AN EXPLANATION OF PRIVATE EQUITY FUND FEES

In 2015, the nation's biggest pension fund, the California Public Employees' Retirement System, better known as CalPERS, publicly disclosed that it has paid more than $3 billion in performance fees to private equity managers over the prior 17 years, while reaping more than $24 billion in profits during the same timeframe.[1]

Other large institutional investors, such as pension funds, university endowments and sovereign wealth funds, have provided similar levels of transparency around the private equity components of their portfolios. This level of detail helps to make a compelling case for why advisors should take the time to better understand the unique characteristics of the asset class, as well as the fees charged by private equity fund managers to investors.

FUND STRUCTURE

Private equity funds are generally structured as limited partnerships. The manager of the fund is called the general partner ("GP") and the investors that commit capital to the fund are called limited partners ("LPs"). The GP invests the fund's capital, manages the portfolio of investments and executes exit events, while the LPs are passive investors who receive distributions from the fund.

INVESTOR ELIGIBILITY

Importantly, investors must qualify to participate in private equity investments. Many funds require "qualified purchaser" status – that is, a person with not less than $5 million in investable assets, excluding their primary residence, or a company with not less than $25 million of investable assets. The minimum commitment level required to invest directly with GPs typically ranges from $5 million to $20 million. These high minimums reflect the fact that private equity has historically been the domain of large, sophisticated investors.

MANAGEMENT & INCENTIVE FEES

Private equity managers charge their investors an annual management fee, typically 1.5% - 2.0% of committed capital, which goes to support overhead costs such as investment staff salaries, due diligence expenses and ongoing portfolio company monitoring. In addition, GPs collect performance fees, known as carried interest, which traditionally represent 20% of any value appreciation or aggregated profits generated by the fund.

However, in order for GPs to begin receiving carried interest, most private equity funds must first achieve a stated hurdle rate, also known as the preferred return. This is the minimum annual return that LPs are entitled to before the GP may begin receiving carried interest. The typical hurdle rate is approximately 8%.

FUND DISTRIBUTIONS

Distributions from private equity funds typically follow a waterfall structure. A standard distribution waterfall flows according to the hurdle rate, a "catch-up rate" and the carried interest rate. In the first phase of a fund's life, when returns have not exceeded its hurdle rate, all distributions are allocated to limited partners. Then, once a fund exceeds its hurdle rate, what is commonly referred to as a "catch-up" provision takes place wherein the GP typically is paid a higher proportional amount until it has caught up to the profit percentage already distributed to LPs. For example, once the fund reaches its hurdle rate and has delivered that to LPs, 80% of the next distributions will be allocated to the GP until the GP's own return equals the pre-specified share of profits. Once this occurs, the remaining profits generated by the fund are then distributed according to the original schedule, or 80% to LPs and 20% to the GP.

CLAWBACKS

It is also worth noting that many PE fund agreements generally include "clawback" provisions, which require GPs to hold a portion of carried interest collected over the life of the fund in escrow to account for scenarios under which the overall performance of the fully liquidated fund dips below the hurdle rate. This allows for the recovery of any excess carried interest that the GP may have retained to ensure that LPs receive their net hurdle rate.

ALIGNMENT OF INTERESTS

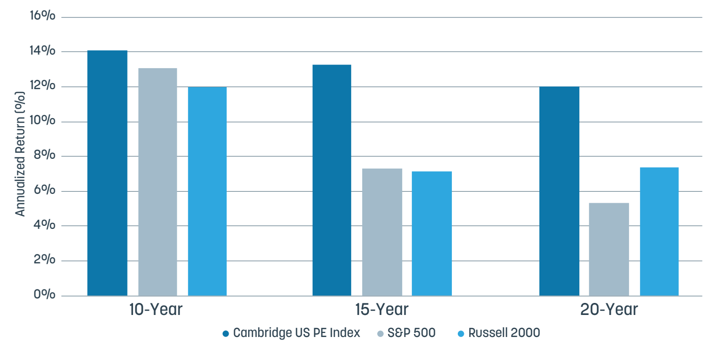
Private equity firms are focused on delivering outsized returns for their investors and have structured their fees in a way that enables them to participate in that upside. As Figure 1 illustrates, private equity has consistently outperformed most major asset classes over the past 20 years, meaning that this profit sharing arrangement has historically proven to be a critical and worthwhile incentive that helps align the interests of managers and investors. It is important to note, however, that past performance does not guarantee future results and there are key differences between private equity and public equities and fixed income, including private equity's higher level of risk and illiquidity.

When viewed in this context, there is a convincing argument for advisors and their high-net-worth clients to consider an allocation to private equity. Private equity offers the possibility of strong performance and may be a valuable addition to a well-diversified portfolio, but it also carries some significant risks that make it appropriate only for certain types of investors. Advisors should learn as much as possible about the mechanics of private equity, the associated fee structures, and the potential benefits and risks before taking action.

[1]CalPERS' Active Private Equity Funds Generated $24.2 Billion in Net Gains for the Fund; Releases Profit Shared with Investment Partners, November 24, 2015, https://www.calpers.ca.gov

FIGURE 1

PRIVATE EQUITY RETURNS vs PUBLIC MARKETS



For illustrative purposes only.

Source: Cambridge Associates, US Private Equity Index and Selected Benchmark Statistics, Q4 2018.

Past performance is not indicative of future results. Historical returns are included solely for the purpose of providing information regarding private equity industry returns and returns of other asset classes over certain time periods. While investments in private equity funds provide potential for attractive returns, they also present significant risks not typically present in public equity markets, including, but not limited to, illiquidity, long term horizons, loss of capital and significant execution and operating risks.

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