

In Sync

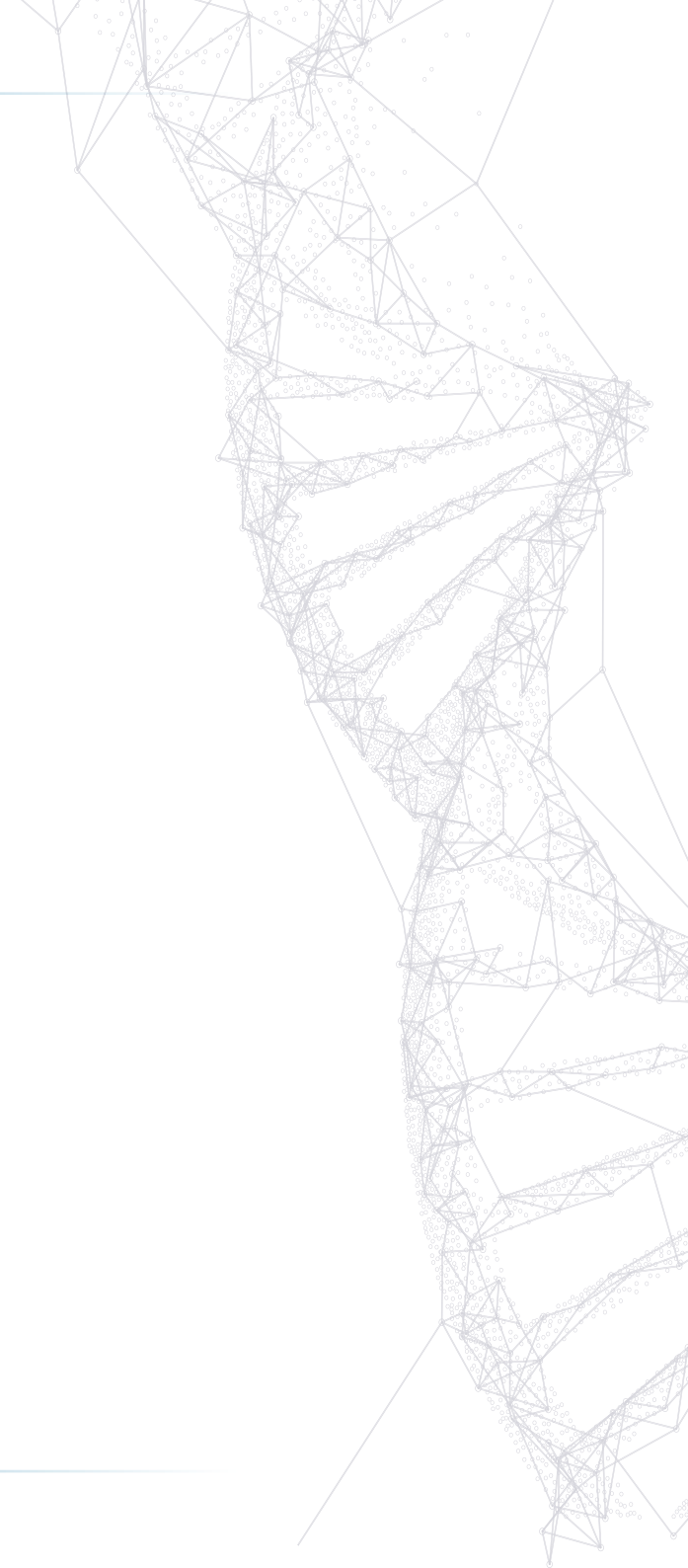
How hedge funds achieve alignment with investors to foster long-term strategic partnerships

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Foreword

When you strip away the lively discourse around the outsized returns that some alternative investment fund managers can generate, the proactive efforts to align their interests with their investors are arguably the most attractive aspect of their offering.

The entwining of the personal prospects of principals and those that entrust their capital to them is baked into the DNA of alternative investment fund structures, and the most successful managers are those that are most in sync with their clients' demands.

The core of this ethos is demonstrated by the increasingly large amount that these fund managers have in their own firm's success. Not only principals but other key staff are also expected to have their capital in the fund as a way of demonstrating to their firm and underlying investors that they are committed to the mission.

Every aspect of the GP/LP offering from the fee model and performance incentives to the products offered includes characteristics designed to ensure that when the fund manager does well, the investor does well, and the fund manager only does well when the investor does well.

Of course, what an optimal model of alignment looks like is a moving target and competition among fund managers and the changing mandates of investors are drivers of change. This evolution has been tracked by AIMA for almost a decade and this third iteration of market research seeks to identify how the key trends are changing.

We would like to thank AIMA's research committee and its Global Investor Board for their valuable input and for taking the time to discuss these findings. We would also like to thank the various managers who provided the number of testimonials included throughout this paper. Finally, we thank you for your time in reading this paper. We hope you enjoy it.



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Acknowledgments

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Methodology

This paper represents the latest research by AIMA to shed light on the relationship between GPs (fund managers) and LPs (investors), with the aim of identifying where the needs of investors are being met and the extent to which the priorities of both parties align.

We previously focused on this topic in 2019 in the report [In Harmony](#) and this paper offers a time series analysis of how trends have changed since then.

Where we have included previous analysis, these are referenced by a 

The paper is built upon the findings of a survey of 138 alternative investment fund managers with an estimated aggregate of \$707 billion in assets under management.¹ The average AUM of fund managers surveyed is \$5 billion, up from \$3.7 billion in 2019, (see **figure 1**).

Broken down by strategy, a quarter of all fund managers surveyed are long-short equity managers, with 14% multi-strategy managers and 13% are private credit managers, (see **figure 2**).

Respondents are divided by size (see **figure 3**). Where we refer to larger managers, these include managers with more than \$1 billion AUM and those with AUM of less than \$1 billion are referred to as smaller managers. The fund manager survey is complemented by a separate survey of 35 institutional investors that allocate to alternative investment funds to get their perspectives on key opportunities for alignment of interests. More than half of these investors allocate more than \$2 billion to alternative investment funds, while the average is \$1.3 billion.

The conclusions drawn in this report are primarily based on the data from these surveys and enhanced by trend analysis by managers and investors who were interviewed after the survey closed.

Figure 1, What is the AUM (in terms of net asset value US\$m) of your alternative investment firm?

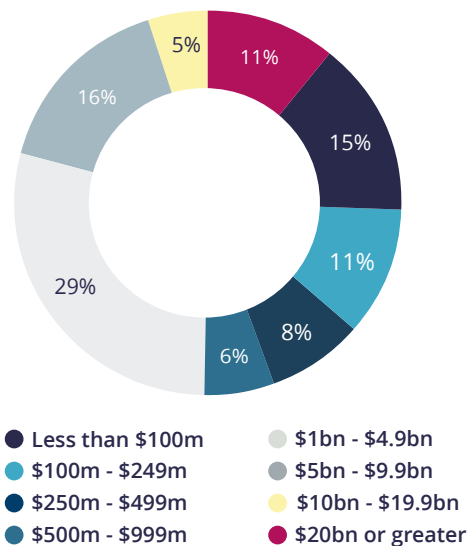


Figure 2, What is the primary investment strategy of your principal flagship fund?

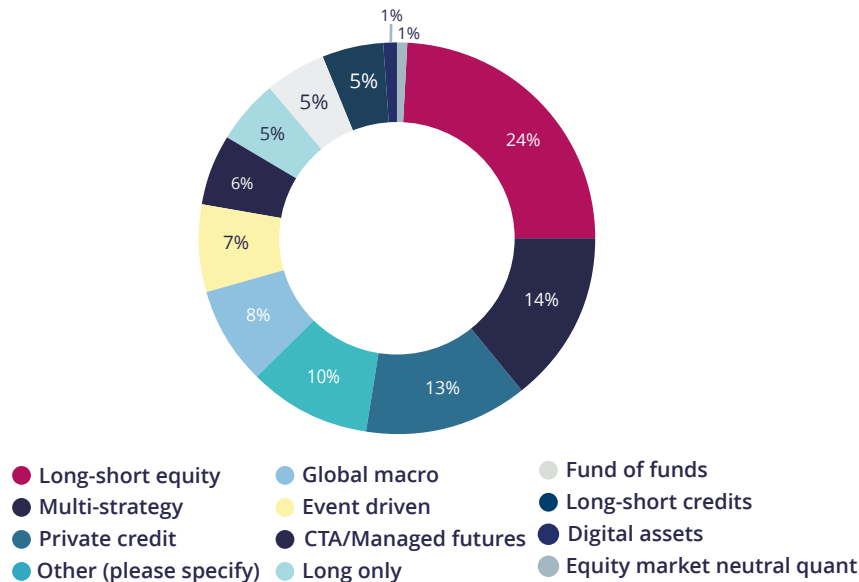
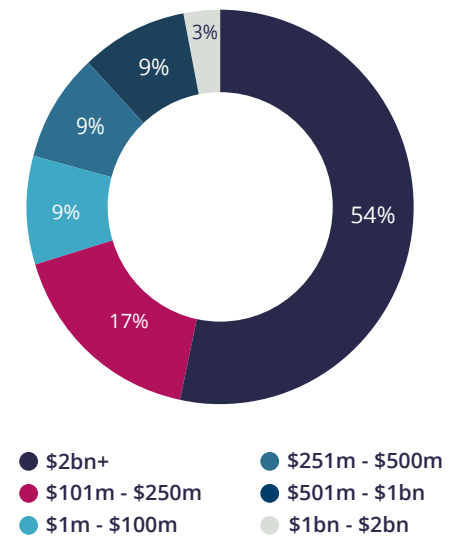


Figure 3, What is the total amount of capital that you invest in alternative investment funds?



Executive summary

Part I. Aligning interests: The fundamentals

For managers, having significant personal capital invested in their fund remains central to reassuring their investors that their interests are aligned. This strong foundation to the relationship is now being built upon the application of greater transparency around the portfolio to facilitate more granular attribution analysis by investors, as well as more flexibility around fees and expenses and other aspects of the business.

Part II. The modern fee model

After years of downward pressure on fees, many investors and fund managers have settled on a new fee model that emphasises rewarding fund managers that can consistently deliver strong performance, albeit with more stringent hurdles to clear. In turn, managers have had to innovate how they charge fees and manage expenses through the use of new product structures and share classes that reward longer lock-up periods in exchange for fee discounts. While management fees remain below the historic 2% level, rising operational costs are being supplemented by more fees being charged to the fund pass-through to investors.

Part III. Innovating to maintain alignment

Fund managers are innovating their offering to win and retain investors with new fund structures and the launch of new products. Specifically, the increasing popularity of co-investment products in the hedge fund space may be providing the ideal vehicle for aligning interests. Relationships are being further deepened through strategic knowledge sharing and sophisticated conversations around complex issues incorporating ESG and responsible investment to the investment experience to ensure investors and their managers are aligned.

Part IV. ESG: adapting to the changing landscape

Responsible investment has entered a new phase. The macroeconomic headwinds of the moment are demanding a more nuanced ESG strategy that transcends binary exclusion lists and is only applied where relevant.

Skin in the game

The central pillar for securing a strong alignment of interests between managers and investors remains how much skin they have in the game (i.e., the personal capital invested in the fund by the principals). Having skin-in-the-game is one of the key differentiators that align interests between alternative investment fund managers and their investors more closely than other fund types, such as mutual funds, which rarely share this characteristic.

When asked how they primarily align interests with investors, over three-quarters of fund managers surveyed said it was achieved through having a significant personal investment in their own funds, a trend that was also clearly visible in our 2019 report.

Interestingly, one might expect the average investment of principals in their fund to have decreased since 2019 given the average fund size (of fund managers that we surveyed) has before increased from \$3.7 billion to \$5 billion.

In fact, we observe the opposite.

Average investment is 8% this time, up from 6% in 2019, (see **figure 4**). Larger managers (with greater than \$1 billion in assets under management) have an average investment of 7% compared to 9% for smaller managers.

Figure 4

| Average % AUM invested by principals and employees | |
|--|--------|
| Overall | 8.01% |
| Less than \$1 billion | 9.33% |
| Greater than \$1 billion | 6.95% |
| By AUM breakdown | |
| Less than \$100m | 11.00% |
| \$100m - \$249m | 10.68% |
| \$250m - \$499m | 7.45% |
| \$500m - \$999m | 6.00% |
| \$1bn - \$4.9bn | 5.58% |
| \$5bn - \$9.9bn | 6.86% |
| \$10bn - \$19.9bn | 6.38% |
| \$20bn or greater | 7.50% |

Broader skin in the game

One reason put forward for the increased investment by fund principals and employees is that investors are keen to see the investment extend beyond the principals, to include highly skilled investment executives who work in the fund. Given the intensifying war for talent, having principals and investment executives lock personal investments in the fund can encourage them to remain with the manager and offers investors greater comfort that they value their partnership with the investor.

[AIMA's 2021 paper Gaining an Edge](#) found that almost all of the 100 fund managers surveyed were 'somewhat' or 'very concerned' about talent retention in the near term. It is therefore unsurprising that almost all the respondents (98%) to this survey said their principals and employees are invested in the fund or are able to do so.

Demand for greater transparency is building

The results of this year's research reveal that fund managers are most likely to offer greater transparency of their fund as a way of reassuring investors that their interests are best aligned.

Transparency can be achieved in a variety of ways depending on the fund type, with managed accounts or 'funds of one' offering a much greater look-through to the portfolio compared to being invested via a commingled fund. Visibility of the portfolio can also be offered through regular interactions with investors – which is where a robust investor relations team can shine. This year's research also highlights the high value investors place on general knowledge sharing and benefiting from regular market insights with their fund managers.



"Providing transparency is becoming more and more 'the norm', including even for funds who have historically closely guarded their data. And, generally speaking, the degree of information access is rising for investors across the board – not just for the largest institutions."

Benjamin Tisdale, Prelude Capital

"Historically, the larger investors have been able to exert more pressure and demand more transparency, but it is becoming more common place now."

This might be due to the increased use of consultants, however, it could also be due to managers realising that, unless there is an inherent risk in disclosure through greater transparency, this can actually be a selling point. There are real-world examples of a fund where retained an investor despite poor performance because the investor was happier with the levels of transparency from the manager."

Chief Operating Officer of a Large European Long-Short Equity Manager

Investors expect more from their fund managers in terms of the overall transparency that they provide regarding their business as well as the underlying portfolio. Multiple fund managers and investors interviewed said that the standard level of transparency of the fund was increasing, requiring new tools and best practices by fund managers. This included the smallest ones, which might previously have not been expected to have these processes in place. Feedback from investors and fund managers confirmed that all fund managers should get used to being more available to all their investors.

Any consideration for managers to offer greater transparency of their fund(s) should be weighed up against reasonable concerns about revealing their fund strategy's IP (secret sauce) and unintentionally disadvantaging the fund's investors.



"Transparency is a mixed bag - if an allocator has 50 managers and each manager has 50-100 positions - that could be 2,500-5,000 positions. It's probably challenging for an allocator to have the time to know each of those. This is why exposures may be more meaningful or valuable. And often transparency may be over-rated."

Michael Oliver Weinberg, Columbia Business School

"A decade ago, regulators were beating the drum for greater transparency. It seemed like only a matter of time before enhanced disclosures were mandated. With greater investment alignment, transparency practices have evolved organically, largely superseding the need for regulatory intervention."

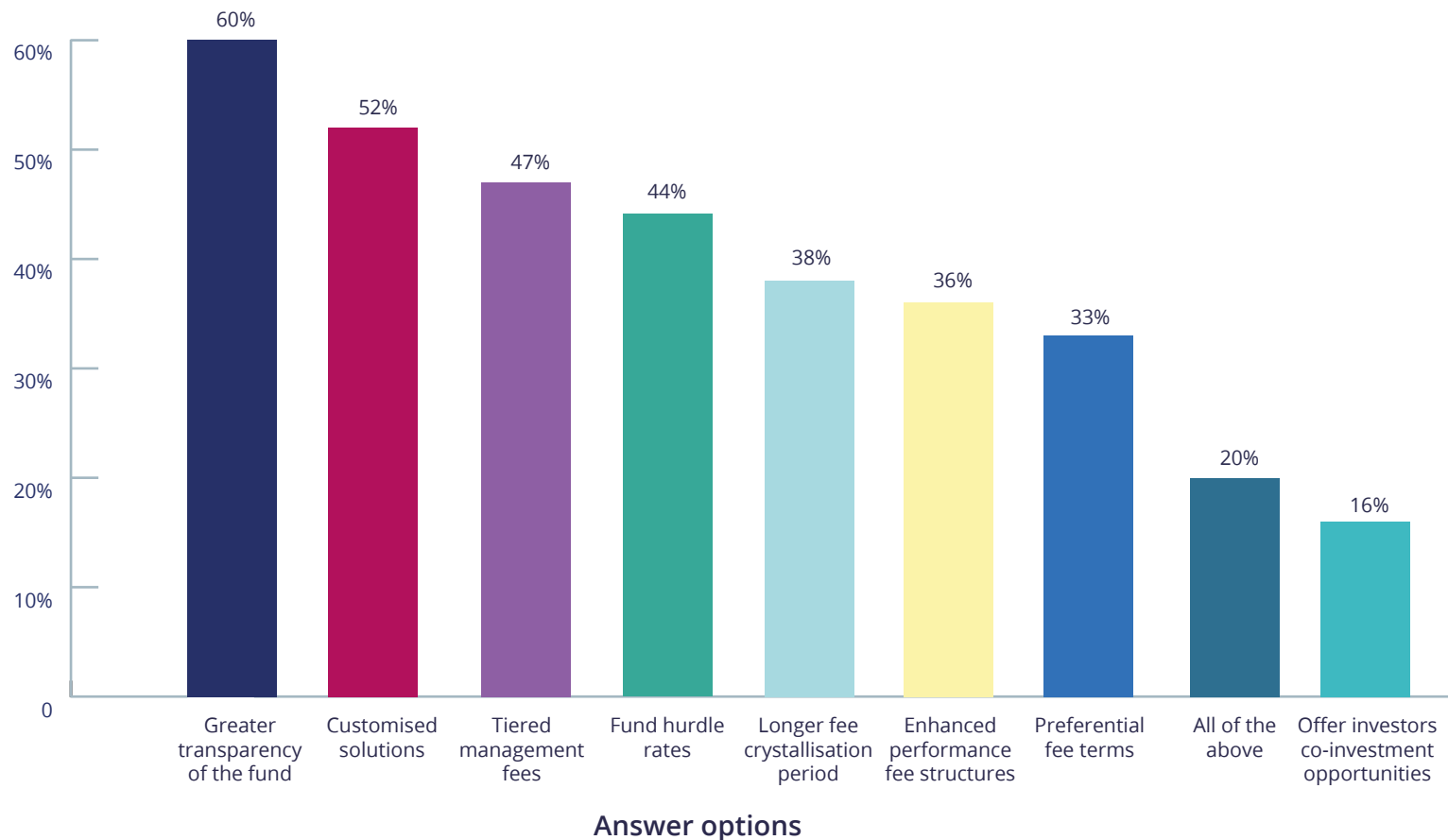
Scott Mackey, Asset Management Audit Leader, RSM US LLP

At the same time, secondary consequences of these demands may be increased costs resulting from additional reporting and the risk of fund principals and their employees being taken away from their trading desks. With all this in mind, it is vital that managers and investors clearly establish where their priorities lie in balancing granular oversight and costs.

To give a sense of the journey that fund managers and investors have been on, we can compare a 2019 question that asked them what they *could* do to improve the alignment of interests, and a 2022 question that investigated what they *are* doing – the results are telling.

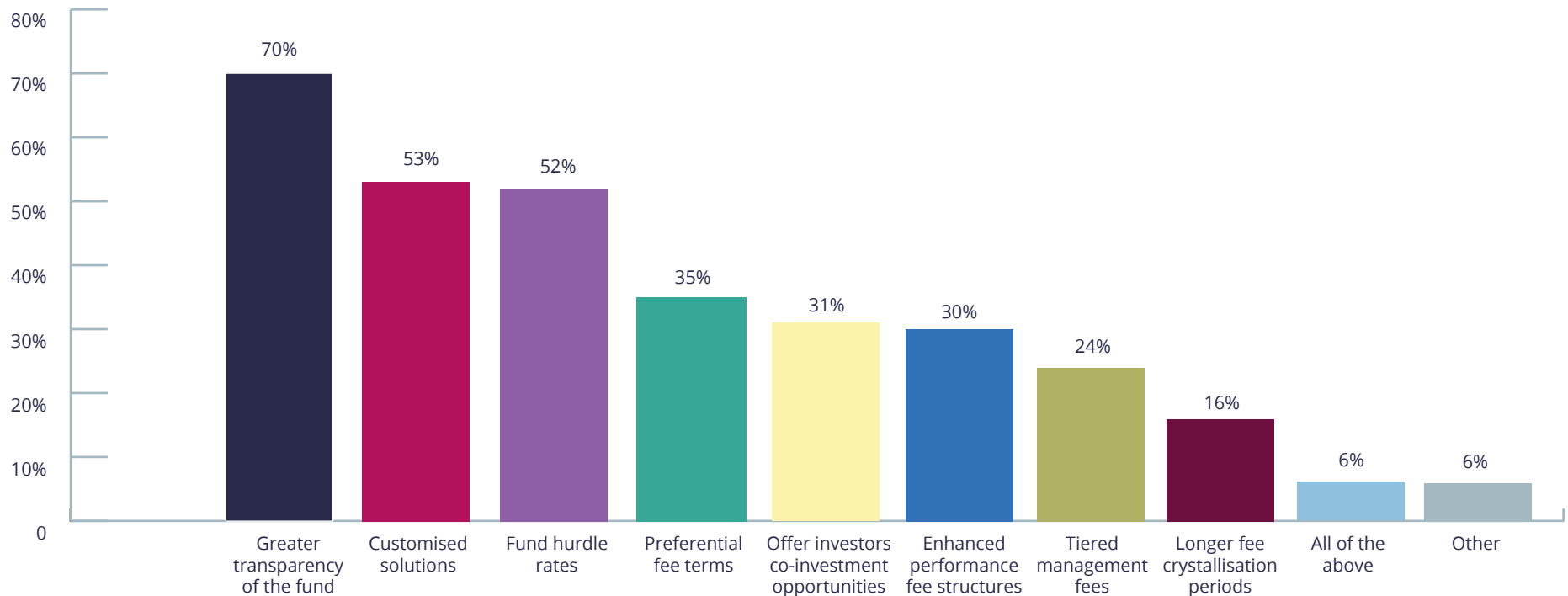
In 2019, 80% of fund managers (including 20% of respondents who said 'all of the above') cited greater transparency as the primary area of improvement, followed by a need for more customised solutions and tiered management fees (see **figure 5**).

 **Figure 5, (2019) What terms could your firm offer investors to better improve their alignment of interest with them? Please check all that apply.**



By comparison under half of managers said they going to offer even greater transparency, suggesting that the new threshold of visibility of the portfolio they are willing to show has been reached (see **figure 6**).

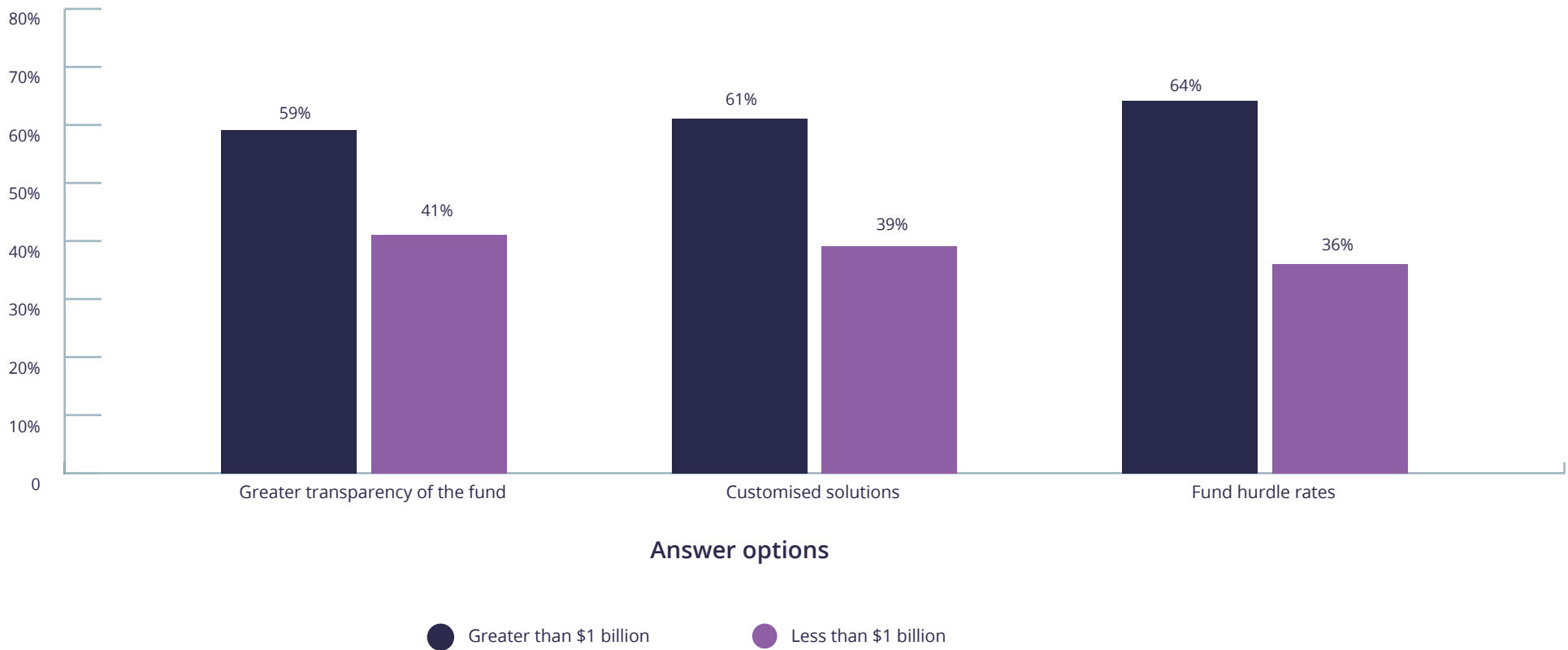
Figure 6, What terms does your firm offers investors in order to better improve their alignment of interest with them. Please check all that apply.



Answer options

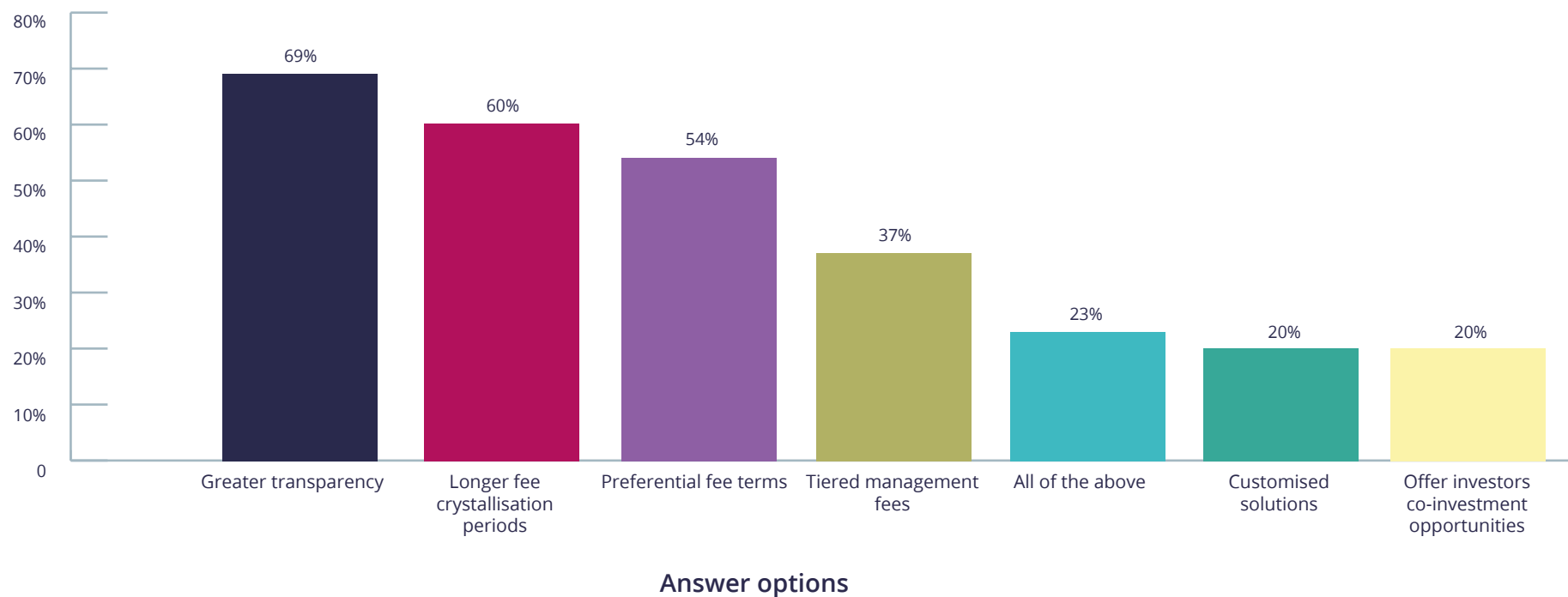
Notably, the data reveals a clear divide between the steps being taken by larger and smaller fund managers (see **figure 7**). Larger managers with more than \$1 billion under management are far more likely to offer fund hurdle rates, customised solutions, and greater transparency of the fund, compared to their smaller peers. This may in part be due to the need to meet the more demanding terms of institutional investors.

Figure 7, What terms does your firm offers investors in order to better improve their alignment of interest with them. Please check all that apply.



More may yet need to be done however, as investors surveyed overwhelmingly point to 'greater transparency of the fund' as an area where managers could further improve (see **figure 8**). Almost all (92%) investors highlighted the need for yet more transparency, while various amendments to fee models were also popular choices.

Figure 8, From the list below, please check the ways you believe alternative investment funds could better improve alignment of interest with their investors. Please check all that apply.





Relationship management

Away from the fundamentals of generating returns for their investors, the most important feature for managers seeking to align interests is the desire to create a 'stickier ticket', i.e., create an appealing offering for investors to dissuade them from redeeming their capital (see **figure 9**). This could be achieved through offering bespoke products, or providing access to new investments, and/or offer favourable pricing for long-term investors, among other methods.

Knowledge sharing was a close second which reinforces the notion that an optimal relationship between investors and their fund managers is a partnership that works for mutual success by discussing trade ideas and market insights, as opposed to a more standard service provider relationship. Notably, the desire to create a stickier ticket was a popular choice across both smaller and larger fund managers, as well as by fund strategy.

"Knowledge sharing may be a big part of the attraction for us and the funds we invest in. Managers may also act as consultants to create a stickier ticket and go beyond being just a hedge fund. If they're big enough, however, there is one material caveat - that irrespective of this one would want to be invested due to the merits of the fund.

Otherwise, there would be questions that arise with respect to observing one's fiduciary duty, if one is staying invested for reasons other than performance. Moreover, it may be less expensive to hire a third party consultant and pay a different manager with higher returns and/or lower fees."

Michael Oliver Weinberg,
Columbia Business School

Figure 9

| Breakdown of options by size and strategy (%) | | | | | | | |
|---|---------|-----------------------|--------------------------|-------------------|----------------|----------------|--------------|
| Options | Overall | Less than \$1 billion | Greater than \$1 billion | Long-short equity | Multi-strategy | Private credit | Global macro |
| Stickier ticket with investors | 33 | 34 | 32 | 35 | 20 | 34 | 30 |
| Knowledge sharing | 28 | 29 | 27 | 30 | 28 | 26 | 34 |
| Cross selling opportunities | 19 | 17 | 20 | 16 | 23 | 20 | 22 |
| New product development | 20 | 20 | 20 | 19 | 28 | 19 | 13 |

i. Fee structures

When writing "In Harmony" in 2019, we noted that fund managers and investors were moving towards a new equilibrium. The focus being no longer fee centric. rather investors and fund managers exploring better ways (via fees and fund terms agreed between both parties) to ensure both parties' expectations are best met. The results of this year's survey confirm this shift.

There is a wider recognition that fund managers who can deliver outperformance for their clients over a sustained period, are entitled to be compensated for the fees that align with the costs of running their business and any performance is also duly rewarded.



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

The management fee represents a percentage of the AUM of the firm charged by the fund to manage the firm's assets – including day-to-day operating expenses – while the performance fee represents the fund's claim on a portion of the total profits earned by the fund's investments.

Figure 10, What is the standard **management fee** charged by your flagship fund?

| 2019 Average management fee | | 2022 Average management fee | |
|------------------------------|-------|------------------------------|-------|
| Total average management fee | 1.30% | Total average management fee | 1.39% |
| Strategy | | Strategy | |
| Event driven | 1.50% | Event driven | 1.32% |
| Global macro | 1.12% | Global macro | 1.41% |
| Long-short equity | 1.35% | Long-short equity | 1.47% |
| Multi-strategy | 1.23% | Multi-strategy | 1.40% |
| Private credit | N/A* | Private credit | 1.35% |
| AUM | | AUM | |
| Less than \$1 billion | 1.64% | Less than \$1 billion | 1.39% |
| Greater than \$1 billion | 1.33% | Greater than \$1 billion | 1.40% |

*Data for private credit was not recorded in 2019

ii. Management fees

With costs continuing to rise across the industry (aggravated by a ferocious war for talent, the need to digitise the business, not to mention the relentless pace of regulatory and compliance change), there is a clear sense that a tipping point has been reached regarding the headline fee that fund managers charge to support the operation of their business. In addition, the strong performance from the industry over the past two years (with hedge funds on average offering the best set of returns over a passive investment/ETFs) has allowed some fund managers to push forward their case to receive higher compensation.

While the average headline fee has seen a modest shift upward from the 2019 result, notably 80% of fund manager respondents have not changed their management fee over the past three years. Where hedge funds can demonstrate that they can deliver outperformance on a consistent basis, investors are happy to pay the necessary headline fee, but will continue to challenge fees being charged by funds that cannot do so.

Headline management fees being charged by emerging managers continue to decline, with the average management fee for the smallest funds being 1.18% (see **figure 11**).

The investors that we spoke to acknowledge the importance of the management fee to cover the operational costs of running their business. Depending on the hedge fund's stage of life, it is critical to ensure that there is an appropriate balance between the headline management fee that a fund manager charges its investor and the need for it to be sufficient to cover the costs of running a fund.

Our sense is that while headline fees will gradually move up, we are unlikely to see a return to the historical 2 & 20 flat fee model. Rather, we will continue to see a variety of more customised fee arrangements (between fund managers and their investors), and where the headline fee falls short, managers will look to pass through additional expenses to investors to help them meet rising operational costs (we will discuss this in more detail in the next chapter).



Management fees continue to vary across the industry. A higher management fee may be charged depending on the sophistication of the investment strategy and the resources required to implement it. Some investment strategies demand continuous investment in technology and/or research and development costs.

Figure 11, What is the standard **management fee** charged by your flagship fund?

| AUM Range | Average management fee |
|-------------------|------------------------|
| Less than \$100m | 1.18% |
| \$100m - \$249m | 1.57% |
| \$250m - \$499m | 1.39% |
| \$500m - \$999m | 1.46% |
| \$1bn - \$4.99bn | 1.41% |
| \$5bn - \$9.9bn | 1.37% |
| \$10bn - \$19.9bn | 1.39% |
| \$20bn or greater | 1.38% |

iii. Performance fees

Performance fees are structured in a way so that any out-performance generated is split appropriately between fund manager and investors. The performance fee is only charged when the fund's profits exceed a prior agreed upon level, subject to various conditions being also met.



The main incentive of a performance fee is to give the fund manager an incentive to generate positive returns.

Figure 12, What is the standard performance fee charged by your flagship fund?

| 2019 Average performance fee | | 2022 Average performance fee | |
|-------------------------------|--------|-------------------------------|--------|
| Total average performance fee | 16.09% | Total average performance fee | 17.31% |
| Strategy | | Strategy | |
| Event driven | 16.07% | Event driven | 17.10% |
| Global macro | 18.94% | Global macro | 18.70% |
| Long-short equity | 17.24% | Long-short equity | 17.80% |
| Multi-strategy | 17.69% | Multi-strategy | 18.80% |
| Private credit | N/A* | Private credit | 16.10% |
| AUM | | AUM | |
| Less than \$1 billion | 14.60% | Less than \$1 billion | 17.17% |
| Greater than \$1 billion | 17.57% | Greater than \$1 billion | 17.90% |

*Data for private credit was not collected in 2019

High watermark remains the dominant mechanism

As per the findings throughout our research into the alignment of interests, the high watermark continues to be the dominant mechanism used by investors to help ensure fund managers only get compensated on any net new increases in the fund's asset value. The high watermark can be calculated over the whole lifespan of the fund since inception (perpetual high watermark) or over a fixed duration of time (annual high watermark). In the latter case, the high watermark would be reset at the start of a new period.

Multi-year rolling high watermark

Recent years have seen the emergence of a multi-year rolling high-watermark. Closer examination of the responses that have this arrangement are private credit funds, two thirds of which are smaller fund managers.

Typically, credit cycles tend to occur over three years resulting in fund managers and investors structuring any performance-based fees to align with that objective (i.e., to have any performance be judged over the course of the credit cycle).



The high watermark is a measure used to ensure that a performance fee is only charged when a fund's value at the end of its term is above its previous level at the end of a performance period (i.e., any performance fee is paid on new profits, not on profits received from previous losses).

Hurdle rates

Increasingly, hurdle rates are being considered a prerequisite in any performance compensation arrangements between fund managers and their investors, especially with regard to any new fund launches.

As per the findings of this survey, one in every two fund managers uses a hurdle rate, up from one in three in 2019 with larger managers tending to use them more than smaller fund managers, (see **figures 13** and **14**).



When setting up a fund, investors can agree with the fund managers on a hurdle rate, that is the minimum return above which fund managers will receive a share of any profits earned for its investors. Put another way, hurdle rates are benchmarks that fund managers must beat to be rewarded.

Figure 13, Do you use hurdle rates in the design of the fund's performance fee?

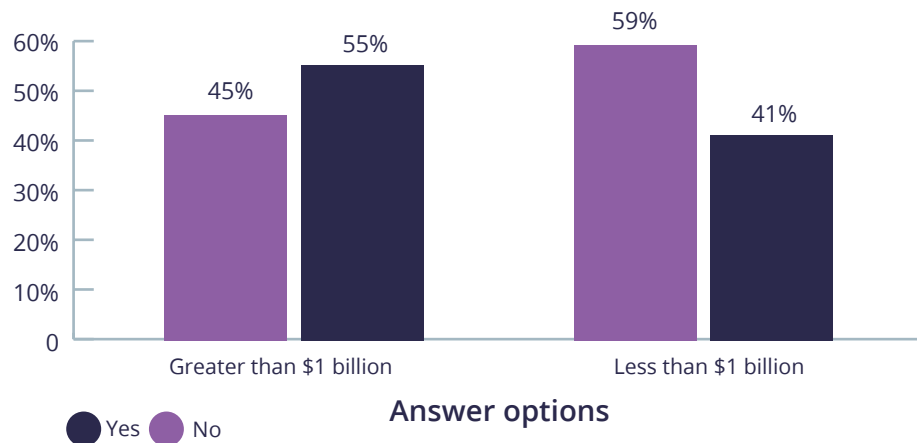
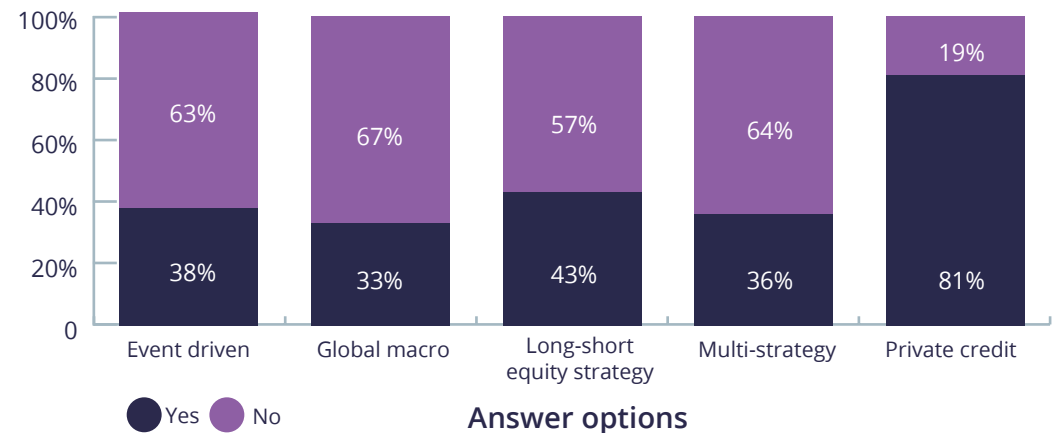


Figure 14, (2019) Do you use hurdle rates in the design of the fund's performance fee?





Many variations of hurdle rates

There are many variations to the types of hurdle rates being agreed between fund managers and their investors. Some funds require the investment manager to achieve a certain level of return, either as a fixed benchmark rate (such as SOFR or SONIA) or the rate of return from an equity benchmark (such as the return from the S&P 500 index) before managers are entitled to receive performance compensation. Others may agree a fixed based percentage of return as a hurdle rate, while some prefer a pre-agreed alpha hurdle rate.

An interesting type of hurdle rate is the so called 'soft' hurdle rate. Using this measure, a hedge fund charges an incentive fee on all profits, but only if the fund's rate of return exceeds a stated benchmark. With a hard hurdle rate, a hedge fund charges an incentive fee only on the portion of returns that exceed a stated benchmark.



Take care to not set hurdle rates too high

Setting high hurdle rates can perversely incentivise taking on higher risks. Faced with decreasing yield opportunities and having to work with a relatively high hurdle rate (as requested by investors), fund managers may be faced with no other choice but to take on more risks to meet their goals.

Endowment and foundations are typically required to pay out at least 5% of their asset value every year to satisfy the required tax treatment or status of its plan. Subsequently their targeted returns are generally around 7%+, to account for an assumed 2% inflation rate as well as between 25-50bps to pay for any additional expenses passed through to the fund. However, with inflation levels likely to trend in a range of 8%-12% over the short to medium term, this puts an entirely different complexion on what returns are needed for the investment portfolio.

Catch-up provision

One trend growing in popularity is the fund 'catch-up provision', whereby once a fund's 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.

As per the results of this survey, one in three fund managers have a catch-up provision set at 50% or greater which enables them to charge fees on the performance up to the hurdle rate. Among the more popular strategies that include this measure are private credit, multi-strategy and event driven funds.



How a catch-up provision works

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



Figure 15, (2019) Does your fund include a clawback agreement?

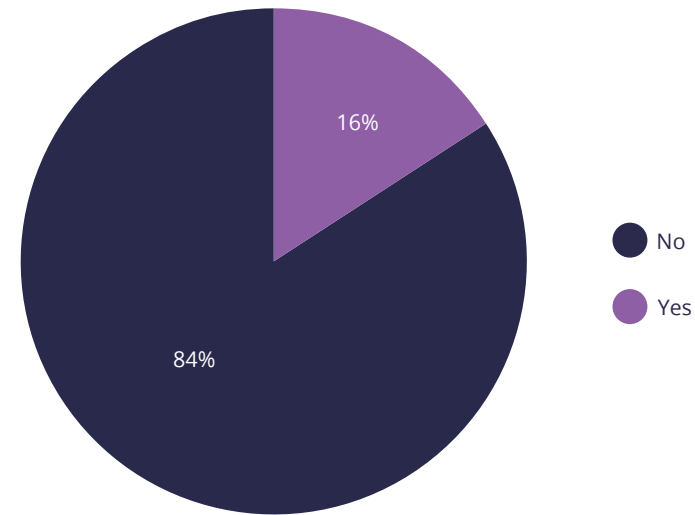
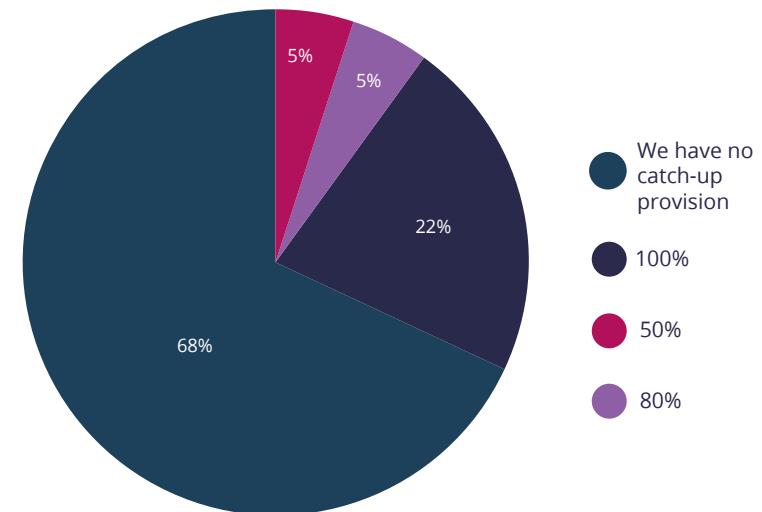


Figure 16, What is your flagship fund's catch-up provision?



Other performance fees related measures

Investor clawbacks

Albeit a less popular tool when it comes to managing expectations regarding how fund managers are compensated for performance is the clawback. These allow investors to take back some of the previous performance fees paid in profitable years when the fund returns losses.

This arrangement could become more popular as investors seek to encourage compensating fund managers for delivering out-performance over the long term.

Crystallisation of fund managers fees

Investors acknowledge that fund managers are crystallising fund performance on a semi-annual and annual basis and some over an even longer-term – further indicating that investors and managers are working to align their interests better.

Investors further acknowledge that given certain investment strategies, and the investment horizon of the underlying positions in the fund(s), it does not always make sense to crystallise fees on an annual basis. Certain fund strategies can liquidate the underlying positions in their fund more often (e.g. those that turnover their investment book regularly) while other strategies may invest with longer liquidity terms, making better sense to crystallise upon the maturity of an investment.

Longer lock-ups in exchange for lower fees

Increasingly investors are more open to locking up their capital in hedge funds for longer periods in exchange for reduced fees. This can be a mutually beneficial arrangement between the hedge fund manager and its client(s). For example, the investor reduces the fee drag on performance, whilst the committed capital gives greater freedom to the fund manager who does not need to hold as much capital on hand to meet potential redemption requests.

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



The crystallisation frequency or the incentive fee payment frequency is the point in time when the hedge fund manager determines the amount of performance fee due to be paid by investors.

Investors preference is for the crystallisation of a fund's fees for the underlying investment of the fund to match the duration of its investment. Importantly the crystallisation of hedge fund fees should be consistent with the realisation of the fund's returns.



"High watermarks are an important component of manager and investor alignment. However, during the global financial crisis, those same provisions resulted in the premature end to many fund complexes as managers opted to shutter operations rather than spend years working back to their high watermarks with only base compensation. High watermarks and other fee limitations should be designed to promote alignment not only for the now, but also with a long-term outlook."

**Alex Bodden, Managing Partner,
RSM Cayman Ltd.**

Preferential terms

Fund managers continue to explore equitable compensation arrangements that are beneficial to both them and their investors. Upon closer examination of the results, almost half of all fund manager respondents offer preferential terms on the management fees that they charge to their investors. In addition to historic fund agreements like founder share class investors being rewarded for early investment via a reduced fee, other arrangements include:

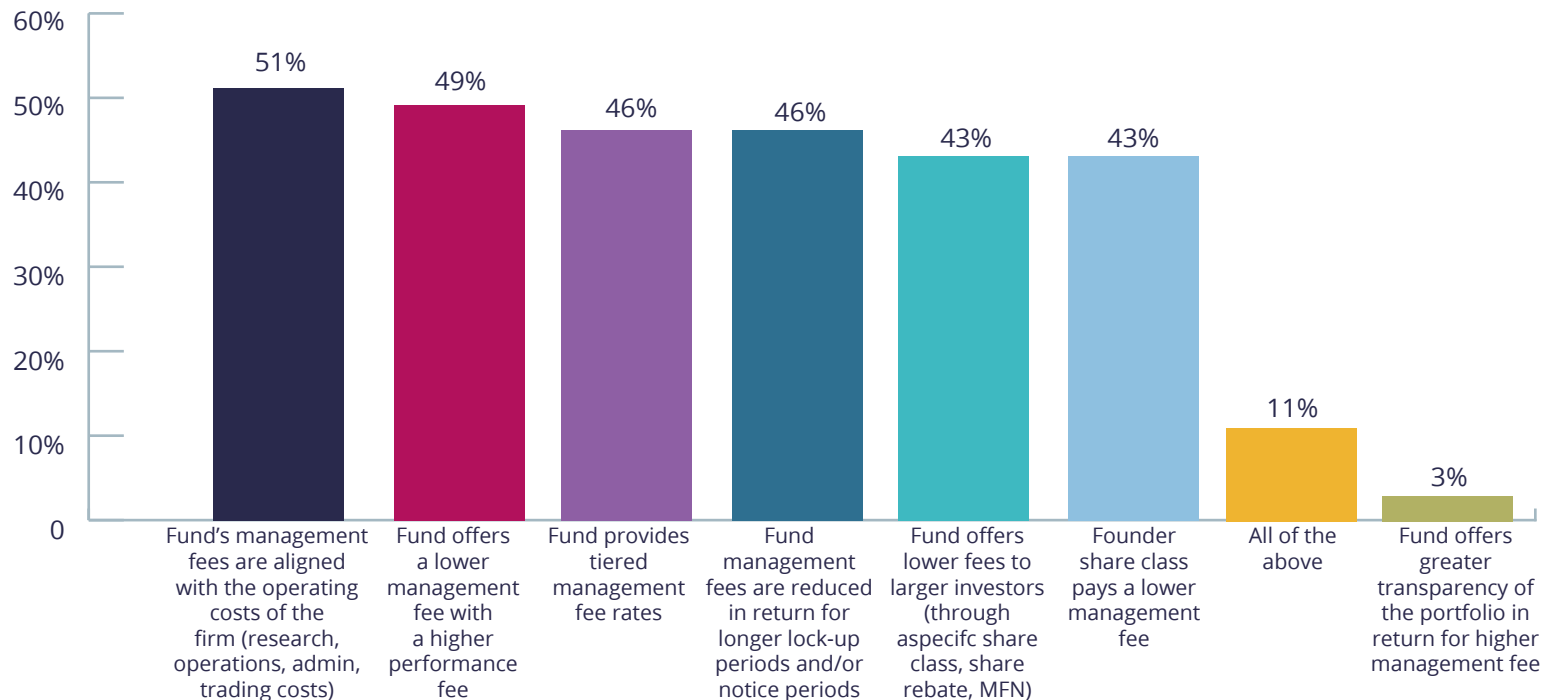
- Aligning management fees operating costs
- Lower management fee being charged with a higher performance fee
- Declining fee structure (fee tiering) as AUM of fund increases in size
- Lower management fee in exchange for a longer capital investment
- Lower management fee for larger investors (via a specific share class, most favoured nation (MFN) clause)
- Fee discounts by fund strategy
- Fee discounts on committed capital rather than invested capital

Incidentally, the top three in the list above are considered the most important factors for investors when negotiating management fees (see **figure 17**).



Interviewees urged caution on having fund managers just be rewarded for performance, there is a danger that in the scenario where fund managers are only being paid for delivering performance that they could make unsuitable portfolio decisions or take excessive risks to do so.

Figure 17, What do you consider most important when negotiating the management fee on any one or more of the alternative investment funds that you invest in? Please check all that apply.



Notably, two-thirds of all fund manager respondents are open to having reduced management fees in return for being incentivised at a higher rate if they meet the performance expectations of their investors (see **figure 18**).

Tiered management fees gaining in popularity

The majority of fund manager respondents (71%) are implementing tiered fees, (see **figure 19**), a significant increase from our 2019 research where only one in three fund managers were doing so. Having a tiered fee arrangement is mutually beneficial to fund managers and investors. For the former, having a larger management fee at the outset of a fund being established can help to meet the operating costs of a business (where the assets of the fund are small). For the latter, tiered pricing allows investors to share the economies of scale as a fund's assets grow.

"It's common to see managers providing some form of loyalty discount to investors, most commonly through either a "founders class" discount that applies to all early subscriptions to a new fund or strategy, or an AUM based discount that applies to investors subscribing in excess of a certain amount of capital. We have seen the latter applied based on firmwide AUM and based on AUM committed to a particular product.

It's less common to see discounts based on the length of the relationship with the investor, or at least explicitly expressed as such in the offering documents rather than through a side letter arrangement, though we have seen this occasionally. The revenue milestones are less common, though somewhat implied by the AUM based discounts. The other trend is in favour of providing investors discounts for agreeing to lock their capital up for longer periods of time."



Steven D'Mello, CFA, FRM Albourne Partners (Canada)

Figure 18, To what extent would you be prepared to forego all management fees via a specific share class in return for a higher performance fee?

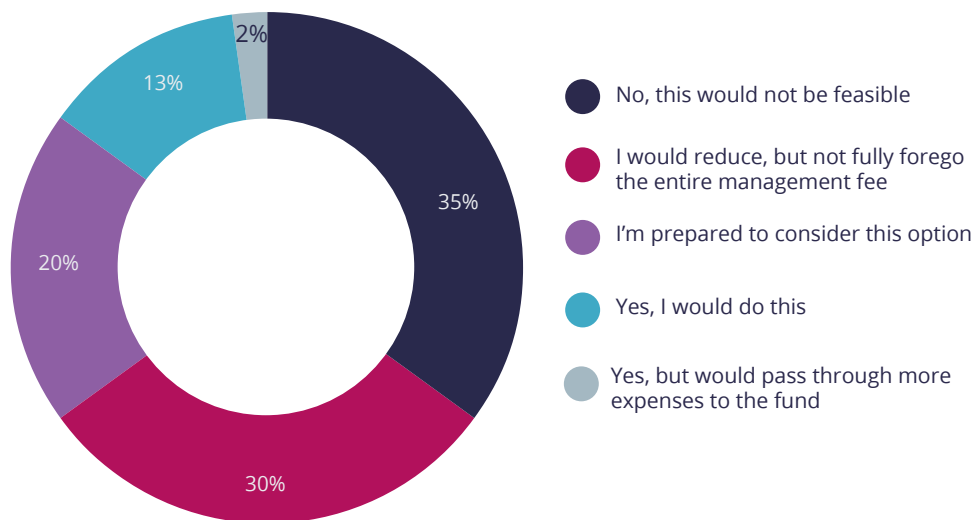
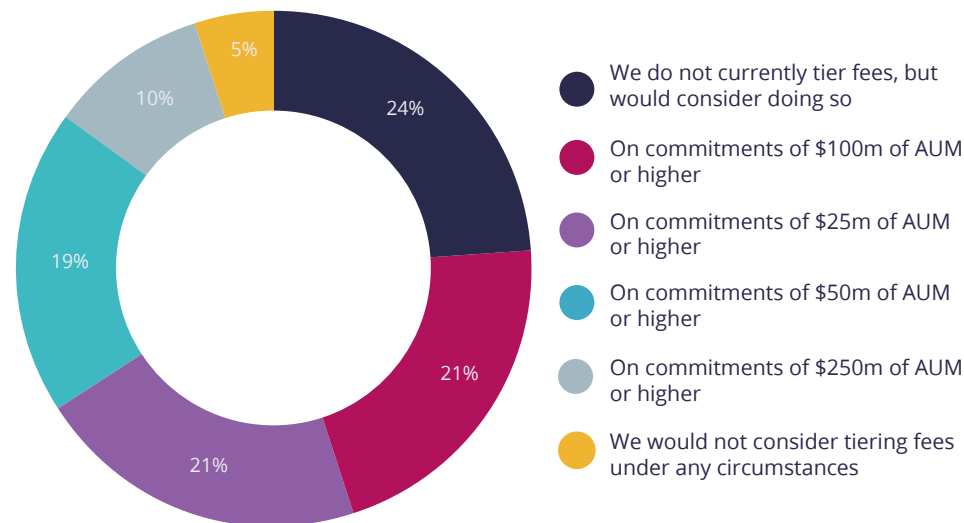


Figure 19, What is the minimum AUM level at which you would tier fees for investors?



Other forms of relationship pricing

Based on the findings of our research, relationship pricing tends to be practiced more by larger fund managers, with half of the largest fund manager respondents (\$20bn AUM) saying that they offer this to their investors.

The suite of discounts being provided, include incremental discounts based on the number of investment mandates, the length of time of a particular investor relationship, certain revenue milestones being met with an investor, through to the most popular discount dependent on an AUM milestone.

Investors did note that some of the largest (multi-manager) platforms do not offer any form of discount, which they are prepared to accept provided that the same managers continue to deliver performance that meets their expectations.

iv. Expenses

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

From the fund managers' perspective, the variety and amount of expense that must be incurred to operate a hedge fund business is becoming increasingly challenging for some firms.

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

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

In the absence of regulations specifically delineating what can or cannot be a fund expense, regulators are likely to expect managers to draft and follow clear policies, keep careful records, and appropriately disclose all relevant costs.

The US Securities and Exchange Commission (SEC) has proposed a rule that would, among other things, prohibit an investment adviser from charging a fund for certain regulatory, compliance, and examination-related fees and expenses for the first time (see following page). The SEC is currently reviewing the public responses to the proposal and is expected to finalise the rules in the Spring of 2023.

In AIMA's response to the SEC's proposal,² we make the argument that it is not obvious how this would be a preferential outcome for investors, particularly investors in a fund that uses a pass-through model, who now will have less visibility into specific fees and expenses and who will be subject to a re-structured fee model different from what they had originally bargained for.

² Letter from Jiří Król, Deputy CEO, Global Head of Government Affairs, AIMA (Apr. 25, 2022)



The SEC's proposed rules, among other things, would prohibit all private fund advisers (including those that are registered and those that are not registered) from doing the following, directly or through its related persons, even if disclosed to investors and regardless of whether the investors have consented to the activity:

1. Charging certain fees and expenses to a private fund or its portfolio investments, such as:
 - a. monitoring, servicing, consulting or other fees in respect of any services that the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment (e.g., accelerated payments)
 - b. fees or expenses associated with an examination or investigation of the adviser or its related persons by any governmental or regulatory authority
 - c. any regulatory or compliance fees or expenses of the adviser or its related persons
2. Reducing the amount of any adviser clawback by actual, potential or hypothetical taxes applicable to the adviser, its related persons or their respective owners or interest holders
3. Seeking reimbursement, indemnification, exculpation or limitation of its liability by the private fund or its investors for a breach of fiduciary duty, wilful misfeasance, bad faith, negligence or recklessness in providing services to the private fund
4. Charging or allocating fees and expenses related to a portfolio investment (or potential portfolio investment) on a *non-pro rata* basis when multiple private funds and other clients advised by the adviser, or its related persons have invested (or propose to invest) in the same portfolio investment; and
5. Borrowing money, securities, or other private fund assets, or receive a loan or an extension of credit, from a private fund client

Passing through of fund expenses

Perhaps unintentionally, but the push in recent years by investors to cut fees, further aggravated by rising industry costs (primarily associated with hiring and retaining staff, investment in technology and data, paying for research) has seen some managers pass on a wider variety of costs onto the fund.

The two models for this are the 'partial pass-through' model where certain costs are charged to the fund (and any additional charge being capped), alongside the management fee. Alternatively, some managers forgo a management fee altogether in favour of full pass-through model, which has a higher cap, or no cap at all (see page 30 for more details).

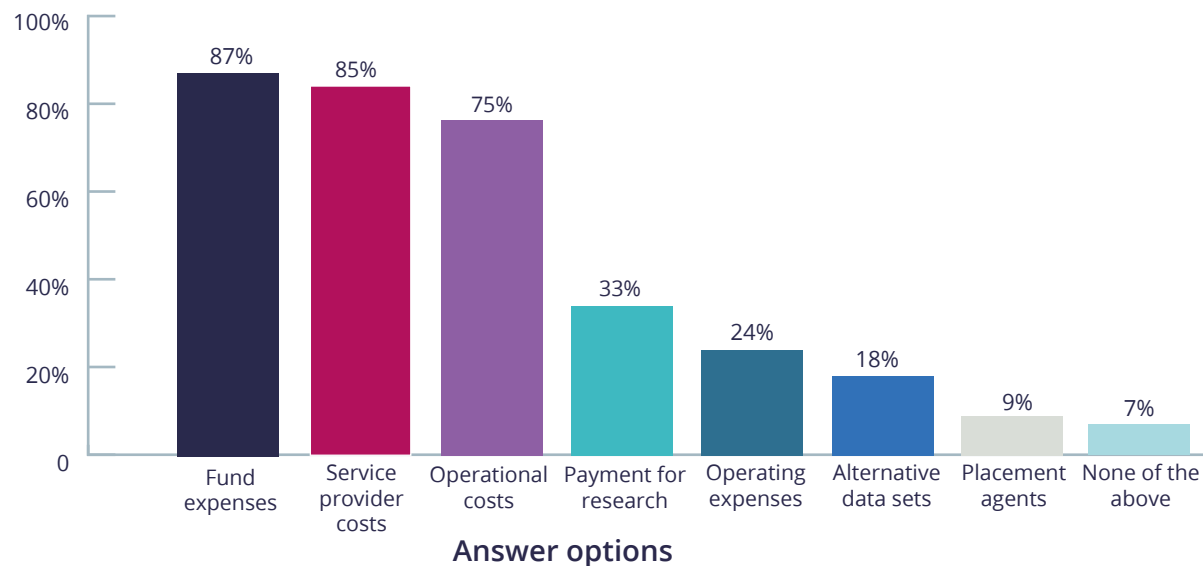
Most survey respondents (93%) assign some costs to the fund, which are then passed through to the investor in addition to the management fee, see **figure 20**. The most common costs are fund expenses, service provider fees, and operational costs, all of which are traditionally borne by the fund.



"Any pass-through we accept should have a cap. We prefer limited pass-throughs, on select line items, rather than open ended pass-throughs as often implemented by some of the largest, most successful multi-strategy managers."

Michael Oliver Weinberg,
Columbia Business School

Figure 20, Which of these expenses would your fund be able to "pass through" to its investors? Please check all that apply.



A similar picture emerges when breaking the responses per fund manager size. As per **figure 21**, small and large managers tend to pass service provider costs, fund expenses and operational costs onto the fund.

Notably, one in three fund manager respondents are passing through expenses as it relates to payment for research, while one in four pass through operating expenses (including salary compensation) and just under 20% of all respondents passing through expenses related to the use of alternative data.

When we put this observation to a leading alternative investment consultant, they replied that “it is more common than not to see these items listed as eligible expense categories and an actual charge of these expenses to these funds across all strategies within hedge funds and private markets”.

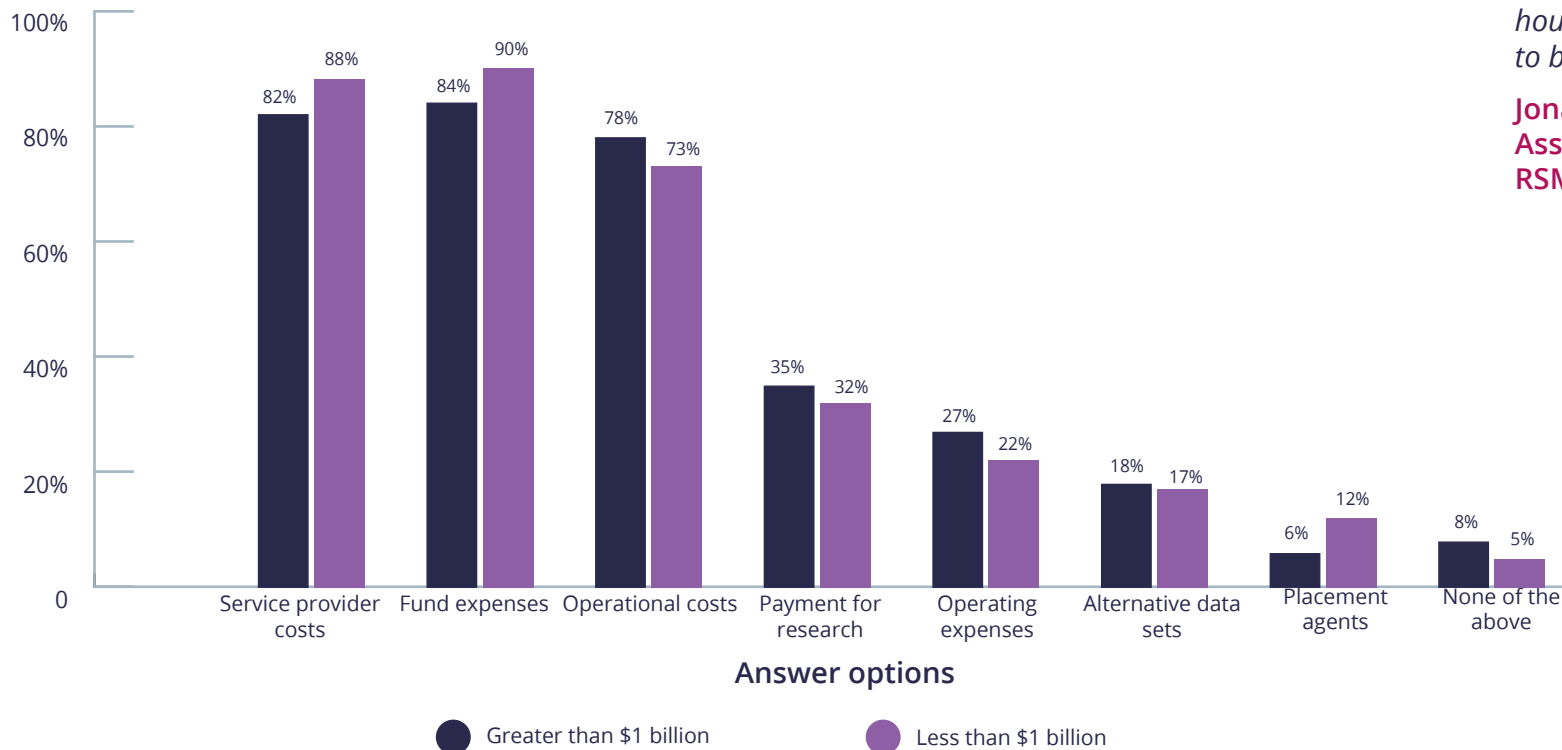
Others pointed to the war for talent and persistent downward pressure on the management fee as other drivers for the more frequent use of pass-through to cover these costs.



“The war on talent to hire direct resources has proven to be challenging. At RSM, we have seen a trend of both large and small managers moving from building out in-house back-office teams to outsourcing fund administration and compliance to third party administrators. When a fund manager engages a third party, it becomes a fund expense; whereas by comparison, the expenses associated with hosting an in-house back-office may not be able to be passed on to the fund.”

Jonathan Waterman, National Asset Management Leader, RSM US LLP

Figure 21, Which of these expenses would your fund be able to "pass through" to its investors? Please check all that apply.



Partial pass-through

The results of this year's research observe a greater incidence of fund managers passing on additional costs to the fund, albeit capped to a certain level. As per **figure 22**, we find that this threshold is around 30bps of the fund's NAV.

Just over half of all fund manager respondents are capping all costs at 25bps, while one in three have ceilings of between 25bps and 50bps. Notably, the pool of respondents capping costs at the lowest threshold is almost equally made up of larger and smaller manager (see **figure 23**).

Looking more closely are the differences in charge caps applied by larger and smaller fund managers, the survey provided an average cap of 27bps for larger managers and 33bps for smaller managers.

Figure 22, Select the most appropriate level you cap any operating expense that you pass through the fund.

Excluding 'prefer not to say/not applicable'

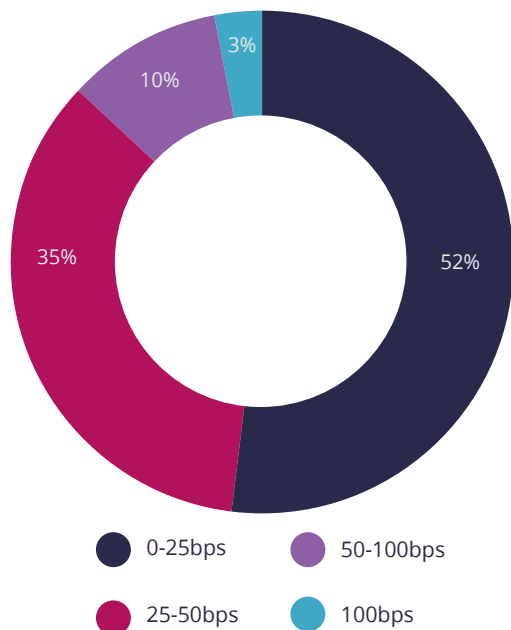
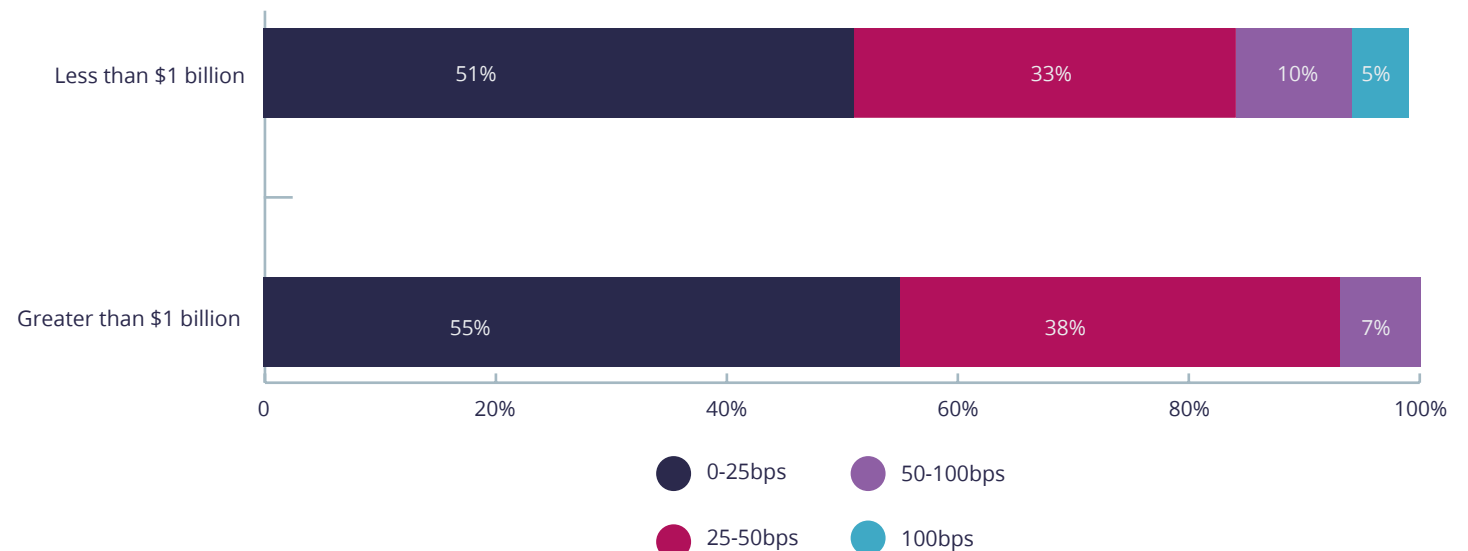


Figure 23, From the range of options below, please select the most appropriate level you cap any operating expense that you pass through the fund.



Full pass-through

In lieu of the management fee, fund managers can deploy the full pass-through model pass for every operational expense (including salaries and bonuses for some or all the fund's traders) on to their investors.

This practice continues to be mainly isolated to multi-strategy and multi-manager funds.

These managers have a proven track record of delivering strong performance to justify their relatively higher fee models.

Notably, many of them are also closed to new investment and some have even returned investors' capital, reinforcing the point that the use of pass-through should not be viewed as simply an asset gathering exercise.

Proponents of this model make the case that having this arrangement in place creates the best alignment with investors, equipping them to be in the strongest position to generate superior risk adjusted returns and attract, as well as retain, the most talented people in the industry.

Investors whom we spoke to acknowledge the rising cost environment, in particular higher costs as a consequence of the fierce war on talent. As such, they tolerate the full pass-through model, so long as the relevant hedge fund firm can continue to outperform, and profits earned for them are more than any fees that they pay.



"We have observed an increase in the number of managers that pass-through expenses related to both investment operations systems (OMS, PMS etc.) as well as research expenses such as alternative data. In our experience it is more common than not to see these items listed as eligible expense categories, and an actual charge of these expenses to the funds across all strategies, including both hedge funds and private markets vehicles.

However, we have not observed an increase in the frequency of managers that are charging salaries directly to the funds. This remains common only amongst multi-strategy/multi-pm funds but outside of that strategy we still believe this is off market and not typical. The exception relates to a trend in favour of outsourcing certain tasks that were historically performed by the manager (i.e., middle/back office, trading) with the related expenses then being charged to the funds."

Steven D'Mello, CFA, FRM Albourne Partners (Canada)

Product innovation

Co-investment

Few features demonstrate the evolution of the modern fund manager/investor relationship clearer than the rise in popularity of co-investment in the hedge fund space in recent years. Co-investment is well established in the private equity arena but has been less common across hedge funds, until recently.

The results of this year's survey reveal over half of all fund managers are either engaged in co-investment arrangements or are open to being in one (see **figure 24**).

The popularity of co-investment is even more apparent when looking at the results of our investor survey. Two out of three investors polled either are currently engaged in a co-investment or are seeking to do so (see **figure 25**).

Investors interviewed suggested that co-investment is becoming more popular as it offered an ideal method for aligning interests by providing a clear win-win for both parties. For managers, it offers additional flexibility to their investment strategy that might otherwise be constrained by liquidity issues or exposure limits. Investors, for their part, can be reassured by managers having skin-in-the-game while also benefitting from a significantly reduced fee model for the co-investment – ranging from no fees to 0.5% of the fund's NAV – along with the opportunity to work more closely with their managers in what can be considered a natural evolution to the knowledge sharing function that can be highly valuable.

Co-investments are also appearing in public markets in what is essentially a vehicle for allowing investors and managers to take larger positions in names where they hold a high conviction, usually with little to no fees being charged to its investors. Some managers are using the prospect of co-investment opportunities as a stepping-stone for institutional investors that do not allocate to the main fund by offering tiered fees that heavily favour those also invested in the flagship fund.

Figure 24, Does your fund(s) offer co-investment opportunities to your investors?

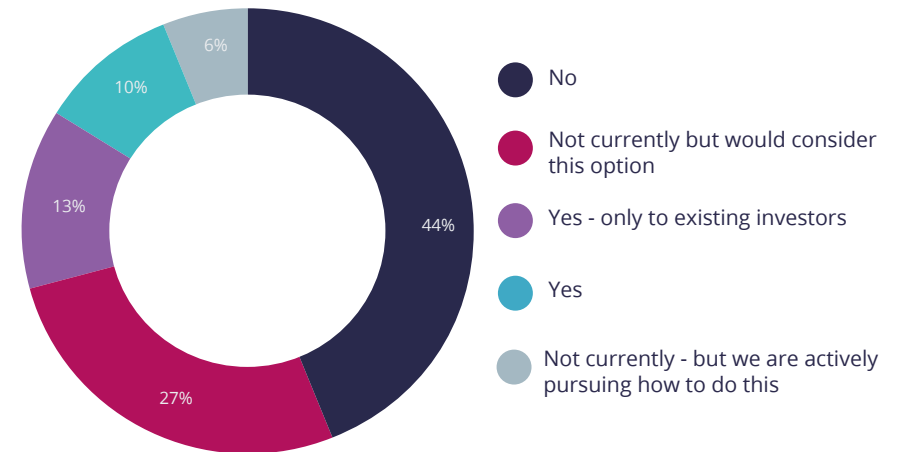
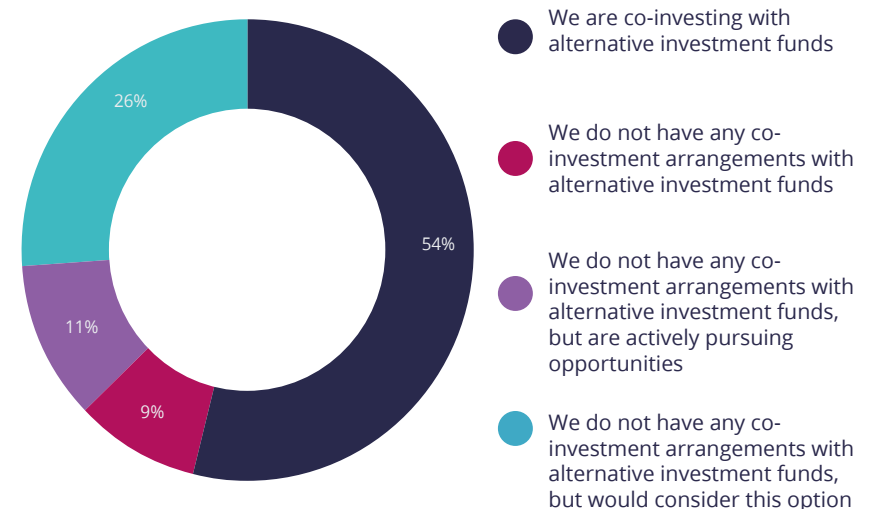


Figure 25, Choose from one option below what best describes your firm's position regarding co-investment.





Case study

"An investor approached our endowment regarding a high conviction idea that they had in public markets. In addition to drawing down capital from its fund, the fund manager was able to call on additional capital, set in escrow via a side-letter arrangement in place with the endowment. Unlike a fund of one, the co-investment is structured post the point of investment and created to house the co-investment idea. Under the co-investment arrangement, the manager and investor can use their combined capital to invest up to 30% in a single position whereas in the commingled fund, they can only invest up to 10%."

Multi-Billion Dollar Endowment



"We see growing interest in co-investments but investors new to this area will need to consider their investment approval processes and structuring needs as quick decisions are needed."

Rebecca Lawley, Cheyne Capital

"Generally, co-investments historically implied lower effective fees, but the market has come to appreciate their mutual benefit – sometimes rising to the level of strategic partnership. Many LPs now use co-investments as a learning opportunity or as a lever to emphasize certain exposures, enabling GPs in turn to participate in larger, perhaps differentiated deals. Many asset owners have been hiring dedicated staff with this specific expertise, and many asset managers are offering dedicated vehicles or fund sidecars in clear recognition of the opportunities co-investments may present to all stakeholders, including borrowers."

Brian Towers, Blackstone



"One of the main differences between a co-investment and a managed account/fund of one is that the former vehicle is typically created post investment or at the point of investment, and created to house a single investment only. Managed accounts/fund of ones are more commonly employed to invest alongside a commingled vehicle in multiple investment opportunities, though they may also have a differentiated strategy or in the case of a managed account, offer consent rights to the underlying investor. The co-investment structure tends to create expense allocation considerations whereby co-investors may benefit from due diligence expenses paid for by the commingled fund, with an "option" to invest in the best opportunities only without paying any of the due diligence expenses for deals that fall through.

Managed accounts often shift the administrative burden onto the investor as it relates to custody, cash controls, pricing and administration, whereas these responsibilities stay with the manager for co-investment vehicles and fund of ones. Finally, fund of ones/managed accounts are likely to present more ongoing allocation risk since they are continually deploying capital, in contrast to the 'one and done' co-investment vehicle (ignoring the possibility of future co-investment vehicles)."

Steven D'Mello, CFA, FRM, Albourne Partners (Canada)

"It is evident that managers have worked hard to engage with, and align interests with, their larger ticket / institutional investors in the areas covered in this report. Managers have also diversified product away from their core flagship fund/s into lower risk or long only funds and by doing so, large hedge fund managers have matured into large hybrid fund management firms and moved away from their alpha chasing / trading roots. Interestingly, this also raises challenges for how firms attract, compensate, motivate and retain talent given the differing skillsets and cultures across a hybrid business model.

In response to this, I would expect to see more widespread use of LTIP compensation arrangements and deferrals involving multi-year performance, returns linked to the underlying products and/or the manager itself. Long term success will reduce reliance on the star-player and require a culture that fosters collaboration and long-term performance across the whole team (players and kit-room staff) in-sync with investors".

Neil Griggs, Financial Services Audit Partner, RSM UK LLP

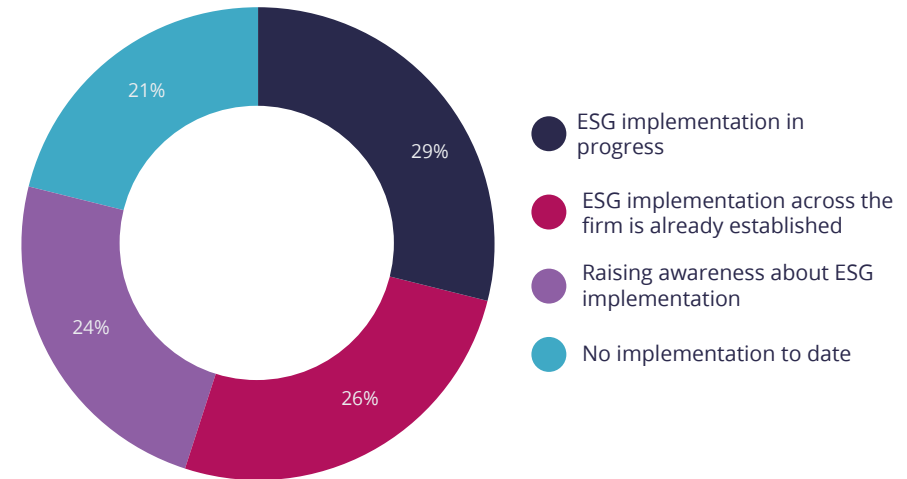
Part IV: ESG: Adapting to the changing landscape

There has been a clear change regarding the trajectory of widespread adoption of environmental, social and governance (ESG) caused by the gravitational pull of macro-economic factors, including geopolitical tensions, and increasing regulatory burdens being experienced globally.

A more complex investment market landscape is requiring allocators to answer the thorny issues of squaring their fiduciary duty to their underlying investors with a desire to do good. The initial focus of many investors was on avoiding seemingly controversial sectors, but many now describe a desire to have a greater positive impact by rewarding and engaging with firms – such as those in the energy sector – that are transitioning to a more sustainable model.

In terms of what this means for aligning interest between managers and investors, a healthy dialogue on what ESG means and how it should influence decision-making is a prerequisite for getting the balance of interests between both parties right. For some managers, a desire to apply ESG principles is manifesting in a greater degree of knowledge sharing and thematic strategies that tailor to investors' needs. For other managers, their mandate is clear: their primary objective is to generate returns for their investors, as shown in the data.

Figure 26, Where is your organisation currently in its ESG implementation lifecycle?



"The invasion of Ukraine was a watershed moment for ESG. It focused the minds of managers and investors on the fragile nature of our western reliance on fossil fuels. The investment needed to divest from western Europe's reliance on Russian gas will be enormous. It is within this context that, in my view, a broader analysis on ESG has begun. The harsh facts are that the returns do not justify the strategy at present. It is also more broadly pushed by European institutional money. Managers have the option not to go for that money. Having run funds which run pari-passu, one with ESG characteristics and the other not, the tracking error in performance is massive.



Also, investors like all of us are fickle. The promise of investment if a fund is ESG doesn't always materialise. However, the changes to ESG may drive off other pools of capital so I think the strategy is in flux at the moment."

Chief Operating Officer of a Large European Long-Short Equity Manager

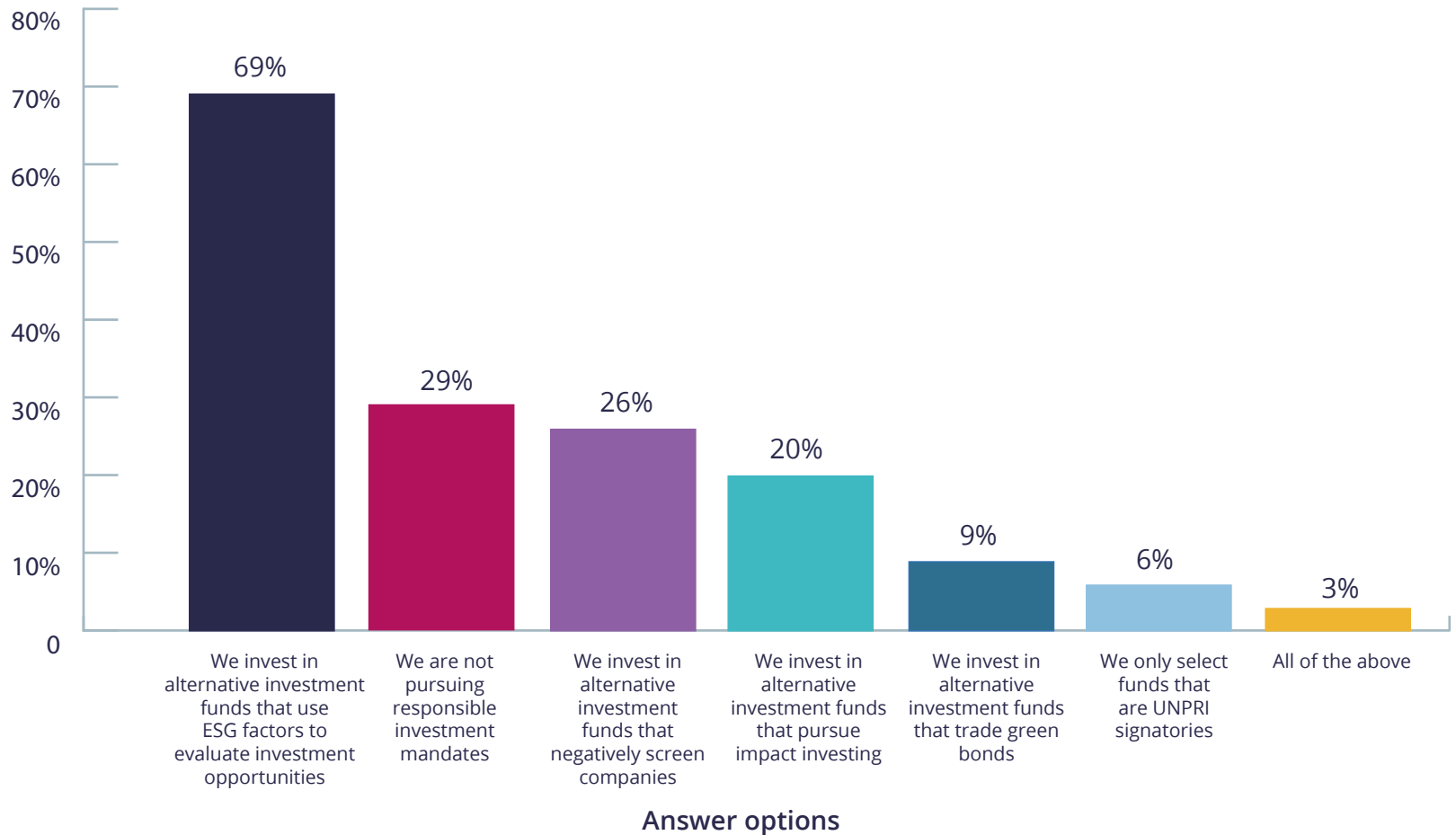
When fund managers were asked how they would best describe their firm's stance on ESG adoption, just over half said they either had established ESG across the firm or were in the process of doing so. One in five had no implementation to speak of (see figure 26).

By size, two-in-three of smaller managers said they have not implemented any ESG principles. Comparatively, only one in three of larger managers have not applied ESG principles to any degree.

Taking a deeper dive into what that means in practice for managers compared to what is expected by investors, the graphs below demonstrate the emphasis placed by both LPs and GPs on front-office applications of ESG.

In **figure 27**, combining those that highlighted that they looked for alternative investment funds that use ESG factors to evaluate investment opportunities specifically, with those that said they place value on all available options, accounts for well over two-thirds of investors surveyed.

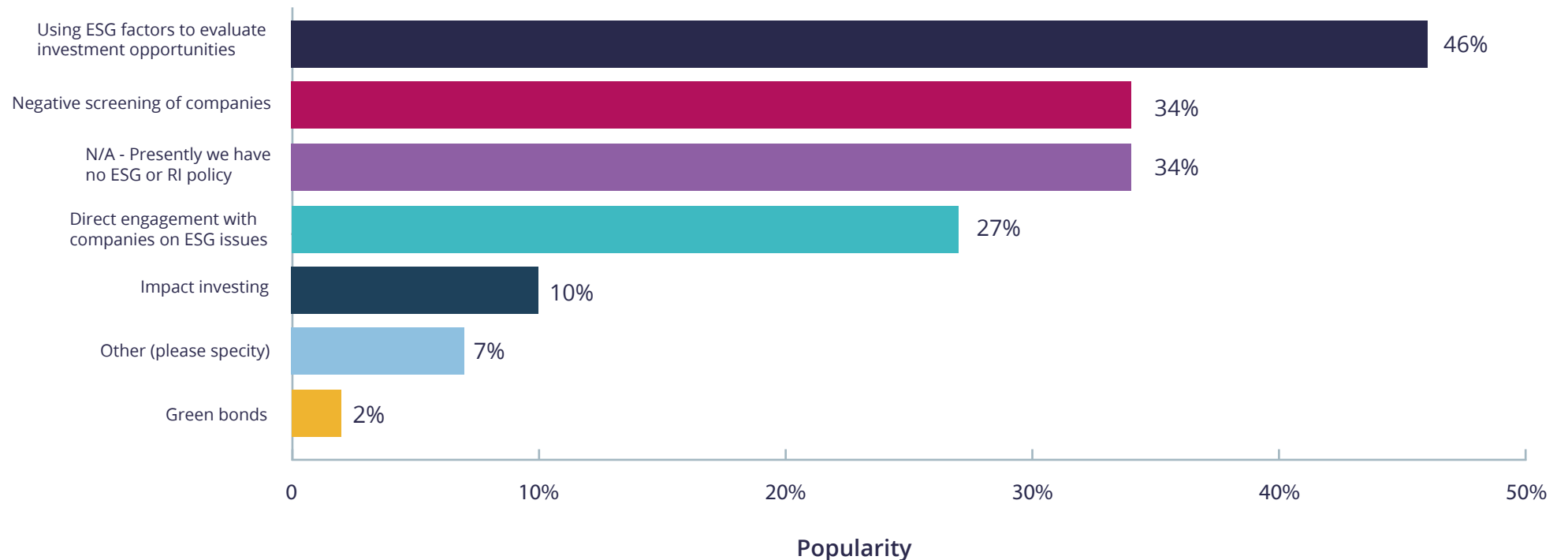
Figure 27, Which of the following best describes your approach to responsible investment? Please check all that apply.



Meanwhile, managers surveyed also highlighted a strong preference for applying ESG factors to their investment opportunities (see **figure 28**).

This implies that both managers and their investors primarily see the addition of ESG factors as a new source of alpha for the front office, as opposed to a broader, firm-wide exercise. This may partly be because most hedge funds are lean operations run by a handful of principals, making the sort of cultural and governance changes being undertaken at larger financial institutions less practical.

Figure 28, Which of the following best describes your firm's approach to responsible investing? Please check all that apply.



The use of negative screening is the second most popular option used for ESG for both managers and investors. Further alignment is demonstrated by roughly a third of managers and investors stating they were not engaging ESG factors in their allocation decisions or investment strategies, respectively, as well as a relatively low emphasis placed on green bonds and fund managers being a UNPRI signatory.

Looking back to the 2019 manager survey, we can see that the ranking of priorities has not changed (see **figure 29**).

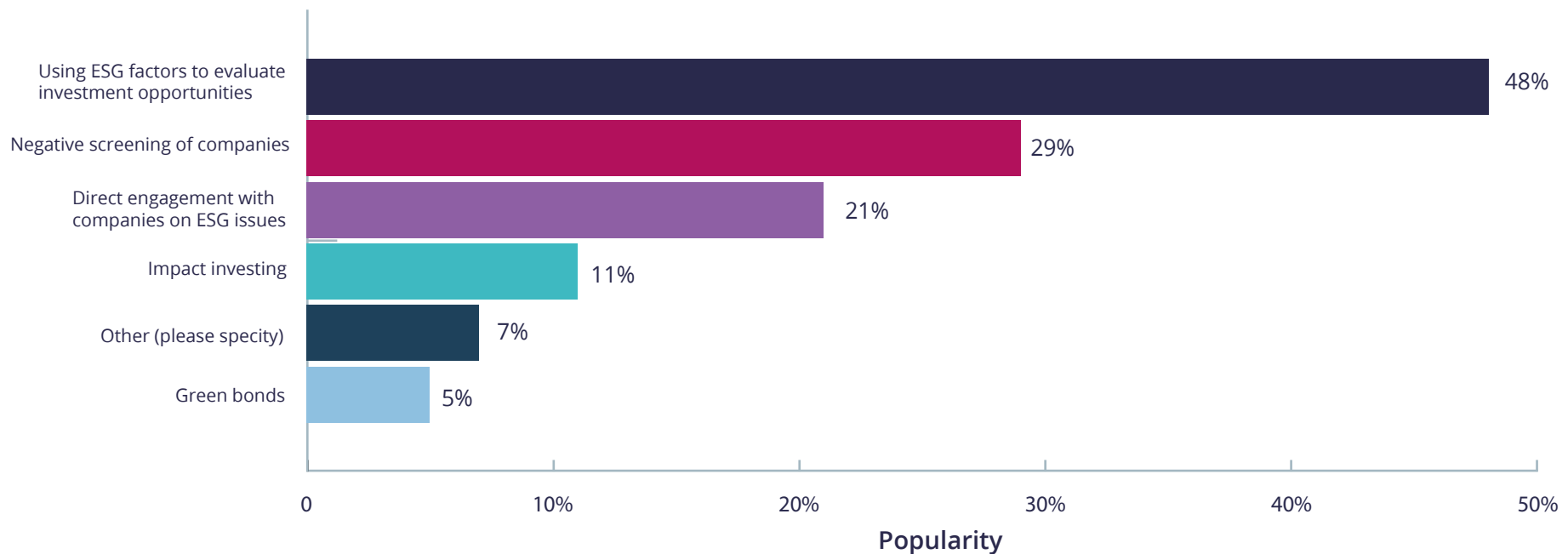
Interestingly, direct engagement with companies has increased modestly since 2019, as has the use of negative screening. However, conversations with investors and managers paint a picture of a shifting trend towards investors and managers favouring a policy of 'engage don't exclude'. The risks of wholesale divestment in so-called 'sin stocks' has been thrown into sharp relief as of 2022 with the traditional energy sector posting stellar returns at a time when the S&P 500 ended the year down some 20% and fixed income markets were erratic.



"We believe there may now finally be a shift to "engage don't exclude" and we are maybe seeing that in other parts of the world, like the Nordics. We generally don't believe exclusion benefits society or beneficiaries. Moreover, if companies are excluded, it is entirely illogical to not allow shorting excluded companies, as some of the worlds' largest pensions currently implement."

Michael Oliver Weinberg,
Columbia Business School

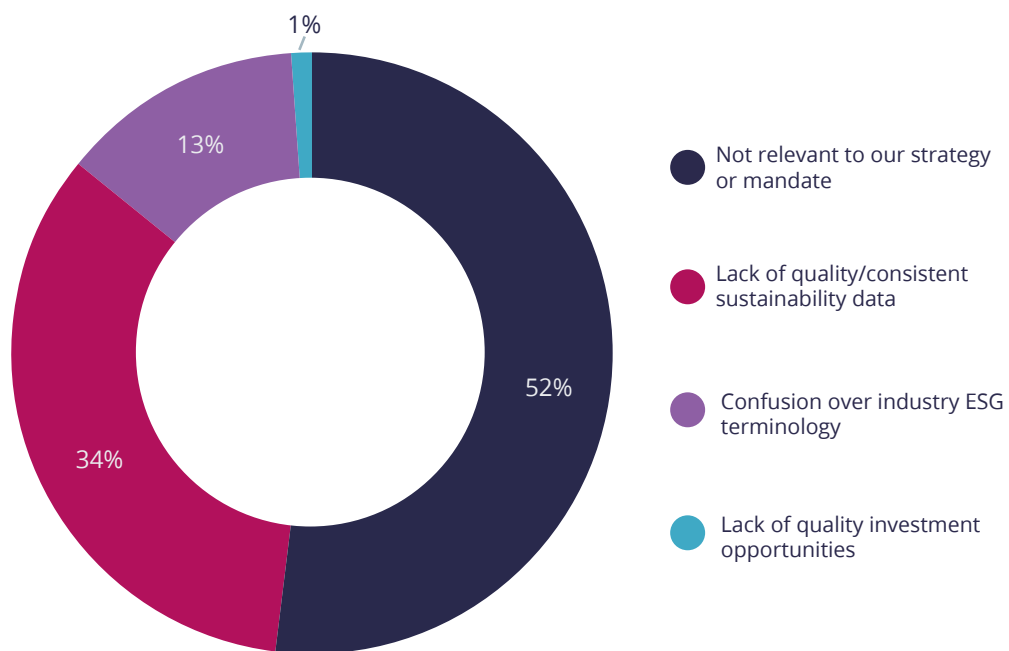
 **Figure 29, (2019)** Which of the following best describes your firm's approach to responsible investing? Please check all that apply.



Considering the headwinds that might be holding back ESG adoption, half of all fund managers that we surveyed said that ESG was not relevant to their fund's strategy or investment mandate. Of those that selected this option, 60% were respondents with less than \$1 billion under management.

Interestingly, no strategy was overwhelmingly represented among those that do not see ESG as relevant (see **figure 30**).

Figure 30, What are your organisations biggest challenges in making ESG-oriented investments?



Views on ESG differ depending on the region, and the strategy of fund managers/type of investor, and that will continue as various markets diverge on their ESG regulatory frameworks.

The collected data for this section does not allow for a geographic analysis but interviewees and additional research reinforce the notion that fund managers in the EU and UK remain ahead of the curve in their embrace of ESG and responsible investing compared to their peers elsewhere. In the US, it was noted that ESG has become politicised, which has polarised the issue between institutional investors in so-called red and blue states, with those in the latter embracing the concept and those in the former becoming ambivalent or even hostile.

In the EU, the UK and Asia Pacific, regulation is a key driver of change in this arena and greater clarity that comes from its development and implementation – even if it brings additional reporting burdens – is widely seen a positive development.

Conclusion

In 2019 our [In Harmony](#) report concluded that, on average, fees had found a floor below the 2 & 20 model, while predicting that there would be greater fund transparency, true knowledge sharing and more co-investment options. The data presented in this updated report demonstrates all these things have come to pass.

However, unlike in 2019 when we pointed to a shift to a buyers' market, the recent strong performance by the industry means fees and performance incentives are now being negotiated on a more equal footing. Although this means some investors will end up paying slightly more to access top-performing funds, we would argue that this will improve the health of the industry while lowering the barriers to entry that have driven fund launches to their lowest levels in many years.

As historic themes around fees and charges are joined by newer considerations around diverse product offerings and ESG, it is more important than ever that fund managers remain sensitive to the needs of investors in order to stay in sync.

Looking ahead, the data suggests transparency of fees and the portfolio will continue to improve for investors and those seeking co-investment opportunities will be offered them in increasing abundance.

For managers, the potential easing of pressure on fees offers an opportunity to focus on their primary aim of delivering returns for investors and investing in the tools necessary to ensure their partnerships are long-lasting and fruitful.

About AIMA

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than US\$2.5 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 250 members that manage US\$800 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).

For more information visit [aima.org](https://www.aima.org)

About RSM

RSM is the leading provider of professional services to the middle market. As the sixth largest global network of independent assurance, tax and consulting firms, RSM operates in 120 countries, across 830 offices, with more than 57,000 people internationally.

The Network's global revenues are US \$8 billion. As an integrated team, RSM shares skills, insight and resources, as well as a client-centric approach that's based on a deep understanding of its clients' businesses. This is how RSM fulfils its purpose to instill confidence in a world of change, empowering its clients and people to realise their full potential.

RSM is a member of the Forum of Firms, with the shared objective to promote consistent and high-quality standards of financial and auditing practices worldwide. RSM is the brand used by a network of independent accounting and advisory firms each of which practices in its own right.

RSM International Limited does not itself provide any accounting and advisory services. Member firms are driven by a common vision of providing high quality professional services, both in their domestic markets and in serving the international professional service needs of their client base.

For more information, visit [rsm.global](https://www.rsm.global)



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