In Harmony

How hedge funds and investors continue to strike the right note in aligning their interests

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Foreword

We are pleased to present AIMA's latest research, 'In Harmony – how hedge funds and investors continue to strike the right note in aligning their interests'. Three years after the 'In Concert' paper was published, this new research paper builds on those findings. It examines to what extent these trends are continuing, as well as identifying how hedge funds and investors are aligning interests that best meet their mutual needs.

Assets under management for the hedge fund industry continue to break new records, as it attracts an increasing number of institutional investors. Their views and expectations of hedge funds have brought about significant changes impacting the overall industry. In the simplest terms, this revolution centres on three Cs – customisation, collaboration and communication.

The industry's institutional, experienced and sophisticated investor base has driven the change towards bespoke investment mandates, value advisory services – and deeper partnerships that now create a closer alignment of investors' and hedge-fund managers' interests.

Our analysis reveals that investors and managers are exploring new approaches to negotiate fees and fund terms, and that hurdle rates are more widespread. The widespread use of the '2 and 20' compensation model is now consigned to the past and we have observed increased use of 'tiered fees' for investors. A new equilibrium in the alignment of interests is on the horizon.

Customisation and co-investing mean hedge-fund managers can now deliver solutions that meet their investors' specific risk and return goals. This trend has been accompanied by a recognition of the value of accurate and informed communication between investor and manager, allowing for a productive exchange of knowledge between both parties and an increased understanding of investment strategies by investors.

We would like to thank AIMA's research committee[1] and the representatives of AIMA's global investor steering committee[2] for their valuable input and for taking the time to discuss these findings. We would also like to thank the various managers who provided the number of testimonials included throughout this paper.

Finally, we thank you for your time in reading this paper. We hope you enjoy it.

Jonathan Waterman
National Asset Management leader, RSM US

Tom Kehoe
Global Head of Research and Communications, AIMA

1 A global committee comprising hedge-fund managers, consultants and representatives from the academic community. It produces and endorses research and thought leadership on all aspects of the hedge fund business model.

2 Members of this global committee represent pension fund managers, sovereign wealth funds, endowments, foundations, large family offices, and private banking platforms.

Executive Summary

The findings from this year's survey are based not only on what is current practice between hedge funds and investors, but also potential future developments and how these could be best implemented.

Below are the **six** key takeaways that emerged from this year's survey:

1. Moving towards a new equilibrium

There is an increasing sense that fund fees and terms between hedge-fund managers and their investors are moving towards a new normal. No longer is the focus solely on fees, rather investors and hedge funds are continuously exploring new ways to negotiate fees and fund terms to reflect a better alignment of interest. Managers are responding to investors' needs by putting in place arrangements that are more closely aligned both to the requirements of the client and the underlying investment strategy. Fund hurdle rates continue to grow in popularity. Almost 40% of all respondents use fund hurdle rates of varying description, including a pre-agreed alpha hurdle rate, used by 14% of the total number of respondents.

2. Beyond 2 and 20

In recent years, investors and managers have agreed on a variety of new flexible fund fee structures. No longer is it only the case that hedge-fund managers charge the traditional 2 and 20 flat fee structure. Rather than merely reducing the headline fee, hedge-fund managers are examining more equitable compensation arrangements that are beneficial to them and their investors. An emerging trend from this year's study is tiered fees for investors; as the hedge fund firm grows its assets under management, investors will benefit from a lower fee. 35% of all respondents offer this fee discount to investors.

When it comes to reconciling the most appropriate fee structure being charged to investors, between 20% to 30% of the alpha earned being paid to the hedge fund feels about right. Our discussions with managers and investors reveal a shared belief that the manager share of any alpha earned should be about one third, with the remainder going to the investor.

3. From manager-led products to investor-led solutions

The hedge-fund manager-led product of the past is being replaced with more bespoke investment mandates including co-investment, customised solutions and other value advisory services which best aligns investors' unique risk and return goals.

Over half of all respondents believe that customised solutions are crucial to driving closer alignment with their investors, a marked increase from the 14% of respondents who offered the same view in our 2016 study.

Hedge-fund investors are now considering co-investing; a popular arrangement with private equity institutional investors. Almost one in five respondents are offering co-investment opportunities, while one in two are open to exploring ways to do this with their investors.

4. Skin in the game

Having 'skin in the game' remains the most important demonstration of alignment between hedge-fund managers and investors, as voted by 76% of all respondents. At the founding stage it is not uncommon for fund founders/principals to invest as much as 80% of their capital.

Investors still value hedge-fund managers having 'skin in the game' and are still discerning of fees, but now partner with them far more to create bespoke investment solutions through increased transparency, better communication and a responsiveness to investor needs.

5. Sharing the expense

The variety and amount of expense that must be incurred to operate a hedge fund business is increasingly challenging for hedge funds. Investors globally are increasingly sensitive not just to the compensation fee to be paid to the hedge-fund manager, but also to the total costs incurred operating a hedge fund. The findings from this year's research point to a clear delineation regarding what the hedge fund firm pays and what expenses are paid by its investors (the fund). Hedge-fund managers work with investors to place a cap on any additional expense burden from one-off costs or expenses incurred from launching a new business.

6. Partnering with investors

Both hedge funds and investors stand to benefit from a closer and more aligned partnership. We see the advantages as three-fold. First, as the investor builds more knowledge about the hedge-fund manager, they gain a deeper understanding of how the hedge fund will behave. This will help to avoid short termism that can damage fund performance. Second, the deepening partnership between the hedge-fund manager and investor enables the investor to take advantage of the hedge-fund manager's unique market insights benefitting their overall portfolio. Third, this closer collaboration can help to deliver new products and services. This is demonstrated by the increased interest in hedge funds developing more bespoke investor solutions and other value advisory services.

Methodology

1. Hedge-fund manager survey with input from 118 hedge-fund managers (*referenced as respondents throughout the paper*) globally representing approximately $440billion in assets under management (AUM)[3]. For simplicity, the use of hedge funds and hedge-fund managers are used interchangeably throughout.

2. In depth roundtable discussion and one-to-one interviews with hedge funds to improve understanding of the key findings from the manager survey. Throughout this report, you will see several testimonials from hedge-fund managers who participated in various roundtable discussions.

3. Input from a global investor steering committee which manages more than $1trillion in AUM and allocates approximately $100billion in AUM to hedge funds.

4. Input from a relevant thought leadership and external research across various hedge fund industry stakeholders. These include investors, hedge-fund managers, hedge fund industry service providers and policymakers.

Demographic of respondents

Figure 1: Main strategy of the flagship fund

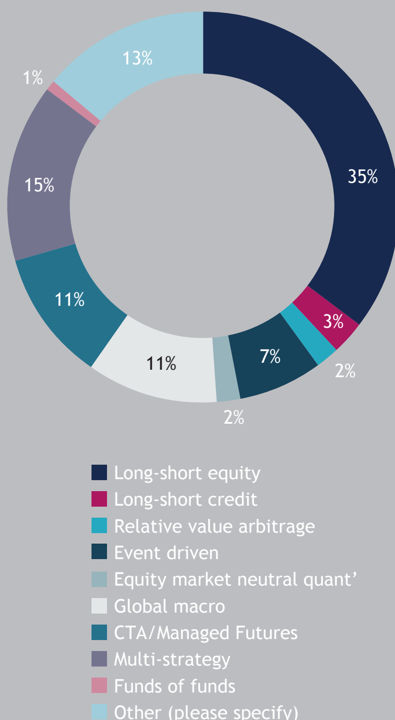
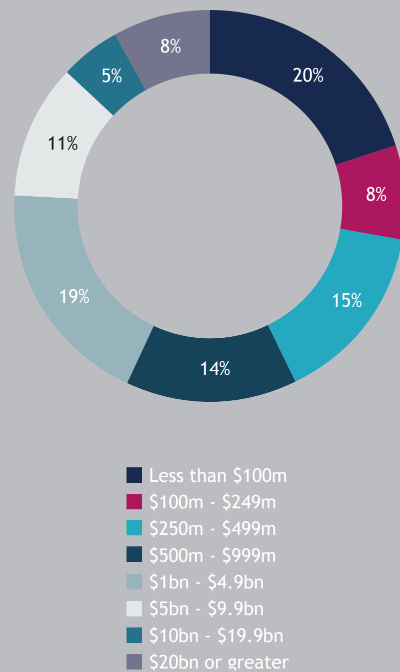


Figure 2: What is the net asset value (in US$) of hedge fund assets under management of your firm?



3 Charts included in the paper represent the number of responses from either the entire population that completed the survey or relevant to the number of responses that elected to respond to a question.

1 Partnering with investors.

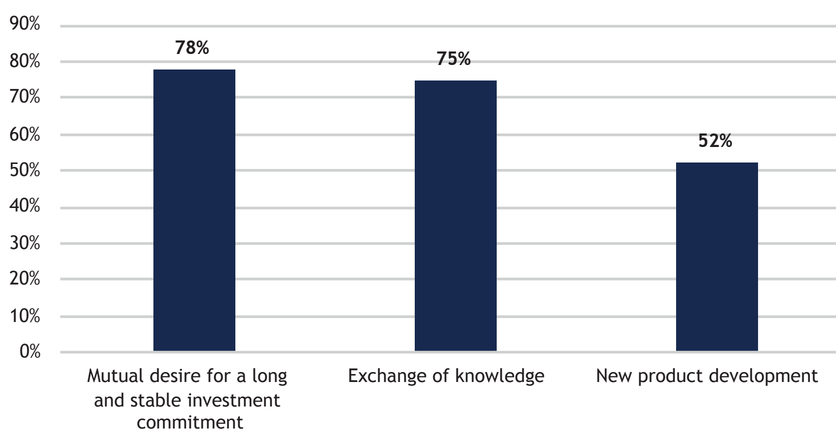
A quiet revolution is taking place across the hedge fund industry. The findings from this survey point to hedge funds and investors breaking new ground in their quest to strike the perfect partnership.

As the hedge fund industry becomes more institutional and its investors more experienced and sophisticated, the hedge-fund manager-led product universe of the past is being replaced with more bespoke investment mandates, value advisory services and deeper partnerships which best align with the investor's unique risk and return goals.

The key motivations for hedge-fund managers to align interests with investors are as follows:

- A mutual desire for a long and stable investment commitment;
- Better communication and a greater exchange of knowledge;
- New product development.

Figure 3: Other than performance, please rank in order of importance what is most important to you when you consider an alignment of interests between your firm and your investors - top three answers.



1.1 Moving from a manager-driven model to a tailored investor solution

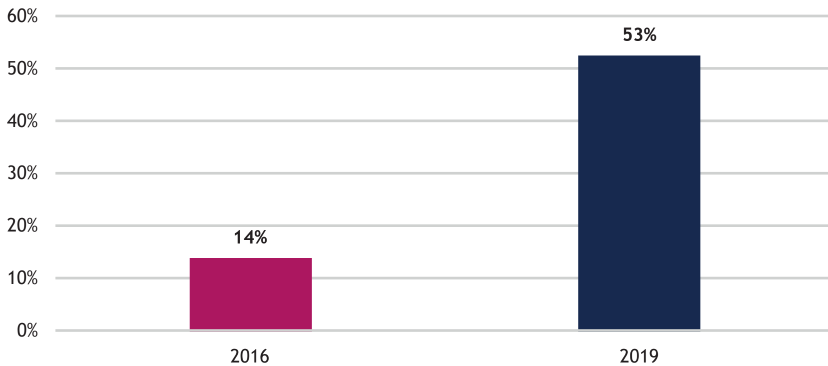
One of the significant transformations of the hedge fund industry in recent years is its evolution from a manager-led to an investor-driven model. This change is characterised by two increasingly popular industry developments.

(i) Customised solutions

Just over half of all hedge fund respondents in our survey cited the use of customised solutions as being an important way to align with their investors. Implementing these solutions ensures that hedge funds can be better tailored to meet an investor's specific risk and return targets precisely and can deepen pre-existing relationships. The two most popular types of fund structures that govern these solutions are the managed account and the fund of one[4].

Just over half of all hedge fund respondents in our survey cited the use of customised solutions as being an important way to align with their investors.

Figure 4: Hedge funds that cite having customised solutions as being an important factor in aligning interests with investors.



Managed accounts enable the investor to give the hedge fund a specific investment mandate and develop a portfolio unique to their specific risk and return appetites. Examples of this arrangement involve investors adjusting their portfolio positions to focus on one niche investment or carve out a more appropriate investment strategy with the hedge fund.

A managed account can also provide significantly enhanced transparency with most arrangements allowing for the fund's positions to be viewed on a live basis with daily reporting. This can improve the investor's understanding precisely how the fund's returns are being generated.

4 A fund of one is an investment structure that has become popular in the fund of funds world. The investor, in this case the FOF, is the sole investor in a specific vehicle or fund.

Why a customised offering is just as important to hedge funds as being able to offer a differentiated product and competitive fees.

"Investors have increasingly specific needs and are looking for hedge funds that can customise their offering in response. In our experience, these needs can be diverse. At the simpler end, investors may wish to tweak the product, so it offers a broadly similar investment process, but better meets their overall mandate by targeting higher risk or offering improved liquidity by removing certain less-liquid strategies. More complicated examples may include wishing to isolate one particular segment of a strategy to include in their overall mandate - for instance, getting Asian exposure only from a global equity long-short provider or focusing on socially responsible investment. Likewise, investors may want the product to be based in a certain jurisdiction.

Ultimately, both hedge funds and investors live in an increasingly complicated world where hedge-fund managers are challenged to produce the best possible outcomes. Hedge-fund managers realise that to ensure their clients succeed, being able to provide a customised offering is just as important as being able to offer a differentiated product and competitive fees."

$10billion + multi-manager

In recent years, the assets under management of managed account platform (MAP) sponsors has grown to reflect the strong level of interest shown by investors. Given the size of some of these MAPS, they can negotiate better incentive fees, and some have even negotiated management-fee only arrangements for its investors.

The scope to negotiate fees within a fund's commingled structure has become more limited in recent years. In contrast, an investor that has a customised solution can achieve significant fund fee reductions over the long term, albeit a more considerable investment is often required at the outset. In comparison to investing in a commingled fund structure, where typically the minimum investment requirement can be as low as $500,000, most customised arrangements are more expensive to access. Anecdotally, it seems some hedge funds require a minimum investment size of $50m before building out a more customised solution.

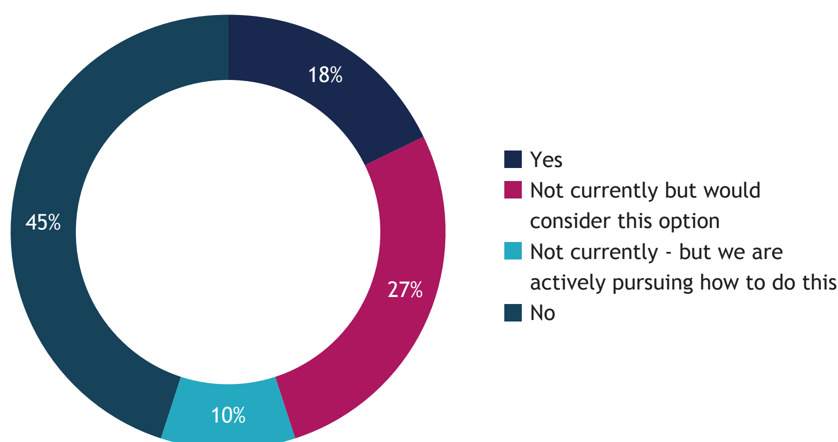
As services like MAPs become popular, the scope for aligning interests through having a customised solution is likely to increase. Managed correctly, this should enhance the ability of fund managers and investors to build more mutually productive partnerships.

(ii) Co-investments

Co-investments are already a popular tool with institutional investors, private equity and real estate managers. Hedge funds are establishing similar arrangements with their investors recognising the mutual benefits of co-investment to generate attractive returns, and better align their interests. In comparison to the 2016 survey[5], the findings of this year's survey suggest that more hedge funds are prepared to co-invest, with **just over half of all respondents are offering co-investment opportunities or open to exploring ways with investors to do so.**

Just over half of all respondents are offering co-investment opportunities or open to exploring ways with investors to do so.

Figure 5: **Does your fund(s) offer co-investment opportunities to your investors?**



Co-investment arrangements can be a one-time investment opportunity within the scope of the main hedge fund or organised as separate and/or independent co-investment funds. The typical motivations for hedge funds launching these vehicles with investors include:

- Hedge funds are more likely to retain investors and build goodwill with them. Often investors will allocate to a flagship commingled vehicle with an eye toward getting access to a niche co-investment opportunity with the hedge-fund manager.
- Where a hedge fund may only be recognised as being expert in one area, they may opt to co-invest so that they can build a track record of expertise elsewhere.

5 In the 2016 study, 48% of the total number of responses indicated that hedge-fund managers offer, or were considering offering, co-investment opportunities to their investors.

- First-mover advantage can provide the hedge fund with an avenue to help it stand out from its peers; as a versatile partner willing to engage in exciting investment opportunities with its investors.
- Depending on the investment approach, co-investments can be useful in a high conviction investment strategy with investors. For example, a manager may have built a large position in a company within its fund, but the absolute amount represents a relatively small proportion of the outstanding stock of the company. For the manager to build a larger position in the company's stock without breaching risk limits within a fund, but to gain more power when negotiating with management, a co-investment opportunity will be offered to clients.

Figure 6: Do you offer co-investment opportunities to your investors? (by strategy)

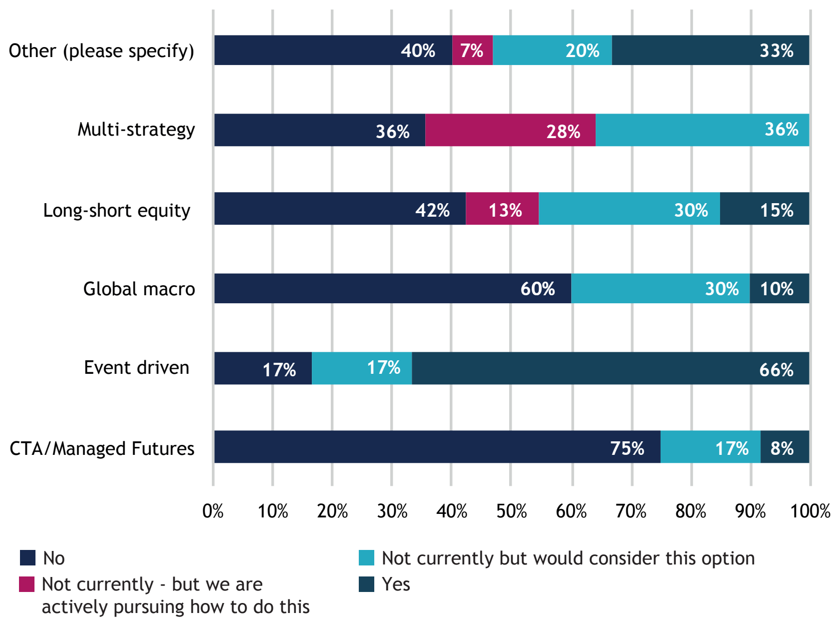
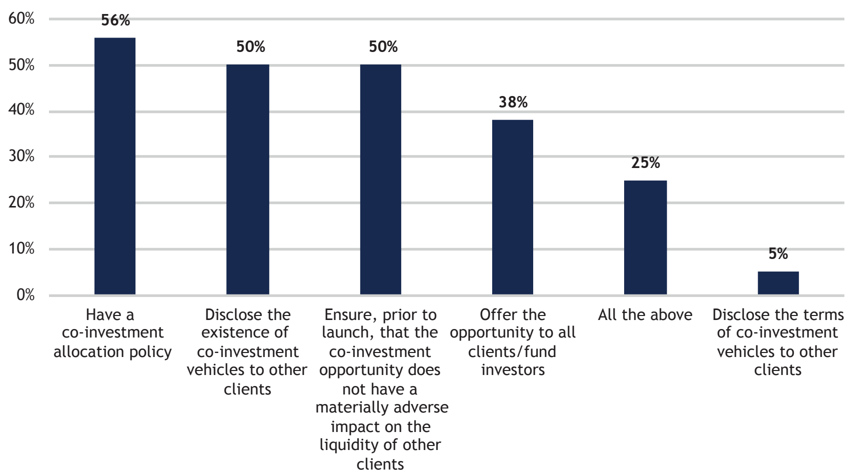


Figure 7: When offering co-investment opportunities, it is important for the hedge fund to (select all that apply).



Typically, opportunities are offered to established investors in the fund. They are often asked to commit a significant investment of capital over a long timeframe. This prevents quick redemptions in the event of the fund incurring losses. In return, management fees charged to investors are negligible or zero, although managers share a proportion of any profits earned.

Any such arrangement with a prospective investor is likely to be the subject of a strict Non-Disclosure Agreement (NDA)[6] with the hedge-fund manager. Recognising the benefit of co-investment opportunities, 18% of respondents offer these arrangements to their investors while a further 27% would consider such an option if requested by investors. The findings of this survey reveal that smaller and emerging hedge funds (below $500m in AUM) and mid-sized funds (with $1billion and $5billion in AUM) are more likely than their larger peers to consider a co-investment with investors[7]. Anecdotally, evidence suggests that larger funds will also agree to such an arrangement, given the right terms.

Given the bespoke nature of co-investments, they are often set up via a segregated structure (fund of one, managed account). This enables investors to have greater transparency and be more actively involved with the hedge fund.

Co-investment at work

"We entered into a co-investment agreement last year with a large investor in one of our pooled funds. This involved an opportunity in a highly liquid company that we saw was being significantly mispriced and where the position was already fully sized in the pooled product. Given the high liquidity of the stock, we felt there was additional capacity to invest in the company and that any arrangement to co-invest would not adversely impact the trading ability of the pooled fund (and therefore would not create a conflict of interest).

Prior to entering into this arrangement, to ensure that we were treating all our clients fairly, we canvassed them to ascertain their willingness or ability to take part in such a co-investment.

The co-investment took the form of a separate managed account where we had full trading discretion and liquidity terms that were not better than the pooled fund. In the end, the co-investment deepened our relationship with the client without it being detrimental to other clients.

We are acutely conscious of the potential for co-investments to create conflicts (as well as align interests). We have therefore put in place a Co-Investment Policy to ensure we consider and prevent any potential conflicts before entering into these arrangements."

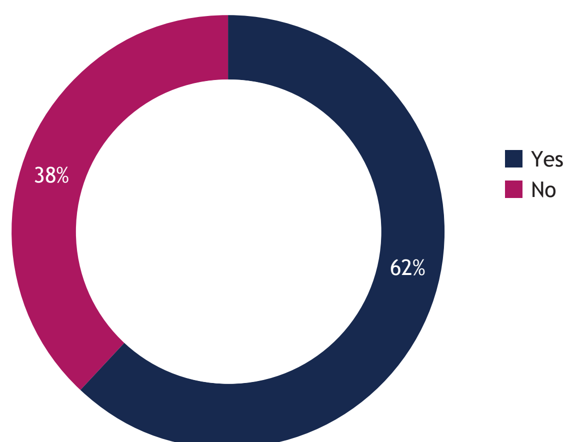
$20billion long-short hedge-fund manager

6 Legal contract between at least two parties that outlines confidential material knowledge or information that the parties wish to share with one another for certain purposes but wish to restrict access to or by third parties. NDAs can be mutual meaning both parties are restricted in their use of the materials provided, or they can restrict the use of the material by a single party.

7 Combined the percentage of emerging and mid-sized managers that would consider a co-investment is 53% of the total population that responded.

(iii) Responsible Investment - Working with investors to do good and do better

Figure 8: Over the past year, have you seen an increase in interest around your firm's responsible investment capabilites from current or prospective investors?



Nearly two thirds of all respondents have seen increased interest in their firm's responsible investment capabilities over the past 12 months

Investors are increasingly demanding that their capital be put towards a more responsible form of investing (RI)[8] that as well as minimising risks and maximising returns, also take environmental, social and governance concerns (ESG) into account.

Nearly two-thirds of all respondents have seen increased interest in their firm's responsible investment capabilities over the past 12 months. This is representative of the strong sentiment we see across the broader hedge fund industry, where ESG and RI is fast becoming one of its most significant considerations.

Certain components of responsible investment are not new to hedge funds. The industry has led the way in pursuing good governance around its investments. Hedge funds have a long history of engaging with the management of the companies in which they invest. The hedge funds that we spoke to report an increase in questions from investors about their RI practices. They may find that by taking small steps, such as becoming an engaged asset owner; they can demonstrate positive practices. Related to that, where a hedge fund teams up with its investor(s), via ownership of a small percentage of a listed company's equity, they can demand the attention of the company's governing bodies and pressure them to improve their ESG practices.

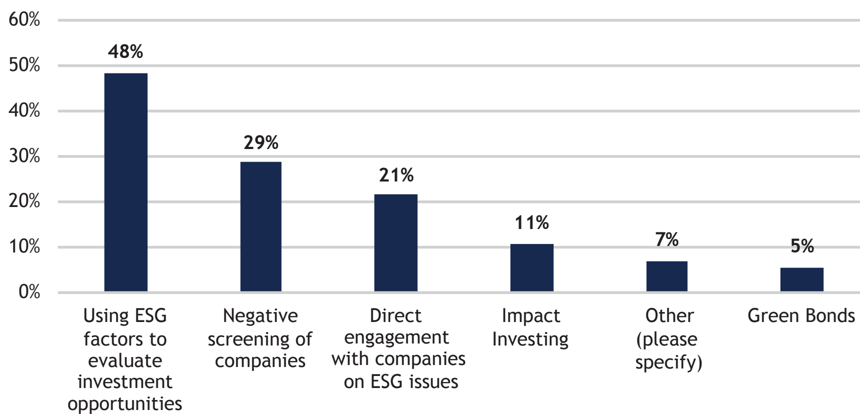
8 Responsible Investment (RI) is a broad term that encompasses a range of choices. At one end of the spectrum, a manager could practice RI simply by screening a handful of securities out of a portfolio. At the other end, a manager could decide to run a fund entirely dedicated to investing in assets that generate social good. For further information on ESG and RI, please see AIMA's Responsible Investment Primer (May 2019), www.aima.org

While some hedge fund strategies may be relatively easy to implement via the deployment of ESG and/or RI, others may be more challenging. The use of segregated accounts can enable more tailored ESG investment portfolios for investors. Examples include more bespoke hedge funds that are invested purely in ESG-friendly companies. Further, an increasing number of hedge funds are implementing a greater ESG focus in their investment approach.

There is a broad differentiation in how hedge fund firms approach responsible investment, with one in two respondents using ESG factors to evaluate investment opportunities. Negative screening continues to be a popular approach, deployed by almost one third of all respondents. There is an on-going debate as to whether negative screening results in a long-lasting social impact on a meaningful scale. One in five respondents say they engage directly with companies on ESG issues while just over one in ten are engaged in impact investing.

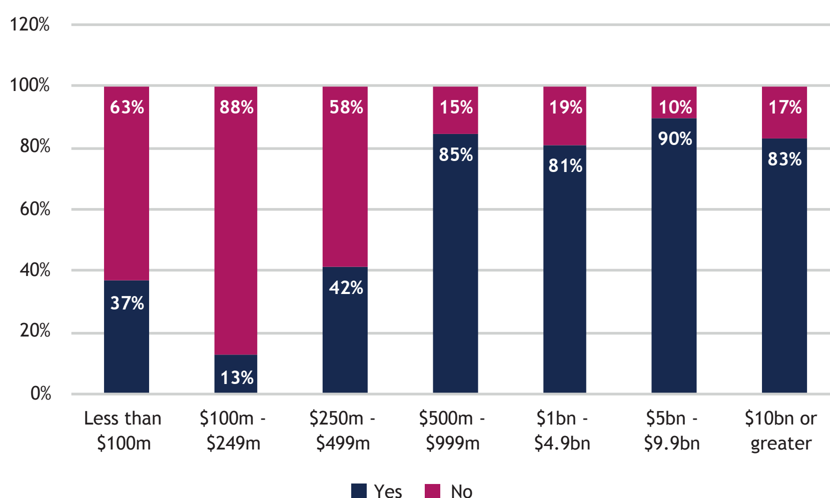
Whatever your view on ESG and RI, a combination of increasing investor demand as well as greater scrutiny from regulators[9] is only likely to increase the appetite for hedge funds to incorporate ESG and RI further.

Figure 9: Which of the following best describes your firm's approach to responsible investing?



9 The European Union is in the process of adopting various sustainable finance measures. This will undoubtedly have an impact on the way that managers operate in the region, and as a result, this topic will continue to grow in importance as those measures are imbedded into investment processes.

Figure 10: **Over the past year, have you seen an increase in interest around your firm's responsible investment capabilities from current or prospective investors? (AUM)**



1.2 Better communication

Knowledge sharing and client support is a crucial element in any partnership between a hedge fund and its investors. Just as no two managers are the same, not all investor types are the same either. Hedge-fund managers typically welcome closer co-operation with investors in order to understand how best to manage the changing requirements and dynamics of their client base.

Knowledge sharing and client support is a crucial element in any partnership between a hedge fund and its investors.

A small or emerging hedge-fund manager may only need to cater to one or two external investors[10] (typically a fund of hedge funds manager or a family office), whereas an established mid or large-scale fund will typically cater to a much greater variety of investor types and a less concentrated client base. Each investor base will have its own views on what constitutes a successful alignment of interests.

A hedge fund that benefits from regular constructive dialogue with its investors will have a better chance of understanding and reconciling their demands. Doing so, they may be able to satisfy a broader range of investor requirements and thus promote long-term investment and a more stable client base.

Among the larger respondents to this survey, some have worked with their investors to offer secondment opportunities to the investors' employees to improve their understanding of their fund's processes and operations.

10 In this case, external investors do not include friends and family money.

Greater interaction can help explain the performance attribution, the drivers behind the performance and the risk profile of the portfolio. The development of customised research for investors allows a hedge fund to differentiate itself more and increase the value it delivers to its clients. At the same time, hedge funds need to be careful in managing this relationship. Providing investors with highly customised material can be a distraction and a potential drain on the hedge fund's resources to the possible detriment of fund performance.

Investor communication can be further improved by making sure a hedge fund has a high-quality investor relations (IR) function. The IR team needs to have enough depth of knowledge about the fund's investment strategy and a proven ability to communicate in sufficient detail about the fund's performance and field any queries related to the fund's portfolio without having to call on senior investment personnel, taking time away from their primary responsibility of looking after the portfolio. The IR team also has the responsibility to listen and understand the unique needs and expectations of its investors and to communicate this effectively to senior members of the fund to deliver the best solution. As greater transparency is provided, IR professionals can expect to field increasingly detailed and technical questions from investors.

Hedge funds are taking steps to ensure that they are acting on these steps. They are making high-quality hires around investor relations that can deliver the firms expertise and solutions in a coherent fashion to its investors. These roles are structured so that they can act as a nexus between the senior investment personnel of the fund and the investor.

How knowledge sharing can help build deeper partnerships with investors

"Our business and investment strategies have been built on an academic approach to markets. And with strong links to a number of premier universities around the world, our researchers, data scientists and business leaders seek to contribute to the advancement and dissemination of knowledge through active discussion and regularly publishing academic articles.

As a firm, we host more than 50 seminars globally to share our understanding around research and technology, including an Annual Spring Seminar featuring leading industry and academic experts. Our insights have been published in over 100 pieces of academic research, white papers and technical notes available on our website and for investors. We have also developed dynamic visual dashboards focused on complex topics such as identifying principal components to construct optimal portfolios across instruments and asset classes.

Through our active approach to knowledge sharing, we can engage in robust conversation with our investors, helping them develop deeper understanding into our approach. In return, these thoughtful interactions are instrumental in guiding our firm, as we look to provide solutions and deliver investment strategies that truly create value for our investors."

$10billion quantitative hedge-fund manager

1.3 An investor partner willing to invest for the long term

Hedge funds are keen to develop meaningful partnerships with investors that are willing to see beyond any short-term fall in a fund's performance and remain committed to the strategy of the fund. This allows the fund manager to offset the performance volatility in the month to month returns and build a more stable relationship with their investors. A long-term commitment by an investor can also enhance their understanding of the fund's investment process and assessment of the long-term return profile of the funds against the motivating criteria of their overall portfolio.

It's critical for investors to gain insight into risk-adjusted measures of performance in their evaluation of hedge funds. For institutional investors, the ability of a hedge fund to add diversification to the overall investment portfolio and reduce correlation to broad market indices is typically a key consideration in assessing a fund's performance. Metrics that capture the volatility of returns, the correlation of fund returns to an index, or aspects of peak-to-trough value declines (drawdown) are all considered in manager selection. Hedge funds may have specific mandates in terms of the type of securities in which they can invest in (for instance, an ESG mandate as per above).

A fund manager's ability to execute the intended strategy is the key factor in performance evaluation. This may require further discussion with investors so that expectations regarding the risk management and expectation for the fund delivering performance are met on both sides.

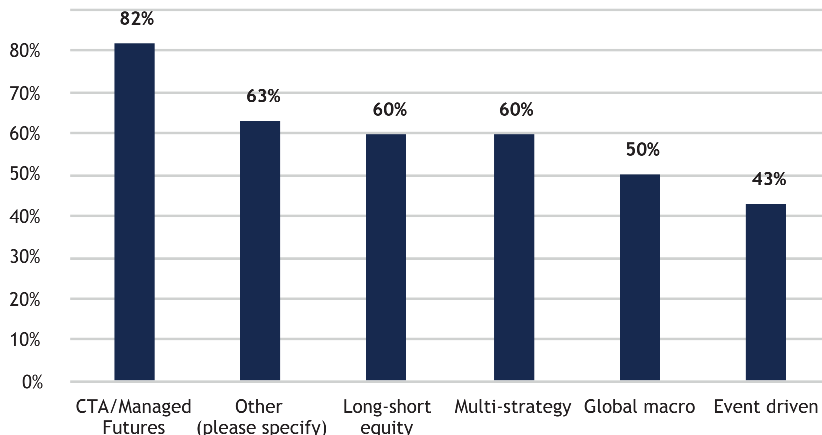
2 Aligning interests outside of fee structures.

2.1 Greater transparency

Investors are increasingly asking for and receiving greater transparency and control of their investment portfolio. All respondents recognise that they are required to provide investors with as much transparency on their fund as is reasonable.

The willingness among hedge funds to provide position level data is closely related to how quickly their fund's portfolio typically turns over (i.e. the more frequent the portfolio turnover, the less risky it is for managers to divulge position level data). On that basis, CTA and managed futures are generally more able to provide this level of transparency. However, for certain hedge fund strategies, position level transparency is not in the best interests of the investor. Rather, it is perfectly acceptable to provide transparency to investors of the fund's positions in an aggregated format.

Figure 11: Hedge funds that believe offering greater transparency to investors can better improve aligment of interests. (by strategy)



Although not as widespread across the hedge fund universe, some of the very large, equity-based hedge-fund managers only provide their long US equity positions (via their 13F filings[11]) to their investors, given the sensitivity that they have to other parties knowing what short positions they hold in their fund.

The increasing variety of fund risk reports that can be requested by an investor has undoubtedly pushed costs higher. This has happened both explicitly, in terms of the amount of capital being invested by the hedge-fund manager in deploying additional risk systems and personnel - and implicitly in the opportunity cost of the hedge-fund manager having to spend time away from its primary business of investing.

11 An SEC quarterly filing required of institutional managers with over $100 million of qualifying assets with relevant long US holdings.

Changes to industry regulations as well as the growing influence from institutional investors and other investor types who allocate to hedge funds have improved transparency and public openness in the hedge fund industry. In the US, the Dodd-Frank Act requires most hedge fund advisers to register with the Securities and Exchange Commission[12]. This results in the public reporting of the basic operations of the fund and any conflicts of interest that may ensue.

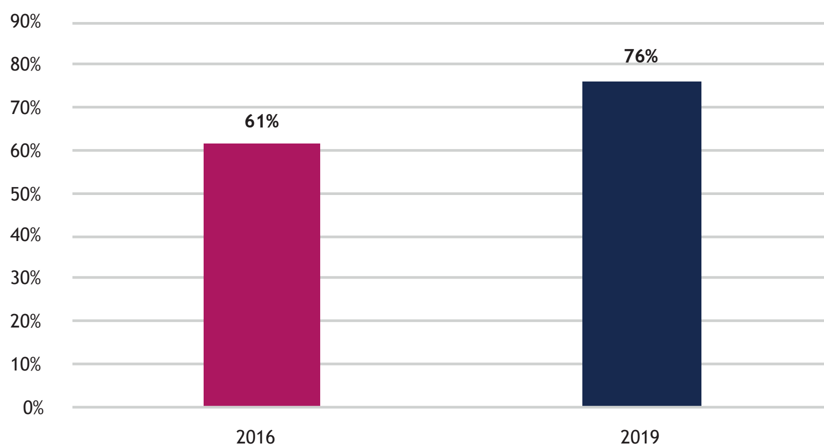
The JOBS Act[13] in the US enables managers to be more ambitious in terms of their engagement with investors and the public. In Europe, the Alternative Investment Fund Managers Directive (AIFMD) enables greater transparency between managers and investors. The on-going 'institutionalisation' of the hedge fund industry and the growing popularity of managed accounts has resulted in a higher level of portfolio transparency provided by the fund manager to the investor.

There must be a balance between investors' demands for complete transparency and what a hedge-fund manager is prepared to offer. Hedge-fund managers may not wish to disclose their strategy's IP or 'secret sauce' which would disadvantage them and their investors. Before making an investment, the hedge-fund manager should agree with their investor the level of ongoing transparency being provided for their fund.

2.2 Holding significant skin in the game

When we asked the respondents how they best describe their way of aligning interest with their investors, 76% of them point to making sure they have significant personal capital invested in the fund. This is an increase on our 2016 finding, where just over 60% of hedge funds polled said the same.

Figure 12: Hedge funds that cite having significant personal capital invested in the fund is the single most important measure to demonstrate true alignment with investors.



76% of all respondents cite having significant personal capital invested in the fund is the single most important measure for true alignment with investors.

12 There is still a large number of fund advisors who are exempt reporting (smaller funds advisors with less than $150m RAUM).

13 Jumpstart our Business Start-ups Act (2012), https://www.sec.gov/spotlight/jobs-act.shtml

The notion of having 'skin in the game' is centuries old. Entrepreneurs place their worldly effects and possessions behind any new ventures that they pursue. To align their interests, investors expect company boards and their investment managers (e.g. fund investment principals) to have a personal investment in the companies which they direct and/or manage. Equity investors like to see that senior executives (including the CEO) of the companies in which they invest hold a significant shareholding, and that any remuneration packages include incentives comprised of stockholdings of the company. Having 'skin in the game' is the single important measure to demonstrate true alignment of interest between the hedge-fund manager and its investor(s) and drives a continual focus on performance.

For hedge funds, this will take the form of the fund's investment principals deploying a meaningful portion of their own personal capital in the funds which they manage. This will ensure that in the event their fund underperforms and loses money for their investors, they would also lose out. However, the way this is implemented is important. It can create conflicts of interest that managers need to avoid. For example, if the hedge-fund manager runs multiple funds and has invested part of its wealth in just one of these funds, there is a risk that they will allocate the best trade ideas to this fund. Therefore, 'skin in the game' needs careful implementation to be beneficial for the hedge-fund manager as well as for all the investors in the fund(s) managed.

One should not forget that performance fees are a simple but effective method of creating hedge fund 'skin in the game'. A performance fee creates an alignment of interest between the investor and the hedge-fund manager in that both profit when the fund performs strongly. Several provisions (which we discuss in the following section) can be put in place to tailor the specifics for this type of arrangement.

Why do you deem skin in the game an important factor in aligning your interests closer with investors?

"The operative description here is being the best possible 'partner' to your investor. I would go further and say skin in the game is crucial. If we wish to attract investors, who will stay with us for the long term, we can't expect them to merely take our word that we would treat their capital as if it was our own, we must demonstrate that fact as well. I would expect any PM to have a substantial portion of their liquid net worth invested in any fund that they manage.

Many investors view the withdrawals of performance fees as redemptions, so I think there must be an obligation to re-invest compensation (of senior members of the manager) in the fund. Consideration must be given for the costs of living (school fees, paying off mortgages etc.) but the expectation must be that manager compensation should be reinvested back into the fund. As a firm, investment principals and firm partners have an obligation to re-invest 75% of their total compensation, once this reaches a certain threshold."

Long-short manager AUM between $500m and $1billion.

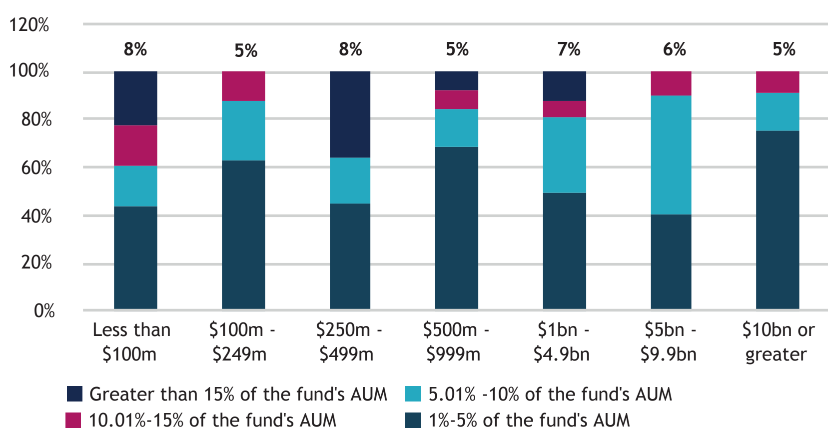
2.3 Appropriate levels of personal capital investment in a hedge fund

It is neither possible (nor appropriate) to offer a blanket rule for the appropriate level of personal investment in hedge funds required by investors. The findings from this survey reveal a significant variation in the levels recorded, especially in relation to the size and the stage of fund development.

The major source of capital invested by an emerging or start-up hedge fund is made up of the founding principals' net worth and from friends, family members or from other personal connections. At this stage, it is not uncommon for founders and principals at funds to have as much as 80% of their personal capital invested in the fund at inception, and throughout its early years. The founder will essentially have unlimited liability with potentially devastating personal consequences if the fund incurs sizeable losses. As a hedge fund increases its AUM and looks to diversify its capital base, the proportion of personal wealth invested will reduce.

Our findings reveal the average proportion of personal investment (*inclusive of employees who are not the founder*) is just over 6% of the funds NAV. It is important to try to understand this evolution and not apply a one-size-fits-all approach. Levels of personal investment will necessarily not be constant across the hedge fund's lifecycle.

Figure 13: To what extent are your principals and employees invested in the fund? (by AUM)



Re-investing fund deferrals/bonuses back into the hedge fund:

Whether as a result of commercial reasons, regulatory changes[14] or investor pressure, hedge-fund managers deferring remuneration has become an increasingly common practice. This helps to guard against the adverse performance associated with key investment talent walking out the door.

Linked with this, it is increasingly becoming the norm for hedge fund employees to invest these deferrals, or their bonuses, into their strategies on a continuing basis. The fact that hedge-fund managers are investing personal wealth in the fund is continuous, rather than an event at the start of the fund, helps to align further the interests of them and their investors.

14 Deferred remuneration is a requirement under the Alternative Investment Fund Managers Directive (AIFMD)

3 Setting the right balance.

The typical fee structure employed by a hedge-fund manager consists of (i) an annual management fee and (ii) a performance or incentive fee.

The management fee represents a percentage of the AUM of the firm charged by the fund to manage the firm's assets while the performance fee is a portion of the net profits earned by the fund's investments[15].

Since the publication of the, "In Concert" paper[16] in 2016, there is an increasing sense that fund fees and terms between hedge-fund managers and their investors are moving towards a new norm. No longer is the focus solely on fees, rather investors and hedge funds are continuously exploring new ways to negotiate fees and fund terms to reflect a better alignment of interest.

There is an increasing sense that fund fees and terms between hedge-fund managers and their investors are moving towards a new norm.

Hedge-fund managers are responding to investor needs by putting in place arrangements that are more closely aligned both to the requirements of the client and the underlying investment strategy.

These include:

- A high-water mark;
- A hurdle rate;
- Investor clawbacks/crystallisation of performance; and
- Longer lockups in return for reduced management fees.

Performance fee tools	Used by manager respondents
High-water mark	92%
Hurdle rate	37%
Longer lockups for reduced management fees	32%
Investor clawbacks	16%

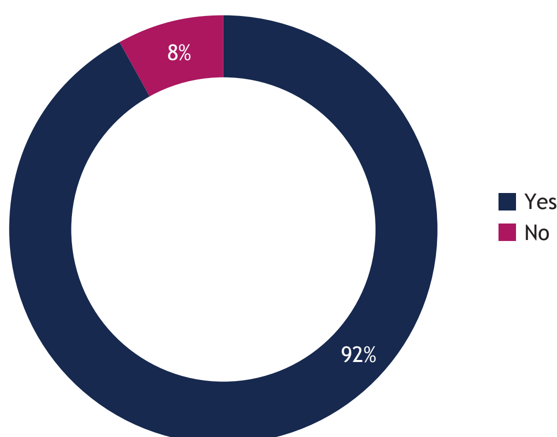
15 Usually net of all fund expense, includes operating expenses.

16 In Concert – Exploring the alignment of interests between hedge-fund managers and investors (2016), AIMA, https://www.aima.org/uploads/assets/uploaded/df23fb37-78ff-4d57-88859a7d70167d02.pdf

3.1 Adopting a high-water mark for the fund

The responses from this year's survey echo the findings from our 2016 paper. As observed from the chart below, nearly all respondents have a high-water mark with their investors, reinforcing our belief that this continues to be the primary mechanism used by investors in setting out the parameters for how an incentive fee is paid. Only a very small percentage of respondents do not use it.

Figure 14: Does your fund include a high-water mark?



A high-water mark can be applied to the calculation of the fund's performance fees, so that the fee is only paid on net new increases in the fund's asset value. Through using the high-water mark, when the net asset value (NAV) of the fund drops below its peak, no performance fee can be charged on any subsequent profit until the NAV reaches its previous high.

Modified high-water mark:

While the goal of the fund manager is to deliver the best risk-adjusted outcome to its clients in all market conditions, the reality is that this may not always be possible. In such circumstances, the modified high-water mark (or as some call a loss provision), is a potential solution. This allows a hedge fund to collect its performance fees in any winning year, even if it comes after the fund has endured a loss period.

It can help spread out any fund losses incurred by the hedge fund over a longer term, enabling them to earn at least some of the performance fees in more challenging conditions. This arrangement is still very much the exception rather than the norm[17].

An example of one type of modified high-water mark involves the deployment of an amortising high-water mark. This spreads out any fund losses over the longer term enabling the hedge-fund manager to earn at least some of the performance fees despite the fund being below the high-water mark.

17 Seward & Kissel LLP, The Seward & Kissel New Hedge Fund Study (2015)

In return for this concession being provided, managers would continue to receive the lower performance fee until its performance beat the previous high-water mark set, plus any carry-forward loss amount.

Where investors allow this practice, managers are under less pressure to take further risks in pursuit of attaining the high-water mark, and/or to close the fund prematurely. As investors continue to compensate the fund, it allows the manager to retain and incentivise its staff.

A long-term client who has experienced some years where the fund has not beaten its high-water mark will generally have paid fewer incentive fees under an amortising high-water mark than they would have done deploying the more conventional structure.

How a modified high-water mark can benefit the hedge fund and its investor(s)

Suppose the high-water mark of the fund was $100m but losses cause assets of the fund to fall by 10% to $90m. Under the traditional high-water mark, no performance fee would be paid to the hedge-fund manager until the high-water mark of $100m was exceeded. At that point the fund manager would then receive its performance fee (and for simplicity, let's say this is 20%)

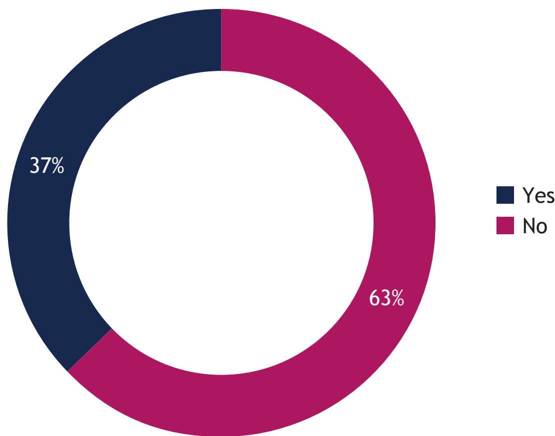
Under a modified high-water mark arrangement, the hedge-fund manager is paid a reduced performance fee (let's say 10%) on profits between $90m to $100m until it exceeds $100m. To make this arrangement more attractive for investors, the manager will be paid a reduced performance fee beyond the previous high-water mark level, for example 150% of prior losses, or in this case, $15m above the previous high-water mark to a new threshold of $115m. Assuming the manager will eventually generate profits so that the new high-water mark is exceeded, the investor ends up saving money ($0.5m in performance fees) than under the traditional arrangement where they would have been paying 20% on all profits.

3.2 Hurdle rate

A hurdle rate is the minimum return a hedge fund must generate for its client(s) before it is permitted to charge a performance (incentive) fee. The use of hurdle rates is far more prominent in hedge funds than in long-only traditional fund structures (i.e. long-only mutual funds), which do not normally employ performance fee structures.[18]

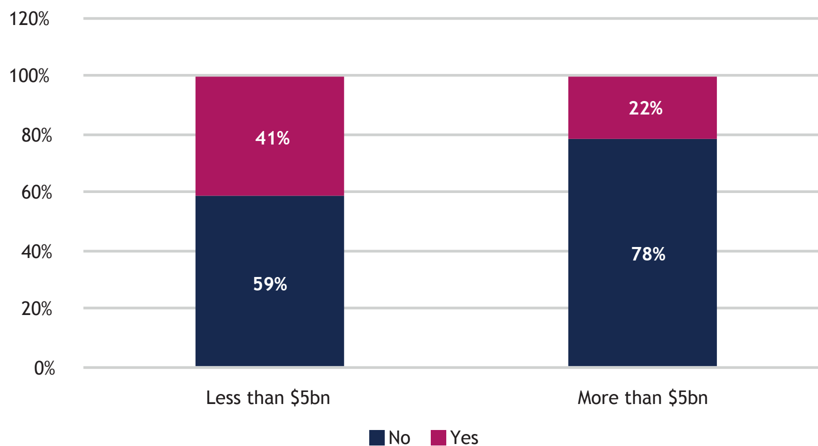
18 In a December 2018 paper published by ECGI on mutual fund performance, the authors found that 15% of the funds analysed measured performance against a fixed hurdle.

Figure 15: **Do you use hurdle rates in the design of the fund's performance fee?**



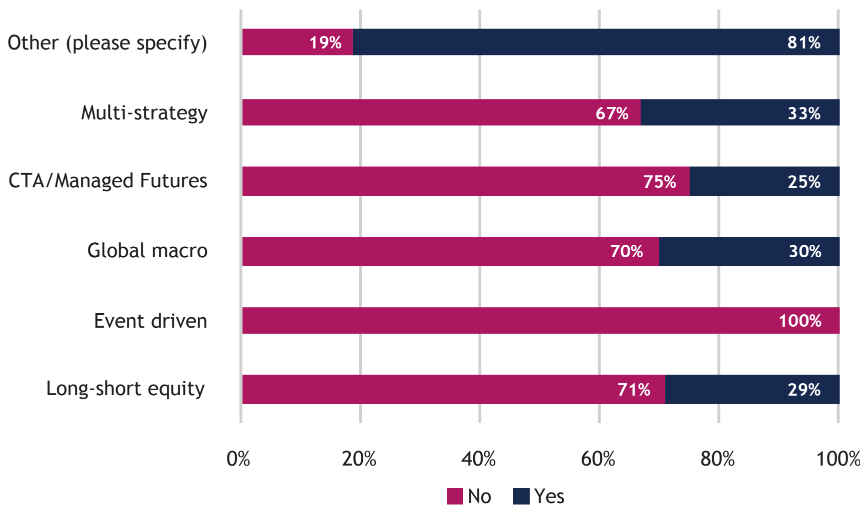
As the chart above shows, 37% of all respondents use hurdle rates in the design of their fund's performance fee. This is a slight increase on our findings from the 2016 survey (when reported that 33% of all respondents used a hurdle rate). More than 40% of all smaller-sized hedge funds (those of $5billion AUM or less) deploy hurdle rates in comparison to just over 20% of larger-sized firms (firms that had greater than $5billion AUM).

Figure 16: **Use of hurdle rates, breakdown by AUM**



Upon closer examination of the hedge fund strategies which have hurdle rates, about 40% of them describe their strategy as 'other'. These include credit hedge funds, activist and risk premia hedge funds. In contrast, the majority of global macro, CTA and managed futures hedge funds surveyed do not have hurdle rates. Different tools for aligning investor and manager interest are implemented depending not just on the fund's size (and sometimes age), but also on the investment strategy being pursued.

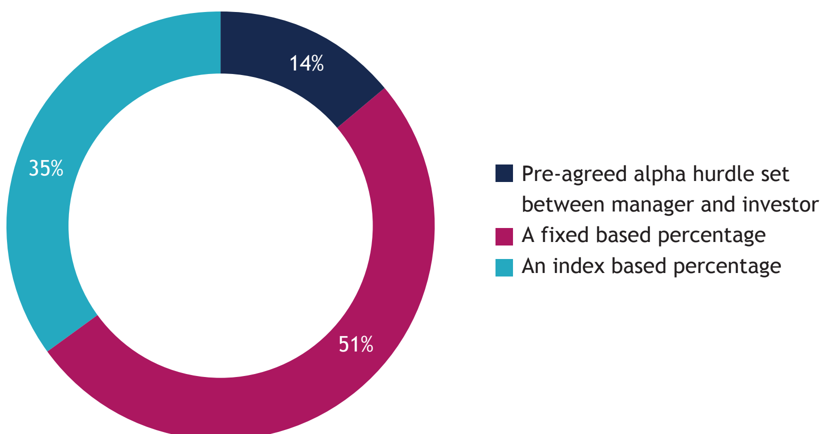
Figure 17: **Use of hurdle rates (by investment strategy)**



There are many variations in the types of hurdle rates being used. Historically, investors have required the hedge-fund manager to achieve a certain level of return, either as a fixed benchmark rate (such as LIBOR) or the rate of return from an equity benchmark (such as the return from the S&P 500) before they are entitled to receive performance compensation.

Just over half the respondents that use hurdle rates deploy a fixed based percentage hurdle rate while just over one-third deploy an index-based percentage hurdle. Hurdle rates are becoming more sophisticated. Depending on the expected risk and returns on offer from allocating to a certain strategy, and with an increasing focus on customised hedge fund solutions, some investors are asking hedge funds to consider pre-agreed alpha hurdle rates. High alpha funds that target out-performance could be pegged at a higher hurdle rate while more defensive strategies may target a lower alpha hurdle rate. As per the chart below, 14% of all respondents using hurdles have a pre-agreed hurdle. We expect that number to increase over the coming years.

Figure 18: **What do you use as your benchmark for your fund's hurdle rate?**



Hurdle rates are most commonly recognised as being either soft or hard. With a soft hurdle, a hedge fund charges an incentive fee on all profits, but only if the fund's rate of return exceeds a stated benchmark. With a hard hurdle rate, a hedge fund charges an incentive fee only on the portion of returns that exceed a stated benchmark.

Typically, the deployment of a hurdle rate is accompanied by a 'catch-up provision', whereby once the hurdle rate has been reached, the fund manager is entitled to catch-up on the fund's return until it receives its full share of performance fees on the fund's net profits.

How a catch-up provision works

A fund sets a hurdle rate at 4% and the fund returns 15%, the investor would only be allocated the first 4% of net profits of the fund. Assuming a 20% performance fee and a full catch-up provision, the fund manager will receive the next 1% of profits (i.e. 20% of the cumulative 5% return). The remaining 10% would then be allocated 80/20 between the investors and the fund manager respectively. Once the fund has fully 'caught up', any additional return would be allocated based on the typical 80/20 split between the investors and the fund manager.

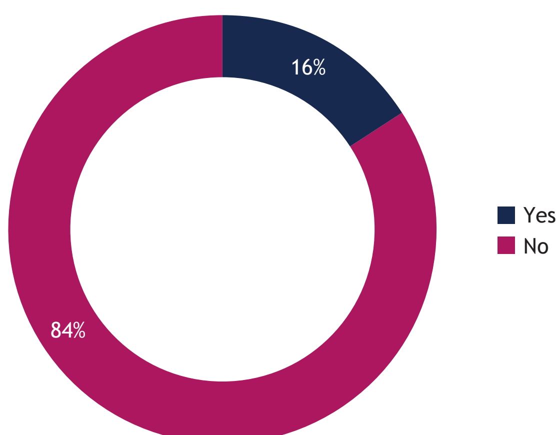
3.3 Other performance fees-related measures

Crystallisation of fees and investors clawbacks - while employed less frequently than hurdles - are other methods used by investors to enhance alignment of interests.

Investor clawbacks

This allows investors to take back some of the previous performance fees paid in profitable years if returns turn negative.

Figure 19: **Does your fund include a clawback agreement?**



As figure 19 shows, clawbacks are not widespread across the industry. Rather, they are being explored by some investors and managers. These arrangements could become more popular as investors seek to encourage performance payouts that reward longer-term outperformance without encouraging excessive risk-taking over the shorter term.

When asked whether their funds had a clawback or deferred compensation arrangement in place, 16% of all respondents said that they did. This was more prominent with larger managers (those that measured to have $5billion AUM or greater) being the more prominent.

Crystallisation of fees:

The crystallisation of hedge fund fees describes how often funds get paid for performance. This can be daily, monthly, quarterly or annually (with some crystallising performance over periods greater than a year).

By partially crystallising fees, an investor can pay a percentage of any performance fee, with the remainder being paid in instalments over several future periods (e.g. 50% now, 25% in each of the next two years). This approach will result in a portion of the un-crystallised performance fees being held in accrual and subject to a fund clawback. The exact mechanics of this arrangement are calibrated to the relevant hedge fund's strategy and risk parameters.

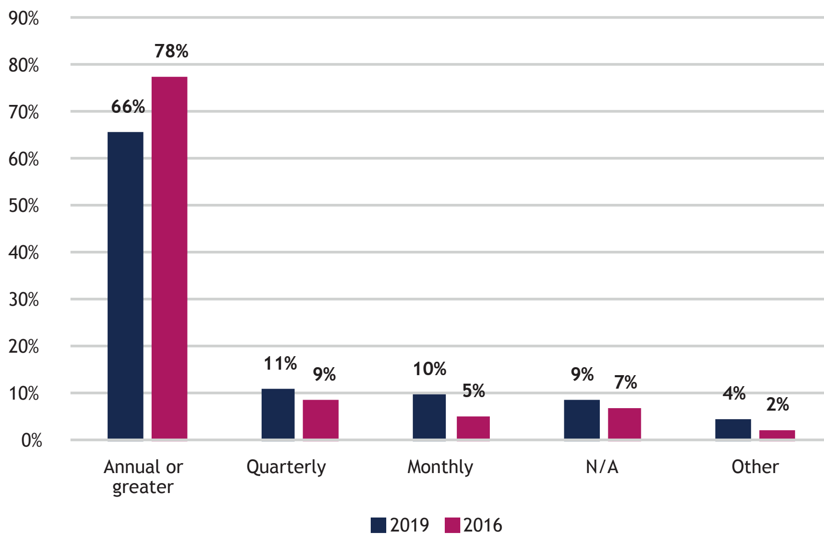
Fund Crystallisation periods:

The preferred structure for the crystallisation of a hedge fund's fees is for the fund's underlying investment to match its investment time horizon. Importantly, the crystallisation of hedge fund fees should be consistent with the realisation of the fund's returns.

As per the findings of this year's survey, approximately two-thirds of all respondents are meeting their investor demands by crystallising fees at least annually. These strategies include credit, event-driven, long-short equity and multi-strategy, which typically have a longer investment duration.

Approximately two thirds of all respondents are meeting their investor demands by crystallising fees at least annually.

Figure 20: What is your fund's fee crystallisation period?



There can be considerable differences in the crystallisation frequencies applied by different hedge fund categories - mainly due to the variety of fund liquidity terms used across the universe of hedge fund investment strategies. For this reason, some managers are keen to stress that it does not always make sense to crystallise fees on an annual basis only. Certain hedge fund strategies (e.g. CTA, managed futures) can liquidate the underlying positions in their fund more often.

For more illiquid hedge fund strategies, the underlying fund positions may not be realised for several years and will have longer investor liquidity terms. In this instance, it may make better sense to crystallise any performance over an investment period longer than one year.

3.4 Longer lockups in exchange for lower fees

As investors have become more sophisticated regarding the types of portfolio solutions that they want, the liquidity on offer from these investments is becoming a key consideration when setting the appropriate fee structure[19].

Hedge fund liquidity terms vary depending on the underlying positions in the fund. Some highly liquid strategies offer daily liquidity, while some of the more niche illiquid strategies require investor capital to be locked up over a multi-year period.

Increasingly, investors are more open to locking up their capital in hedge funds for longer periods in exchange for reduced fees. This can be a mutually beneficial arrangement between the hedge-fund manager and its client(s). For example, the client reduces the fee drag on performance, whilst the committed capital gives greater freedom to the hedge-fund manager who does not need to hold as much cash on hand to meet potential redemption requests. Several hedge-fund managers we spoke to mentioned that they have agreed to reduce their performance fee in exchange for investors locking up their money over a longer period.

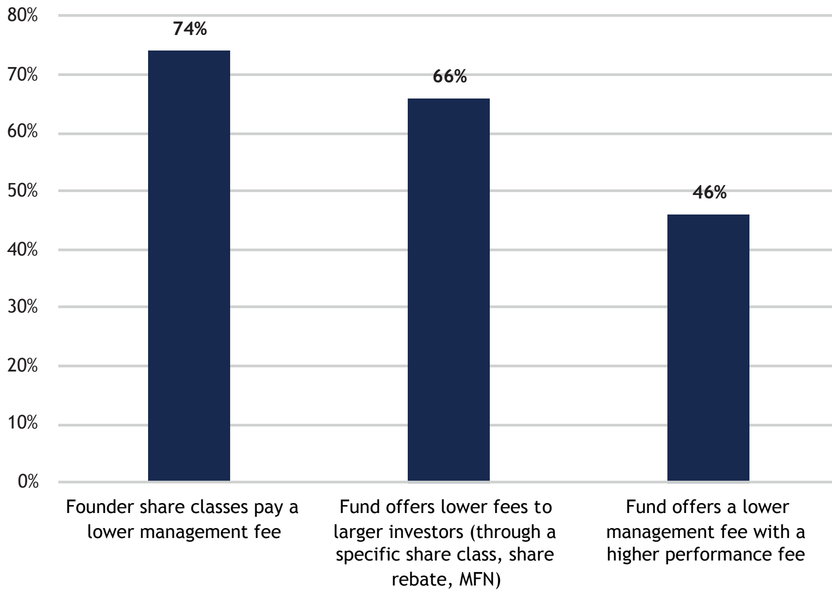
With longer lockups, investors benefit from illiquidity premiums as they surface across markets. This is particularly pertinent for investment strategies involving activism, distressed assets or credit.

19 For a further understanding of liquidity in alternative investment funds, please see 'Efficient Flows', the fourth paper in AIMA and CAIA's trustee education papers. Available at www.aima.org

4 Moving towards a new equilibrium – management fees.

The management fee, historically set at 2% of the fund's total assets, provides the manager with the necessary revenue to cover the operating costs of the firm. Amidst increasing competition from more flexibly priced financial products and an increasingly price-sensitive investor base, the hedge fund management fee is moving towards a new normal.

Figure 21: What do hedge-fund managers consider most important to them when negotiating the management fee on any one or more funds that they offer. Top three responses



Although the direction of travel points to a shift away from the historical '2 and 20' fee model, some hedge funds that reported to this survey, continue to charge a management fee of 2% while a small number responded that they were charging higher fees.

Management fees vary across the industry. A higher management fee may be charged depending on the sophistication of the investment strategy and the resources required to implement it. Some investment strategies demand continuous investment in technology and/or research and development costs. The number of persons required to operate the hedge fund also varies between hedge fund strategies, impacting on costs.

From the sample of hedge funds that reported to this survey, the average management fee charged was 1.3%, while the average management fee for new fund launches over the past 12 months was marginally higher at 1.4%.

Our research shows that both hedge-fund managers and investors understand the importance of the management fee to meet the day-to-day costs of operating a hedge fund. Depending on the hedge fund's stage of life, it is critical to ensure that there is an appropriate balance between the management fee that is charged to the investor and the need for it to be large enough to cover the costs of running the fund.

Rather than simply reducing the headline fee, hedge-fund managers are examining equitable compensation arrangements that are beneficial to both them and their investors.

These include:

- Founder share class;
- Lower management fee with higher performance fee;
- Tiered (declining) fees;
- Competitive fees for larger investors;
- Lower management fee in exchange for a longer capital investment;
- Fee discounts by fund strategy.

Investors are keen to point out that hedge funds should be compensated for their skill when they demonstrate that they can deliver outperformance (alpha) on a consistent basis. In these circumstances, they are very happy to compensate the manager. However, their tolerance for paying hedge funds who deliver anything less than what is value accretive to their investment portfolio is rapidly diminishing.

Investors are keen to point out that hedge funds should be compensated for their skill when they demonstrate that they can deliver outperformance (alpha) on a consistent basis.

4.1 Founder share classes

Investors who allocate to hedge funds at an early stage tend to be rewarded with a lower fund fee structure. 76% of all managers that we spoke believe that this concession should be awarded to early-stage investors (see chart above). This benefit is available either for a limited time period (the fund's first year of trading) or until the fund reaches a certain level of AUM. A hedge-fund manager may offer investors the same terms on subsequent investments. Any extended benefit will be limited to a certain level of the hedge fund's AUM. Once this AUM threshold is exceeded, the concession may no longer be made available.

Given the absence of a long-standing track record for their fund, many start-up and emerging hedge funds find it necessary to offer this concession to investors who are willing to take on the perceived higher risk of making an allocation to a new fund as opposed to an allocation to a fund with an established track record.

Founder share classes and related fund terms that are included in these arrangements have historically been included in one-off side letter arrangements with the fund's investor(s). Currently they are typically reflected in a separate share class (i.e. founder share class or early stage investor share class). These are incorporated into the fund's offering documents.

Institutional share classes:

Other share classes can be made available by the hedge-fund manager to allow certain investors to receive certain preferential fund terms. This is often dependent on the size of the ticket taken by the allocator. Included in these terms may be a provision for the manager to charge a reduced fee structure, normally for a set commitment period.

As per the chart on page 36, two-thirds of all respondents cited this as the second-most popular investor concession. Hedge fund firms of all sizes are willing to provide this concession. The findings from this survey show that this concession features prominently among hedge funds with $5billion or greater in AUM. Typically, they are more likely to receive allocations from institutional investors, including pension plans, sovereign wealth funds, endowments, insurers and private bank platforms.

Investors should be aware that negotiating a disproportionately lower management fee may compromise the manager's ability to execute its investment strategy effectively. Having a fee structure that is below the market levels may also hamper the manager's ability to retain key investment professionals.

4.2 Fund offers lower management fee with higher performance fee

Sometimes, hedge-fund managers agree with investors to lower their management fee in return for an increased performance fee. Almost half (46%) of all respondents voted this the third most popular investor concession (see for reference page 36).

From the investor's perspective, they are paying a lower, regular management fee. If the manager delivers the agreed performance to the investor, they will receive a larger performance fee. For the investor, this results in a lower regular cost but also a lower share of a hedge fund's profits.

The hedge-fund manager must ensure that the fund can operate on a lower management fee. When the fund delivers alpha, the hedge-fund manager receives a greater proportion of returns because they can charge a higher performance fee. Although the regular revenues from the management fee will be lower, the share of profits that the hedge-fund manager receives will be higher. Under this fee structure, investors keep their capital allocation costs low while managers are incentivised to earn a performance fee.

15% of all respondents charge management fees below the average management fee (1.3%), while charging a performance fee of 18%; one percentage point higher than the average performance fee (charged by the respondents).

Beyond 2 & 20

In recent years, investors and managers have agreed on a variety of new flexible fund fee structures. Commonly referenced fee structures include the '1-10-20'. Here the management fee is 1%, with 10% performance fee on net returns below 10% and a 20% incentive fee on net returns above 10%. Another version of this fee structure is the '1-or-30' model where the manager can opt for a 30% performance fee and 0% management fee, or for a 1% management fee. However, when the fund delivers alpha, the performance fee is calculated as 30% times the alpha generated, minus the management fee paid up to that point. The total fees paid to the hedge-fund manager are capped at 30% of alpha, ensuring that the investor receives 70% of returns.

When it comes to reconciling the most appropriate fee structure being charged to investors, between 20% to 30% of the alpha earned being paid to the hedge fund feels most appropriate. Our discussions with managers and investors reveal a shared belief that the manager share of any alpha earned should be about one third. The remaining two thirds should go to the investor.

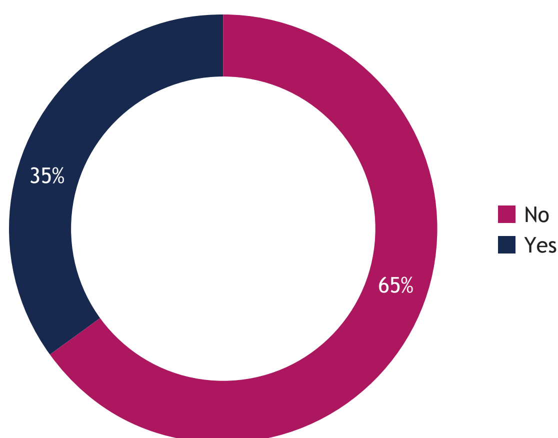
4.3 Tiered management fees

The costs of running a hedge fund are higher than they have ever been. Investors recognise that hedge funds, especially those launching a new business, rely on the revenue from any management fee they charge. Hedge funds have made significant investments in their operational infrastructure in response to regulatory change. This means the operating costs of a hedge fund can be prohibitively high in the early stage when assets tend to be usually small.

As the AUM of the fund grows, it benefits from increasing scale and it can operate more efficiently. The fund manager can offer management fee discounts (or a tiered fee structure) where the investor agrees to pay a higher management fee when the fund AUM is low, with a declining percentage paid as the fund's AUM grows. In this way, the dollar amount of the fee remains relatively constant, best matching the operating costs of the fund as it grows. The initial share class offers a management fee that reduces incrementally as specific AUM milestones are reached. For example, a 2% management fee on AUM of a hedge fund that runs up to $100m, 1.75% on AUM of a hedge funds that has up to $500m and 1.5% on AUM of a hedge fund that has $500m or more. This is like a sliding fee scale arrangement – a common form of pricing used by many popular professions and services.

In the 2016 study, we asked hedge-fund managers whether they would consider implementing a tiered management fee structure. Almost a quarter of them (23%) answered the question positively. Revisiting the topic for this year's survey, we posed the question differently, asking managers if they are implementing a tiered management fee structure. Over a third of all respondents replied positively (see chart below). To us, this suggests that the tiered management fee has moved on from not only being a concept but rather a legitimate tool that can align interests better between managers and investors.

Figure 22: Are your management fees on the fund tiered in any way?



Investors who benefit from this concession tend to be of a significant asset size or hold a sizeable interest in the hedge fund firm or have invested at an early stage in the fund. Its appeal extends more broadly. Nearly half of all hedge funds managing less than $500 million in assets, believe the introduction of tiered management fee structures would better align interests with investors[20].

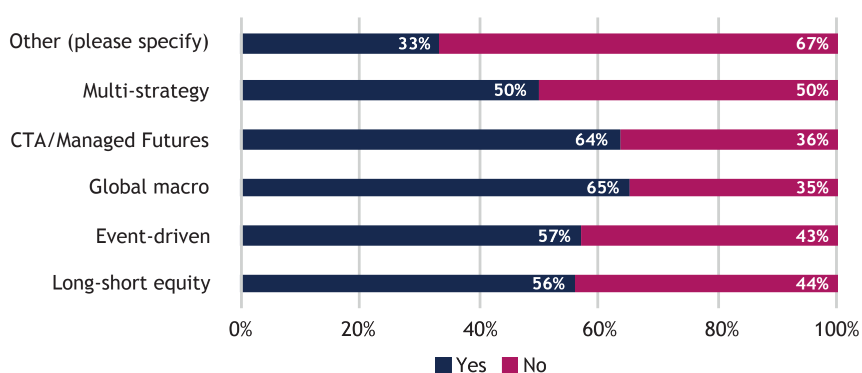
While hedge-fund managers are open to providing tiered structures on management fees, they are less inclined to reduce their performance fee structure. The clear majority prefer that the full performance fee is paid in a period of positive performance.

20 46% of all hedge fund firms (that manage $500m in AUM or less) polled suggest that offering tiered management fees to investors improve alignment of interests.

4.4 Fee discounts depending on the fund strategy

Discounted management fees are becoming increasingly popular amongst hedge funds across many strategies. This is driven partly by greater competition from the proliferation of more fee-sensitive investments.

Figure 23: Does your fund offer preferential terms for the management fee that it charges to investors? (by strategy)



Funds that are unable to deliver the expected outperformance or meet their investment objectives are likely to come under increasing pressure to reduce headline fees or face going out of favour altogether with their clients.

Hedge fund strategies that have a lower operating cost structure, can be more accommodating of investors demanding this fee concession. Hedge funds with higher operating costs (especially systematic funds, credit funds, certain equity-based strategies and multi-strategy funds) are more likely to resist investor pressure to provide management fee discounts. Irrespective of the fund's investment strategy, if the hedge fund is no longer taking investment, the fund's manager is very unlikely to provide any fee discounts.

4.5 Other fund fee concessions that can be granted to investors

Other fund rebates available to investors include:

- Most Favoured Nation (MFN) clause is a side-letter provision which allows the investor with this provision to align themselves to any more favourable contract clauses that a newer investor might have agreed on. Typical provisions included in an MFN relate to the investor receiving better fee terms, greater transparency rights or better redemption rights.

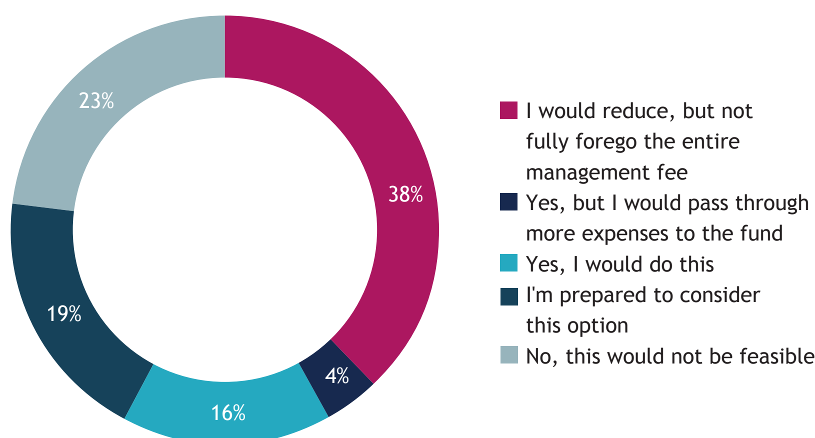
- Rebate on the management fee - The hedge-fund manager agrees to reduce the management fee in exchange for a relative increase in the performance fee. For example, a manager charges a 2% management fee and a 20% performance fee. At the request of the investor, and following the approval of its fund directors, the hedge-fund manager lowers its management fee to 1% but increases any performance fees to be paid out from 20% to 25%. The exact mechanics of the arrangement can be calibrated so that the economics of the fee structure remain similar, whilst the alignment with the investor is strengthened. Some fund firms pay back a percentage of the management fee to the firm. For example, the investor pays a 2% management fee and 20% performance fee, but the hedge-fund manager rebates 1% of the fee back to the investor, so the net management fee is 1%.

4.6 Compensation on profit earned to the investor

Closer examination of the performance fees being charged to investors reveals that just over half of all the respondents charge an incentive fee between 10%-20%, while 11% charge an incentive fee of 30% or higher.

In an ideal world for investors, a hedge fund would be compensated only when it delivers good performance. Such a model is, however, not realistic. Hedge funds have fixed costs and expenses that must be paid throughout the year. As per the findings from this year's survey, nearly 80% of all respondents are open to accepting reduced management fees in return for being paid a higher performance fee if they out-perform. Of the remainder, 16% said that they would be prepared to forego all management fees offset by a greater level of performance compensation.

Figure 24: To what extent would you be prepared to forego all management fees via a specific share class in return for a higher performance fee?



5 Sharing the cost - managing hedge fund expenses.

In recent years, the debate regarding how hedge-fund managers pay for their expenses has intensified, with scrutiny from both regulators and investors. Given the sensitivity of this topic, it is critical that investors have a complete understanding as to what fees and expenses they may be expected to pay hedge funds.

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The variety and amount of expense that must be incurred to operate a hedge fund business is increasingly challenging for some hedge fund firms. There are no regulations specifically delineating how hedge-fund managers should allocate expenses among their firms and funds. However, regulators expect managers to draft and follow clear policies, keep careful records and appropriately disclose all relevant costs.

In general, anything that is providing a direct service to the fund tends to be charged as an expense to the fund. On this basis, the fund usually pays the fees of its directly contracted service providers, including:

- Fund administrator fees;
- Prime broker;
- Other broker/dealer fees;
- Depositary/custodian fees;
- Audit fees (related to the fund);
- Regulatory reporting;
- Legal fees (related to the fund);
- Directors' fees.

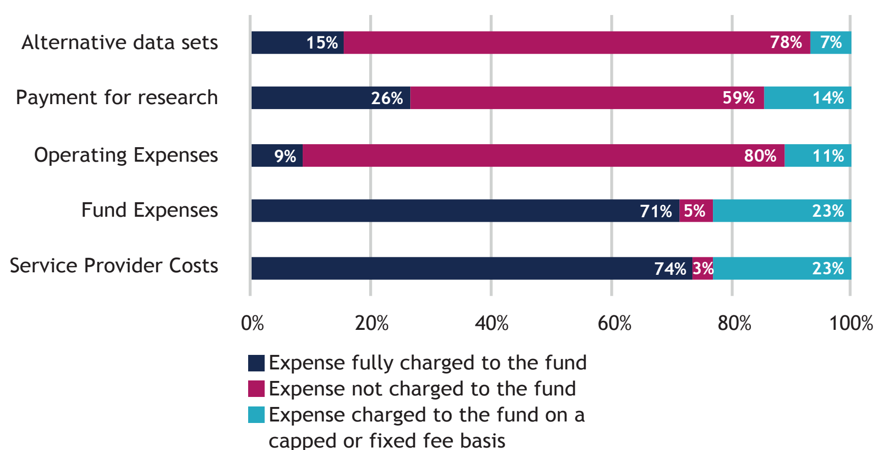
Upon closer examination of the hedge-fund managers surveyed, close to 100% of them charge their service provider costs (i.e. for fund administration and custody) and fund expenses (directors' fees, annual audit fees and tax costs) to the fund. For each set of costs, over 70% of hedge funds fully charge their expenses to the fund. Any exception to this rule is usually very small, for example start-up managers who reach a tailored agreement with selected seed capital investors.

Passing through of fund expenses

In the 2016 'In Concert' paper, we commented on a practice where some managers had in place arrangements that permitted them to pass certain hedge fund expenses (for example, operating expenses such as team costs) through to the fund via the management fee. This practice raises the potential for a conflict of interest between the hedge-fund manager and its clients.

None of the hedge-fund managers that we spoke to engage in this practice. It is recognised to be the exception among a small selection of hedge funds (predominantly US based multi-manager hedge funds), rather than the norm.

Figure 25: **What model do you deploy in paying for expenses on the main/flagship fund that you offer?**



Investors globally are increasingly sensitive not just to the management fee and the performance fee, but also to the total costs incurred by the hedge fund, and the impact that this has on the fund's total expense ratio (TER)[21].

The TER is a very useful benchmark to compare the costs of running an investment fund. In other words, how much of your investment is eaten away by the fund's operating costs? For example, when a fund incurs higher operating expenses, the TER will be higher. From our conversations with hedge-fund managers, we understand the TER tends to be higher ranging from 30bps-50bps (above the management fee charge) for managers that are starting out and declines as the fund(s) AUM grows. A more acceptable range for more established funds tends to be between 15-30bps (above the management fee charge) depending on the fund's investment strategy.

21 The total expense ratio is a measure of the total costs associated with managing and operating an investment fund (such as a hedge fund). These costs consist primarily of management fees and additional expenses, such as trading fees, legal fees, auditor fees, and other operational expenses. In order to calculate the TER, the total cost of the fund is divided by the fund's total assets. The TER is designed just to capture the fund's administration costs that are more fixed in nature, so excludes the fund's trading costs (commission, financing costs).

Working with investors to minimise the fund's TER

A fund's operating costs are typically higher as a percentage of their NAV in the fund's start-up phase. This is due to the fund's initial organisational costs and many other costs not being wholly variable with the fund's AUM (for example, admin and depositary costs generally have tiered fees and audit, professional and directors' fees are generally fixed).

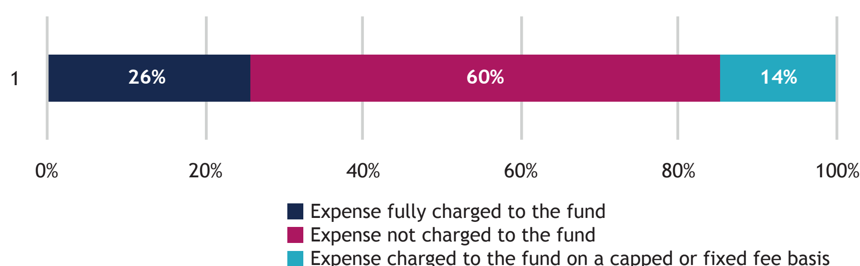
To prevent early-stage investors from bearing the burden of one-off start-up costs, hedge funds can work with them to place a limit on these expenses. This can also be described as placing a cap on the fund's total expense ratio.

From our conversations with hedge funds, fund expense caps range from 20 to 25 bps of the fund's NAV. Any excess beyond that level is typically borne by the investment manager.

5.1 Who pays for research?

Research expenses cover a wide array of costs, typically broker related research, use of independent research providers and expert networks.

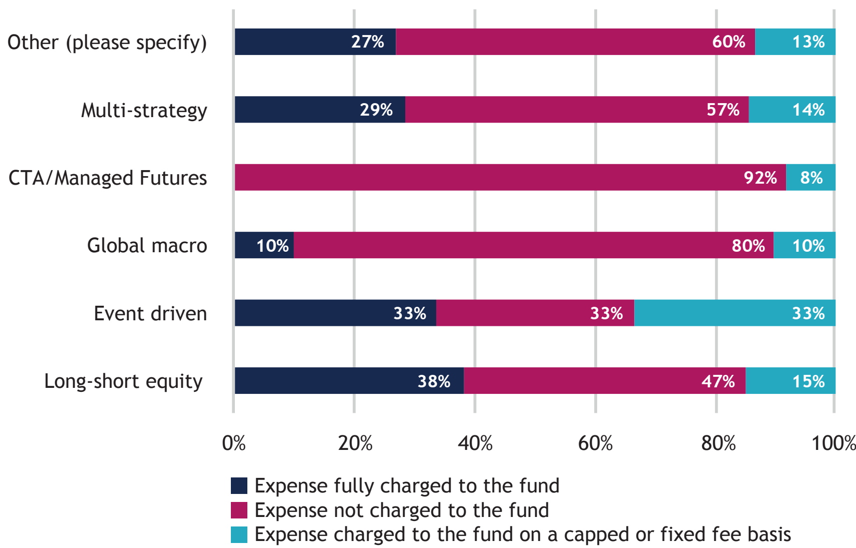
Figure 26: **'Who pays for research?'**



Whether the fund pays for research or not (either through bundled commissions paid to brokers or via hard dollar payments), it should be part of the disclosure that hedge funds provide to their investors. Hedge-fund managers should, in the various fund governing documents, disclose to their investors the types of expenses borne by the fund and the manager in the various fund governing documents. These include fund limited partnership agreements, articles of incorporation and, in some circumstances, an investment management agreement between the manager and its funds.

In some jurisdictions, regulation may prescribe which research related costs can be borne by the fund's investors. In Europe, MiFID II (which came into effect last year) has forced asset managers to separate the cost of research from trading commissions paid to brokers. This is known as unbundling. Allocations of research expenses are discussed further in *AIMA's Guide to Sound Practices for the payment for research and in section 4.1 of AIMA's MiFID2: A Guide for Investment Managers (Feb' 2017).*

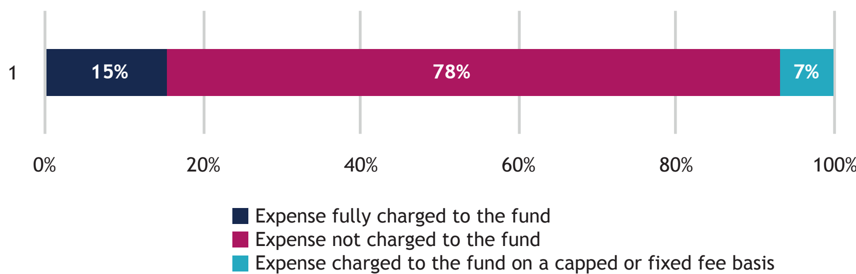
Figure 27: What model do you deploy in payment for research (i.e. broker research, expert networks)?



Technology / alternative data:

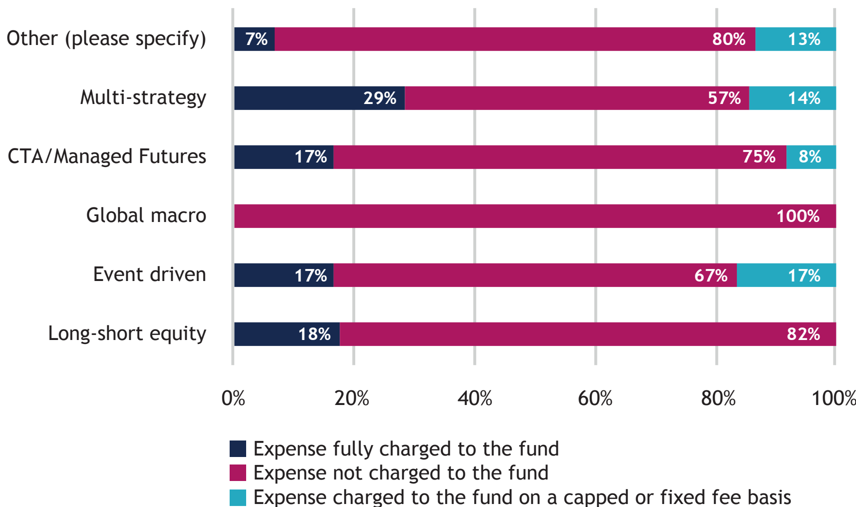
Technology is playing an increasingly important role in the development of hedge funds. Advanced quantitative techniques and forms of machine learning are primarily being used by hedge funds to collate and categorise data. This is highly useful for all hedge funds whether they are discretionary or systematic in their approach to investing. The hedge fund industry has always been at the forefront of rigorous data-driven investing and the new technology available to hedge fund firms will allow them to make use of the ever-greater volumes of data becoming available.

Figure 28: 'Who pays for alternative data?'



Arguments range as to who should pick up the costs of implementing, developing and maintaining the technology being used and the data derived. For some investment strategies, the need to invest in these techniques as well as the human talent to manage it will be greater than others. Looking across the sample of hedge funds that use alternative data[22], the majority (85% of the population) charge any/all costs to the firm.

Figure 29: What model do you deploy in paying for alternative data on the main/ flagship fund that you offer? (by strategy)



22 Alternative data is information used to obtain insight into the investment process that comes from using non-traditional data sources. Often categorised as big data meaning the data can be very large and complex and often cannot be handled by software traditionally used for storing or handling data, such as Microsoft Excel. The data can be compiled from sources such as financial transactions, mobile devices, satellites, public record and the internet

Conclusion

Faced with what is fast becoming a buyers' market, hedge funds are becoming more responsive than ever. Hedge funds and investors are forging deeper partnerships. These are characterized by customised investment mandates, as well as offering value advisory services. Over the coming years, there will likely be greater fund transparency, true knowledge sharing and more co-investment options as hedge funds and investors align their interests more closely. By cultivating these arrangements, hedge funds can retain investors and build goodwill with them.

Flexibility remains the key for hedge funds wanting to deepen their partnerships with investors. This reflects a general trend within the hedge industry as it moves away from the product-led environment of the past to a marketplace populated by more bespoke investor solutions.

Hedge fund should not lose sight of their ultimate purpose: to help clients - ranging from pension plans to charitable organisations - meet their investment needs. As an industry, they need to stay focused on that commitment, prepared to listen to its clients and think about how best they can help them. Our previous paper talked about hedge funds being 'In Concert'. Borrowing a phrase from the title of this paper, it is now apparent that they also need to be 'in harmony'. Put simply, hedge funds that embrace innovation and flexibility will succeed and grow.

About AIMA

The Alternative Investment Management Association (AIMA) works to grow the alternative investment industry to benefit the world's economy, savers and investors. To achieve this, we strengthen the links between fund managers, investors, regulators and industry service providers.

Our thirty-year heritage means AIMA understands our members' priorities, who access our resources to grow their businesses, create lasting connections using our events and benefit from the effect our advocacy work has on the environment in which they must operate. Since our formation the industry has grown by 60 times.

AIMA's capacity to deliver local support across the globe has made us connected, knowledgeable and influential, and means our 2,000 members are now based in over 60 countries.

For further information, please visit AIMA's website, **www.aima.org**

About RSM

RSM is a powerful network of audit, tax and consulting experts with offices all over the world. As an integrated team, we share skills, insight and resources, as well as a client-centric approach that's based on a deep understanding of your business. This is how we empower you to move forward with confidence and realise your full potential. This is The Power of Being Understood.

Giving you confidence

Our firms are here to advise you on a wide range of issues from audit and assurance, consulting, tax, risk advisory, IFRS, restructuring, transaction and business and financial advisory solutions. As well as these core services, our member firms also offer a wide range of specialist services, such as wealth management, IT consulting, legal advisory, forensic accounting and human resource consulting.

We put ourselves at the heart of your business where we can be most effective. As your long term adviser, we gain a deep understanding of every aspect of your business so we can respond with the right expertise and insights at the right time. Wherever you are in the world, you will enjoy the same seamless service, combining astute local knowledge with the global expertise of our most senior professionals. We're passionate about your success and about empowering you so you can face the future with confidence.

Fast facts:

We have firms in 116 countries and are in each of the top 40 major business centres throughout the world.

- We have combined staff of over 41,000;
- We have 750 offices across the Americas, Asia Pacific, Europe, Middle East and Africa;
- Our clients range from growth-focused entrepreneurial businesses through to leading multi-national organisations across many sectors and operating nationally and across borders.

For more information visit our website at **www.rsm.global** or our **Linkedin**, **Twitter** or **Facebook** pages.

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