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Fees and Expenses

Deutsche Bank Alternative Investment Survey Explores Fee and Liquidity Trends, the Landscape for Investment Intermediaries and Early Stage Investment Terms (Part Two of Two)

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Deutsche Bank Global Prime Finance (DB) has released the results of its 13th annual Alternative Investment Survey. This article, the second of two-part coverage, summarizes the portions of the survey that address fee and liquidity trends; trends among intermediaries; and early stage investing and seeding. The first article described the survey methodology and demographics and summarized the portions of the survey that deal with allocations to alternative investments in general, and to hedge funds in particular; allocation plans by strategy and region; and investor preferences regarding hedge fund track record, minimum size, and initial and target investment ticket sizes. For coverage of DB's November 2013 survey, see "Deutsche Bank Survey Describes the Contours of the Nontraditional Hedge Fund Product Market: Investor Appetite, Performance, Marketing, Fees and More," Hedge Fund Law Report, Vol. 7, No. 3 (Jan. 23, 2014).

For more on fees, liquidity terms and early stage investments, see "Sidley Partners Discuss Evolving Hedge Fund Fee Structures, Seed Deal Terms, Single Investor Hedge Funds, Risk Aggregators, Expense Allocations, Co-Investments and Fund Liquidity (Part One of Two)," Hedge Fund Law Report, Vol. 7, No. 36 (Sep. 25, 2014).

Fee Terms

As indicated in the first article, survey participants included 435 public and private pensions, sovereign wealth funds (SWFs), endowments and foundations and insurance companies (collectively, institutional investors); investment consultants and advisers (collectively, consultants); funds of funds (FOF), asset managers and "outsourced" chief investment officers (CIOs); and other investors, including family offices, private banks and wealth managers.

On average, survey participants said they paid management fees of 1.65% and performance fees of 18.03%, and institutional investors as a class said they paid management and performance fees of just 1.57% and 17.71%, respectively. DB asked participants to choose the "most persuasive argument" for fee reductions. The greatest proportion of institutional investors (29%) cited a willingness to lock up capital. The top answer among consultants (30%) was that a fund had "a

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strong beta element." The top answer for all other participants (29%) was willingness to invest on day one.

Most participants indicated that they negotiated fees in every allocation (32%) or in specific situations (44%). DB received similar responses in its 2013 and 2014 surveys. Sixty percent of pensions negotiate fees in every instance. Institutional investors as a group were most likely (86%) to negotiate fees some or all of the time, an increase from just 67% in 2013. Family offices, private banks and wealth managers were least likely to negotiate fees. DB noted that a growing proportion of FOF negotiate fees in every instance (35%, up from 26% in 2013), calling this "one of the primary ways in which funds of funds differentiate themselves from their peers." Most institutional investors and FOF negotiate fees some or all of the time. DB found that institutional investors and FOF with more than $5 billion in assets under management (AUM) were much more likely than their smaller peers to negotiate fees in every instance. Ninety-five percent of respondents who negotiate fees negotiate management fees. More than two-thirds (68%) negotiate both management and performance fees. Very few negotiate only performance fees (3%) or some other fee (2%).

DB found that the proportion of respondents who reported that they were successful in negotiating fees at least half of the time has grown steadily, from 29% in 2013, to 37% in 2015. Such respondents had average AUM of $5.6 billion, had average ticket sizes of $70 million and incurred lockups of at least one year. The most successful negotiators appear to be pensions and FOF/asset managers, of which 44% and 42%, respectively, reported success at least half of the time. The least successful by that measure were insurance companies and consultants, only one-fifth of which reported success at least half the time. Even when unsuccessful in negotiating fees, nearly two-thirds of participants said they would invest anyway "most of the time" (57%) or every time (6%). Thirty percent would proceed "rarely," and 6% would always walk away.

In the survey, 55% of participants said they would allocate to a manager that charged fees in excess of 2% / 20%, compared with just 48% in the prior survey. Consultants were the most likely (62%) to consider such a fee structure, whereas endowments/foundations were the least likely (32%) to consider it. Fifty-nine percent of respondents cited strong performance in absolute terms as the most persuasive argument for accepting higher fees; 25% cited outperformance of peers.

Most respondents reported paying average management fees in the range of either 1.26%-1.5% (23% of respondents); 1.51%-1.75% (35%); or 1.76%-1.99% (26%). Only nine percent paid 2% or more. A much greater proportion of institutional investors (12%) reported average fees of 1.01%-1.25% than respondents overall (5%). Compared with 2014 results, the proportion of respondents paying between 1.51% and 1.99% has fallen, and the proportion paying 1.5% or less has grown. DB cites this as evidence that management fees continue to decline gradually.

The greatest proportion of respondents (44%) reported paying average performance fees of 17.51%-19.99%. Just over one-fifth pay 20%, and nearly one-quarter pay 15.01%-17.50%. The results for the subset of institutional investors were similar. Forty-four percent of private banks/wealth managers and 43% of insurance companies would pay a full 20% performance fee, the highest proportions of any respondent subset. Most respondents (84%) said that managers should have a hurdle rate. Of them, 81% would prefer LIBOR or LIBOR plus a spread; the rest would prefer a fixed percentage.

For more on hedge fund fee terms and fee pressures, see "Infovest21 White Paper Provides Industry Perspectives on Hedge Fund Fee Pressures, Expense Allocations and Liquidity Terms," Hedge Fund Law Report, Vol. 6, No. 31 (Aug. 7, 2013).

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Liquidity Terms

DB reported that the proportion of respondents willing to accept lockups has remained relatively constant over the past few years. This year, 37% of respondents said that the longest lockup they would accept was either a one-year hard (23%) or soft (14%) lockup. Just over half would accept a hard or soft lockup of two years or more. Eleven percent would only accept a lockup of less than one year or would not accept any lockup. Respondents based in the Americas showed a much higher willingness to accept lockups of more than one year than those based in Europe, the Middle East and Africa (EMEA) or those based in the Asia-Pacific region (Asia). Private banks/wealth managers were the least likely to accept lockups of more than one year. In contrast, more than three-quarters of pensions said they would do so, the highest proportion of any subset of respondents.

About one-third of respondents have no liquidity requirements. Most require at least quarterly (42%) or monthly (14%) liquidity. The proportion requiring at least quarterly liquidity is higher than in 2014, while the proportion requiring monthly liquidity has fallen. Half of respondents said they prefer either a 30-day (30%) or 45-day (20%) notice period for liquidity; 29% expressed no preference. DB noted that private banks, as a group, required the most frequent liquidity and the shortest notice periods.

Most respondents (86%) said they would invest in a fund with either investor-level gates, fund-level gates or both – roughly the same proportion as in 2014, but somewhat higher than 2013, when 81% said they would accept gates. The proportion willing to accept both fund- and investor-level gates has grown to 60% in 2015 from 56% last year.

For more on liquidity terms, see "Sidley Austin Private Funds Conference Addresses Recent Developments Relating to Fund Structuring and Terms; SEC Examinations and Enforcement Initiatives; Seeding Arrangements; Fund Mergers and Acquisitions; CPO Regulation; JOBS Act Implementation and Compliance; and Derivatives Reforms (Part One of Three)," Hedge Fund Law Report, Vol. 6, No. 41 (Oct. 25, 2013).

Intermediaries

Funds of Funds / Asset Managers

DB notes that there are now about 100 FOF with at least $1 billion in AUM, a number comparable to 2012. However, the assets managed by FOF in the so-called "Billion Dollar Club" have grown dramatically in that time, from about $600 billion to $762 billion. Sixty percent of FOF/asset managers that participated in the DB survey had more than $1 billion in AUM. Their assets were concentrated in the biggest firms. Thirteen percent of FOF/asset managers in the survey reported more than $10 billion in AUM; those firms held 55% of all FOF/asset manager assets represented in the survey. Most FOF/asset managers indicated that their AUM either increased (55%) or stayed the same (32%) in 2014. Ninety percent of the FOF/asset managers with more than $10 billion in AUM increased those assets in 2014; none lost assets.

Since 2008, FOF/asset managers as a group have moved away from discretionary commingled accounts to discretionary bespoke accounts and advisory accounts. This year, 59% of their business consisted of commingled accounts, compared with 74% in 2008. Bespoke accounts accounted for 26% of their business in 2015, compared with 18% in 2008. Similarly, 15% of their business consisted of advisory accounts in 2015, compared with just 8% in 2008. DB found that

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in 2015 FOF/asset managers with more than $10 billion in AUM derived a greater proportion of their business from bespoke accounts (44%) than from commingled accounts (41%); in contrast, in 2008 they derived 31% of business from commingled accounts and 61% from bespoke accounts. The proportion of FOF/asset manager AUM derived from institutional investors has grown significantly since 2008; of all FOF/asset managers, those with more than $10 billion in AUM derive the greatest proportion of their assets from institutional investors. For example, in 2015, 81% of such firms derived at least 75% of their AUM from institutional investors, compared with just 62% of such firms that did so in 2008.

One-third of respondents said they use FOF. Of those that do, nearly half use FOF for commingled products; 41% use them for discretionary mandates; and 31% use them for advisory business. Consultants (60%) were the respondents most likely to use FOF, followed by pensions (48%). Family offices (18%) were least likely to use them. Access to niche strategies was the most commonly cited "main benefit" of allocating to a FOF. It was the first choice for one-quarter of respondents and a "top-three" choice of more than one-third of respondents. Knowledge sharing and access to capacity-constrained strategies were the second and third most commonly cited benefits. There was somewhat less interest in access to emerging managers. See "SEI Report Highlights Challenges Faced by Fund of Hedge Funds Industry and Recommends Improvements," Hedge Fund Law Report, Vol. 5, No. 47 (Dec. 13, 2012).

Consultants

Consultants made up 11% of survey respondents by number and 30% by hedge fund AUM. More than half of consultant respondents said they advise with respect to more than $1 billion of hedge fund assets. Twenty-eight percent of consultants said they advise with respect to more than $10 billion; those consultants account for 89% of the hedge fund assets of all consultants in the survey. See "Getting to Know the Gatekeepers: How Hedge Fund Managers Can Interface with Investment Consultants to Access Institutional Capital (Part One of Two)," Hedge Fund Law Report, Vol. 6, No. 27 (Jul. 11, 2013); and Part Two of Two, Vol. 6, No. 28 (Jul. 18, 2013).

Since 2008, investment consultants have moved away from purely advisory business. In 2015, 74% of such consultants' business was advisory, compared with 79% in 2008. During that time, their discretionary commingled business also fell, from 14% of total business in 2008 to 11% in 2015. In contrast, their discretionary bespoke business has grown from 7% of total business in 2008 to 15% in 2015.

About one-third of survey respondents in both 2014 and 2015 said they used investment consultants, compared with just 13% in 2008. They used consultants primarily for advisory business and for operational due diligence. Nearly two-thirds of pensions and nearly half of both endowments/foundations and insurance companies said they use consultants. Family offices were least likely to use consultants.

The reason most frequently cited by consultants for not researching a fund manager was lack of investor interest; it was one of the "top three" reasons cited by 74% of consultants. Other "top three" reasons cited by significant proportions of consultants included geographical location; having less than a one-year track record; having less than $100 million in AUM; and lack of internal resources.

Outsourced Chief Investment Officers

DB estimates that chief investment officers (CIOs) that had "complete discretion over all investments across all asset classes for their clients" had $500 billion in AUM in 2014, compared
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with just $100 billion in 2007. Most CIOs seek to manage a client's entire portfolio. However, DB found that some compete with FOF or consultants to manage only a client's hedge fund allocation. At the same time, DB found that some FOF and consultants are trying to develop outsourced CIO services to expand their own businesses. See "McKinsey Report Identifies Six Strategies for Competing Successfully in the Alternative Investment Business," Hedge Fund Law Report, Vol. 7, No. 31 (Aug. 21, 2014).

Early Stage Investing

Overall, 70% of respondents will invest within the first six months of a fund's life (early stage), including 51% that will invest on day one. DB found that early stage investing is concentrated among the largest allocators; just half of early stage allocators in the survey have more than $1 billion in hedge fund AUM but represent 96% of total hedge fund AUM. FOF/asset managers account for the greatest proportion (47%) of early stage allocators, followed by family offices (19%). Most early stage allocators are based in the Americas (65%) and EMEA (27%). Nearly one-third of early stage investors in the Americas and Asia said new launch opportunities look more attractive in 2015 than in 2014. Less than one-quarter of EMEA early stage investors see a more attractive environment. In each region, roughly half of the early stage investors see no change from last year. DB attributes the greater degree of uncertainty in EMEA to "regulatory uncertainty and changes."

Sixty-nine percent of respondents indicated that they would consider early stage investments with managers with whom they have a strong pre-existing relationship. Just over half would invest in a new fund launched by an established manager. Nearly half would invest with an emerging manager with a "strong pedigree" or significant AUM at launch. Forty percent regularly invest with emerging managers as part of their investment strategy.

Nearly two-thirds of respondents who can invest on day one do not have a minimum AUM requirement. Those that have a minimum require, on average, $145 million in AUM. Of the respondents that cannot invest on day one but can invest within the first six months, nearly three-quarters require a minimum AUM; the average requirement for such allocators is $175 million. The average minimum AUM required by allocators who do not make early stage investments is $386 million.

By far the most common method of early stage investing among survey respondents is through a founder share class with preferential terms; 91% said they use that method. Significant proportions also use anchor investing (36%), seed deals (24%), acceleration capital deals (11%) and platforms (7%), all of which offer preferred economics. Interestingly, 29% indicated that they would invest through a "standard share class." See "Report Offers Insights on Seeding Landscape, Available Talent, Seeding Terms and Players," Hedge Fund Law Report, Vol. 8, No. 1 (Jan. 8, 2015).

Founder Shares

DB estimated the weighted average management and performance fees paid by investors in founder share classes to be 1.26% and 14.10%, respectively. The most commonly cited management fee was 1% (cited by 48% of respondents), followed by 1.5% (23% of respondents) and 1.25% (14% of respondents). The most commonly cited performance fee was 15% (cited by 53% of respondents), followed by 10% (26% of respondents) and 17.5% (10% of respondents). Thirty-one percent of founder class investors agreed to a one-year soft lock; 25% agreed to a

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one-year hard lock; and 19% agreed to lockups of more than a year. One quarter of such investors had no lock up at all. See "How Can Hedge Fund Managers Use Founder Share Classes to Raise and Retain Capital?," Hedge Fund Law Report, Vol. 5, No. 28 (July 19, 2012).

Seed Capital

Twenty-four percent of early stage investors in the survey said they offer seed capital. Of those that revealed their business model, most said they take a revenue share of the fund's general partner. Others take an equity stake in the general partner. Others use a venture capital or incubator model. All seeders indicated that they are subject to lockups, with the vast majority of them having either one-year (30%), two-year (28%) or three-year (36%) lockups. Six percent commit to four or more years.

The weighted average seeding ticket was $55 million in this year's survey, nearly twice what it was in 2013 ($30 million). DB expects seeding activity to be slightly higher in 2015 than last year. Of the seeders who revealed how many seed deals they anticipated for 2015, just over one-third expect to seed a single deal; about two-fifths expect to seed between two and four deals, and the rest do not expect to seed any deals.

For more on seeding terms and negotiating seeding arrangements, see "Participants at Eighth Annual Hedge Fund General Counsel Summit Discuss Terms with Institutional Investors, Seeding Arrangements and the Convergence of Mutual Funds and Hedge Funds (Part Four of Four)," Hedge Fund Law Report, Vol. 8, No. 7 (Feb. 19, 2015); and "Sidley Partners Discuss Trends in Hedge Fund Seed Deals, Governance, Succession, Estate Planning and Tax Structuring (Part Two of Two)," Hedge Fund Law Report, Vol. 7, No. 37 (Oct. 2, 2014).

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