THE IMPACT OF ADVISORY INCENTIVE FEES ON RETURN AND RISK OF INVESTMENT COMPANIES

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This study examines the relationships between incentive contracting for registered investment company advisors and the performance and the risk of the portfolio managed by the advisor. To test these relationships, four measures of return and three measures of risk are employed in a pooled time-series, cross-sectional regression.

The results of this study indicate that managerial incentive fees do not significantly correlate with the overall performance of the managed fund. No significant positive relationship between fees based on the performance of the fund and three of the four measures of portfolio return was found. However, the empirical results did show a positive relationship between the presence of a performance-based fee and a fund's risk adjusted return.

The results confirm that incentive contracting does impact portfolio management risk-taking. In particular, management fees that are based on the size of the portfolio correlate positively with the fund's nonsystematic risk and negatively with the fund's systematic risk. Incentive management fees based on the relative performance of the fund relate positively to a fund's systematic risk. These results imply that both signaling and gaming aspects of incentive contracting are present in the investor-advisor relationship.