

PERFORMANCE FEE EQUALISATION

By Tony McDonnell, Bank of Bermuda's Global Fund Services

When setting up a fund, one of the first decisions a manager has to make is the choice of fund structure. Partnership structures are very common in US domestic funds because they offer tax transparency to investors. Accounting calculations for partnership structures are relatively straightforward. Individual capital accounts are maintained for each partner and performance fees are calculated at the capital account level per partner. Therefore, there are no equalisation issues for managers to contend with.

In Europe, a combination of other fund structures is frequently used which requires calculations of per share/unit price. In calculating performance fees in these structures, the overriding concern among managers has been in determining how to fairly reward the manager for positive performance while at the same time ensuring investors are treated equitably. Essentially, this is where the various forms of performance fee equalisation come in.

One of the most common methods of equalisation - certainly among European managers - which we explore in this article, is the 'Equalisation Credit /Contingent Redemption' approach. This form of equalisation involves making certain adjustments on an investor's account.

An **equalisation credit** is awarded to investors who subscribe in periods when the Gross Asset Value (GAV) per share is greater than the fund High Water Mark (HWM). The amount of equalisation awarded per share is the equivalent to the difference per share between the GAV and the Net Asset Value (NAV). This is to ensure that investors in the fund do not pay a fee to the manager for performance they did not enjoy. This equalisation credit is invested with the other assets of the fund and may depreciate. However, it will never appreciate above the maximum equalisation credit, i.e. that awarded on entry. Assuming an investor has an equalisation credit at a period-end, additional shares in the fund will be awarded to them to the value of the total equalisation credit available at that point in time. If the equalisation credit is not applied in full at the first period-end, additional shares will continue to be allotted at each future period-end until the equalisation credit, allowing for subsequent appreciation or depreciation in the fund, has been fully applied.

If an investor buys into a fund when the GAV/NAV per share is below the HWM, the investor will owe an additional performance fee relating to the fund growth from the share price at which it entered up to the HWM. This amount is referred to as the **contingent redemption**. This calculation ensures that

the investor does not benefit from a "free ride" up to the HWM. A contingent redemption will be applied at each period-end until such a time as the GAV rises above the HWM. The investor will experience a reduction in their number of shares to the value of the contingent redemption. This redemption amount is paid directly to the manager by the fund, by way of a fee.

We provide further explanation below of this Equalisation Credit / Contingent Redemption approach by way of example scenarios.

Example Scenarios

Consider a fund with the following criteria:

Offer Price:	\$100
Performance Period:	Yearly
Performance Fee Rate:	20%
NAV Frequency:	Quarterly

There are four dealing days in the period, on which the deals listed in Table 1 are placed.

An account of the adjustments and fees on each investor's account based on the year-end NAV of the fund is summarised in Table 2 and 3.

An explanation of each investor scenario is provided below.

Investor A: year-to-date performance has been + 10% for this investor, therefore the manager will earn a fee of \$200,000 on this investment. No equalisation is applied as the investor subscribed at the fund HWM.

Investor B: this investor paid \$105 per share on entry on April 1st. However, the market value of those shares at that date was actually \$104 per share (the NAV), as \$1 per share was payable to the manager as a fee for the positive performance that the fund enjoyed over quarter 1. As this investor did not participate in this performance they should not be obliged to pay a fee. Thus, an equalisation factor of \$1 per share is issued as a form of compensation to this investor. According to the NAV of the fund, on entry the investors account is valued at \$10,400,000 (\$104 * 100,000 shares). The difference of \$100,000 (\$1 * 100,000 shares) brings the value of the account up to the investment amount of \$10,500,000.

Table 1: Shareholder Dealing

Date	Deal	Investor	Amount	GAV	Shares Issued
January 1 st	Subscription	A	\$10,000,000	\$100	100,000.00
April 1 st	Subscription	B	\$10,500,000	\$105	100,000.00
July 1 st	Subscription	C	\$12,000,000	\$120	100,000.00
October 1 st	Subscription	D	\$9,000,000	\$90	100,000.00

Table 2: Shareholder Accounting

Investor	A	B	C	D
Threshold	100.00	105.00	120.00	90.00
GAV per share	110.00	110.00	110.00	110.00
Performance Fee Payable	2.00	1.00	0.00	2.00
Equalisation Credit Issued	0.00	1.00	4.00	0.00
Equalisation Credit Lost	0.00	0.00	2.00	0.00
Contingent Redemption	0.00	0.00	0.00	2.00
True Value Per Share	\$108	\$109	\$110	\$106

Fund Data	
GAV	110
HWM	100
NAV	108

Note: True Value Per share = NAV per share + (Equalisation Credit Issued - Equalisation Credit Lost) - Contingent Redemption

Table 3: Summary

Investor	Shares	NAV	Equalisation Credit (Contingent Redemption)	Account Value	Shares To Be Issued (Redeemed)
A	100,000.00	108	Zero	\$10,800,000.00	0.00
B	100,000.00	108	\$100,000.00	\$10,900,000.00	925.93
C	100,000.00	108	\$200,000.00	\$11,000,000.00	1,851.85
D	100,000.00	108	(\$200,000.00)	\$10,600,000.00	(1,851.85)

Year-to-date this investor has enjoyed a return of \$5 per share on their investment and so “owes” the manager a fee of \$100,000. At year-end the NAV quoted is \$108, thus not a true reflection of the market value on their account. As such, the fund crystallises the \$1 per share equalisation factor issued on entry. As of January 1st in the new period, investor B will receive an additional \$100,000 worth of shares in the fund. This ensures that the investor’s threshold will equal the fund HWM of \$108 for the new period, meaning that this investment lot will never again be subjected to an equalisation adjustment.

Investor C: this investor paid \$120 per share on entry. Inclusive in this price was a fee accrual of \$4 per share payable to the manager for the positive performance over the previous two quarters. As this investor did not participate in this performance they are issued with an equalisation credit of \$4 per share as compensation. The NAV of the fund on entry of \$116 means that the investor’s account is valued at \$11,600,000 ($\$116 * 100,000$ shares). The difference of \$400,000 equalisation ($\$4 * 100,000$ shares) brings the value of the account up to the investment amount of \$12,000,000.

A loss of \$10 per share is incurred on this investment at year-end. Although the NAV reported is \$108, this investor should not have to pay the manager a “performance” fee of

\$2 per share. As such, the fund will compensate investor D by crystallising \$2 per share equalisation. Thus, this investor will receive \$200,000 worth of additional shares on January 1st in the new period. Note that there is still an additional \$2 per share equalisation on this investment that is lost as of December 31st. This is to ensure that the investor will never be compensated for any performance fee charged on their investment below the price at which they entered the fund.

Investor D: having enjoyed an increase in the value of their investment of \$20 per share, investor D can expect to pay the manager a fee of 20% of this gain. However, the NAV of the fund is \$108, thus the manager is only earning a fee of 10% of the increase in the value of this investor’s account. To ensure that investor D doesn’t get a “free ride” between the price they subscribed (\$90) and the fund HWM (\$100), the manager receives a fee of 20% of this difference in the form of a Contingent Redemption.

Essentially this means that \$200,000 (i.e. \$2 per share) worth of shares will be redeemed from their account at *crystallisation*. The proceeds will be paid to the manager and the investor’s threshold will increase to equal that of the fund HWM. This is a one-time adjustment on this investment that ensures the performance of these shares will move in line with the performance of the fund.

Crystallisation

Note: shares issued/redeemed on crystallisation are calculated by dividing the equalisation adjustment by the NAV per share at year-end. Although shares have been issued and redeemed from respective investor accounts, the total account value for each investor has not changed, as the equalisation adjustment amount after crystallisation will then be zero.

Advantages/Disadvantages

The Equalisation Credit /Contingent Redemption approach has both advantages and disadvantages.

Advantages

1. Only shares that have appreciated in value pay a performance fee.
2. All investors have the same amount at risk per share in the fund.
3. Every share in the fund has the same NAV per share.
4. The manager is rewarded fairly for the positive performance of all shares.

Disadvantages

1. Complex calculations may cause confusion among investors.
2. Published NAV per share may not be reflective of the actual value on an investor’s account, as only investors’ statements will reflect the equalisation adjustment.