iCapital

# PRIVATELY PLACED '40 ACT FUNDS

## PRIVATE EQUITY PRIMER

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'40 Act Market:

Investments designed to provide accredited investors and qualified clients with access to the private capital markets which have historically been the domain of institutional investors.

# EXECUTIVE SUMMARY

As advisors seek to meet the objectives of income and diversification in client portfolios, registered funds that incorporate direct access to private equity, private credit or hedge funds are often overlooked. While relatively few funds provide this type of exposure to accredited investors, there have been significant recent developments that can make them an attractive alternative.

iCapital is dedicated to providing insight on emerging product trends and will focus this initial primer on funds that incorporate private equity, of which there are only a handful today. Future editions will focus on private credit, direct lending, real estate and hedge funds.

The registered fund market encompasses both closed-end and open-end funds that can be sold either publicly or through private placement. To differentiate from listed closed-end funds, ETFs and open-end mutual funds, we will refer to privately placed funds that incorporate access to private capital as the **'40 Act Market**, consistent with the term used by many practitioners.

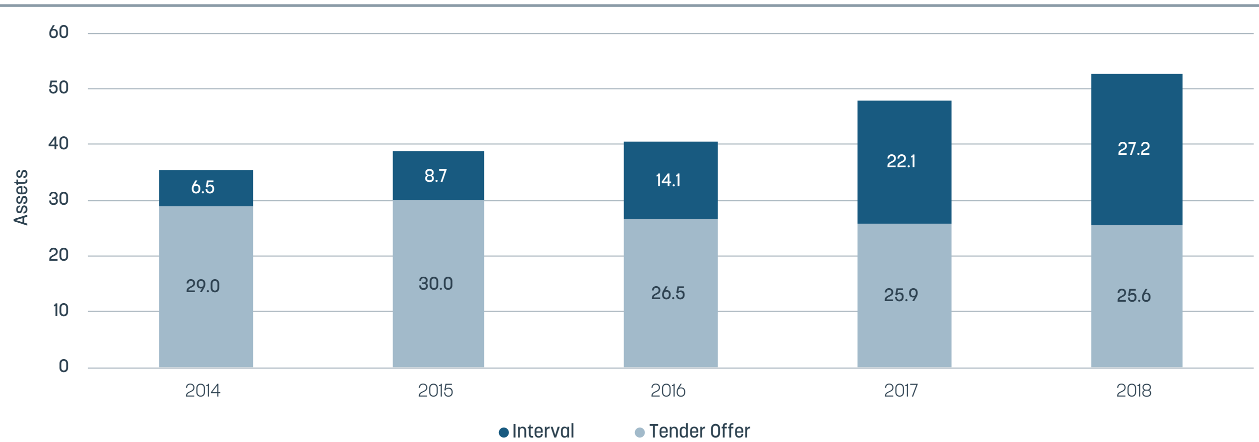
Specifically, we define '40 Act as an *Investment Company registered under the 1940 Act that is a privately placed (e.g., non-listed) closed-end tender-offer fund that has elected to be taxed as a Regulated Investment Company*. Additional definitions can be found in the glossary at the end of this primer.

There are compelling reasons to consider this class of investments, which is designed to provide accredited investors and qualified clients with access to the private capital markets which have historically been the domain of institutional investors, such as endowments and pension funds, and large family offices.

- **Increased Availability:** The number of these funds is growing, with many new products currently in registration. Those in market have been somewhat slow to garner attention and investors' capital, with the entire asset class now approaching just $48 billion in total assets (Figure 1). Consequently, there is virtually no independent research on the '40 Act market; it is still small enough that traditional research firms can afford to ignore it. However, despite its

FIGURE 1

## UNLISTED CLOSED-END FUND ASSETS, 2014 – 2017 ($ BILLIONS)




*Source: Fuse Research. For illustrative purposes only.*

A growing number of established private equity managers are focusing on addressing the challenges of liquidity, transparency and the inevitable cash drag that can occur in making private investments through registered vehicles.

relatively small size, the quality and breadth of these offerings have reached a level that we believe merits attention.

- **Expanded Set of Managers:** As the'40 Act market has evolved in recent years, it has attracted a growing number of firms with demonstrated success in managing private investments. Established players such as Partners Group, Carlyle (CPG) and Pantheon have launched funds under this structure and others have explored this space and we expect more new entrants.

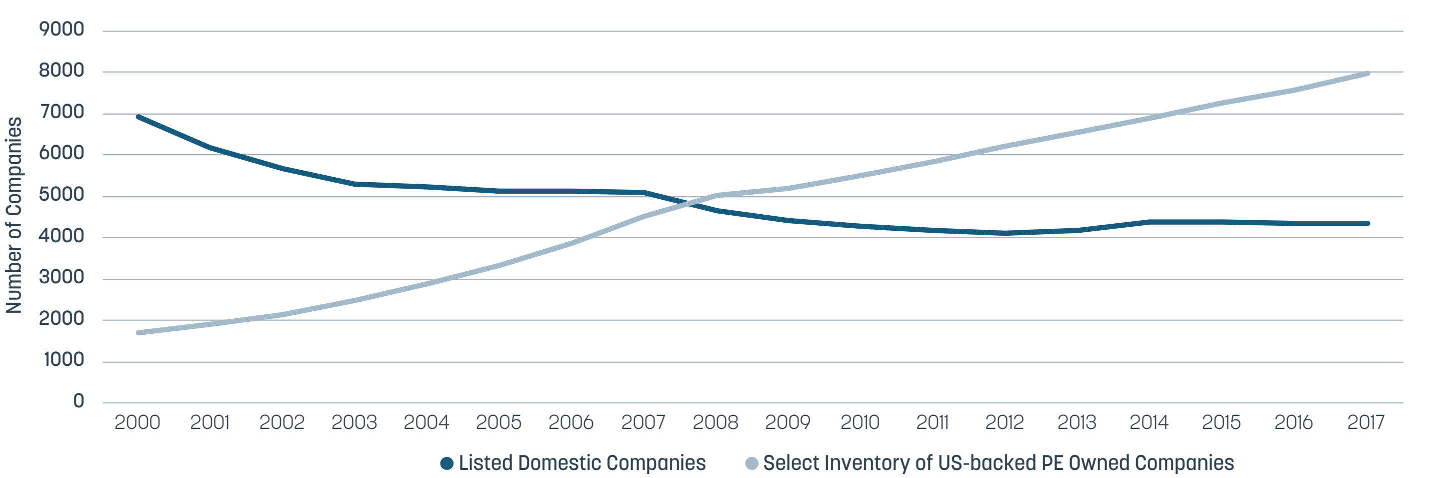
- **Improved Product Features:** As these firms have become interested in tapping into the multi-trillion-dollar accredited investor market, we're seeing positive developments in the construction of these funds (no doubt a consequence of increased competition). More of these established managers are reducing fees and thoughtfully addressing the challenges of liquidity, transparency and the inevitable cash drag that can occur in making private equity investments through registered vehicles.

- **Liquidity Expectations Have Changed:** Managers are keenly aware that the only way to successfully open the market is to provide real value and solve the problems that held back the often flawed first generation of '40 Act funds, many of which disappointed investors. One of the features that has garnered attention is to more closely align '40 Act fund liquidity with the underlying investments' anticipated liquidity. We will discuss this in more detail later in this primer but most investors can expect lock-up periods of at least two years when a fund first launches, early repurchase fees and pro-rata redemptions if a tender is over-subscribed. There is no guarantee of liquidity.

- **Limited Opportunities in the Public Market:** It is no coincidence that the increase in registered funds incorporating private capital is occurring as the universe of public companies ages and shrinks. The combination of fewer IPOs, continued M&A-driven consolidation, and take-privates has led to a sharp reduction in the number of U.S. publicly-listed companies — from almost 8,000 in 1998 to around 4,000 today (Figure 2). Meanwhile, the average age of a

FIGURE 2

## U.S. PUBLICLY LISTED COMPANIES VS. U.S. PE-BACKED COMPANIES




*Source: PitchBook. For illustrative purposes only.*

U.S. public company has increased from 12 years in 1996 to 20 years today – with dynamic, high-growth companies primarily finding their home in the private markets, out of reach for the average equity market investor. In fact, Cambridge recently reported that top quartile PE managers have substantially outperformed the S&P 500 each year from 2008 through 2016 (most recent full year performance reporting). Even the average PE manager has outperformed the S&P 500 in 8 out 9 nine of the years tracked (Figure 3). This highlights the investment opportunity outside the public markets.

While non-listed, closed-end funds have been around for quite some time, they differ from open-end mutual funds in ways that advisors and their clients should consider. A long-held rule of thumb has been that investors should not invest in a mutual fund unless they expect to hold the investment for at least three to five years. This is particularly true of the '40 Act structure, where investors should consider hold periods of five years or more in order to gain the full benefits of the private equity value creation process.

Perhaps the most critical concept for advisors and their clients to bear in mind when considering '40 Act funds that invest in private companies is that, regardless of the liquidity terms, these are fundamentally longer-term holdings and should be viewed as such in a broader portfolio. Private equity firms generate an illiquidity premium through their ability to collaborate with the management teams of their portfolio companies to execute value creation plans that require three to five years (or longer) to realize. These strategies may include expansion into new markets, selective consolidation of a fragmented sector through add-on acquisitions, efficiency improvements/cost reduction, the sale of non-core assets, and/or professionalization of senior management teams. These plans take time. Put a different way, one of private equity's main

**In for the Long Haul**

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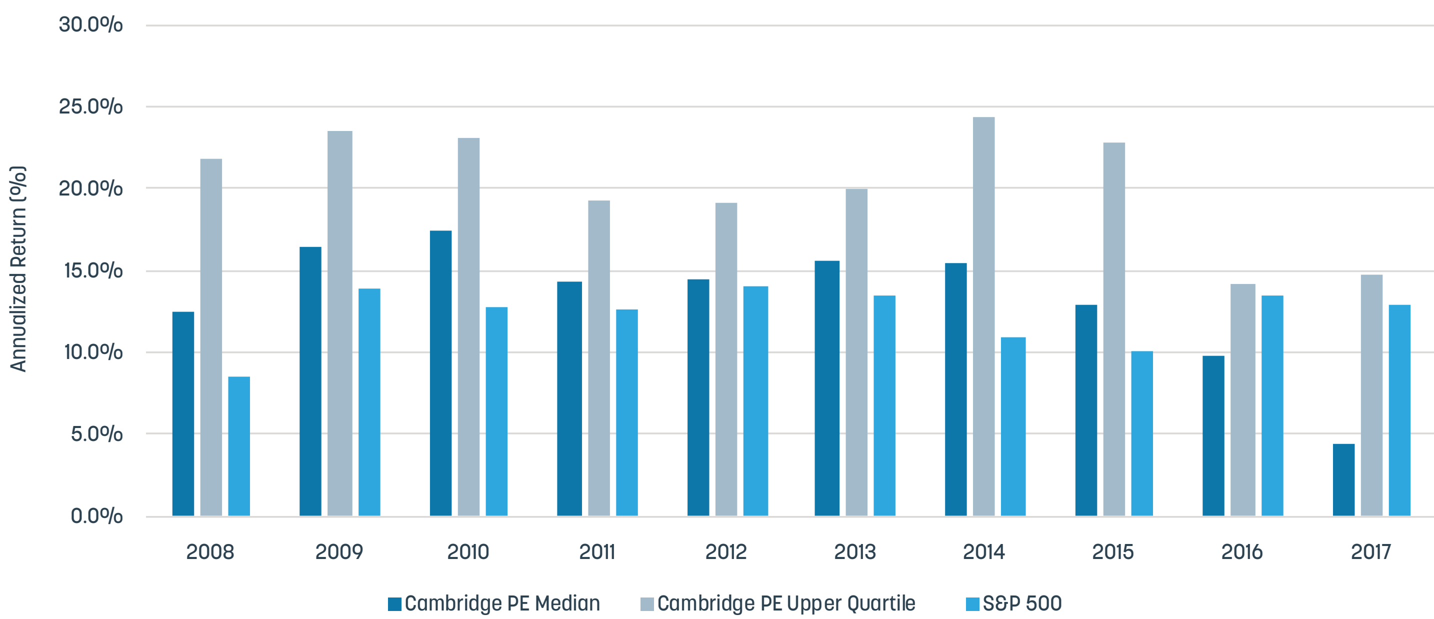
FIGURE 3

## U.S. PRIVATE EQUITY RETURNS




*Source: Cambridge. For illustrative purposes only.*

> It is not credible to allow an entire generation of retail investors to be left with only diversified public market exposure to generate retirement returns, while institutional investors crowd into innovative business models [through the private markets] that offer potentially higher returns.
> – CFA Institute

advantages, particularly over public companies which must deal with the pressures of quarterly earnings and "short-termism", lies in thinking and acting with a long-term time horizon in mind. It is essential that individual investors understand these fundamentals and have realistic timing expectations regarding liquidity.

Indeed, as a CFA Institute report in 2018 concluded, "Public markets are often perceived to be short-termist in their outlook, causing corporate managers to focus on meeting quarterly earnings targets rather than working on creating long-term value. Private markets are perceived to be more long term in their thinking and in their structural characteristics by comparison … it is not credible to allow an entire generation of retail investors to be left with only diversified public market exposure to generate retirement returns, while institutional investors crowd into innovative business models [through the private markets] that offer potentially higher returns." The Institute made several policy recommendations in its report, including improving access to private market investments by retirement savers. These registered funds represent an important advancement in providing retail investors with access to the private capital markets and in leveling the playing field with institutional investors.

## CURRENT STATE OF THE MARKET

Since 2000, there have been several false starts in the closed and open-end registered fund space, as managers sought to deliver private market returns generally reserved for the institutional market. The first generation of these funds was characterized by high annual fees, substantial upfront load fees, market-like beta and/or liquidity mismatch issues. While there were some quality products developed in this first generation, most of the funds fell well short of investors' expectations.

At least for now, the vast majority of advisors and their investors appear to be paying heed and staying in these funds for relatively long periods. These funds generally offer limited quarterly liquidity through a share re-purchase tender process, and a review of SEC filed documents reveals that most funds have been able to meet the redemption requests of investors who have chosen to tender their shares. Redemptions appear to have been relatively light, which is a sign that most investors and their advisors understand the longer-term nature of these funds and the need to remain invested to reap the upside. And, of course, buoyant market conditions have also likely helped.

- **Matching liquidity features with the underlying investment:**
    - Private equity-focused funds generally register as a tender-offer fund (as opposed to an interval fund), allowing the fund's advisor and its independent board to limit redemptions through tenders if they deem it necessary. While tender-offer funds try to maintain some minimal level of quarterly liquidity, 5% for example, these funds have fairly wide latitude in establishing the amount and timing of their share repurchases. In contrast, an interval fund must adopt a fundamental policy, changeable only by a majority vote of the outstanding voting securities of the company, and in which the timing and minimum amount of each tender is mandated (between 5% and 25%);

It is no coincidence that the increase in registered funds incorporating private capital is occurring as the universe of public companies ages and shrinks.

  - Credit-focused funds often register as interval funds with a minimum requirement of 5% per quarter. In these structures, the underlying investments generally have a greater level of liquidity and the fund sponsor should be able to manage the share re-purchases even through challenging market cycles.

- **Registration:** These funds must all register with the SEC under the 1940 Act. This registration allows access to these private opportunities for accredited investors (some funds are restricted to qualified clients), but maintains the suitability and limitations on the manner of the offering, somewhat similar to private funds.

- **Board Oversight:** Consistent with all registered funds, each '40 Act fund is overseen by an independent board designed to represent shareholders' interests. The board reviews the fund's operations, including adherence to its stated investment objective and investment advisory fees, and is responsible for approving any share repurchases or tender offers. It is important to note that during times of market stress or dislocation, the board may decline to make a tender offer if it believes that such an action is not in the best interest of all shareholders (as noted, interval funds are required to meet their minimum stated tender amounts). For example, the board may find that to honor the tender offer, the fund would have to sell investments at distressed prices significantly below their true market value, which may not be in the best interests of the overall shareholder base (even if some shareholders wished to sell) and thus the board could decline to allow any tenders during that period. While these instances tend to be rare, they highlight the responsibilities of the board towards all shareholders, and not just those looking to tender shares for repurchase in a possible "fire sale" situation.

- **Simplified Tax Reporting:** Almost all of the current PE-focused registered funds now elect to be taxed as a Regulated Investment Company (RIC) by the IRS, delivering a 1099 form (instead of a K-1). This simplifies tax reporting and filing for investors in these funds.

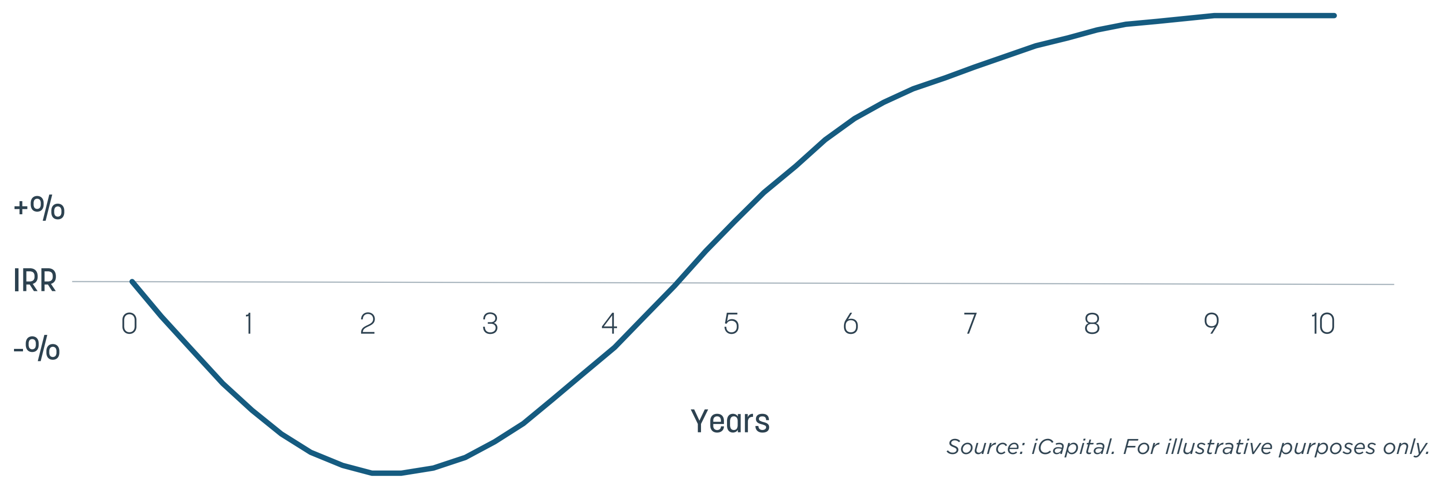
## THE CASH DRAG CHALLENGE

'40 Act funds that focus on less liquid investments such as private equity also face a "ramping-up risk" that traditional mutual funds do not. When most mutual funds receive a new subscription from an investor, they can invest those proceeds almost immediately into public equities or fixed income securities. In contrast, many of the typical underlying investments made by '40 Act funds can take months from identification to due diligence to actual investment, and then three to five years to an exit and the realization of proceeds.

Capital that is committed to private equity funds is deployed over several years and thus, in the traditional private fund structure, the fund manager calls that capital down from investors when needed as deals are completed. In the '40 Act fund model, there is generally no call down process as 100% of an investor's money is placed into the '40 Act fund at the time of investment. As a result, the nature and structure of a '40 Act fund's deployment of capital into underlying investments can lead to significant cash drag on overall performance if not properly managed. There are strategies that '40 Act funds can employ to try to mitigate this risk, such as purchasing equity index ETFs or pursuing an over-commitment strategy. Each of these strategies has benefits and drawbacks.

FIGURE 4

## J CURVE GRAPH




*Source: iCapital. For illustrative purposes only.*

**The J Curve:** The J Curve refers to an investment performance arc where a significant gain follows an initial loss. In private equity, the fund manager charges fees and expenses from day one on the total committed capital. In the early years of the investment period when the manager calls down that capital to invest in private companies, those fees and expenses can result in a near-term loss since it takes time to both deploy the capital and then to create value in the portfolio companies (Figure 4).

One of the most common ways to address this "cash drag" issue in registered funds is to have a high exposure to secondary and income-generating investments until the fund reaches scale. For example, a typical private equity fund will take several years to execute its value creation plan and does not generate meaningful distributions until around year 4, leading to a relatively slow ramp-up in investment performance. By contrast, a secondary investor typically purchases a mature stake in a primary fund that is already 4 to 7 years old with portfolio companies that are close to an exit. Thus, a secondary investment will typically start generating liquidity for investors within several months from the original investment. Further, the mature nature of secondary investments means investors have the opportunity to deploy significant amounts of capital right away and reduce the "drawdown" period, which can further help alleviate the cash drag.

Similarly, investing in credit-oriented strategies allows investors to earn positive income immediately. This income allows a '40 Act manager to build a cash cushion that can be redeployed or help meet investors' liquidity needs.

Direct investments (or co-investments) can also help mitigate the J Curve, but not as quickly as secondary or credit-oriented investments. An advantage of direct investments is their reduced cost, as most transactions are offered on a fee basis well below the traditional 2% management fee and 20% performance fee schedule that underlying private fund managers typically charge. This low-fee structure, combined with exposure directly to privately-held businesses, leads to a shallower J Curve compared to primary investments as the investor's capital can be put to work at a faster pace than a typical primary fund investment, which deploys capital over several years.

One risk in a registered fund loading up too quickly on secondary investments or co-investments early on is that it can end up with a significant concentration of assets acquired in the same vintage year or period of time when asset prices (both secondaries and co-investments) may be trading at historically high levels. If, for example, a registered fund invests in a large pool of secondaries or co-investments that end up accounting for 40% of the fund's assets, and those private assets were purchased at a high point in the market cycle, that fund could be vulnerable if prices normalize and cause the valuation of those assets to decline. This risk can be mitigated by being disciplined during the acquisition phase and spreading investments over a longer period to achieve vintage year diversification and limit performance risk attached to a specific valuation environment. Thus, managers will have to strike a balance between deployment pace and the desire to offset the J Curve.

The other issue that '40 Act managers face is how to manage cash sitting on a fund's books while the manager is deploying capital and the underlying fund commitments are waiting to be called down. This can lead to performance dilution until the portfolio is fully deployed. While the above-described strategies of secondary investments, direct investments and income-generating securities help with cash management, they do not eliminate this issue. There are several ways '40 Act managers can manage cash and earn positive income. Below is a list of cash management strategies we have seen:

- **Cash or money market accounts:** This is the least risky strategy since the likelihood of earning a negative return on cash is very small, but '40 Act fund expenses may out-strip any positive income generated. Typically, one can invest capital in vehicles such as money market funds, treasury bills or certificates of deposit, which can provide modest short-term income. However, this approach can be highly dilutive as cash tends to generate the lowest return of all asset classes.

- **Invest in equity index strategies:** This approach focuses on investing the "idle cash" in the registered fund directly in investments tied to broad market-based indices like ETFs. This style allows a '40 Act manager to capture the returns of a target index but also poses the risk of loss of capital during periods of significant market decline. This market beta exposure is one of the reasons managers tend to avoid this strategy.

- **Invest in listed PE:** This involves investing in the equity securities of listed private equity fund managers such as Apollo, Blackstone or Carlyle, or in an index such as Red Rock. This poses a significant risk of experiencing a capital

**Minimizing "Cash Drag"**

The other issue that '40 Act managers face is how to manage cash sitting on a fund's books while the manager is deploying capital and the underlying fund commitments are waiting to be called down. This can lead to performance dilution until the portfolio is fully deployed.

**Fund Fees Impact Performance**

One critical factor directly impacting performance is fund fees. However, deciphering the prospectuses of registered funds can be challenging.

loss since these securities tend to be more volatile, may have more "market beta", and sometimes trade more on negative sentiments. Also, the limited float of some of the listed vehicles adds to volatility concerns.

- **Over-commitment strategy:** One of the newer concepts that is gaining traction is to commit more capital to underlying investments than the total subscription received by the '40 Act fund. Generally, private equity managers only draw 70% to 80% of the original commitment and fund the rest of the commitment with expected distributions. This approach is feasible since private equity investments don't require 100% of the capital at the time of the original investment. Thus, the '40 Act fund can theoretically deploy more capital in anticipation of an expected uncalled commitment and reduce cash drag. The challenge with this approach is that if the pace of distributions from previous investments is slower than expected, the '40 Act fund could be overexposed.

A combination of the above strategies can help solve the cash-on-hand problem faced by '40 Act managers aiming to deliver traditional private equity exposure.

## DECODING THE PRIVATE EQUITY FEE TABLE

One critical factor directly impacting performance is fund fees. However, deciphering the prospectuses of registered funds can be challenging. On the following page is a sample fund prospectus fee table. While similar to the fee tables found in mutual fund and ETF prospectuses, there are some important nuances to understand prior to allocating capital to these funds.

Some of the most important components of a fund's fee structure are:

- Management fee
- Performance fee or "carry" paid to the fund advisor
- Acquired fund fees, if any
- Performance fees or carried interest assessed on any underlying fund
- Fund fee waivers or fee caps

Some of these components may not always be clearly laid out in the fee table.

FIGURE 5

## SAMPLE REGISTERED PE FUND FEE TABLE

| ANNUAL FUND EXPENSES | SHARE CLASSES | |
|---|---|---|
| | ADVISORY | INSTITUTIONAL |
| Management Fee | 1.00% | 1.00% |
| Distribution/Service Fees | 0.50 | 0.25 |
| Operating Expenses | 0.85 | 0.75 |
| Effect of Fee Cap/Waiver | (0.35) | (0.25) |
| Operating Net Sub-total | 2.00 | 1.75 |
| Acquired Fund Fees | 0.85 | 0.85 |
| **Total Expense Ratio (TER)** | **2.85%** | **2.60%** |

*Source: iCapital. For discussion purposes only.*

Advisors should look carefully at the footnotes to the fee table, and in the body of the prospectus, to understand how the other fees impact the total fee level (and consequently net performance). Everything else being equal, funds with more assets under management tend to have lower operating expenses, which is an important component of the overall fee (Figure 5).

**Pay particular attention to footnotes.** The footnotes, generally found just after the prospectus fee table, contain important information about how the fees are calculated and, in the case of a fee waiver or fee cap (defined on the following page), the period for which they will be in place. Fee waivers and caps are generally in place for 12 months and are renewed on an annual basis.

### *Registered PE Fund Fee Glossary*

**Annual Fund Expenses** are typically found in a table format within the fund's prospectus (the SEC Form N-2 for registered closed-end funds) – this is similar to open-end funds, often referred to as mutual funds. The fee table can generally be found directly after the prospectus summary. Per SEC requirements, the table typically lists the expenses for all share classes covered by the prospectus as a percentage of net assets. Some funds choose to file a separate prospectus for each share class, however this is less common.

**Management Fees** for a registered fund will be the same across all share classes. If the fund has qualified client investor restrictions, the SEC also allows the manager to charge a performance fee, which need not be included on this line or in the fee table at all. Advisors should check the "Management of the Fund" section of the prospectus and the fund's annual report to understand the full management fee structure. Certain accredited investor funds (and some BDCs and REITs) that focus on fixed income may have a performance fee that is a percentage of the income generated over a hurdle rate — this is also described in the "Management of the Fund" section.

**Distribution/Services Fees** are structured similar to 12b1 fees for a mutual fund. These are fees generally paid on a sliding scale, depending on the share class, to the selling broker-dealer or agent. They are generally between 0.25% and 0.75% of a fund's net assets.

**Operating Expenses** are expenses for running the operations of the fund. They include fees paid to the fund accountant and administrator, transfer agent, fund auditor, external legal counsel, SEC and FINRA fees, tax preparation, mailing, printing, and other fees and expenses. Some of these expenses can vary by share class.

**Fee Waiver or Fee Cap** are mechanisms used by the fund sponsor to limit the total expenses of the fund, generally for competitive reasons. Newer funds that have not reached scale often have a fee waiver or cap to keep the fund expenses at an assumed level (as if the fund were at scale). Expenses in excess of the cap are paid by the fund's sponsor out of their own resources. The SEC allows these fees to be recouped by the fund's sponsor in certain instances.

**Acquired Fund Fees** represent the fees and expenses of any underlying private or registered (including ETFs and money market) funds held by the '40 Act fund. These generally do not include the impact of a carried interest charged by an underlying private fund held by the '40 Act. The typical private equity fund charges an annual management fee of 2% plus a 20% performance fee (defined in the glossary). It is important to understand the total acquired fund fees, which are not always clearly and prominently disclosed in the fee table.

## WHAT TO EXPECT FROM iCAPITAL

Each Institutional Capital Network, Inc ("iCapital") primer will update the network on the '40 Act market and highlight features that differentiate this market from open-end mutual funds and private funds that tend to be open only to the qualified purchaser market. We believe a growing number of new entrants to this market are making a good faith effort to provide investors with an attractive entry point into the private capital markets. While this inaugural issue focuses on '40 Act funds that invest in private equity, future editions will focus on other segments, for example hedge funds, direct lending, and real estate.

We hope that the iCapital '40 Act Primer will prove to be a useful tool to our network and we look forward to discussing this space with you as we selectively add more registered funds to our menu of offerings.

– the iCapital team

# GLOSSARY

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|---|---|
| **1940 Act** | The Investment Company Act of 1940 is an act of Congress. Along with the Securities Act of 1933, Securities Exchange Act of 1934 and Investment Advisers Act of 1940, and extensive rules issued by the Securities and Exchange Commission, it forms the backbone of United States financial regulation. It has been updated by the Dodd-Frank Act of 2010. Often referenced as the Investment Company Act, the 1940 Act or simply the '40 Act, it is the primary source of regulation for mutual funds and closed-end funds, an investment industry currently managing many trillions of dollars. In addition, the '40 Act impacts the operations of hedge funds, private equity funds and even holding companies. |
| **Alternative Investments** | An alternative investment is an asset that is not one of the conventional investment types, such as stocks, bonds and cash. Most traditional alternative investment assets are held by qualified purchasers or accredited, high-net-worth individuals due to the complex nature and limited regulation of the investments.<br><br>*The most common alternative investments are in private equity, real estate, hedge funds and commodities. Alternatives tend to have attributes that differ from typical stock and bond investments from a risk return and time horizon perspective, so adding them to a portfolio may provide broader diversification, reduce risk, and enhance returns while reducing liquidity. Historically, alternative investments have played a major role in institutional investors' portfolios such as endowments and pension funds.* |
| **Capital Call**<br>**(also known as a Drawdown)** | A capital call occurs when a fund collects capital from investors as the need arises to make investments or pay fees and expenses.<br><br>*Most private equity funds do not invest all of an investor's committed capital upfront. Instead, managers will "call" capital as needed to make investments. Typically, capital for new investments is drawn down during a fund's investment period, which often lasts for the first five years of a fund's life. However, capital calls may also be made after the investment period to fund follow-on investments and expenses.* |
| **Carried Interest** | Carried interest, or carry, is a share of any profits that the general partners of private equity and hedge funds receive as compensation. This method of compensation seeks to motivate the general partner (fund manager) to work toward improving the fund's performance.<br><br>*Carried interest serves as one of the sources of income for a fund manager, traditionally amounting to 20% of the fund's overall profit. In private equity, this normally kicks in above a certain rate of return, typically an 8% annualized return. For example (for a fund with 20% carry above an 8% hurdle), a fund must first generate an 8% annual return on capital called to investors before the fund manager can receive any share of the profits. Second, the fund manager will receive 100% of all additional distributions until they "catch up" to an overall 20% of all distributions. Thereafter, any distributions are split 80% to the investors/LPs and 20% to the fund manager.* |

# GLOSSARY

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| **Co-investment/Direct Investment** | Direct investments involve acquiring an interest in securities issued by an operating company. Such investments are typically made as co-investments alongside private equity funds and are usually structured such that the lead investor holds a controlling interest. Direct investments and co-investments, unlike investments made through funds, generally do not incur fund management and performance fees. |
| **Committed Capital** | The amount of money that an investor commits to investing into a fund. The commitment will be confirmed to the investor at the fund's closing, although capital will only be called as needed during the fund's life.<br><br>*This is the overall cash amount than an investor commits upfront to a fund. A fund's total commitment is the aggregate of all its underlying investors' commitments. Unlike mutual funds, private equity managers do not call capital upfront. Instead investors are bound by a commitment agreement, which PE managers then rely on to make investments.* |
| **Dry Powder** | *The amount of cash or other liquid assets available for a fund to deploy, based on capital committed to the fund by investors. In other words, dry powder is the difference remaining between a fund's total committed capital and invested capital to date.*<br><br>*This is a fund's total commitments less any dollars committed to investments. For example, if a fund raised $100 million and committed to 5 deals requiring $60 million in total equity capital, the remaining dry powder would be $40 million, which represents what the fund manager has left to invest.* |
| **Due Diligence** | The research performed by an investor on a potential investment, in order to determine its merits and uncover potential risks.<br><br>*The due diligence process is designed to uncover the strengths and weaknesses that could potentially affect performance. The key areas that are typically analyzed are: a fund's past performance, the team members and their experience and consistency, the fund's strategy, market opportunity, the attractiveness of the sector(s), how deals are sourced and how value is created during the firm's ownership period.* |
| **Fund-of-Funds** | A fund that takes equity positions in other funds. Fund-of-funds can invest in private equity funds, secondary funds or hedge funds.<br><br>*In other words, an alternative investment fund that aggregates investors' commitments to invest in underlying fund managers. The basic idea is that a fund-of-funds can offer greater diversification and access to high-minimum funds, albeit with an additional layer of fees.* |
| **General Partner (GP)** | The manager of a private equity fund. The GP is given unlimited liability for the debts and obligations of the fund as well as the right to manage the fund.<br><br>*In other words, the fund manager.* |

## GLOSSARY

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| **Hurdle Rate (a/k/a Preferred Return)** | Represents the minimum rate of return that a fund must earn before it can begin to charge a performance fee.<br><br>*A hurdle is typically 8%. This means that investors are entitled to a minimum 8% annual return before the fund manager may begin receiving carried interest (see definition: carried interest).* |
| **Incentive (or Performance) Fee** | A payment made to an investment manager for generating positive performance in excess of the hurdle rate. The performance fee is calculated as a percentage of the profits, both realized and unrealized, over the course of a year. In private equity, the performance fee is typically 20% of the profits. |
| **Illiquidity Premium (interchangeable with Liquidity Premium)** | A premium expected by investors when any given security cannot be easily converted into cash for its fair market value.<br><br>*The illiquidity premium compensates an investor for tying up their capital in an illiquid security or fund. In return, they are typically compensated by the expectation of greater potential returns.* |
| **Investment Period** | The initial period of a private equity fund's life in which deals are sourced and new investments can be made.<br><br>*The investment period is typically the first five years for a private equity fund. After that period, management fees are typically lowered and cash can only be called from investors to cover follow-on investments or fees.* |
| **Investor Qualification**<br>*Accredited Investors* | Under Rule 501 of the Securities Act, an individual is an accredited investor if he or she:<br>(i) has a net worth (along with his or her spouse) that exceeds $1,000,000 (excluding the value of his or her primary residence); or<br>(ii) income in excess of $200,000 (or joint income in excess of $300,000 with spouse) in each of the two most recent years with a reasonable expectation of reaching the same income level in the current year.<br>An entity is an accredited investor if it:<br>(i) is owned exclusively by accredited investors; or<br>(ii) is not formed for the specific purpose of acquiring the interest in the fund and has total assets in excess of $5,000,000. |
| *Qualified Clients* | Under Rule 205-3, an individual or entity is a qualified client if he, she, or it:<br>(i) has $1,000,000 or more of assets under management with the investment adviser after the investment in the fund;<br>(ii) has a net worth of $2,100,000 prior to the investment in the fund (excluding the value of his or her primary residence);<br>(iii) is a "qualified purchaser" (see the next section); or<br>(iv) is an officer or director of the fund manager or is an employee who participates in the investment activities of the investment adviser and has been doing so for 12 months. |

# GLOSSARY

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| *Qualified Purchasers* | Generally, a qualified purchaser is an investor who meets any of the following criteria:<br>(i) an individual or family-owned business not formed for the specific purpose of acquiring the interest in the fund who owns $5,000,000 or more in investments;<br>(ii) a trust not formed for the specific purpose of acquiring the interest in the fund which is sponsored by and managed by qualified purchasers;<br>(iii) an individual or entity not formed for the specific purpose of acquiring the interest in the fund which owns and invests at least $25,000,000 in investments (or someone who is acting on account of such a person); or<br>(iv) an entity, of which each beneficial owner is a qualified purchaser. |
| **J Curve** | A phenomenon where a significant gain follows an initial loss. Typically shown as a line graph which illustrates how capital flows into a fund manager in the early years of a fund to make investments; and how the capital then produces gains towards the latter years in the fund's lifecycle. Plotted over time, the J Curve shows the historical tendency of private equity funds to deliver negative returns in early years as money is invested, and investment gains in the outlying years as the portfolios of companies mature.<br><br>*This demonstrates how private equity funds typically have 'negative' returns in the first few years (as investors have to pay management fees and initial investment costs from day 1) which then turn into positive returns as the underlying investments mature and start to generate returns that significantly outweigh the fee and expenses. When these cashflows are charted over a private equity fund's life, they typically follow a "J" shaped curve.* |
| **Limited Partner "LP" (also Investor)** | An LP is an investor who makes a commitment to a private equity fund and provides capital as it is called. The investor has no control over the management of the fund.<br><br>*While an LP could be an individual investor, the vast majority of the $5.8 billion in global private equity capital (including dry powder) is from institutional investors such as public and private pension funds, endowments, foundations, sovereign funds, and insurance companies.* |
| **Percent Called** | The amount of money that the fund has called from investors (less recallable distributions) divided by the total amount of commitments to the fund.<br><br>*In other words, if you committed $2MM to a fund and the fund has asked you to contribute $400K thus far to pay for deals, then you are 20% called. Any recallable distributions that take place are added back to the amount of unfunded capital that has yet to be called.* |

# GLOSSARY

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| **Private Credit** | Private credit is credit extended to companies or projects on a bilaterally negotiated basis. Unlike corporate bonds, private credit is not publicly traded and is originated or held by lenders other than banks. It takes various legal forms including loans, bonds, notes or private securitization issues.<br><br>*Private credit encompasses various strategies including real estate debt, distressed debt, direct lending, mezzanine financing, and structured financing.* |
| **Private Markets** | Investments not traded on a public exchange or market. This includes equity or fixed income investments directly into private companies or investments in partnerships investing in such private companies.<br><br>*Private markets asset classes include private equity, hedge funds, private credit, venture capital, infrastructure and real estate, amongst others.* |
| **Real Assets** | Real assets are physical assets that have value due to their substance and properties. They are appropriate for inclusion in most diversified portfolios because of their relatively low correlation with financial assets such as stocks and bonds and due to their role as a hedge against inflation.<br><br>*Real assets are a separate and distinct asset class from financial assets and include precious metals, commodities, infrastructure, and real estate.* |
| **Regulated Investment Company (RIC)** | A regulated investment company (RIC) is a US tax term and can refer to any one of several investment entities. For example, it may take the form of a mutual fund, an exchange-traded fund (ETF) or a real estate investment trust (REIT) among others. Whichever form the RIC assumes, the structure must be deemed eligible by the Internal Revenue Service (IRS) to pass through taxes for capital gains, dividends or interest earned to the individual investors.<br>A regulated investment company is qualified to pass through income under Regulation M of the IRS based on the following:<br>• A RIC must derive a minimum of 90% of its income from capital gains, interest or dividends earned on qualifying investments. |
| **Secondary Private Equity Market** | A market for private equity interests where existing investors in funds sell both their existing assets and their unfunded commitment in a fund.<br><br>*The secondary PE market provides liquidity to private equity investors, allowing them to sell their existing positions in private equity funds. The secondary market is typically the only way for investors to exit their private equity investments early. The pricing is privately negotiated between the buyer and the seller.* |

# GLOSSARY

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| **Tender Offer and Interval Funds** | Interval funds are closed-end managed investment companies ("closed-end funds") registered under the 1940 Act that rely on Rule 23c-3 under the 1940 Act to periodically offer to repurchase shares at their net asset value ("NAV") from shareholders at predetermined intervals. Tender offer funds, on the other hand, are closed-end funds registered under the 1940 Act that conduct periodic tender offers on a discretionary basis pursuant to the applicable provisions of the Securities Exchange Act of 1934 (the "Exchange Act") and the rules thereunder.[1] |
| **Valuation** | Private equity funds value their investments on a quarterly basis. U.S. GAAP — specifically, ASC 820, Fair Value Measurements and Disclosures (formerly known as FAS 157) — provides a single framework for measuring fair value and related disclosures.<br><br>*Typically, a fund manager will work with their investment team (and sometimes a third party) to determine an investment's market value. This could include a discounted cash flow analysis ("DCF"), public comps etc. Fund managers typically provide quarterly reports to their investors, which include each portfolio company's valuation, including information on valuation methodology. Registered fund valuation models will typically rely heavily on the quarterly valuations from the underlying managers. To strike a monthly net asset value the registered fund may consider and make adjustments to those quarterly valuations.* |
| **Value Creation** | Value creation is how fund managers generate returns in their portfolio companies for investors. There are three key value creation levers: earnings growth, multiple expansion, and debt paydown.<br><br>*Analyzing value creation methods allows investors to see the key drivers of a fund's returns. Fund managers who create value primarily through earnings growth are typically favored as this reflects a manager's skill in operationally improving a company, rather than relying on financial engineering or buoyant exit markets.* |
| **Vintage Year** | The vintage year is the year in which the first influx of investment capital is delivered to a project or company. This marks when capital is contributed by venture capital, a private equity fund or a partnership drawing down from its investors. Investors can use the vintage year of an investment to further explain its returns.<br><br>*For example, if a private equity fund starts investing in 2016, it is typically considered a 2016 vintage fund. However, there are no official guidelines to determine a vintage year and some PE fund managers will instead use the fundraising year as the vintage year. This metric is particularly useful when benchmarking a fund's performance – as funds of the same vintage are typically compared to each other.* |

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