AIMA

# In Concert

## Exploring the alignment of interests between hedge fund managers and investors

www.aima.org

RSM

# Contents

# Foreword

I am delighted to contribute the foreword to this important new AIMA paper, "In Concert – Exploring the alignment of interests between hedge fund managers and investors" on behalf of the AIMA Investor Steering Committee (ISC).[1]

Since the global financial crisis, the nature of the relationship between hedge fund managers and investors has undergone tremendous change. Driven in large part by investor demands for greater transparency, fund managers and investors are increasingly forging partnerships with each other. As a previous paper[2] authored jointly by the AIMA Investor Steering Committee ("AIMA ISC"), and Barclays Capital Solutions found, many institutional investors such as pensions, endowments and foundations are looking for relationships with their external investment managers that may include greater knowledge sharing, customised solutions, co-investment opportunities, product seeding and/or equity investing. As fees continue to come down, "2 and 20" is increasingly the exception, rather than the norm.

This new report builds on those findings. The survey and report were overseen by AIMA's Research Committee, which comprises executives at fund managers and service providers. The report was reviewed by the AIMA ISC, and AIMA also consulted with the Hedge Funds Standards Board (HFSB), the global standard-setting body for the hedge fund industry. As the report shows, investors are increasingly asking for, and obtaining, tiered fee structures (so that, for example, management fees come down as the assets under management of the hedge fund firm grows), hurdle rates (where performance fees are paid only if a target is met) and claw-backs (where a portion of past fees are returned to investors in down years).

These efforts are of course welcome, but they follow a longer-term trend. Interests between hedge funds and investors, thanks to decades-old concepts like "skin in the game" and the high water mark, have always been aligned. In recent years, hedge fund managers have listened to investor feedback and gone further than before. As hedge funds continue to evolve and institutionalise, we look forward to an even closer alignment of interest.

Michelle McGregor Smith
Chairman, AIMA Investor
Steering Committee

We are pleased to present AIMA's latest research paper "In Concert – Exploring the alignment of interests between hedge fund managers and investors", an initiative of AIMA's Research Committee.

Over the past several years, hedge funds have become an established player in the institutional asset management space. As the hedge fund share of institutional assets under management continues to grow, hedge fund managers have developed new investment strategies, technology and risk management solutions that have been driven by their investor demands for greater transparency, sound governance and more favourable investor terms.

More than ever, fund managers are likely to find that operational considerations such as how to structure investment management fees in a way that is consistent with their funds' investment strategy and investors' expectations, are critical to setting the ground for a successful hedge fund enterprise.

Institutional investor demands have brought about significant changes that affect the overall industry.

This paper brings together the perspective of a broad range of managers from a variety of geographic regions and strategies to identify ways in which fund managers have developed an even closer business partnership with their investors.

In a highly competitive environment for the asset management industry, this AIMA survey provides keen insight on how hedge fund managers continue to take the lead in finding solutions that drive growth and innovation and add value to their investors.

John T. Hague
Partner, Financial
Services Industry Leader
RSM US LLP

1 The committee undertakes educational initiatives with and provides practical guidance to AIMA. Members of the committee represent pension fund managers, endowments, foundations, large family offices and sovereign wealth funds.

2 The Extra Mile – Partnerships between Hedge Funds and Investors – AIMA / Barclays, June 2014 -www.aima.org/en/document-summary/index.cfm/docid/C2EC4BE7-D014-49A0-8195917E4849C81D

# Executive Summary

In this paper we investigate the methods that are being employed to align the interests of managers of hedge funds ('managers'), and investors in hedge funds ('investors'). Our findings are based on an extensive manager survey comprising 120 respondents with assets under management (AUM) of over $500bn. The respondents are varied in terms of strategic approach and size. AUMs range from below $100m to more than $20bn.

**We analyse the findings based not only on what is currently being done, but also in terms of potential future developments and how these could best be implemented.**

We begin by investigating the measures which, if put in place, can reduce fees. We find that high water marks are extremely popular, with 97% of managers using the structure. Hurdle rates also prove to be commonly used (employed by one third of the managers) and, for fixed percentage thresholds, are usually in excess of 3% (60% of managers who have a target set it in excess of this benchmark). Indirectly, we discuss how investors can negotiate lower fees by accepting a longer lock-up period on their capital. We consider how this could further enhance returns by allowing the manager to execute his investment thesis more efficiently, without having to compromise performance by having to maintain cash buffers to offset potential redemption requests.

We then look at other features managers have employed to make their offering more attractive to potential investors. We think about transparency and observe how the disclosures made by managers have greatly increased since the global financial crisis of 2008. We also discuss the importance of managers having "skin in the game" or personal capital invested in their strategies. We find that 61% of managers currently use this as their primary means of aligning interests with their investors.

Our third section examines the varying fee structures that managers can employ. We look at the cost-push factors that led to the 2% management fee and 20% incentive fee (or as it is more colloquially called "2 & 20") becoming the norm in the recent past and discuss the special types of share classes used to provide discounts to certain groups of investors. We look particularly closely at tiered fee structures, where the fees paid reduce as the AUM of the fund grows. Almost 77% of hedge fund managers who participated in our research said they are considering implementation of this measure.

The final section seeks to demonstrate that, in achieving a closer and more aligned relationship, both managers and investors stand to benefit. We see the advantages as three-fold. First, as the investor attains more knowledge about the manager they will gain a deeper understanding of how the fund will behave. This will help to avoid short-termism which can damage performance. Second, the enhanced clarity of relationship enables the sharing of expertise which can benefit both parties: the manager because he will gain a better understanding of the client's needs, and be able to cater to them more effectively, and the investor because they will be able to take advantage of the manager's unique market insights to the betterment of their overall portfolio. Thirdly, closer collaboration enables new products and services – such as co-investments and managed accounts – to be developed which will give the investor a greater range of products to enhance their portfolio returns.

We conclude the paper by highlighting the flexibility of the tools that have been discussed. We assert that there is no one-size-fits-all when aligning investor and manager interests and that the different methods should be calibrated to the specifics of the individual situation. The aim should be to reach a point where manager and investor are incentivised to act in a way which is mutually beneficial, and that in doing this a relationship of symbiotic collaboration might develop.

# Methodology

1. Hedge fund manager survey with input from 120 hedge fund managers globally representing approximately $500bn in assets under management (AUM)
2. In-depth one-on-one interviews with hedge fund managers to help get a better understanding of the key findings from the manager survey
3. Input from a global investor steering committee which manages approximately $1 trillion AUM and allocates c.$100bn AUM to hedge funds
4. Input from a variety of thought leadership and external research across a variety of hedge fund industry stakeholders including investors, hedge fund managers, hedge fund industry service providers and policy-makers

# Demographic of respondents

**Figure 1:** What is the primary hedge fund strategy of your principal flagship fund? Please select one option from the list below.

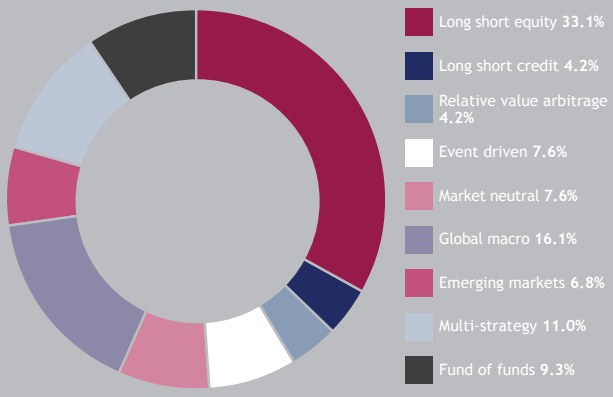



**Figure 2:** What is the net asset value (in US$) of the hedge fund assets under management of your firm?

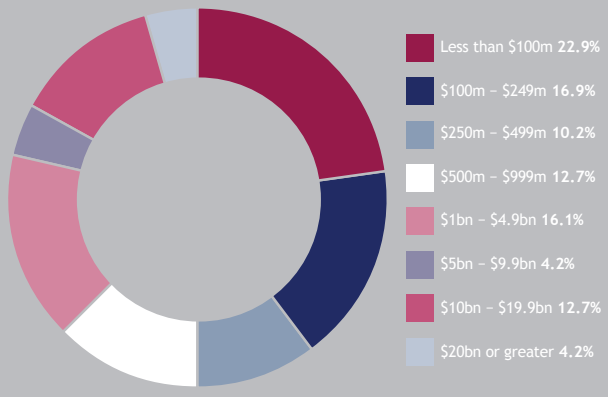
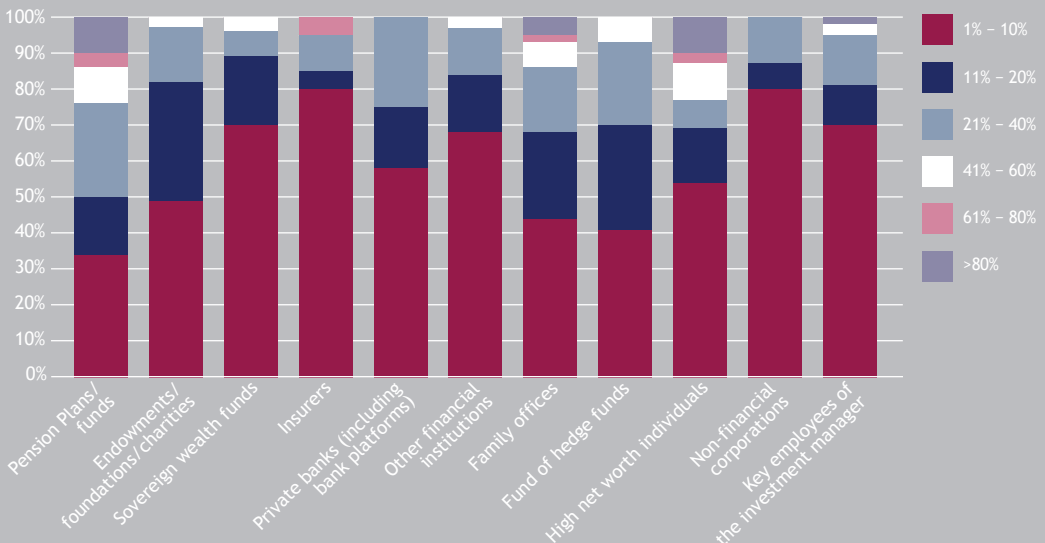



**Figure 3:** How much of your hedge fund AUM do the various investor types listed below account for?



# 1 Popular fund tools that managers make available to investors to help moderate their fees.

It is evident that managers are responding to client's needs by putting in place a number of tools that help ensure that their investment strategies are carried out as is intended, and fees are structured in a way so that the alpha capture is split appropriately between managers and investors.

These measures are:

- Imposing a high water mark on the fund;
- Imposing a hurdle rate on the fund;
- Imposing fund claw-backs and other related tools; and
- Having longer lock-ups agreed by investors.

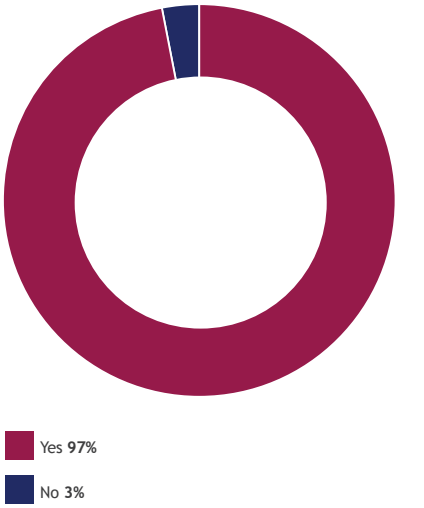
## 1.1 Imposing a high water mark on the fund

The deployment of a high water mark in hedge funds is a very popular tool among investors to help managers remain focused on producing the best possible returns for investors. 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. A high water mark means that, where 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. As per the responses from our survey, 97% of managers deploy a high water mark in the design of their fund's performance fee.

Some hedge fund managers make use of a modified high water mark. This allows a hedge fund to collect its performance fees in any winning year even if it comes after a losing period. However, this is very much the exception rather than the norm.[3] Related to this, funds that have provisions to reset their high water marks (where the fund can erase any fund losses after a defined period of time has elapsed) are becoming less and less acceptable among hedge fund investors, irrespective of the fund's size or its history of a strong performance track record.

An example of another modified structure among some of the manager respondents in this survey includes the deployment of an amortising high water mark which 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. 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; for example 150% of the carry forward loss amount. Arguably this measure will benefit the investor, as it reduces the pressure on managers to take further risks in pursuit of attaining the high water mark, and/or to close the fund prematurely, when faced with an unattainable and permanent high water mark. Further, as investors continue to compensate the fund, it enables the manager to retain and incentivise his staff. It is generally the case that, for a long-term client who has experienced some years where the fund has not beaten its high water mark, they will generally have paid less incentive fees under an amortising high water mark than they would have done with the more conventional structure.

**Figure 4: Do you use a high water mark in the design of the fund's performance fee?**




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

**Example:**

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 his 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 the 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 high water mark of $115m. Assuming the manager will eventually generate profits so that the new high water mark is exceeded, the investor ends up saving $0.5m in performance fees than under the traditional arrangement where they would have been paying 20% on all profits.

## 1.2 Hurdle rate

Related to the high water mark, the deployment of a hurdle rate in a hedge fund means that a hedge fund manager cannot charge a performance fee until the fund's performance exceeds a pre-determined target. So, for example, if a fund sets a hurdle of 5% and returns 15%, performance fees would only apply to the 10% above the hurdle. This target can be pre-specified as a fixed percentage (anything between 0.1% and 10%) or an index based benchmark (usually LIBOR or LIBOR plus a spread).

One third of the hedge fund managers that participated in this survey said that they use hurdle rates in the design of their performance fees.[4] In comparison to recent years, we note this to be a significant increase. The use of hurdle rates are far more prominent than in a long-only traditional fund structure which do not normally employ performance fee structures.

Across the sample of managers that use a hurdle rate, there was an even split between those who use a fixed percentage as a hurdle and those that use an index based percentage (LIBOR, LIBOR plus a spread or a more relevant index specific to the fund's strategy), with larger hedge fund managers preferring to use an index based percentage. Some investors feel that the typical hurdle rate of LIBOR or LIBOR plus a spread is not demanding enough, amidst historically low interest rates, and in recent years, there has been a push for hedge funds to set their hurdle rates higher.

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 net profits. 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. For instance, if 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.

**Figure 5:** Do you use hurdle rates in the design of the fund's performance fee?

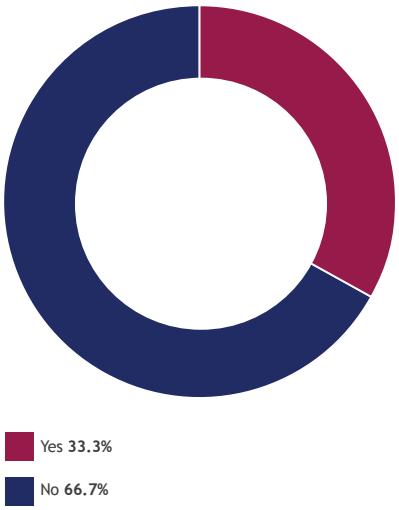
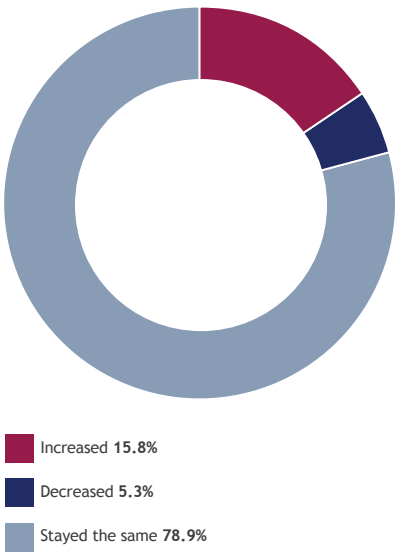



**Figure 6:** How has your fund's hurdle rate changed over the past five years?




4 Across a wider universe of hedge funds, approximately 23% of the total number of hedge funds that subscribe to a global database operated by Hedge Fund Intelligence deploy a hurdle rate.

## 1.3 Fund clawbacks/crystallisation of performance fees

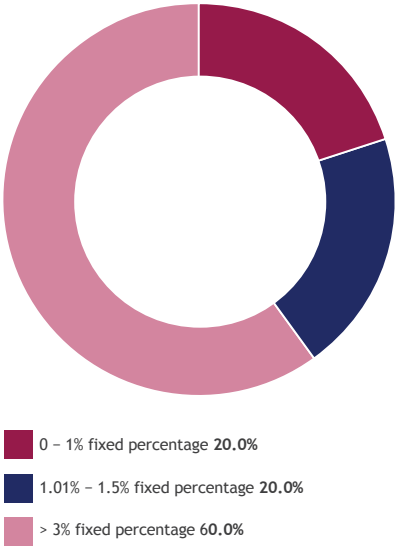
In addition to hurdles and high water marks, some hedge fund managers are exploring other ways to align interests. One such tool is the deployment of a clawback measure which allows investors to clawback performance fees that were paid in profitable years if returns turn negative. Clawbacks are not by any means widespread across the industry, rather an emerging trend that is being explored by some investors and managers.

A derivation of this approach which has been adopted is the partial crystallisation of hedge fund performance fees, as appropriate and dependent upon the relevant fund's strategy, expected liquidity or targeted performance time horizon for the strategy of the fund and the fund's risk parameters. For example, a performance fee arrangement of this nature may allow the hedge fund manager to crystallise a proportion of their performance fee in the first year, and attribute the remaining pro-rata amount over several periods – thus an investor would pay a percentage of any incentive fee in the present 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 will obviously have to be calibrated to the relevant hedge fund's strategy and risk parameters.

The preferred structure for the crystallisation of a fund's fees is for the underlying investment of the funds to match the duration of its investment. Technically, the crystallisation of hedge fund fees is consistent with the realisation of the fund's returns – so there is 100% correlation. A closer look at the manager population in this survey shows that over 70% of those surveyed are meeting investors' demands in crystallising their fees no more frequently than on an annual basis[5] (that is investors only pay any performance related incentive fee to the fund manager on an annual basis), with a further 5% crystallising their fees over a longer 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 across the universe of hedge fund investment strategies. Some managers are keen to stress that it does not always make sense to crystallise fees only annually. Certain hedge fund strategies (e.g. CTA, managed futures) can liquidate the underlying positions in their fund on a daily basis while arguably, strategies that have a high frequency of trading do not require fees to be crystallised. One manager observed "if you crystallise too early in the trading cycle, it will detract from the fund's Sharpe ratio, therefore managers should have some flexibility regarding fee crystallisation." It may not make sense for some of the more illiquid hedge fund strategies to crystallise on an annual basis either. Typically, the underlying positions in these funds may not be realised for a number of years (similar to a private equity structure) and will have longer liquidity and fund redemption periods. On that basis, any fees that do get paid out should only be when the return has been fully realised.

**Figure 7: From the list of choices below, what fixed percentage do you use as your hurdle rate benchmark?**




5 Alignment of Interests Association Hedge Fund Investing Principles (performance fees) www.altaoi.org/principles

## 1.4 Longer lock-ups in exchange for lower fees

Increasingly, investors in hedge funds are more open to "locking up" their capital for a longer period of time in exchange for paying a reduced fee. This can potentially be a mutually beneficial arrangement. 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. Furthermore, tying up capital can allow investors to benefit from illiquidity premiums as they surface across markets. This is particularly pertinent for strategies involving activism, distressed assets or credit. For hedge funds pursuing these approaches it is not uncommon to see lock-up terms of five years or more – similar to what would be provided to investors under a private equity arrangement.

The trend towards lock-up periods seems to be increasing. Moreover, the average length of lock-up seems to be increasing as well. These are patterns which are occurring irrespective of AUM: a number of larger managers who reported to this survey mentioned that they agreed to reduce their performance fee in exchange for their investor locking up capital in the fund for two years. Anecdotal evidence tells us that some hedge funds have reduced their management fee on any funds open to investment in return for investors agreeing to lock up their capital for two years or more.

**Figure 8:** What is your fund's fee crystallisation period?

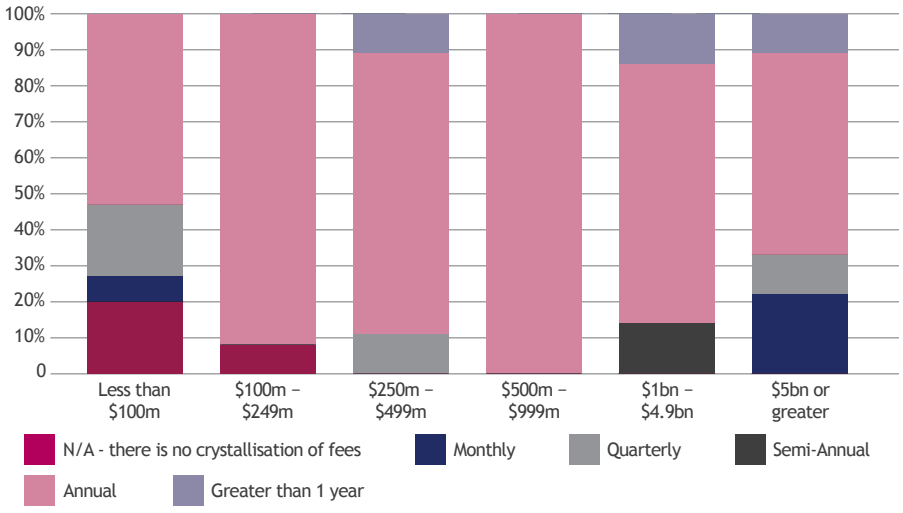
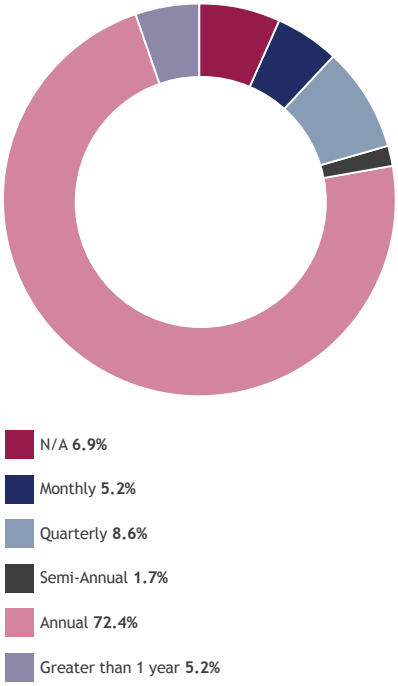



**Figure 9:** What is your fund's fee crystallisation period?



Non fee-specific ways in which managers are building better alignment with their investors

- Greater transparency
- Holding significant "skin in the game"
- Deferred manager compensation reinvested in the fund

## 1.5 Greater transparency

Investors are increasingly asking for (and receiving) greater transparency and control of their portfolio. Across the universe of hedge fund manager respondents in this survey, the majority of them readily engage in discussions with their investors on the underlying positions and risks subsumed within a fund. Most concur that they are obliged to provide as much transparency with regards to their fund as is reasonable. The willingness among hedge funds to provide position level data on their fund 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. For certain hedge fund strategies position level transparency is not in the best interests of the investor base. In these instances it is perfectly acceptable to have transparency on the fund's positions provided in an aggregated format. While not 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[6] filings) to their investors, given the sensitivity that they have to other parties knowing what short positions they hold in their fund.

**It is important to note that fund transparency is not a free lunch. The increasing variety of fund risk reports that can be requested by an investor has undoubtedly pushed fund costs higher.**

This has happened both explicitly – in terms of the amount of capital being invested in additional risk systems and personnel – and implicitly in the opportunity cost of the hedge fund manager having to spend time away from their primary business of investing.

There will be times where it is in the best interests of the investor base for the hedge fund manager to impose additional costs on a client to whom they have provided additional reporting outside normal requirements. This helps to ensure that other investors are not negatively affected by the opportunity cost spent on the extra services rendered.

There is a further incentive for hedge fund managers to increase transparency – this refers to the regulatory obligations of hedge funds. In the years that followed the global financial crisis, 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 advisers to hedge funds to register with the Securities and Exchange Commission, resulting in the public reporting of the basic operations of the fund and any conflicts of interest that it might have. The JOBS Act[7] in the US has also created the potential for managers to

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

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

be more ambitious in terms of their engagement with investors and the public. In 2015, the Hedge Fund Standards Board (HFSB) published amendments to the Hedge Fund Standards to improve investor disclosure and address conflicts of interest that can arise between parallel/competing funds.[8] In Europe, the recently introduced Alternative Investment Fund Managers Directive (AIFMD) is also increasing transparency. In addition, the on-going "institutionalisation" of the hedge fund industry has resulted in the level of portfolio transparency provided by the fund manager to the investor being higher than in the past.

A balance needs to be struck between an investor demanding full and complete transparency for a fund that they invest in and what a hedge fund manager is prepared to offer to them – from the perspective of not giving away their fund strategy's IP or "secret sauce" and disadvantaging the hedge fund and its investors. Both points are valid. Before making an investment, the hedge fund manager should agree with their investor the level of ongoing transparency being provided for their fund.

## 1.6 Skin in the game

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. In order to align their interests, investors expect company boards and their managers 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 stock-holdings of the company.

Hedge fund managers believe that a fundamental tenet behind building a deeper alignment of interests with their investors is to have similar skin in the game like their investors. This will take the form of managers deploying a meaningful portion of their own personal capital in the funds that they manage. This will ensure that, in the event their fund under-performs and loses money for their investors, that they would also lose out.

Nearly two thirds of the hedge fund managers polled for this survey believe that having a significant personal investment in the fund is the single most important method they can use to align interests with their investors.

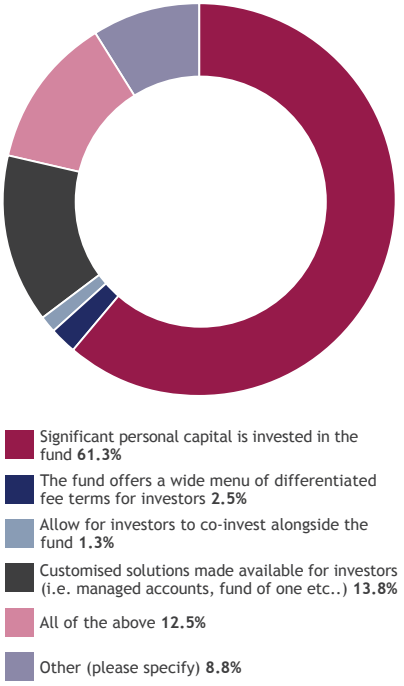
One should also not forget that performance fees are, in themselves, a simple but effective method of creating skin in the game. A performance fee creates an alignment of interest between investor and manager in that both profit when the fund performs strongly. A number of provisions (detailed earlier in the section) can be put in place to tailor the specifics of the arrangement.

## 1.7 Appropriate levels of personal capital investment

It is not possible to make a blanket rule around the appropriate level of such an investment. Across the sample of hedge fund managers that responded to our survey there is significant variety, especially in relation to the size and the stage of development of the fund.

At the outset, the major source of capital invested by an emerging/start-up hedge fund manager is made up of the founding principals' net worth and occasionally from friends, family members or other personal connections. It is not uncommon for founders/principals at start-up/emerging hedge funds to have as much as 80% of their personal capital invested in the fund at its inception, and throughout its early

**Figure 10: How do you best describe how you currently align interests with your investors?**




8 Hedge Fund Standards Board (HFSB) Consultations www.hfsb.org

years. In these cases the founder will essentially have unlimited liability to the fund's business, with potentially devastating personal consequences if the fund makes sizeable losses. As a hedge fund increases its AUM and looks to diversify its capital base, the percentage holding of personal wealth invested will reduce in size.

Upon closer examination of the hedge fund managers that responded to this survey, the average proportion of personal investment (inclusive of employees who are not the founder) is 10% but, as described above, there is significant variety across different levels of AUM. It is important to try to understand this evolution and not apply a one-size-fits-all approach, accepting that levels of personal investment will necessarily not be constant across the hedge fund's lifecycle.

Finally, it is important to note that it is not necessarily desirable for hedge fund managers to invest 100% of their personal capital. If their investment is purely nominal then there could be a concern that there may be no duty of care towards their investors. Equally, however, if the manager invests 100% of their personal capital, the emotions of the manager could take over and ultimately the overall performance of the fund could suffer – having all of the manager's liquid net worth in the fund could encourage the manager to run it with too little risk or take too many risks.

## 1.8 Managers investing fund deferrals/bonuses into the hedge fund

Whether as a result of commercial reasons, regulatory changes[9] or investor pressure, deferred remuneration has become an increasingly common feature practised by hedge fund managers. A significant and growing number of hedge fund managers have adopted some form of deferred remuneration policy within their funds to ensure that key investment personnel are appropriately aligned to the welfare of the hedge fund. 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 the investing of personal wealth is ongoing, rather than just a one-off at the fund's genesis, helps to further align the interests of hedge fund investors and hedge fund managers.

**Figure 11: To what extent are your principals and employees invested in the fund?**

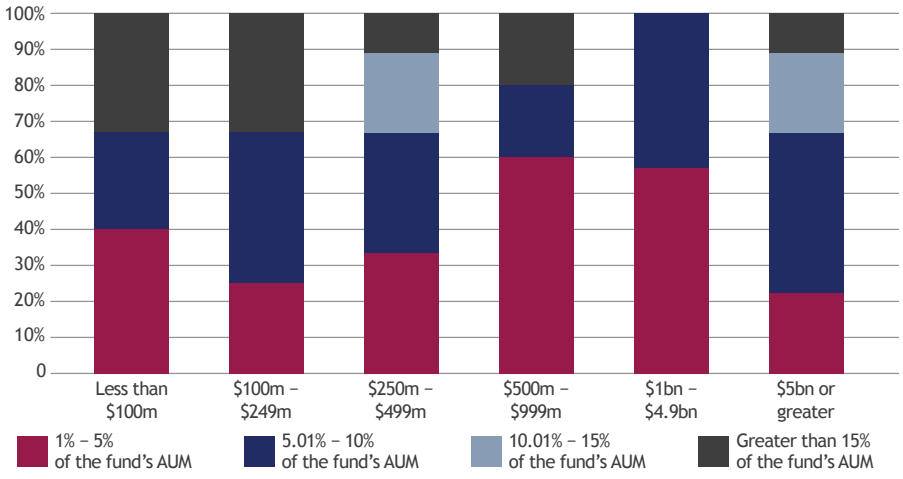
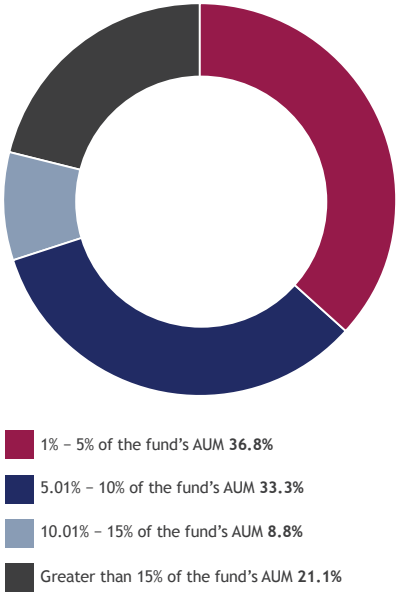



**Figure 12: To what extent are your principals and employees invested in the fund?**




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

# 2 Hedge fund fee structures and expenses.

- Overview of popular fund structures which provide fee concessions to investors
- Are hedge fund managers open to reducing their management fee?
- How do hedge fund managers treat their various expenses?

The typical fee structure employed by a hedge fund manager will consist 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. The performance fee represents the fund's claim on a portion of the total profits of the fund's investments.

For decades the classic fee structure was 1 and 20 (1% management fee and 20% performance fee), and indeed some of the earliest hedge fund vehicles operated with nominal management fees. The institutionalisation of the industry and widespread regulatory demands placed on hedge funds to improve their operational efficiencies led to rising hedge fund fees and changing fund structures resulting in many hedge fund firms charging "2 and 20".

**In more recent years amidst increased competition from more cost-competitive financial products and growing investor demands, hedge fund managers have begun to re-think their approach to the fee structure that they charge to investors.**

Rather than simply reducing fees, many hedge fund managers are exploring more innovative arrangements which aim to find an equitable meeting point between the interests of manager and investor.

## 2.1 Fund structures made available to investors which may reduce headline fees

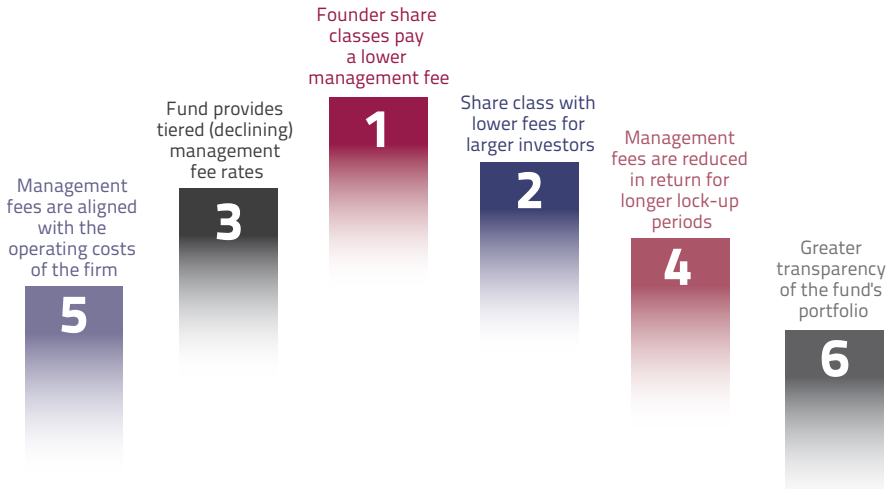
**Founder share classes**

Early stage investments in hedge funds are often rewarded with a reduction in management or performance fees. Given the absence of a long-standing track record for their fund, many start-up and emerging hedge funds find it necessary to offer a fee concession for investors 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. Equally, founder share classes are being deployed by second generation hedge fund managers (i.e. successful portfolio managers that have spun out of an existing hedge fund) to early stage investors to make sure their fund reaches a viable size before its launch.

Previously these arrangements were included in a one-off side letter arrangement with the fund's investor. Now these arrangements are typically reflected in a founder's share class, which are incorporated into the fund's offering documents and provide concessions to any investor(s) in the form of lower fees. The premise of a founder's share class is to encourage investors to allocate assets early by creating a separate share class with more favourable terms. This share class 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 favourable terms on subsequent investments. If offered, any extended benefit given to an investor will be limited up to a certain size of a hedge fund's AUM. Once this threshold is exceeded, the concession may no longer be made available.

**Figure 13: From the list of preferential terms provided to investors below, please rank in order of importance (1 being the most important and 6 being the least important) what you consider when negotiating the fund's management fee.**




As per the findings of this survey, it is not uncommon for hedge fund managers to extend offers to any prospective investors of between 1% and 1.5% for the management fee of a founders share class, sometimes even lower, and between 10 percent and 15% for the performance fee of the same share class. While not as common, some of the hedge fund managers that responded to this survey refer to another more creative share class that is being provided to its early stage investors. This arrangement involves having the investors pay the full fund fee terms of, for example, "2 and 20" at the fund's inception, but once the fund has reached a critical mass, the hedge fund manager may reduce the management fee to a lower amount.

**Other special share classes:**

In addition to a founder share class, other special share classes can be made available by the hedge fund manager to allow certain investors, by virtue of the size of the allocation that they are making in the fund, to receive certain preferential terms. 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 responses from this survey, hedge fund firms of all sizes are willing to provide this concession, although the offering is more prominent among hedge fund firms who manage more than $5 billion. Typically these firms are more likely to receive allocations from more institutional type investors like pension plans, sovereign wealth funds, endowments, insurers, and private bank platforms.

**Concessions to the management fee being charged to investors by emerging and start-up managers:**

To closer align with investors and further attract initial capital, typically from an anchor investor willing to commit a substantial amount (e.g. $100m), some start-up and emerging hedge fund managers are implementing tiered fee structures, through an initial class offering of their funds. In such arrangements, the initial share class offers a management fee that reduces incrementally as specific AUM milestones are reached. For example, a fund might charge a 2% management fee on AUM up to $100m, 1.75% on AUM up to $500m and 1.5% on AUM of $500m or more. By way of a comparison, this could be similar to a sliding fee scale arrangement – a common form of price discrimination used across many popular professions and services. Hedge fund managers require a high management fee to be paid in the early life of their fund, amidst having to pay fixed operating costs from a lower AUM base. However as the AUM of the fund grows and the fund benefits from an increasing economies of scale, it can operate more efficiently. Presently, investors who receive such a concession on the management fee being charged to them, 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.

**Figure 14: Which fee structure, if any, are you most likely to reduce?**

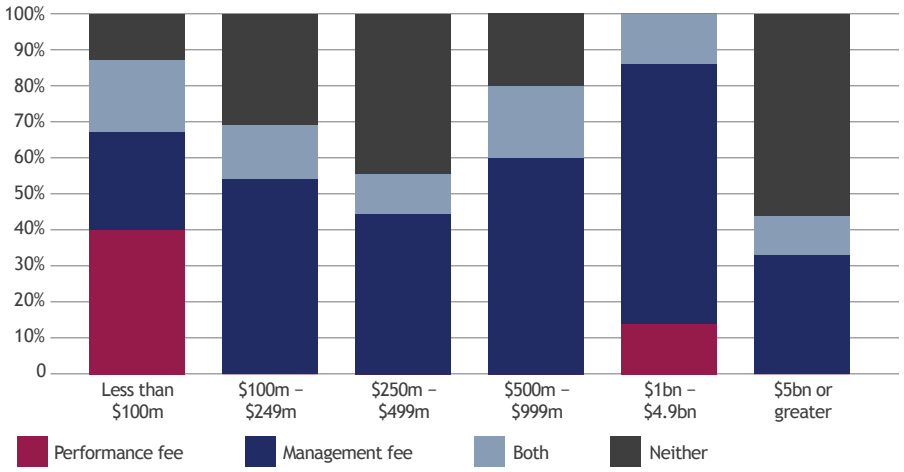
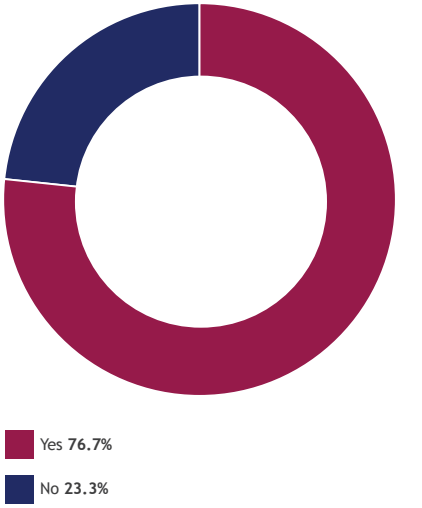



**Figure 15: As you grow your fund's AUM, would you consider implementing a tiered management fee structure?**



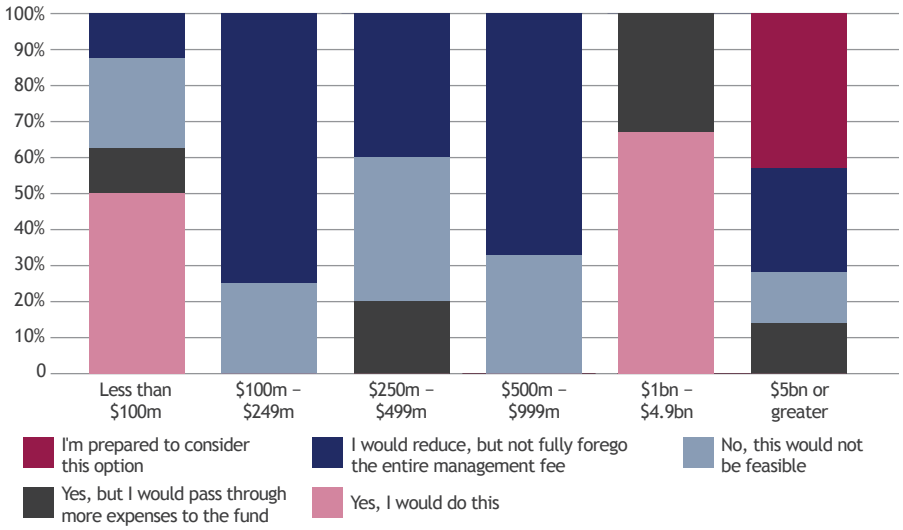

The costs of running a hedge fund are higher than they have ever been. In response to the vast regulatory changes that have impacted on the hedge fund industry since the crisis, hedge fund firms have made significant investments in their operational infrastructure. A report from AIMA/MFA in 2013 revealed that hedge fund managers were found to be spending as much as 10% of their operating costs on compliance, technology and other back-office functions.[10] In addition, the costs of research, retaining talent and executing certain hedge fund strategies is becoming more of a burden to the hedge fund manager. Nowhere are these costs felt more acutely than among smaller and emerging managers (which we loosely define as hedge funds which manage up to $500m AUM). Despite these limitations, nearly all the hedge fund managers (that reported to this survey) below $500m are willing to introduce tiered management fee structures, in the event that their fund's AUM has exceeded a certain threshold. When pressed as to what that fund's AUM threshold should be

10 AIMA/MFA, "Cost of Compliance" 2013.

before introducing a tiered fee arrangement, one $300m equity-based manager said "that they would introduce a tiered fee structure once its fund's AUM had exceeded $500m".

While hedge fund managers are open to providing tiered structures on their management fees, they are less inclined to reduce their performance fee structure, with the vast majority preferring that the hedge fund's full incentive fee is paid to them, in the event that it reports a positive period of performance.

**Figure 16: To what extent would the fund be prepared to forego all management fees paid to you in return for a higher performance fee?**




### Fee discounts by fund strategy

With hedge fund managers encountering greater competition from more fee-sensitive investments, discounted management fees are becoming an increasing trend across many strategies. Across the universe of hedged equity managers (who are receiving the most pressure to reduce fees) in this survey, funds that manage $1 billion AUM and below are being increasingly challenged by their investors to reduce their headline fees. Against a background of increased investor demands, this momentum for change is likely to continue, and funds that are not able to demonstrate an ability to out-perform or meet their investment objectives are likely to come under increasing pressure to reduce their headline fee rate or face going out of favour altogether with investors.

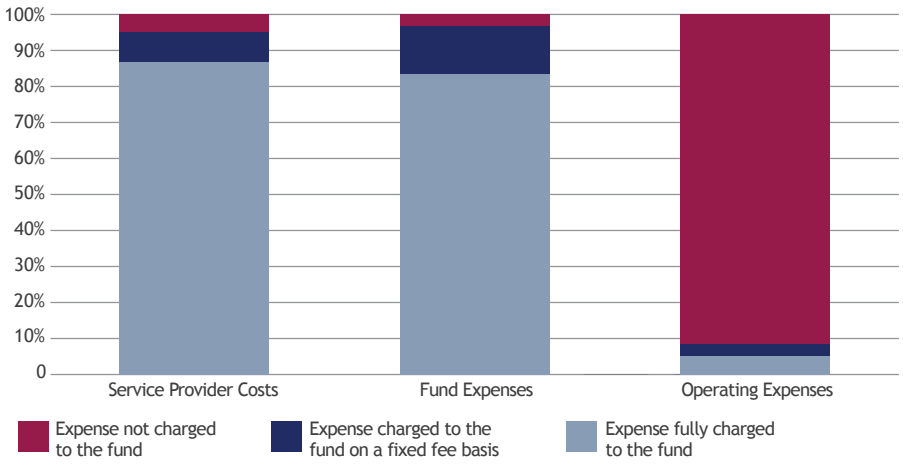
Where certain hedge fund strategies have a lower operating cost structure they can be more amenable to investor's demands to grant a concession on the fees being charged to them. In comparison, the higher the operating cost structure of a hedge fund (this will be especially relevant to credit funds, certain equity based strategies and multi-strat approaches), the more likely they are to resist any investor pressure to provide discounts on the management fee that they pay. Irrespective of the fund's investment strategy, if investment in the hedge fund is at full capacity, the fund's manager is very unlikely to provide any fee discounts.

## 2.2 Other fund rebates

While not as popular, nor as common among the preferential terms being provided to investors, other fund rebates that can be made available to investors include:

- Most Favoured Nation Clause (MFN) is a side letter provision which allows the investor which has a MFN to align themselves to any more favourable contract clauses that a newer investor might have agreed on. Typical provisions included in a MFN relate to the investor receiving better fee terms, greater transparency rights or better redemption rights.
- Where the hedge fund manager agrees to reduce the management fee it charges, but to the extent the management fee is reduced, this is offset by an 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, it 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 such that the economics of the fee structure remain similar, whilst the alignment with the investor is strengthened.
- Some investors are charged the hedge fund's standard fee structure but the hedge fund firm pays back a percentage of the management fee to the firm, i.e. the investor pays 2% management fee and 20% performance fee, but the hedge fund manager rebates 1% of the management fee back to the investor, so the net management fee is 1%. While there are some examples of this concession being provided by hedge fund managers,[11] it is still very much the exception, rather than the rule.

**Figure 17: What model do you deploy in paying for the fund's expenses?**




## 2.3 Hedge fund expenses

In recent years the debate as to how a hedge fund manager treats its expenses has intensified with scrutiny from both regulators and investors. For investors, understanding what fees and expenses they may be expected to pay to hedge fund managers is critical for them to assess to what extent the management fee being paid is justified or not. With this question in mind, we polled our managers as to what model they deploy in paying for their funds expenses. In terms of what the

11 Some managers that we spoke to when writing this paper mentioned that they were deploying this rebate.

fund should pay, anything that is providing a direct service to the fund tends to be a fund expense. On this basis, the fund usually pay the fees of its directly contracted service providers, typically these include:

- Fund administrator fees
- Prime Broker fees
- Other brokers/dealers
- Depositary/custodian fees
- Audit fees (related to the fund)
- Legal fees (related to the fund)
- Directors' fees

According to our findings, over 80% of the hedge fund managers surveyed charge their service provider costs (i.e. for fund administration and custody) and fund expenses (director's fees, annual audit fees and tax costs) to the fund.

**On the other hand, over 90% of the hedge fund managers polled do not charge their firm's operating expenses (employee compensation, regulatory reporting costs) to the fund.**

Any exception to this rule will usually be for very small, new managers who reach a tailored arrangement with selected seed capital investors.

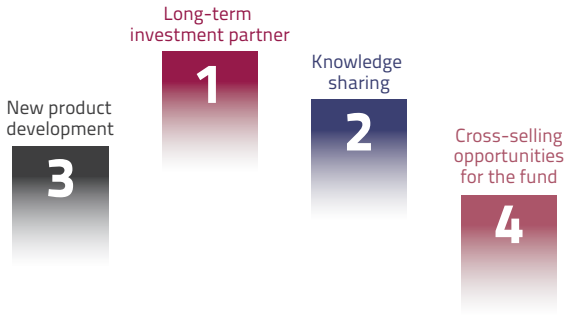
Whether the fund pays for research or not (either through bundled commissions paid to brokers or via hard dollar payments) should be part of the disclosure provided to investors. Similarly, other categories of expenses to be allocated to the fund should be disclosed to investors, but will vary. Beyond that, all other fees should typically be paid for by the hedge fund manager.

The variety and amount of expenses that must be incurred to operate a hedge fund business is becoming more challenging for some hedge fund firms. There are no regulations specifically delineating how hedge fund managers should allocate such 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. Hedge fund managers will disclose to their investors the types of expenses borne by the fund and the manager in the various fund governing documents, including fund limited partnership agreements, articles of incorporation and in some circumstances an investment management agreement between the manager and its funds. In some cases, managers have agreed to provide a cap (i.e. limit) on the expenses being charged to the fund. With this limit in place, the manager will subsequently pay for any remaining fund expenses once the cap on expenses being charged to the fund has reached its limit.

Some managers have implemented arrangements that allow them to permit the hedge fund manager to pass certain fund expenses (for example, operating expenses such as team costs) items through to the fund and to its investors via the management fee. The passing through of expenses raises the potential for a conflict of interest between the hedge fund manager and their clients. This practice appears to have subsided with fewer managers passing through expenses to the funds – perhaps in part due to greater regulatory scrutiny or as is more likely, directly related to the fact that investors have become more focused on the individual types of expenses that they are bearing and the impact this has on the overall expense ratio of the fund.

# 3 Hedge fund managers' primary objectives in developing a stronger alignment of interest with their investors.

**Figure 18: Please rank in order of importance what is most important to you (1 being the most important, 4 being the least important) when you consider an alignment of interests between you and your investors.**




Increasingly hedge fund managers are striking partnerships with investors.[12] As per our survey of manager respondents, the key motivations for the aligning of interests with investors were as follows:

- Enhanced communication and exchange of knowledge between both parties
- Opportunity for the manager and investor to explore new asset solutions of mutual benefit
- A mutual desire for a long-term and stable investment commitment

## 3.1 Knowledge sharing

Knowledge sharing is a crucial element of any partnership between a hedge fund and its investors, and can be of significant benefit to both parties. Just as no two hedge fund managers are the same, not all investor types are the same.

### 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.

A small or emerging hedge fund manager may only need to cater for one or two external investors (typically a fund of hedge funds manager and a family office) whereas an established mid/large scale manager will typically cater to a much greater variety of investor types and a less concentrated client base. Furthermore, each investor base will have its own views as to what constitutes a successful alignment of interests. A hedge fund manager that benefits from regular constructive dialogue with their investors will have a better chance of both understanding and reconciling their various demands. As a consequence, the manager may be able to satisfy a broader range of investor requirements and thus promote long-term investment and a more stable client base.

In pursuing their goal of greater communication with their investors, an increasing number of hedge fund managers are providing their clients with open-access to their portfolio managers and investment staff. Among the managers polled in our survey, some have worked with their investors in offering secondment opportunities to the investors' staff so that they can get a better appreciation of the fund's processes and operations. Understandably, this appears to be more of a trend across the larger managers in our survey, who are more able to run schemes such as this due to the greater number of employees that they have in their firm.

12 The Extra Mile: Partnerships between hedge funds and investors. http://www.aima.org/en/education/partnerships-hedge-funds-investors.cfm

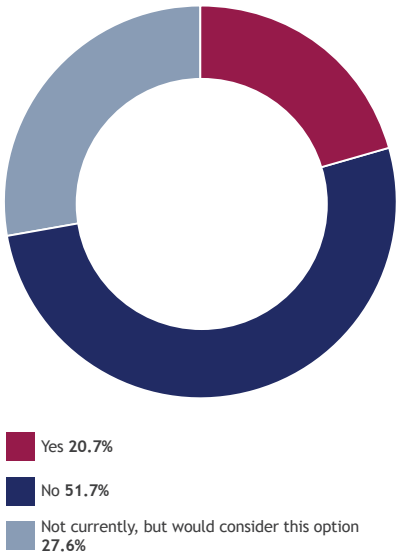
Greater levels of interaction can help better explain the performance attribution, the drivers behind this performance and the risk profile of the portfolio. Moving this one step further, the development of customised research for investors can allow a hedge fund to differentiate itself better and increase the value it delivers to its most important clients. At the same time, hedge funds need to be careful in managing this relationship, as providing investors with highly customised material can be a distraction and a drain on their resources to the possible detriment of the fund's performance.

Investor communication can be further improved by making sure a hedge fund's investor relations (IR) function is at a sufficient standard where investors feel that they can effectively communicate with them.[13] The importance of such a high-quality IR function is two-fold:

- to have a sufficient depth of knowledge about the fund's investment strategy and a proven ability to communicate in sufficient technical detail about the fund's performance (e.g. why it took up certain positions in the fund's portfolio, why it put on risk/took off risk etc.) and field any queries related to the fund's portfolio without having to call on senior investment fund personnel, taking time away from their primary responsibility of looking after the portfolio. As greater transparency is provided, IR professionals can expect to field increasingly detailed and technical questions from investors.
- to have the ability to listen and understand the unique needs and expectations of its investors and to communicate this effectively to other senior members of the fund to deliver the best possible solution for its investor.

Some managers are already taking steps to ensure these points are acted on by making significant high quality hires in the area of investor relations that are capable of delivering the firms expertise and solutions in a coherent fashion to its investor base. The nature of these roles and the personnel being charged to carry out these functions are structured so that they can act as a nexus between the senior investment personnel of the fund and the investor.

**Figure 19: Do you offer co-investment opportunities to your investors?**




## 3.2 Opportunity for the manager and investor to explore new asset solutions

As the hedge fund industry evolves and becomes increasingly institutional, many hedge funds are re-orienting their business models away from selling a fixed product offering towards providing a "customised investment solution".

### Co-investments

Co-investments have been a popular tool with institutional investors, private equity and real estate managers for many years. Increasingly, hedge fund managers are establishing similar arrangements. These may be via a one-time investment opportunity within the scope of a main fund or organised as separate and/or independent co-investment funds. The typical motivations for hedge fund managers launching these vehicles include:

- Hedge fund managers are able 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 co-investment opportunity

13 Further discussion on the changes in the way that client relationships are managed, investment management brands are built and assets are raised can be found in AIMA's 2016 Guide to Sound Practices for Investor Relations. Source: https://www.aima.org/en/document-summary/index.cfm/docid/43CB9C08-D94F-4694-8198881BEEBCA905

- Where a hedge fund manager may only be recognised as being expert in one particular area, they may opt to co-invest so that they can build a track record of expertise elsewhere
- Co-investment is a relatively new concept for hedge fund managers, and having first mover advantage can provide the hedge fund manager with an avenue to help it stand out from its peers in being a versatile partner that is willing to engage in interesting investment ideas with their investors

Typically co-investment opportunities are offered to established investors in the fund, who are often asked to commit a significant investment of capital over a long timeframe. This stops them from redeeming quickly in the event of losses. Any such arrangement with a prospective investor is likely to be the subject of a strict Non-Disclosure Agreement (NDA)[14] with the hedge fund manager.

Recognising the benefit of co-investment opportunities, over one fifth of our hedge fund manager respondents offer these arrangements with their investors while a further 27% would consider such an option if requested by investors. Upon closer examination of the manager sample in this survey, smaller and emerging managers (below $500m AUM) and mid-sized managers (which managed between $1billion and $5 billion in AUM) are more likely to consider a co-investment with their investor. Anecdotal evidence suggests that larger managers will also agree to such an arrangement, given the right terms.

**Figure 20: Do you offer co-investment opportunities to your investors?**

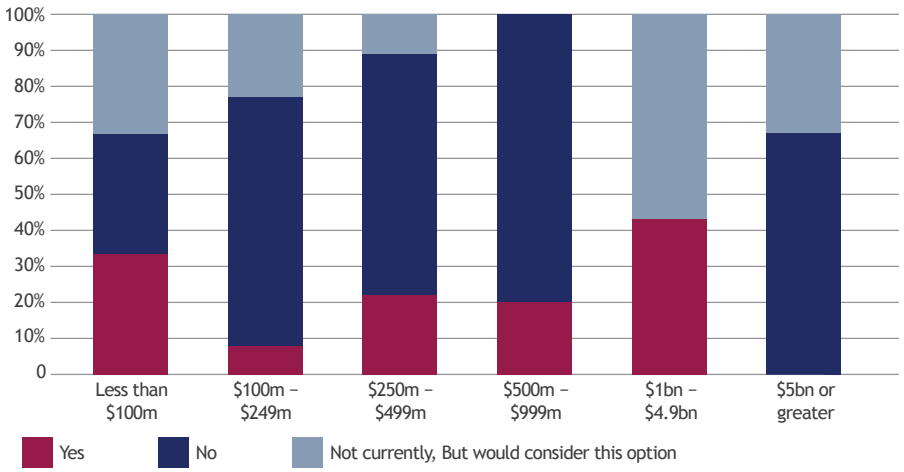
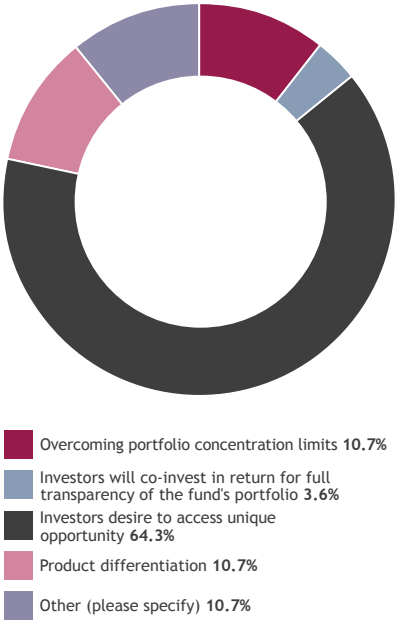



**Figure 21: What are your motivations behind offering co-investment opportunities with your investors?**




### Customised solutions

As investors have become more sophisticated there has been an increasing trend towards the creation of customised hedge fund solutions. These ensure that hedge fund offerings can be better tailored to complement the wider portfolio of the investor. The two most popular types of customised fund solutions are the managed account and the fund of one.[15]

14 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.

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

A managed account gives the investor the scope to set the hedge fund manager a specific investment mandate. This enables the investor to develop a portfolio unique to their individual risk and return appetites. Furthermore, a managed account provides greatly enhanced transparency with most arrangements allowing for the fund's positions to be viewed on a live basis with daily reporting. This enhances the ability of the investor to understand exactly how the fund's returns are being generated, whilst offering full risk management insight of the process.

In recent years, the number of managed account platform (MAP) sponsors has been growing. Given the rising AUM that MAPs have to allocate, they can use this leverage to negotiate better incentive fees, and some have even negotiated management-fee only arrangements. While the scope to negotiate fees within a commingled structure has become more limited in recent years, the nature of a customised solution means that investors can still achieve significant fund fee reductions over the long term, albeit a greater investment is often required at the outset. In comparison to investing in a commingled fund structure where typically the minimum investment requirement is $100,000, most customised structures will have a minimum requirement of on average $1 million, and it is not unusual to have tickets as large as $50m. There are examples of some smaller hedge fund firms having a minimum investment requirement of $500,000 for a managed account offering, but this is very much the exception.

## 3.3 An investor partner willing to invest for the long term

As we have already discussed, investors typically wish to see that hedge fund managers hold "significant skin in the game". Similarly, a common priority for hedge fund managers is to find an investor partner who is willing to be invested with them for the long-term.

It's critical for investors to gain insight into risk-adjusted measures of performance in their evaluation of hedge fund managers. For institutional investors, the ability of a hedge fund manager 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 a particular index, or aspects of peak-to-trough value declines (drawdown) can be critical in manager selection. Also, managers may have specific mandates in terms of the type of securities in which they are allowed to invest in (for instance, an ESG mandate). A fund manager's ability to execute the intended strategy should be a key factor in performance evaluation, and may require some further discussion with investors so that expectations are met on both sides.

In this context, hedge fund managers are keen to develop meaningful partnerships with investors who 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 manager to offset the vicissitudes of performance volatility in 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.

# Conclusion

None of the measures that increase the alignment of interest between managers and investors described in this paper are binary. All can be adapted or tailored. A high water mark can be set to cover different periods or be subject to amortising provisions. The frequency of a partial crystallisation structure can be infinitely adjusted, whilst managers have a massive array of different types of share classes available to them to construct varying fee architecture. We emphasise this as it is essential to realise that a one-size-fits-all approach is an inappropriate way of aligning interests. Clients have very varied requirements and risk tolerances whilst the phrase 'hedge fund' encompasses a vast array of different strategies. Creating alignment should therefore be a bespoke process of calibrating the various tools we have described in this paper to create a symbiotic relationship between manager and investor such that both are incentivised to act to their mutual benefit.

Taking a less nuanced approach can have a damaging effect on portfolio performance. An investor insisting on total transparency, for example, may compromise a manager's strategy by exposing position-sensitive information. At the same time any condition which imposes too high an administrative burden on the manager has the potential to impact the effective deployment of investment ideas.

Flexibility, therefore, is key to the alignment of interests between hedge fund managers and investors. This reflects a general trend within the hedge fund industry away from pre-defined products and toward variable solutions. As services such as managed account platforms gain traction the scope for a tailor-made alignment of interests is likely to increase. If handled correctly, this should enhance the ability of hedge fund managers and investors to build sustainable mutually constructive partnerships.



## About AIMA

AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with more than 1,600 corporate members in over 50 countries. AIMA works closely with its members to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes, and sound practice guides.

Providing an extensive global network for its members, AIMA's primary membership is drawn from the alternative investment industry whose managers pursue a wide range of sophisticated asset management strategies. AIMA's manager members collectively manage more than $1.5 trillion in assets.

AIMA is committed to developing industry skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the industry's first and only specialised educational standard for alternative investment specialists.

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

## About RSM

RSM US LLP is the leading provider of audit, tax and consulting services focused on the middle market, with more than 9,000 people in 86 offices in the United States and 38,300 people in over 120 countries as a member of RSM International, a global network of independent audit, tax and consulting firms.

RSM serves the financial services community in key financial hubs all over the world. Our professionals help organizations navigate complex reporting, governance and regulatory issues to achieve their business objectives. Based on the knowledge that comes from serving investment advisers and commodity pool advisors, investment companies of all types, and brokerage and trading entities, we understand the complex financial reporting, operational, tax and regulatory compliance issues facing the hedge fund industry. We also offer independent compliance testing services to meet regulatory obligations, GIPS verification, AML testing, and technology due diligence and risk assessments, including security and privacy consulting.

RSM provides industry insight, advice and solutions to financial services organizations across the country and around the world. Whether your business operates on a national or global scale, we have the resources to consistently deliver personalized attention across your organization. That's what you can expect from RSM. Experience the Power of Being Understood.[SM]

For more information, visit www.rsmus.com, like us on Facebook at RSM US LLP, follow us on Twitter @RSMUSLLP or @RSMUSFINSVC or @RSMUSRISK and/or connect with us on LinkedIn and Instagram.

# Acknowledgements:

**AIMA wishes to offer its sincere gratitude to all its research committee members for their dedication towards the creation of this document.**

**Carol Ward (Chairperson)**
**Chief Operating Officer**
Man GLG

**Conrad Levy**
**Global Chief Operating Officer**
Brummer & Partners

**Brian Towers CAIA**
**Vice President**
BlackRock

**Spencer Rhodes**
**Alternative Investments Global Business Manager**
Allianz Global Investors

**Aberdeen Asset Management Plc**

**Cedric Kohler**
**Head of Advisory**
Fundana Asset Manager SA

**Richard Hindley CAIA**
**Head of Business Development & Investor Relations**
ARG Asset Management

**Michael Oliver Weinberg CFA**
**Senior Managing Director, Chief Investment Strategist**
Protégé Partners

**Antonella Puca CFA**
**Senior Manager**
RSM US LLP

**Ermanno Dal Pont**
**Managing Director**
Head of Capital Solutions EMEA, Barclays Capital Solutions

**Chris Farkas**
**UK Hedge Fund Leader**
Deloitte UK

**Dr Robert Kosowski**
**Associate Professor**
Imperial College Business School and Associate Member
Oxford-Man Institute

**Peter Jayawardena**

**Tom Kehoe CAIA**
**Global Head of Research**
AIMA


**AIMA**
Alternative Investment
Management Association

www.aima.org