PAVILION

HOW CAN TWO LPS IN THE SAME FUND HAVE DIFFERENT PERFORMANCE?

by Richard Pugmire, CFA
Managing Director, Pavilion Alternatives Group, LLC

Many alternative asset managers use closed-end funds to execute their strategy. These funds have a finite life where capital is drawn from limited partners (LPS) over the first few years of the fund and is returned as investments are realized in the later years of a fund's life. As the fund managers make all investment and exit decisions, a characteristic of these vehicles is that generally all LPs have the same exposure to the investments made by the fund (a notable exception is discussed below). Despite the common exposure, there can be performance differences among LPs or from what the manager reports at the fund level. How and why does this happen?

As part of our standard due diligence process, we review gross and net cash flows and recalculate performance for prior closed-end funds. Through our experience, we have identified several common reasons for performance differences which could be helpful to LPs in understanding the variations.

- **LPs commit in different "closes":** While some funds hold a single close, many will hold more than one with as much as a year separating the first and last close. Not unexpectedly, the magnitude of the performance differences can be larger for funds with longer fund-raising periods, especially if the fund is making investments after its early closes. As the fund has subsequent closes, capital is reallocated from the early LPs to the new LPs, basically diluting the early LPs' ownership interest in the fund's first investments. Additionally, LPs participating in later closes are typically assessed a "late charge" that is passed on to the early LPs as they essentially financed the later LPs' interest in the fund. Thus, early LPs will have a cash inflow while later LPs will have a cash outflow. This difference in cash flows as well as the timing of the cash flows can create a difference in performance. Furthermore, if the fund has written up any of its investments, the later LPs will benefit since they receive the same valuation as the early LPs but their capital was contributed later. However, the increased use of capital call credit lines at the beginning of a fund is somewhat mitigating performance differences caused by LPs participating in different closes. If the first capital call to LPs occurs after the final close, both early and later LPs will have the same performance.

- **In-kind distributions:** Although most fund distributions are in cash, fund managers can make an in-kind distribution of company shares, typically of publicly-traded stock. As defined in the fund's Limited Partnership Agreement, the fund will record the cash flow on the date and typically at the value it was distributed. However, an LP may record the cash flow as the value he/she received on the date the shares are sold. Thus, there can be a substantial difference between cash flows reported by the fund and the LP, particularly for volatile stocks.

- **Different parallel funds / fund terms:** Funds can have different structures that generate dissimilar cash flows. For example, some fund managers are offering LPs options regarding what terms LPs would like to receive as investors in the fund. To illustrate, one class of shares will pay a higher management fee and lower carried interest percentage whereas a second class of shares will pay a lower management fee and higher carried interest percentage. Although LPs in these two different classes will have exposure to the same investments, the difference in terms can lead to performance differences.

- **Inclusion of the General Partner (GP) commitment:** The fund manager may include the GP commitment when reporting net cash flows. While the LPs of a fund pay management fees and carried interest, the GP commitment typically does not pay either. A larger GP commitment being included in the net cash flows will bias performance upwards. Thus, it is important to read the performance disclosures as well as to ask the fund manager for a full accounting of what is included in the reported fund performance.

- **Opting out of investments:** Some fund managers allow LPs to "opt-out" of participating in certain investments, such as for socially conscious reasons (e.g., gambling companies). LPs that opt out will have a different exposure to the fund's investments than other LPs and, therefore, potentially a different return. Depending on the performance of the opt-out investments relative to the remainder of the portfolio, this could impart either a positive or negative bias to performance.

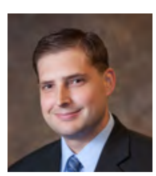
- **Fund manager excludes certain investments:** As part of their marketing materials, fund managers may exclude certain investments for a variety of reasons such as these investments may be attributable to a person who departed, or that type of investment is no longer part of the fund manager's core strategy. For example, a buyout firm may exclude venture capital investments it made in previous funds as it no longer focuses on this area. When investments are excluded, further due diligence should be undertaken to understand what the fund performance was with these investments and if excluding them is justifiable.

- **Fund currency differences:** An LP whose base currency is not the fund's primary currency may convert cash outflows and inflows to their base currency which can add or detract from the fund performance due to currency fluctuations. For a U.S.-based LP investing in a euro-denominated fund, if capital calls are made when the euro is weak relative to the U.S. dollar and distributions are made when the euro has strengthened against the U.S. dollar, the LP will benefit from a positive currency fluctuation. The reverse can be true and a strengthened U.S. dollar can have a negative impact on funds denominated in foreign currencies. Thus, it is important to consider a fund manager's performance in both its home currency as well as the LP's base currency.

- **Other situations:** The list above is not exhaustive and there can be a variety of other reasons performance differences may exist. For example, an LP may have received a management fee discount for being in the first close or for being of a certain commitment size to the fund. Alternatively, an LP may have acquired ownership interest in the fund on the secondary market and have a different return than an LP that was in the fund from the beginning.

As briefly discussed above, there are a number of reasons why performance can vary between LPs in the same fund. As the industry continues to evolve and fund managers offer more variety in a single fund (such as different terms, opt-out provisions, etc.), performance differences likely will continue to propagate. As a general rule, reading the footnotes that accompany a performance presentation is helpful to provide insight into some potential sources of these differences. Doing so also demonstrates the importance of thoroughly researching fund managers to differentiate between fund managers that generate their returns from their investment acumen and those that do so through accounting gimmicks.

Inquiries or comments concerning this article may be addressed to:



Richard Pugmire
Managing Director
Pavilion Alternatives Group, LLC

rpugmire@pavilioncorp.com