Navigating Investment Management Fees

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At VELA, our mission statement, reflected in our name, calls on us to serve our clients through a disciplined, intrinsic **v**alue-based approach to investing guided by our substantial **e**xperience, while maintaining a **l**ong-term perspective and **a**ligning our interests with those of our clients. Our mission permeates our business, including our determination of the appropriate management fees for our strategies. In setting management fees for each of our mutual funds, we consider the necessary inputs required to achieve our investment goal of returns in excess of passive alternatives, net of fees and expenses.

Active vs. Passive Management and Related Fees

Passive investing, also known as indexing, has rapidly grown its share of the total investment business since its inception 50 years ago[1]. The appeal includes extremely low total costs for investors due to:

- Management fees that are a fraction of active management fees,
- Scale that reduces other administrative expenses, and
- Minimal market impact costs, due to very low portfolio turnover.

As discussed in our earlier paper, **Structuring for Outperformance**, the goal of passive managers, unlike active managers such as VELA, is to match rather than outperform the returns of an index such as the S&P 500.

The vast majority of passive investing utilizes a market capitalization weighting methodology, matching an index such as the S&P 500, where position sizes are based on the market value of the companies in the index. This allows for the most substantial cost differential, the management fee, because it does not require research to evaluate companies, as does active management.

Over short periods of time, such as a year, the investment returns from passive investing often tend to be slightly above average due to the low-cost advantage, particularly when market returns are positive[2]. Over a longer-term period of time, such as five years, compounding passive investing's low-cost advantage suggests investment returns much better than average.

An unintended outcome of passive index investing, in my observation, is that as money flows into such a strategy, the effect is similar to momentum investing, i.e. investing in the stocks that are rising the most (which makes their market value even larger), creating a self-fulfilling dynamic.

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Some active managers may be influenced by momentum and may purchase some of the largest stocks in an index irrespective of valuation. Implicitly (sometimes explicitly), “risk” in these cases is considered to be underperforming a benchmark over some period of time, rather than the absolute loss of clients’ capital. At some point, when money flows out of such strategies, the process reverses, causing the greatest decline in market value of the largest companies[3].

At VELA, our goal is to achieve net of fee returns that exceed passive alternatives over time, inclusive of higher active management costs. Importantly, we consider “risk” to be the permanent loss of client capital

Strategy Value Add

Currently, VELA offers five mutual funds covering both equity and fixed income securities. In determining the fee schedule for each, we begin by estimating our ability to achieve returns in excess of the passive benchmark over a five year time period. The management fees, as of time of writing, are reflected below for each fund. The additional legal, administrative, and distribution costs associated with mutual funds result in the Expense Ratio.

Fund	Management Fee	Expense Ratio
Small Cap	0.75%	1.16%
Large Cap Plus	0.75%	1.38%
International	0.75%	1.15%
Income Opportunities	0.50%	0.90%
Short Duration	0.35%	0.69%

Like many mature businesses, investment management is very competitive, and in my experience the market for large cap funds tends to be more competitive than small cap funds, reflecting the capacity constraints inherent in small cap investing. As a result, the level of outperformance necessary to achieve a certain peer ranking for a small cap fund is typically greater than the outperformance necessary to achieve the same ranking for a large cap fund.

Additionally, in our view, active management fees should be greater for funds where the opportunity to outperform is greatest, primary research efforts are highest, and capacity constraints limit the amount of revenue that can be generated to support the fund.

With these factors in mind, we recently reviewed and made the decision to lower our management fee on the Large Cap Plus Fund, believing that future returns above the benchmark will be less than our recent history, given the greater market efficiency with the largest companies than their small cap counterparts. Effective October 1, the management fee for the Large Cap Plus Fund will be 0.60%. Coupled with a 0.03% reduction in the funds’ unitary administrative fee, the fund’s Expense Ratio will be reduced from 1.38% to 1.20%.

As an active manager, VELA understands the importance of current valuation as a component of the future return on investment (the “V” in VELA). Our decades of investment experience (the “E” in VELA) is a tremendous advantage for estimating business economics. The aforementioned compounding effect on returns over the long term (the “L”) is increasingly meaningful over time, consistent with our five year period emphasis. Finally, paying the same expenses as our clients, our alignment of interests (the “A”) reinforces the awareness that total costs are always part of the net investment return.

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Disclosures:

VELA Investment Management, LLC is a registered investment adviser. Information presented is for educational purposes only and does not intend to make an offer or solicitation for the sale or purchase of any specific securities, investments, or investment strategies. Investments involve risk and unless otherwise stated, are not guaranteed. Be sure to first consult with a qualified financial adviser and/or tax professional before implementing any strategy discussed herein. Past performance is not indicative of future performance.

The views expressed are those of VELA Investment Management, LLC as of 08.26.2024 and are subject to change. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Third-party information in this report has been obtained from sources believed to be accurate; however, VELA makes no guarantee as to the accuracy or completeness of the information.

Investors should carefully consider the investment objectives, risks, and charges and expenses of the fund before investing. The prospectus contains this and other information about the fund, and it should be read carefully before investing. Investors may obtain a copy of the prospectus by calling 833-399-1001.

The funds are distributed by Ultimus Fund Distributors, LLC. (Member FINRA). VELA Investment Management, LLC and Ultimus Fund Distributors, LLC are not affiliated.

As of 6.30.2024 the annualized Total Return for the I-Shares 1-year for the VELA Small Cap Fund was 13.66%, 3-year was 6.21%, and since inception (09.30.2020) was 18.82%; the annualized Total Return for the I-Shares 1-year for the VELA Large Cap Plus Fund (Class I) was 16.75%, 3-year was 7.90%, and since inception (09.30.2020) was 15.63%.

Mutual fund performance data quoted represents past performance. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance data quoted. Investors may obtain mutual fund performance data current to the most recent month-end by calling 833-399-1001.

Important Risk Information: An investment in the Fund involves risk, including possible loss of principal. The principal risks of investing in Funds include equity, market, management and non-diversification risks. The market value of a security or instrument may decline due to general market conditions that are not specifically related to a particular company, such as real or perceived adverse economic conditions, changes in the general outlook for corporate earnings, changes in interest or currency rates or adverse investor sentiment generally.

The VELA Small Cap Fund invests in a diversified portfolio of small capitalization stocks. Investments in smaller companies may be riskier, less liquid, more volatile and more vulnerable to economic, market and industry changes than investment in larger, more established companies.

The Large Cap Plus Fund uses short selling which incurs significant additional risk. Theoretically, stocks sold short have the risk of unlimited losses.

A complete list of portfolio holdings can be found at www.velafunds.com.

Indexes are not available for direct investment.

Intrinsic Value: Intrinsic value is a measure of what an asset is worth, arrived at by means of an objective calculation or complex financial model. Intrinsic value is different from the current market price of an asset. However, comparing it to that current price can give investors an idea of whether the asset is undervalued or overvalued.

Footnotes:

[1]Sources: S&P Global, Morningstar
[2]Source: Morningstar
[3]A recent example is the recent volatility of major U.S. indices, such as the S&P 500 (comprised of the 500 largest public companies in the U.S.), in which the largest companies in the index were the beneficiaries of outsized positive and later negative momentum. Source: Wall Street Journal

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