Pricing Incentive Fee Of Hedge Fund Managers: A Discussion Of Moral Hazard

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This paper explores the conflict of interests raising between the manager and the shareholders of hedge funds. It is related to the excessive risk taking by the manager in implementing investment strategies with respect to the optimal level of risk for the shareholders. The main element explaining such a conflict is the structure of the manager's compensation whose main component is represented by an incentive fee contingent on the realization of conveniently defined profits. The contingent claim nature of the incentive fee allows of pricing it as if it was an option written on the fund's assets with a strike price represented by the historical maximum reached by the fund's assets. We show that even introducing a double contingency (an absolute and a relative performance) on the fee payment the incentive to maximize risks in order to maximize the fee's value is not removed from the manager's behavior. Furthermore, we show that by allowing the manager to own a share of the fund assets has the crucial advantage of mitigating his/her risk taking attitude. Finally we show that a good alignment of the manager-shareholders conflicting interests can be reached to the extent that shareholders are able to control the weight of the managers participation to the fund in his/her total compensation.