

Chapter Ten: Equalisation

Kieran Conroy,
Citco Fund Services,
Dublin

Should we bother?

Equalisation has been with us for almost a decade now, and having been involved with it for the majority of that period, it appears to me that understanding within the industry, definitely among investors, has grown considerably. While investors may not yet be fully conversant with the minutiae of the calculations and probably have no great desire to be, they do appreciate that it is a fair and even-handed method of calculating and allocating incentive fees.

Another issue that gathers momentum from time to time is whether or not one should bother at all. If a hedge fund manager is consistently making +20% returns, charging incentive fees quarterly, with drawdowns few and far between, it probably is not in everyone's interests to incorporate equalisation into the performance fee calculation. Many of the big names within the hedge fund industry — the Soros, Moore and Tudor Groups, for example have not used it in their flagship funds. When these funds started, equalisation as a concept was in its infancy and, having already had a number of years of steady success behind them, the investment managers decided that if investors wanted in, then they could pay the entire package for the privilege.

In more recent times, with the arrival of the larger institutional investors, such as endowment funds and pension schemes, an attempt to eke out every last dime and dollar from an investment has become more and more prevalent. Nowadays, it is rare to see a fund launched on the market which does not employ some method of equalisation, be it an equalisation factor, with its many variations, or a form of continuous offering with multi-series being issued within one fund class.

Traditionally, Europeans have been more comfortable with the corporate structure and are more at home with having a holding in the form of shares of a fund rather than a membership interest — weaning them away from share certificate to register or book-entry form was difficult enough. Equalisation, on the other hand, offers the benefit of equality among investors and ease of reporting in having only one net asset value (NAV) per share. This makes it easier for shareholders to track their performance and their holdings at any given time during their investment.

So, while equalisation is now a well-known concept, it is not universally well-loved. Consider, for example, the challenge faced by the large institutional investors who invest in hedge funds using nominee accounts and who are therefore obliged to track the equalisation account reporting they receive from the administrators all the way back to their (many) underlying client accounts. As a result, we know of some institutions that refuse to invest in hedge funds that use equalisation. Clearly, one can imagine the discussion for and against the concept of equalisation swinging both ways.

The free ride

Nowadays, whenever you mention the necessity for employing an equalisation method, everyone nods knowledgeably and talks about a 'free ride' (as if it were old hat). The jargon flows off the tongue from both managers and investors with great ease. For those who haven't been affected, in times of drawdowns, it was becoming clear to all that certain investors were getting a 'free ride' as the NAV went up.

The classic case is of a fund charging an incentive fee on a per share basis, with a simple high-water

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mark (HWM), that commenced at an NAV of \$100 per share and declined to \$90. An investor putting in between \$90 and \$100 would not pay a performance fee until the share reached \$100, and would therefore get a 'free ride' as the NAV went up to that number. The manager quickly realised that he was losing out on the performance fee that he rightly deserved. However, if you were to explain this to your average investor, who was used to delving in stocks only occasionally, you would hear another side to the story. They would be of the opinion that as they are carrying the risk by putting in their money when the manager has already lost money, then surely they should reap the benefit for taking on this additional risk. Such an approach takes an over-simplistic view of the hedge fund market, where periodic drawdowns are part and parcel of the industry cycle and the manager is earning a fee based on the performance of the fund as a whole.

Multi-series versus equalisation factor

Various methods were to come and go, and for a while continuous offering, or multi-series, was one that was most often touted among industry professionals. The beauty of this measure was that it was so simple to explain for managers, lawyers and administrators. The concept remained in vogue for a long time, as it mirrored the US limited partnership model that so many US investment managers and investors were familiar with, having been investors or general partners of the US domestic equivalent vehicles. It also benefited from the fact that it could be easily adapted to track funds that utilised a lock-up period, a hurdle rate, or even a hurdle rate with different fee structures once the return reached different performance levels; not to mention the fact that it was ideal for tracking rebates on management fees and performance fees. Ultimately, investing money with a hedge fund manager is not comparable to buying a mutual fund share. Not only are you taking the additional risk, but you are also trusting that manager with a large amount of your capital and you want and expect to be treated on an individual basis. Multi-series allows you that freedom.

When the multi-series method was first introduced, all new series were issued at the same NAV of, say, \$100. Soon funds were hearing complaints about the

confusion among investors and custodians alike not knowing their own share class and series, they consequently had incorrect NAVs reported to them. The method was further confused by the fact that a standard method of reporting or classification was never clearly adopted within the industry. Essentially, each set of boilerplate documents gave the multi-series method a new name with some attempt to tinker here and there. Banks, family offices and custodians, in particular, who were trying to make a science out of the custody of hedge fund assets, had all sorts of problems.

Take, for example, a bank or custodian that wishes to invest in a fund, but does not know the 'identification number', or the name, for that matter, that will be used for the subsequent series or class. There is no way for them to record it on their systems, leaving large sums as unsettled or sitting in suspense pending completion of the NAV process.

Given the complications and the problems with reporting for multi-series, the method now appears to have lost some of its allure, due to the multiplicity of share classes on offer and the additional work involved in keeping track of such. Once managers started to receive calls from unhappy investors, it was once again back to the drawing board and the popularity of equalisation began to rise once more.

The beauty of equalisation is one NAV can be reported to all investors, while it retains the feature of a total equitable allocation of incentive fee. It is this combination that makes it attractive to investment managers and investors alike. Investors might have some difficulty with the more complex characteristics of the method which arise in cases of losses and equalisation factor carry-forward, but they can and do take reassurance from the method's basic tenet of fairness.

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The easiest approach in a corporate structure would be to calculate and report gross asset values (GAVs) and only worry about the performance fee on a yearly basis, when these fees are due to the manager. One could even account for this by compulsorily

redeeming shares from the investor at the end of the year in an amount equal to their portion of the incentive or performance fee.

This method has some support in the US market used to a general partner taking his performance allocation at the end of the year by debiting the capital accounts of the limited partners on a one-for-one basis and crediting his own. Dealing with loss carry-forward is also quite straightforward. For administrators and accountants, this method is workable, as it is similar to tracking a multi-series fund.

Of course, ‘performance reporting’ — that other ‘holy grail’ of the hedge fund community — was not entirely satisfied by this method. Then along came the accountants and lawyers who turned into mathematicians. Between them, they developed models that would compensate each shareholder as necessary, by making appropriate adjustments to the number of shares that each shareholder would have or by calculating a bid/offer NAV per share. Equalisation may be best explained by a mathematical example.

What about when the NAV is increasing?

Take a fund, which does not use equalisation and which commenced the year at a NAV of \$100 per share. At the end of month one, the GAV (before the deduction of any performance fees) had reached \$125. A shareholder who invested at the original NAV would owe \$5 in incentive fees (assuming a 20% performance fee rate). An investor who came in at NAV at the end of month one, rather than the G AV, would invest \$120. In this example, the GAV of the fund increases to \$260 (ie, \$130 per share, with two shares in issue) and the manager would be entitled to \$12 (\$130 less \$100 times 20% times two shares). However, on a shareholder basis, Shareholder 1 should have paid \$6, as he made \$30, and Shareholder 2 should only have paid \$2, as his profit was only \$10. With an equalisation method, what should have happened is that the second investor should have invested at the GAV (the offer price) of \$125 and received 0.96 shares for the \$120 that he invested, with an equalisation factor of \$4.80. With the GAV of the fund increasing to \$260 (ie, \$132.65306 per share, remembering that there are now 1.96 shares in issue), the manager would get \$8 (\$132.65306 less \$100 times

20% times 1.96 shares in issue, less the equalisation factor of \$4.80). Shareholder 2, at the end of the year, would then receive shares to the value of \$4.80 at the year-end NAV per share.

What about an investor that comes in below the high-water mark?

The approach here is to make the investor prepay for any incentive fee that an investment manager may earn. Such prepayment is referred to as the ‘depreciation deposit’. This works as follows: the fund begins with a NAV per share of \$100. After six months, the NAV falls to \$90. An investor investing at that date will be asked to pay the offer price of \$92, being the NAV or bid price of \$90 plus an amount equal to 20% of the difference between the HWM and the NAV per share of \$90. At the year-end, the GAV has reached \$120 and each shareholder will pay \$4 per share, being 20% of \$20. The \$2 that the second shareholder paid as depreciation deposit will then be paid to the manager as he actually owes \$6, having made a total of \$30. This approach appeals to the manager; however, the investor who invested when the fund was below the HWM has had to leave his \$2 in the fund for six months during which time that amount was not entitled to any performance. Spotting this, some managers would also pay a T-bill rate to the investor to compensate them. However, as we all know, investors do not invest in hedge funds to earn T-bill rates.

The preferred method now is the equalisation factor that allows for a forced redemption in situations where an investor invests at an NAV below the HWM. For example — the fund commences with an NAV of \$100. When the second shareholder invests, the NAV is \$90. This shareholder, who invested \$100 at the NAV of \$90, received 1.1111 shares. At the end of the year, the GAV is \$120 per share and the performance fee charged is \$4 per share, with a resulting NAV of \$116 per share. At the year-end, the second shareholder has earned \$30 per share (\$120 less the \$90 invested) and has to pay an additional \$2 to the investment manager for the appreciation between \$90 and \$100. This is achieved by the fund redeeming 0.017241 shares, being \$2 divided by the NAV of \$116. The resulting redemption proceeds, \$2, is then paid to the investment manager.

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Of all the different methods described here, I prefer what we call the equalisation credit approach, which calls for an investor to invest at gross NAV when the NAV is above its HWM (with shares issued at the subsequent performance fee payment date) and where the investor invests at the NAV where the NAV is below its HWM (with shares redeemed at the subsequent performance payment date). Many of the lawyers who draft fund offering documents are also comfortable with this approach, and it can only be good for the business if a form of convention evolves with respect to the treatment of equalisation.

Conclusion

As mentioned at the outset, investors have definitely become more comfortable with the concept of equalisation. Occasionally, given that they may not be entirely familiar with the actual mathematics and unending permutations, it is unclear if they are sure whether or not it is being correctly calculated. To a certain extent, some of them take a leap of faith that an administrator can perform and report the calculations. The good news is that we have invested a lot of time and effort in making this an exact science. Many administrators have now developed investor reporting systems that calculate equalisation adjustments and track investors' holdings on an integrated basis, so that investor reporting is clear and complete. However, we cannot lose sight of the fact that the industry is based on personal preferences, in which large sums of money are entrusted to a manager and each manager may have a different approach as to how they would like to treat each individual investor. In practical experience, there is the danger that the science will become an inexact one, with inevitable consequences resulting from issues such as different interpretations of documents, difficulties in using various electronic settlement procedures and so on. Nonetheless, equalisation, despite its complexities, offers all interested parties a method whereby incentive fees are accurately and equitably calculated and reported.