Underlying private fund fees and expenses

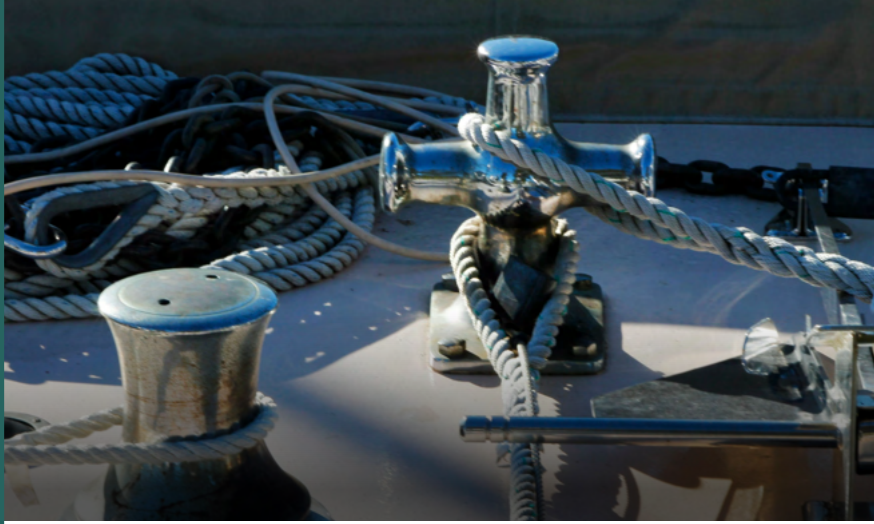

Image courtesy of Leonie Clough

This short explainer breaks down the fees you are expected to pay and expenses you will need to cover when investing in private markets funds, and what they are actually paying for.

It is important to note that these fees and expenses are generally taken out of the investor's capital balance, rather than paid via invoice or capital call.

MANAGEMENT FEES

These are best thought of as the fees you pay to cover the costs accrued for the active management of your chosen fund. Active management is an essential part of the private markets model, and an important potential source of alpha generation.

Management fees are directly attributable to certain necessary operating expenses, including salaries, rent, due diligence, and certain regulatory compliance costs, among others. They are typically levied annually on committed capital (the total amount you agreed to invest in the fund), though certain managers may employ more creative structures. Before investing, you need to determine if the fee approach makes sense in terms of managing portfolio liquidity and in the context of the specific fund.

Management fees typically range from 1-2% annually with provisions for a reduction later on once the investment period is complete.

PERFORMANCE FEES

A performance fee should be thought of as the reward for manager outperformance. While a fee of 15-20% (depending on strategy) is superficially very high, this fee is typically only charged if a fund performs very strongly. This serves to align manager incentives with those of you, the investor.

The level at which a manager starts to earn a performance fee is referred to as a hurdle rate, or preferred return, or sometimes a "carry". The annual hurdle rate is typically about 8% in private equity, but varies by asset class, with hurdle rates not standard in venture capital. Only above this rate does the 15-20% profit share kick-in. In fact, an excess profits fee might be a better term to describe a performance fee.

The catch-up

The final element of the performance fee structure that you need to understand is what's called the "catch-up." Most private funds are set up so that once invested capital has been returned to the investor and the annual hurdle rate has been met, the manager may receive a "catch-up". This basically gives the manager the performance fee it would have received had it not applied a hurdle rate to returns. In other words, if the manager beats the hurdle rate it effectively disappears, and the division of fund profits falls in line with the agreed performance fee share.

To visualize this, we can look at the distribution waterfall, which describes the typical way distributions from investments flow to the investors and the fund manager. It has a few stages (see chart 1 on the next page).

Chart 1: Illustrative distribution waterfall for a fund with a 20% performance fee

Share of distributions from private funds

Stage, in sequential order	% to investor	% to fund manager
1. Return of principal + the annual hurdle rate	100	0
2. Catch-up	0	100
3. Returns above the annual hurdle rate	80	20

To make this hopefully even clearer, in charts 2 and 3 we show a couple of sample $100 investments - one that performs moderately well and returns an annual 13% over a ten-year fund lifespan, and one that returns "only" 8% - in line with an average fund hurdle rate.

Chart 2: Division of distributions for a sample $100 investment over ten years that returned an annualized 13%

Distributions assuming a 20% performance fee (but not including management fees or expenses)

Stage, in sequential order	$ to investor	$ to fund manager
1. Return of principal + the annual hurdle rate (over ten years at 8%)	215.89	0
2. Catch-up (20% of an 8% annual profit compounded over ten years)	0	23.18
3. Returns above the annual hurdle rate	98.85	24.71
Total Returns	314.74	47.89

Chart 3: Division of distributions for a sample $100 investment over ten years that returned an annualized 8%

Distributions assuming a 20% performance fee (but not including management fees or expenses)

Stage, in sequential order	$ to investor	$ to fund manager
1. Return of principal + the annual hurdle rate (over ten years at 8%)	215.89	0
2. Catch-up (20% of an 8% annual profit compounded over ten years)	0	0
3. Returns above the annual hurdle rate	0	0
Total Returns	215.89	0

Source: Opto Investments. Purely hypothetical example provided only for illustrative purposes to explain performance fee distribution waterfall. Does not include management fee or fund expenses.

Key takeaways that should have been illustrated here:

1. Performance fees are only charged when returns are strong; which means...
2. Managers are heavily incentivized to outperform their hurdle rate; which means...
3. The interests of you and the fund manager are strongly aligned.

EXPENSES

Most private funds also pass on selected fund expenses and shared services (including fixed costs such as audit, accounting, and legal) to investors. In addition, they may pass on fees related to investment activity, such as placement fees, advisor fees, and transaction fees. However, many funds will credit back these additional fees to investors by offsetting them against the management fee.

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