

The logo for the Alternative Investment Management Association (AIMA), consisting of the letters 'AIMA' in a bold, white, sans-serif font on a dark blue background.

AIMA

THE ALTERNATIVE INVESTMENT
MANAGEMENT ASSOCIATION

HOW MUCH?

The evolution, structure, use and future
of fees from an allocators view point

Australia Investor Advisory Group



ABOUT AIMA:

www.aima.org/about.html

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than \$2 trillion in hedge fund and private credit assets.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry.

AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 100 members that manage \$400 billion of private credit assets globally.

AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

IMPORTANT NOTE:

While every care has been taken in preparing the Information, except as required by law, no representation or warranty, express or implied, is made in relation to the accuracy or completeness of the information provided in this document. The Information is not intended for distribution or use in any jurisdiction where it would be contrary to applicable laws, regulations or directives and does not constitute a recommendation, offer, solicitation or invitation to invest. The Information may contain projections, forecasts, targeted returns, illustrative returns, estimates, objectives, beliefs and similar information ("Forward Looking Information"). Forward Looking Information is provided for illustrative purposes only and is not intended to serve, and must not be relied upon as a guarantee, an assurance, a prediction or a definitive statement of fact or probability. Actual events and circumstances are difficult or impossible to predict and will differ from assumptions. Past performance is not a reliable indicator of future performance. While every care has been taken in preparing the Information, except as required by law, no representation or warranty, express or implied, is made in relation to the accuracy or completeness of the information provided in this document. Photographic images used are for illustrative purposes only and may not represent actual images of assets or opportunities described in the Information. This Information, unless otherwise specified, is current at the date of publication and will not be updated or otherwise revised to reflect information that subsequently becomes available, or circumstances existing or changes occurring after that date. The information contained in this document represents the personal opinions of the respondents and must not be construed as the opinions of the firms they represent. By accepting this Information, you agree to be bound by these limitations, terms and conditions.



AIMA MEMBERSHIP

AIMA's Global Reach



Did you know that AIMA members are entitled to a host of benefits?

Committees and Working Groups

Working with peers to shape the industry and share expertise

Industry-Standard DDQs

Streamlines manager and service provider selection

Events and Networking Opportunities

Connect and network with peers at over 275 events held globally

Access to Experts

One-to-one contact with AIMA to discuss regulatory queries

Sound Practice Guides

Used to assist implementation of sound policies and processes in an increasingly complex operating environment

Government and Regulatory Affairs

Benefit from AIMA's advocacy work on a global scale

Research and Investor Guides

Shaping the industry narrative to promote a better understanding of the alternative investment sector

Communications

Keep up-to-date on AIMA's recent activity, industry news and regulatory change

AIMA Journal

Share your thought leadership with the global industry via our quarterly publication

To learn more about the benefits of AIMA membership, please visit www.aima.org

AIMA

Dear Member,

Fees... that single word which, more than any other word or topic, has polarised both investors and managers alike, is never far from the spotlight. Once upon a time the 2 & 20 model was the default position, now there are so many variations its hard to keep up with them all.

AIMA Australia's Investor advisory group's (IAG) latest paper "How Much?" ** aims to navigate the some times vexed issues of fees by examining the evolution of fees, fee budgeting, fees for differing strategies, fee negotiating and conditions, what's normal, where are fees headed, and ultimately a look at aligning interests.

One of the goals of the IAG is to provide guidance on best practice for the local industry, and offer insights into product development, gleaned from exposure to international firms and trends. Fees, and an in-depth discussion of them, falls clearly into these objectives, and the IAG is committed to an on-going discussion on this, and all aspects of funds management.

Whilst this paper was specifically designed by the Australian IAG, it follows on from a number of AIMA research reports where fund fees and structures have been discussed over the last number of years. The most notable were the two surveys conducted with RSM, In Concert (2016) and In Harmony, the latter being published last year. The key finding of these papers being that hedge funds have moved beyond the 2&20 fee model to a variety of flexible fund fee structures. Rather than merely reducing the headline fee, hedge fund managers are examining more equitable compensation arrangements that are beneficial to them and their investors.

AIMA's extensive library of research papers, best practice guides and due diligence questionnaires can be found at www.aima.org for all members.

AIMA is also teaming up with international law firms Simmons & Simmons and Seward and Kissel to explore the latest trends regarding hedge fund fees and fund structures. This work will be informed by an industry wide survey which will be sent out in August 2020, with the report published in late Q4 2020/early Q1 2021.

Like the previous papers from the IAG, we expect the discussion in "How much" will be thought provoking and, with feedback from you the member, will provide additional key topics that we can look to delve into in more detail in the future, including further thought pieces, roundtables, forums, or general discussion topics.

We would like single out and thank the members of the Investor Advisory Group, who contributed to the virtual round table; Grant Harslett (Maritime Super), John Zavone (NSW T-Corp), Anastassia Juventin (AMP Capital), Ben Samild (Future Fund), Charles Wu & Keri Pratt (SAS Trustee Corporation) and thanks to the other members of the Investor Advisory Group for their ongoing involvement and support.

We hope you enjoy the latest IAG virtual round table and as usual all feedback is welcome.

Michael Gallagher,
Director, Head of Australia
AIMA Australia

Alistair Rew,
AMP Capital & Chair,
AIMA Australia

** The paper can be downloaded for free at www.aima.org/educate/aima-research/how-much

CONTRIBUTORS



Anastassia Juventin

Portfolio Manager,
Hedge Funds and Alternative Strategies

Anastassia joined AMP Capital in November 2018, after relocating to Sydney from Auckland, New Zealand. Within AMP Capital's Multi - Asset Group, Anastassia's focus is on investment research and portfolio construction across absolute return strategies, including hedge funds and other alternative investments. Anastassia started her career in equities research before spending a significant amount of time at BT Funds Management (NZ) where she assumed research responsibility for alternative investments asset class, as well as contributing to market analysis and development of tactical asset allocation views. Anastassia also drove the creation and implementation of the Responsible Investment policy and framework utilised across BTNZ's managed portfolios.

Anastassia holds a Bachelor of Arts (Chinese language) and Masters of Commerce degrees (Economics (Honours) and Finance) from the University of Auckland.



Ben Samild

Head of Alternatives,
Future Fund

Ben Samild joined the Future Fund as a Director in October 2013 after a 10 year career in the hedge fund industry, and 4 years as Head of Investment Strategy at Industry Super Fund LUCRF Super. Ben completed a 6 year undergraduate degree at the University of Melbourne majoring in behavioural finance, psychology and history. After University he was employed as a research fellow within the Psychology department where the work of his group was supported from investors in the United States. These investors later employed the group to run a systematic global macro hedge fund. Ben completed a Masters in Applied Finance while leading the research at the Connecticut-based hedge fund.



Charles Wu

Deputy CIO,
SAS Trustee Corporation

Mr Wu joined State Super in 2015. In his role as Deputy Chief Investment Officer and General Manager, Defined Contribution Investments, Mr Wu is responsible for formulating investment strategy to assist members to achieve return objectives on a risk-adjusted basis. He was previously an Investment Manager at Media Super and an analyst at Mercer.

Mr Wu holds a Master of Commerce and a Bachelor of Computer Engineering and is a Chartered Financial Analyst holder. He also serves as Vice President and the Director of University Outreach at Chartered Financial Analyst Society Sydney.

CONTRIBUTORS



Grant Harslett

General Manager Investment and Finance,
Maritime Super

Grant has been General Manager Investments & Finance of Maritime Super since 2004.

He has over 40 years experience in the Australian superannuation industry, having worked in a range of management and consulting roles covering actuarial, investments and finance areas.

Grant is a member of the AIST working group on operational due diligence of investment managers.



John Zavone

Senior Portfolio Manager, Portfolio Construction,
NSW Treasury Corporation (TCorp)

John Zavone is a senior portfolio manager on TCorp's Portfolio Construction Team. The team is responsible for the portfolio management of the full range of TCorp client funds (approximately A\$100bn), and ensuring the funds are individually constructed to meet specific portfolio objectives and client risk appetites. John is directly responsible for the strategic allocation of capital and risk for a number of these funds. John also has responsibility for ensuring that TCorp's strategy in the Alternatives sector is appropriate to the needs of TCorp's portfolios, as well as recommending and implementing risk hedging overlays where required.



Keri Pratt

Head of Strategic Relationships,
SAS Trustee Corporation

Ms Pratt joined State Super in 2017. In her role as Head of Strategic Partnerships, Ms Pratt is responsible for overseeing the \$35 bil investment outsourcing arrangement with NSW Treasury Corporation, and managing the interface the Trustee has with non Crown employers. In addition to her investment governance role she also supports the CIO and Senior RI Manager in ESG-related matters (proxy voting, climate risk, manager engagement, etc).

She was previously Head of Institutional, Australia & NZ, at Franklin Templeton Investments, held an equivalent role and was a partner at GMO Australia Ltd, as well as working in superannuation and consulting roles with NAB, MLC & Lend Lease.

Ms Pratt holds a MBA (Exec.) and a Graduate Diploma in Applied Finance & Investment and GAICD. She is also a Non Executive Director of Guild Trustee Services Ltd (Guild Super) and the CIMA Society of Australia, and has served on a number of industry associations and investment committees.

FEE EVOLUTION



How have you seen fees rates & compositions evolved in the last 5-10 years?



Anastassia Juventin

Over the most recent past, we have seen significant changes to hedge funds and liquid alternative strategies managers to reduce fees. Along with increasing competition from product providers and increasingly price-sensitive investors, the industry has started moving towards a new fee equilibrium. Generally, the move has been focused on re-aligning compensation to the skill of the manager and ability to deliver outperformance on a consistent basis. Additionally, a move from commingled structures towards more customised offerings in the space, further driven investors' ability to negotiate fee structures and arrangements.



Ben Samild

For basic strategies with no obvious edge there is some more flexibility and average fees have come down somewhat, although not commensurate with the cash rate or alpha production. Generally there is more flexibility but for the best managers the fees have gone up.



Charles Wu

As a general rule, for hedge funds we are no longer seeing 2% and 20% structures any more (or we are not entertaining them). We see 1% and 10% and in a few cases 1% or 30% arrangements. Some of the private equity brethren are a little more stubborn in moving away from 2% & 20%. We see more movement in the Private Credit managers. They are prepared to offer flat fees and no carry, as well as opportunities for coinvestments. Our experience is that this a supply/ demand issue ultimately.



Keri Pratt

TCorp has primarily accessed Alternatives strategies through strategic partners and large managers, rather than through widely commingled vehicles. This has meant that manager fees for our Alternatives strategies were already somewhat lower than hedge funds in general. Though hedge funds have seen a downtrend in fees since their heyday in the 2000's, we have probably seen less of that, starting from a lower base.



John Zavone

What we have seen however, is increased value and service for the fees being paid - for example, the willingness of managers to share views and ideas with TCorp, to offer deeper transparency into their strategies, or to customise to our needs. In part this is due to TCorp's ability to allocate meaningful capital to managers, and in part due to a greater recognition in the industry that to preserve healthy fees the proposition must often extend beyond performance. In this sense, we view that value for money has been on the rise.

BUDGETING FOR FEES



Fee budgets – How are they determined in light of your firm’s approach and the regulatory environment eg: RG97 – please provide some insights into your firm’s approach to fee budgeting.



Anastassia Juventin

Regulatory backdrop in Australia put even more pressure on achieving the right fee structure. At AMP Capital we aim to maximise alpha per unit of fee paid away. In the most recent restructure of the hedge fund allocation, we worked towards maximising alpha per unit of fee and the percentage of return captured by the end investor. For this to happen we shifted to a custom mandate, specific to the objectives of our funds. This approach helped us achieve what we see as more fair and attractive return capture relative to what could be achieved in a more traditional fund of funds structure.



Ben Samild

We don't have an explicit fee budget. Each opportunity is assessed per the value of the net outcomes.



Charles Wu

We are not APRA regulated but do follow all APRA guidance where it makes sense to do so for our members and other key stakeholders. Information on fees paid does go to Government who expect we can demonstrate value for money for members. Overall, and within the transparency framework just noted, we are more focused on 'bang for buck' at the individual manager level. Higher fees can be accommodated where we are confident outsized returns can be found and the allocation will be sized accordingly. Performance fees are not preferred and are mostly avoided where practicable.



Keri Pratt

We have always had a strong focus on member outcomes, hence on net returns to members; investment fees are one component of that process but should be assessed against the value-add they are expected to deliver, rather than as a topic in isolation. However RG97 has forced funds to take much more account of fees vs peers, and not only fees paid to the manager, but also the, often much larger, transaction costs and other indirect costs. So the need to be peer-competitive on fees leads to a fee budget concept being more influential in deciding the mix of asset classes and of investment managers within an asset class. This is more in focus with MySuper products because of the media interest and the APRA data being readily available.



Grant Harslett



John Zavone

A fee discipline is critically important to ensure that clients are receiving the best possible after-fee results. While we do not apply any specific fee budgets, we have undertaken significant reviews of total manager fees for our client portfolios, and looked to hone that spend on areas of greater value-add, and eliminating the more marginal.

Accordingly, we are not constrained from paying up for strategies where we have conviction in the value to clients. We measure this value through "alpha", or skill-based return that cannot be easily and more cheaply replicated by known risk factors. To achieve these diversification benefits, Alternatives can tend to be a higher cost area of client portfolios and we need to evaluate attractiveness on a net-of-fees basis. We also recognise that while forward-looking returns are subject to uncertainty, fees have a certain cost, so in individual cases higher fees demand even greater conviction in the skill of the manager.

DIFFERENT STRATEGIES, DIFFERENT FEES?



What are the considerations around allocating to different strategies given a fee budget constraint and what is the optimal mix of management and performance fees?



Anastassia Juventin

The way we look at the absolute returns sector is to divide it into alpha and alternative risk premia blocks (somewhat alike active/ passive split). The majority of the fee budget is allocated to alpha component, with the latter being viewed as a diversifier in the total portfolio. The optimal mix of management and performance fees is specific to each fund (on a diversified level) but we do generally structure investments to have a performance fee component to further align interest between investors and managers.



Ben Samild

We are very flexible and open minded and tend to work with the manager to seek the best outcomes and alignment. This can mean front loading, back-ending, changing the mix or bearing proportionate costs. Also trading off capacity and other structural aspects that are important to us.



Charles Wu

See comments in previous question answer for performance based fees.



Keri Pratt



Grant Harslett

High RG97 cost mandates, typically portfolios with high transactions costs (some alternatives fall into this space) or with multiple layers inside the vehicle structure, are having to provide a greater deal of confidence in their ability to deliver on the return targets (or deliver greater alpha) to be able to justify the higher RG97 cost.

Portfolios with performance fees also are a very clear example of the problems with comparing fees alone as, by definition, performance fees (should) only occur when returns have been greater than the agreed benchmark; which is clearly good for members. From a fee budget perspective alone, performance fees are more problematic but it comes back to the ability to focus on net investment returns.



John Zavone

As we do not apply a specific fee budget, but a fee discipline, fees do not act as a constraint on allocating to different strategies. However, fee efficiency is critical.

The role of Alternatives in TCorp's client portfolios is to add differentiating risk and return streams to the total portfolio, increasing risk-adjusted returns. Our assessment of the level of this differentiated value-add, on a net-of-fee basis, is the key driver of our allocation to the space.

The optimal mix of management and performance fees varies case by case, and depends on multiple considerations, including the style of manager and the objective. We have some managers on performance fees, and many others not. Where we have negotiated performance fees, we have undertaken scenario analysis, and considered likely behavioural responses of the manager to ensure alignment - in dealing with human incentive, there is as much art as science.

NEGOTIATING



Do you ask for, or consider, differentiated fee structures by strategy/risk? Give some examples.



Anastassia Juventin

We absolutely consider the pricing of the strategy, depending on a few factors. Generally, strategies with lower expected alpha, strategies that are more commoditised and strategies with lower operating cost can be more accommodating to fee requests. One example that I can provide is a strategy that is available at different volatility levels. Higher volatility would be slightly more expensive overall.



Ben Samild

We have pass through; performance only; management only; cost sharing; tiered fee structures ascending; tiered descending to zero; rebate structures based on revenue goals.



Charles Wu

Expected Tracking Error drives fee to a large extent. We also would consider whether to pay up for a 'brand'/ track record or for uniqueness of some sort.



Keri Pratt

For some more complex strategies such as Multi-Asset or ARP we might look at the additional value that the firm's research insights can bring to our investment team, so there may be reasons for differences.



John Zavone

There are multiple pragmatic considerations in determining whether an incentive fee structure makes sense, and what form it should take. For example, this alignment can be especially important if the strategy represents an outsourcing of the allocation function, such as to a fund-of-fund manager. Considerations would include the business structure, the culture of the firm, and any capacity constraints.

FEE CONDITIONALITY



Highwater marks; hurdles; liquidity; clawbacks etc – YES/NO? Comment on what is expected, unacceptable and why?



Anastassia
Juventin

Our four alternative building blocks have been structured to incorporate HWM and hurdles. Furthermore, hurdles have been negotiated to be above a certain return level, rather than on Cash performance (for those strategies that don't have an appropriate benchmark). Some of the investments have clawbacks in place, and we have been exploring this option further with more managers in the recent past.

I also wanted to add that apart from considering management / performance fees and features, we have also been working to make sure we understand what fees and expenses may be charged to the fund. Generally, anything that provides direct service to the fund tends to be charged as an expense to the fund and is often not considered. During the recent restructure of our hedge fund allocation, we have spent considerable amount of effort to make sure we minimised those expenses. For example, some of the operational costs have been excluded from those expenses. It is useful to consider those additional costs and how those may impact the total expense ratio.



Ben Samild

Always HWM; rarely hurdles given the nature of strategies (well cash hurdle); best liquidity we can negotiate, nearly all is inside a month, often daily. No clawbacks.



Charles Wu

We always look at all the trade offs that come with each structure and determine what is of most value to us at the time and within the context of the asset class/allocations. For example, we might be comfortable to accept a 3 year (or longer) lock up if we can secure suitable terms on hurdle, highwater mark and/or clawbacks.



Keri Pratt

We do not believe that there is a clearly optimal performance fee structure, and it is the way the various features interact that are likely to influence behaviour.

In most instances we view highwater marks and hurdles as a useful alignment with clients' longer-term outcomes. Highwater marks can create a closer alignment with clients' long-term outcomes (avoiding free 'optionality' to the manager in short periods), and hurdles can be set such that the manager is only rewarded once the strategy has adequately compensated for its level of risk and governance cost. In certain cases, a fee cap is a useful way of stabilising cost outcomes over time.

None of these features operate in isolation. There are various trade-offs and interactions to be considered in the 'total package', as well as the ability to implement.

The level of choice with commingled investments can be limited however and we would be open to the overall impact of the fee structure, including its reasonableness and alignment.



John Zavone

IS THERE A NORMAL FEE STRUCTURE?



What less “vanilla” fee structures have you been offered or seen?
E.g. payment on Sharpe ratios. What is your view?



Anastassia
Juventin

That is a good question. Investor clawbacks are still not very common features. I have discussed a hurdle based on an achieved Sharpe but I have not seen one in practice / widely offered. A more unusual one that is already utilised across some funds is the “1 or 30%” structure, where the manager can choose to receive 30% performance fee and a 0 management fee, or a flat 1% management fee. However, when alpha is delivered, total fees paid will not exceed 30% resulting in the investor still receiving 70%. Another structure I have seen is where the performance fee increases after a certain net performance is delivered, say 10% on net returns up to 10%, and then a 20% performance fee on anything above net returns of 10%. (Just to note AMPC haven’t yet utilised any of these structures*)



Ben Samild

We have seen a few of these, the Texan ‘or’ structure, ascending Sharpe-based; fee caps; ascending return-based etc. We judge each on its merits. We think it’s very important to not be dogmatic.



Charles Wu

Given who we are (and our stakeholders) we tend to be pretty vanilla.



Keri Pratt



John Zavone

We have not really seen exotic fee structures beyond more vanilla performance fees.

ALIGNMENT OF INTERESTS



How do you assess fees with regards alignment of your interest to that of managers?



Anastassia Juventin

I think custom and bespoke fee arrangements do provide for better alignment of interests. In the idea world, managers would only be paid if returns are delivered, however that is not realistic! Inclusion of a performance-based fee and a hurdle are a simple and effective combination to create an alignment of interest where the investors and manager jointly benefit if the fund performs well.



Ben Samild

We do a detailed diligence on the utility of different fee structures for the manager and for us and try and arrive at an intersection of interests.



Charles Wu

From our perspective, there is a philosophical debate here. Some would say that managers don't need a large performance fee to do their job well for investors. Our view is it's all about trust and understanding between funds and investment managers. We have been prepared to back newer fund managers or existing managers launching new strategies and to share our insights/ provide our feedback on the work they have undertaken. In a couple of these situations, our managers have told us they appreciated the support and understanding and this has allowed them to go on and secure other clients/AUM. Trust and understanding can take you a long way.



Keri Pratt

Alignment is critical. The 'stick' of losing the mandate from poor performance is not as strong as the 'carrot' of extra dollars. While acknowledging, as commented in question 3, that paying a performance fee generally suggests members have gained through a higher net return, we believe that a better structure is one where the key staff at the investment manager invest their own money in the vehicle and the manager charges the fund a flat fee. We believe that structure provides a stronger alignment of interests and increases net returns for our members over the performance fee model. Clearly achieving that preferred structure is not possible in all cases and is certainly very difficult in some asset classes. But it is our preferred position.



Grant Harslett



John Zavone

We have used scenario and Monte-Carlo analysis as informative tools to evaluate the cost-benefit and alignment with clients. Using these tools, we can test for alignment with objectives, and whether the expected fee per unit of alpha looks like a fair deal for investors. This is particularly important if we are negotiating a fee structure.

FUTURE FEE EVOLUTION



How do you see fees evolving in the next 5-10 years?



Anastassia Juventin

Ultimately, both investors and hedge fund managers exist in a consistently evolving environment. Managers are likely to continue to be challenged to produce consistent performance, provide differentiated / customised solutions and competitive fees. The industry will continue to build mutually productive partnerships where fee structures will continue to evolve to the benefit of the investors, be it overall lower fees or more sophisticated fee structures with various features like HWM, hurdle rates, longer lockups for reduced fees or clawbacks becoming more standardised. Only significantly differentiated strategies with lower capacity and skilful managers are likely to be able to continue at current fee levels, and even those will face pressure if, for instance, they want to diversify client base. Across private markets, fee structures have been less impacted to date, however I do expect to see some consolidation there, standardization of features, and some more bespoke fee arrangements. The more commoditised strategies are likely to see further reduction in fees, alike to what happened during the shift to passively managed strategies in other asset classes.



Ben Samild

I think fees for top tier manager will only rise as we also see the alpha capture coalescing in these platforms. The rest of the industry should gradually decay like the broader active management industry.



Charles Wu

Our expectation is that the trend is towards lower (flat) fees for institutional investors here and elsewhere. Allocations to low cost passive strategies have continued to grow, as have allocations to factor-based or beta-enhanced strategies. The search for alpha, especially lowly correlated alpha sources continues.



Keri Pratt

We rigorously test alternative strategy return streams against traditional risk premia to ensure they are bringing something unique to the total portfolio. The true "alpha" is the piece of the return that we cannot naively replicate ourselves, and our view is that fees should primarily relate to this skill-based component of return. The industry has trended toward this view over time, and we would expect that to continue.



John Zavone

There also appears to be increasing appreciation of the quality of alpha streams, such as their skewness and consistency. These impact on their value to total portfolio outcomes, and may be a source of fee differentiation also.



AIMA AUSTRALIA
Tel: +61 412 224 400
Email: apac@aima.org