as illustrations. The hedge fund example assumes a 2.0% annual management fee and a 20% incentive fee on profits, with no hurdle rate. Manager participation increases with positive investment performance, while the management fee is earned regardless of performance. Actual terms vary by manager, strategy, investor size, and negotiating leverage.

Private Markets Fee Structures:

A Useful but Distinct Comparison

Private markets provide a useful comparison because performance-based compensation has been a defining feature of many private market partnerships for decades. At first glance, private market fee structures appear well aligned. Managers typically earn a management fee, often ranging from 1.5% to 2.0% of committed capital during the investment period, and a share of investment profits through carried interest. Investors generally receive their contributed capital back, plus a “preferred return,” before the manager participates in profits. The preferred return functions as a hurdle rate, meaning a minimum return the fund must generate before the manager becomes eligible to receive carried interest.⁹ In private equity, a 20% carried interest rate remains the most common rate, and a preferred return of 8% annualized, net of fees and expenses, is the most common hurdle.¹⁰

The preferred return is less protective than it first appears, because most funds pair it with a “catch-up” provision. Once investors have received their capital and the preferred return, a catch-up directs a large share of subsequent profits to the manager until the manager has received its full carried interest percentage of all profits, not merely the profits above the hurdle. Catch-up rates commonly range from 50% to 100%. Under a 100% catch-up, a manager entitled to 20% carry above an 8% preferred return receives 20% of total profits once

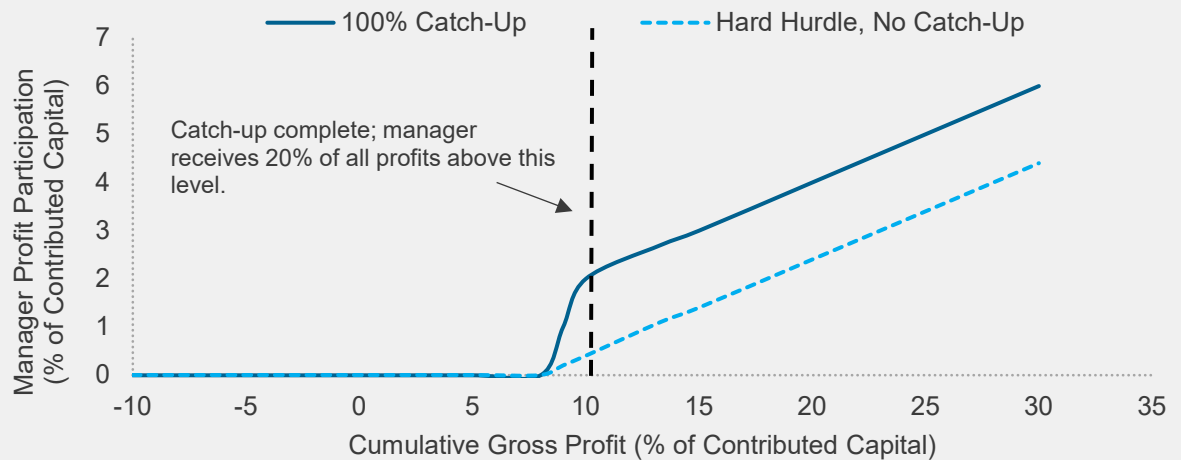
cumulative profits reach roughly 10% of contributed capital, and 20% of all profits at any higher outcome. The preferred return therefore tends to delay the manager’s participation rather than reduce it (see Figure 4). Investors evaluating these structures may find the catch-up rate at least as consequential as the preferred return itself.

Unlike the fulcrum fee structures commonly used in traditional long-only mandates, carried interest is generally based on absolute investment profits rather than benchmark-relative performance. The comparison is also affected by the catch-up mechanism described above, which has no counterpart in a fulcrum arrangement. Under a fulcrum fee, the manager’s compensation moves continuously with performance in both directions. Under a private markets structure with a full catch-up, the manager’s share of profits is effectively fixed once the hurdle and catch-up have been satisfied. Compensation is also earned over a much longer horizon, often spanning the life of a fund rather than a rolling measurement period. These differences provide a useful contrast when evaluating how performance-based compensation influences manager behavior.

While carried interest links a portion of manager compensation to investment outcomes, management fees often remain a meaningful source of revenue throughout the life of a fund. This creates incentives that extend beyond investment performance alone.

Figure 4

Illustrative
Private Equity
Carried Interest
Participation
Structure



The fee schedule shown is intended only as an illustration. It assumes an 8% preferred return, a 20% carried interest allocation, and a 100% catch-up rate, consistent with the traditional buyout structure described in Meketa's Private Markets Fees Primer. Under these terms the manager receives no carried interest until the preferred return is satisfied, then receives all incremental profits until it has been allocated 20% of total profits, and 20% of profits thereafter. The dashed line shows the alternative of a hard hurdle with no catch-up, under which the manager receives 20% only of profits above the preferred return. Carried interest would generally be earned in addition to management fees, which often range from 1.5% to 2.0% of committed capital during the investment period. The preferred return is shown here on a simplified cumulative basis; in practice it accrues as an annualized internal rate of return, net of fees and expenses, so the hurdle rises with the holding period. Actual terms differ based on the preferred return, carried interest rate, catch-up rate, carried interest structure, and other negotiated fund terms.

Managers may benefit from raising larger successor funds, which in turn generate even more management fees. One study of manager fees found that approximately two-thirds of expected private equity manager revenue came from fixed-revenue components that were not sensitive to performance.¹¹

Conclusion

Asset-based fees remain the dominant compensation structure in investment management because they are simple, transparent, and operationally straightforward. However, they are not perfectly aligned with investor outcomes. Manager compensation can increase as markets rise or assets grow, even when little or no alpha is generated. These dynamics help explain the continued interest in performance-based fee arrangements as a means of strengthening the relationship between what investors pay and the value they receive.

Performance-based fees seek to address these concerns by linking manager compensation more directly to investment results. When designed appropriately, they can improve alignment by increasing compensation when value is added and reducing compensation when performance falls short of expectations. Their effectiveness, however, depends heavily on implementation. Benchmark selection, measurement periods, fee caps and floors, and the treatment of risk factors can all materially influence whether a

performance-based fee structure rewards genuine alpha generation or simply compensates managers for market exposure.

At the same time, performance-based fees introduce additional complexity and are not without risks. Poorly structured arrangements may encourage excessive or inadequate risk-taking and produce outcomes that differ from investor expectations. The wide variety of fee structures used across traditional and alternative asset classes also highlights that there is no single approach to aligning manager and investor interests.

Recent fee negotiations for clients have shown that managers are often willing to decrease fees, especially if they have recently underperformed. For top-tier, hard-to-access managers, performance fees may be warranted and, in some cases, may be the only means of access. Otherwise, investors may be able to negotiate a competitive asset-based fee instead.

Ultimately, the evaluation of performance-based fees extends beyond the fee structure itself. Whether a performance-based arrangement achieves its intended purpose depends on the broader context in which it is applied and the extent to which it aligns the interests of managers and investors. Like many aspects of investment management, the effectiveness of a fee arrangement depends less on the concept itself and more on how it is implemented in practice.

End Notes

¹ Source: Meketa Investment Group. Small Cap Stocks: Strategic Allocation. October 2021.

² Consider a small cap manager with \$500 million under management. A 5% position would require a \$25 million investment, which may be easier to establish and exit without affecting the stock price. If the strategy grows to \$20 billion, a comparable 5% position would require a \$1 billion investment, potentially limiting the manager's ability to invest in the same opportunities and making it more difficult to maintain the strategy's prior return profile. Despite these challenges, a 1% management fee on \$20 billion generates substantially more revenue than the same fee on \$500 million, creating an incentive for managers to continue gathering assets even when additional growth may no longer benefit investors.

³ Rule 205-3 under the Investment Advisers Act of 1940 permits registered advisers to charge performance-based compensation in certain circumstances, including for qualified clients. As of June 2026, the qualified-client thresholds generally include at least \$1.4 million under management with the adviser or a net worth exceeding \$2.7 million. These thresholds are periodically adjusted for inflation. Most institutional investors would clear these tests as qualified purchasers or through their assets under management.

⁴ ERISA refers to the Employee Retirement Income Security Act of 1974, which governs the administration and oversight of private-sector employee benefit plans.

⁵ Source: US Department of Labor, Advisory Opinion 1989-31A (Alliance Capital Management L.P.), October 11, 1989.

⁶ Expected excess return is typically estimated using a combination of the manager's historical excess returns, expected active risk (often measured by tracking error), and the investor's assessment of the opportunity set. Information ratios can provide a useful framework because they relate excess return to active risk and therefore help establish a reasonable long-term alpha target. The objective is not to predict future returns precisely, but rather to identify a level of outperformance that reflects the manager's investment process and that both parties believe is achievable over a full market cycle. For example, a manager with an expected tracking error of 2% and an information ratio of 0.50 would imply an expected excess return of approximately 1% per year, before fees. Actual assumptions should reflect the manager's strategy, market opportunity set, and investor expectations.

⁷ One study of hedge funds found that, over a 22-year period, managers ultimately collected performance fees that were approximately 2.5 times higher than investors might expect based on the funds' stated incentive-fee arrangements. The authors argue that this occurs because performance fees earned during strong periods are generally not returned when results subsequently deteriorate. Source: Ben-David, Itzhak, Justin Birru, and Andrea Rossi. The Performance of Hedge Fund Performance Fees. National Bureau of Economic Research, 2020.

⁸ Source: Lim, Jongha, Berk Sensoy, and Michael Weisbach. Indirect Incentives of Hedge Fund Managers. National Bureau of Economic Research, 2013.

⁹ Under a whole-fund carried interest structure, the manager generally receives carry only after investors have recovered contributed capital and the applicable preferred return across the fund, whereas a deal-by-deal structure permits carry to be paid on individual realized investments before the fund's overall performance is known.

¹⁰ Source: Meketa Investment Group, Private Markets Fees Primer (2019), citing Preqin 2018 Private Capital Fund Terms Advisor. The primer describes the traditional private equity fee structure as including a 20% carried-interest allocation and an 8% preferred return. The underlying data found that approximately 85% of direct private capital funds utilized a 20% carried-interest rate, while 56% utilized an 8% preferred return.

¹¹ Source: Metrick, Andrew, and Ayako Yasuda, "The Economics of Private Equity Funds," Review of Financial Studies, Vol. 23, No. 6 (2010). The authors found that approximately two-thirds of expected private equity manager revenue in their sample came from fixed-revenue components that were not sensitive to performance.

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