Alternative Mutual Funds and Performance Fees

NEI

What are they?

A performance fee (PF) is a payment made to an investment manager for generating positive returns.

- **Did you know:** Performance fees are generally higher than standard management fees (20% is a typical performance fee rate in the Alternative Mutual Funds space) because these funds are often looking purely for alpha[1] rather than relying on the market beta[2] to drive returns. A fund manager utilizing a long-short strategy[3], for example, effectively has at least double the number of active decisions to make compared to a long-only[4] manager. In the context of a total portfolio, it is worth thinking of the fee per unit of alpha to help allocate fee budgets.

A hurdle rate is a minimum rate of return the manager must achieve before a performance fee is payable – it means that underperformance or negative performance is not rewarded.

- **Did you know:** The industry often talks about a '2 and 20' fee structure. This is referring to a structure with a 2% management fee on total assets and an additional 20% performance fee on profits. Funds with performance fee structures may or may not utilize a hurdle rate in addition - it's an extra bar for a fund manager to jump over.

A high-water mark (HWM) is the peak value that a fund has previously reached. It acts as a double layer of protection for investors because at any point in time, the investor only pays for performance above the existing high-water mark. This ensures investors do not pay for the same performance twice and motivates the fund manager to perform well and manage volatility to achieve more consistent outperformance.

- **Did you know:** If a manager has a period of underperformance, they must get the fund back up to the previous high-water mark level and exceed their hurdle rate if they have one before performance fees will start to accrue again.

How do they work?

Calculating performance fees: example

Let's assume a fund has a 1% management fee, 20% performance fee, 2% hurdle rate and a high-water mark, and performance fees are calculated and paid annually. A client invests $10,000 on day 1. Over the year the fund returns 5%.

Starting value (A)	Gross return (B) = 5% x $10,000	Performance fee (C) = (5%- 2%) x 20%	Management fee (D) = 1% x $10,000	End value (E) = A + B – C - D
$10,000	$500	(500 – 200) x 20% = $60	$100	$10,340

- A $60 performance fee is paid as part of a total $160 fee and the new high-water mark on the fund becomes $10,500 because this is the peak value the fund has reached.
- In the next period the fund manager will only be paid for performance above both the high-water mark and hurdle rate.

[1] Alpha is the excess return of an investment relative to the return of a benchmark index.

[2] Beta is a statistical measure of the volatility of a stock versus the overall market. A beta above 1 means a stock is more volatile than the overall market. A beta below 1 means a stock is less volatile than the overall market.

[3] Generally speaking, a long-short equity is an investment strategy that seeks to take a long position in underpriced stocks while selling short overpriced shares. The strategy seeks to augment traditional long-only investing by taking advantage of profit opportunities from securities identified as both under-valued and over-valued.

[4] Generally speaking, a long-only strategy focuses on buying and holding assets for the long term to achieve capital growth.

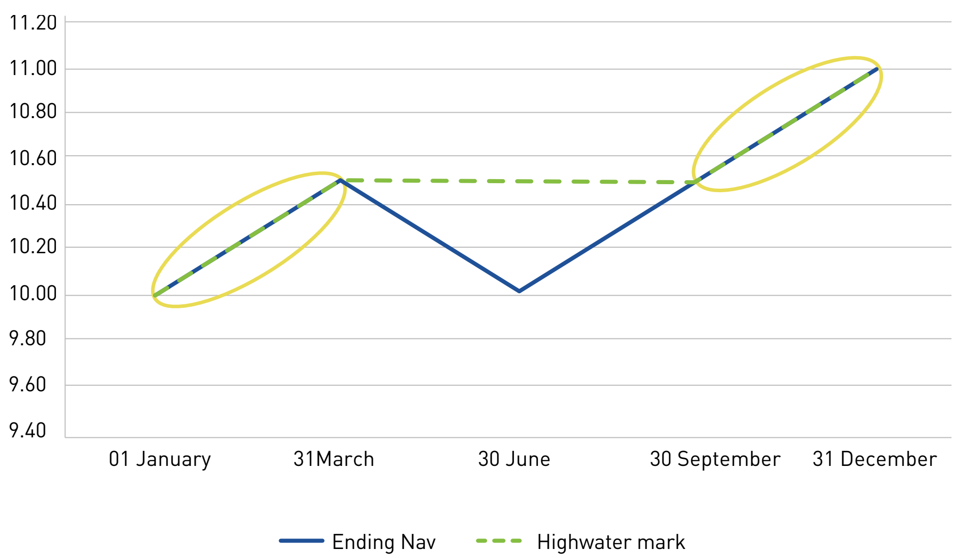
Year	NAV beginning of period	Gross return	Hurdle (2%)	Excess return	PF (20%)	Management fee (1%)	Net Nav end of period	HWM (for next period)
0							$10,000	$10,000
1	$10,000	$500	$200	$300	$60	$100	$10,340	$10,500
2	$10,340	$200	$207	–	–	$103	$10,437	$10,540
3	$10,437	-$200	$209	–	–	$104	$10,132	$10,540
4	$10,132	$400	$203	–	–	$101	$10,431	$10,540
5	$10,431	$500	$209	$182	$36	$104	$10,790	$10,931

- In years 2 and 3, no performance fee is payable as the fund manager did not exceed the hurdle return and in fact had a negative performance in year 3.
- In year 4, no performance fee is payable because even though the fund manager exceeded the hurdle rate, the total fund value remained below the previous high-water mark.
- In year 5, the manager received a performance fee, but only on the excess return above both the high-water mark and the hurdle rate.

High-water mark in action

In the scenario below, performance fees are only payable for the performance highlighted green. Where the fund value (NAV) is below the high-water mark, no performance fees are payable.

The high-water mark matches the period in which performance fees are accrued (whether that is daily, quarterly, or annually) and as such, investors never pay for the same performance twice.



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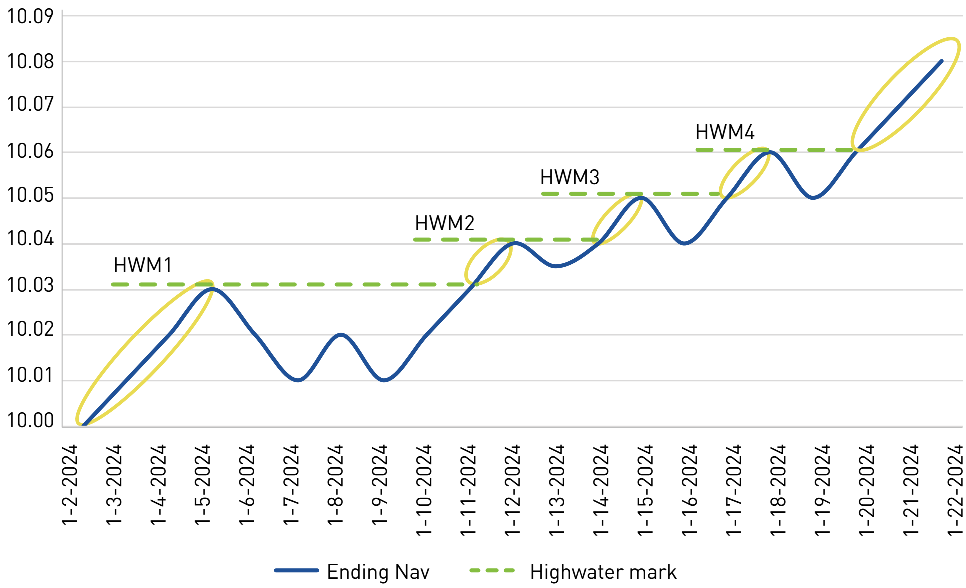

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Other fees and expenses

Other fees, such as administrative and operating expenses, taxes, etc., are charged to the fund as part of the fund's on-going operation and are independent of whether a performance fee is charged. The simplified prospectus provides further information around applicable fees and expenses

For more information about Alternative Mutual Funds and the NEI Long Short Equity Fund, please visit neiinvestments.com.

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