CAMBRIDGE ASSOCIATES LLC

RESTORING BALANCE TO GP/LP RELATIONSHIPS

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ABSTRACT

1. Seismic shifts in the capital markets and in institutional portfolios over the last year have made capital scarce and ever more valuable. As opportunities in public markets become increasingly attractive, investors are justifiably thinking critically about their basic asset allocation assumptions. In particular, many are questioning the role and costs of alternative investments in their portfolios. These investments have been a part of the institutional portfolios Cambridge Associates has advised for over 30 years. That experience serves as a guide for what has worked well and brings into clear relief what is ineffective. We continue to believe that well-constructed allocations to alternative assets implemented through high-quality managers can play an important role in investors' portfolios. However, due to the headiness of the last several years, the status quo at many firms has become skewed such that there is no longer a fair distribution of risks and rewards between limited partners (LPs) and general partners (GPs).

2. The current environment provides institutional investors a unique opportunity to bring their alternative asset fund manager relationships into better alignment. While we believe it is critical to reward good performance by GPs, risks and returns should be equitably shared. In order to aid investors in their efforts to improve the status quo, this paper presents our perspective on what terms we consider to be reasonable for non-marketable alternative asset (NMAA) strategies and hedge fund strategies. Given recent events, we hope that there can now be a return to first principles in the alternative assets sector. The GP/LP relationship should be characterized by well-defined expectations, clear communication, fair compensation, alignment of interests, transparency, and mutual respect. We suggest that investors re-examine what they expect from their managers and ask whether the terms of those relationships are properly aligned. Fund managers, too, should reflect on how their underlying markets have changed, how the financial and nonfinancial needs of their LPs have changed, and how they will adapt to those changes.

3. NMAA investors should engage with their GPs to rationalize fund sizes that may not appropriately reflect investment opportunities, address inappropriate fee arrangements, and rein in other terms that dilute proper alignment of incentives. Going forward, we see four related areas in the non-marketable space on which to focus improvements: (1) fee income of all types (compensation), (2) fund sizes and the pace of capital deployment, (3) transparency, and (4) other terms that diminish the alignment between GPs and LPs.

4. Investors in hedge funds should likewise work with their managers to ensure they are getting proper value for the fees they are paying and adequate protections during times of underperformance. We see the greatest opportunity for improvement in more closely tying compensation to value creation, which includes the use of high-water marks (or modified high-water marks), introduction of hurdle rates, and reasonable management fees. Other issues for consideration include transparency, gates, and liquidity provisions.

5. We encourage LPs to engage with one another and their GPs in addressing these issues. While there are no one-size-fits-all answers, it is clear what questions need to be asked to start the conversation. It has taken many years for partnership terms to deteriorate to their current state, and it may take several years for them to improve, given the long-term nature of partnerships and the continuing flows of new capital still chasing past returns. Investors should look for areas where good faith trade-offs can be made, but also should be willing to walk away from opportunities where the terms do not make sense.

SUMMARY

Introduction

Seismic shifts in the capital markets and in institutional portfolios over the last year have made capital scarce and ever more valuable. As opportunities in public markets become increasingly attractive, investors are justifiably thinking critically about their basic asset allocation assumptions. In particular, many are questioning the role and costs of alternative investments in their portfolios. These investments have been a part of the institutional portfolios Cambridge Associates has advised for over 30 years. That experience serves as a guide for what has worked well and brings into clear relief what is ineffective. We continue to believe that well-constructed allocations to alternative assets implemented through high-quality managers can play an important role in investors' portfolios. However, due to the headiness of the last several years, the status quo at many firms has become skewed such that there is no longer a fair distribution of risks and rewards between limited partners (LPs) and general partners (GPs).

The current environment provides institutional investors a unique opportunity to bring their alternative asset fund manager relationships into better alignment. While we believe it is critical to reward good performance by GPs, risks and returns should be equitably shared. In order to aid investors in their efforts to improve the status quo, this paper presents our perspective on what terms we consider to be reasonable for non-marketable alternative asset (NMAA) strategies and hedge fund strategies. NMAA investors should hold frank discussions with GPs about fee arrangements, fund sizes, and other activities that may dilute a proper alignment of incentives. Likewise, hedge fund investors should determine whether a proper balance between fees paid and value created exists, and whether the fund provides investors sufficient protections in periods of underperformance. There are also ample opportunities to improve transparency, reporting, nonfinancial legal terms, and taxes.

In stressful times, the degree to which relationships are true partnerships becomes clear. It is time to recognize and strengthen good partnerships and mend those that may have gotten off track. We recognize that LPs likely have different objectives and that each GP/LP relationship is different. Nevertheless, we encourage LPs to engage in more conversations with other LPs and with GPs about what is reasonable and fair to expect from GPs. Similarly, we believe GPs that understand and support the fiduciary needs and motivations of their institutional LPs will benefit from high-quality, long-term capital bases.

How Did We Get Here?

The Last Decade

Several high-profile endowments gained particular fame in the last decade from the remarkable returns they earned with low apparent volatility. Notably, these investors captured much of the upside in the 1990s technology bubble and avoided much of the downside in its aftermath. This track record is in large part the result of embracing high equity allocations, paying close attention to measures of absolute and relative valuations, and selectively using alternative investment strategies as a part of a diversified, multi–asset class approach.

The larger investment community rightly took note and worked to try to copy the formula. Success from this style of investing, however, is not formulaic and cannot be achieved merely by including alternative investments in asset allocation targets. Rather, success comes from exhaustive coverage of these markets, bottom-up analysis of investment opportunities, sophisticated oversight of total portfolio exposures, and knowledgeable governance. Success in alternative investments takes considerable resources; there are no short cuts.

Nevertheless, a wide range of investors adopted new or expanded existing target allocations for alternative investments. The drivers of alternative investment success have rotated over time—venture capital in the late 1990s tech boom, hedge funds in the 2000–02 equity market bust, and most recently, buyout funds and hard assets—and their inclusion in portfolios provided strong returns and much desired diversification in equity dominated portfolios (Exhibit 1).

In the NMAA space, as LP demand increased over the past several years, managers responded by deploying capital at a feverish pace. In the four vintage years between 2004 and 2007, the 744 non-venture private equity funds actively tracked in our database have called $273 billion in capital as of September 30, 2008. That total is close to the $312 billion called across the prior 11 vintage years, 1993–2003, combined (Exhibit 2). LPs directly enabled this deployment of capital by supporting firms raising new funds at an unprecedented scale and pace. In three recent vintage years (2005–07), non-venture private equity funds raised more than $460 billion, outstripping the $396 billion raised in the prior 12 vintage years combined (Exhibit 3).

Annual transactional data show that this investment pace has inevitably put upward pressure on prices and downward pressure on expected returns. Buyout entry valuations have changed, with higher multiples logically depressing expected returns. Over the 14-year period 1995 to 2008, purchase multiples averaged 7.4 times (Exhibit 4). In 2007, the average multiple was 30% higher, at 9.6 times, and the standard deviation of 3.4 implies that roughly 16% of deals that year were closed at a multiple of 13 times or higher.

A similar story has been playing out in the hedge fund market. By year-end 2007, hedge fund assets had reached $1.8 trillion, a 10 times increase compared to assets under management 12 years ago, and a doubling in just three years (Exhibit 5). The rapid increase in capital flows into the industry, a marked increase in proprietary trading activity on Wall Street, and significant advances in computing power greatly intensified competition and led to a gradual degradation of unlevered return on assets in most marketable alternative strategies. At the same time, as demand for these strategies increased, managers aggressively capitalized on surging institutional demand for hedge funds by raising management fees and imposing a rash of restrictive liquidity provisions on their LPs. With competition intensifying and cost pressures continuing to rise, margins in the industry were compressing, and investors were being asked to pay higher fees for lower prospective returns.

These strategies may be becoming victims of their own success, as investors at each step collectively unleashed a torrent of money into what were historically relatively obscure parts of the investment landscape. This huge uptick of assets under management has created a landscape for a wide array of alternative

investments that bears little resemblance to that of ten or 15 years ago, distorting markets and strategies where, by definition, there are limited opportunities and/or pools of talent. Alternative managers with attractive track records have seen investors clamor for access, and even the growth in the number of newly created firms has not been able to slake demand.

As with any market where demand exceeds supply, prices headed ever higher, where "price" is a combination of not only explicit fees charged for such alternative investments, but also of nonfinancial terms (more on those below). In their zeal to stretch for outsized performance, LPs have progressively allowed the terms of the typical GP/LP relationship to deteriorate and become much more favorable to GPs. In order to maintain relationships with sought-after managers (or to gain access to new relationships), LPs have often been faced with little choice but to accept this new order or terminate the relationship. All the while, the larger pools of capital managed by these firms have driven down expected returns in the very strategies where they previously built their reputations.

The pressures of peer-based compensation schemes at many institutional LPs may also contribute to the growing reticence to make a strong stand on terms. GPs understandably favor LPs that are more accommodating on terms, and LPs that are measured against other LPs feel the pressure of being left out of sought-after opportunities if they are the ones to push too hard on terms. The result can become a creeping reluctance to push back, and an implied consent for terms to continue to drift. While each LP's particular needs are different, LPs likely have much to gain from recognizing their common interest.

The Last Year

These excesses came into stark relief when the proverbial music stopped and virtually all assets fell sharply in fourth quarter 2008. After this abrupt decline, investors are appropriately re-examining their fundamental asset allocation decisions and their manager selection within those allocations. Marketable equity valuations have now adjusted rapidly (and painfully) lower, but the valuation adjustment process for alternatives is necessarily slower. The capital overhang in non-marketable alternatives, in particular, will likely be a drag on performance for as long as it persists. Ultimately, opportunities will develop, and clearly some areas are already attractive (e.g., select hedge funds, distressed), but on balance, the demand for alternatives is likely to decline as investors become more selective. While alternatives still have a strong role to play in investors' portfolios, the current environment has raised the bar—only managers that can be expected to outperform public markets net of fees with reasonable terms should be expected to thrive in this more challenging environment.

Along with the changes in the capital markets has come a liquidity squeeze for many institutional investors. Portfolio values have fallen, hedge fund gates have activated, near-term NMAA distributions have become increasingly unlikely, and unfunded capital commitments as a percentage of portfolio value have grown substantially. Added to that, many endowed institutions face higher payout rates to support their institutions and pensions must address declining funding ratios. These all combine to limit the appetite for taking on new illiquid investments, presenting a challenge for GPs and LPs to determine how their relationships must change going forward.

Against this backdrop, we hope that there can now be a return to first principles in the alternative assets sector. We suggest that investors re-examine what they expect from their managers and ask whether the terms of those relationships are properly aligned. Fund managers, too, should reflect on how their underlying markets have changed, how the financial and nonfinancial needs of their LPs have changed, and how they will adapt to those changes.

Role of Alternative Investments

Investors look to alternative investments for exposures they cannot get with traditional, long-only managers that invest in the public markets. Within alternative assets, the key is to know the exposures you seek, find managers that are likely to deliver them, and pay them fairly when they do. Rewarding foolhardy risk-taking that happens to work out makes little sense, as does paying a high price for a cheaply replicated, naive strategy.

Non-Marketable Alternative Assets

The NMAA universe encompasses a wide range of private investment strategies, such as venture capital, leveraged buyouts, distressed securities, and real estate. In general terms, institutions invest in NMAA strategies to earn returns in excess of the public markets by finding managers with specialized expertise that focus on the less efficient corners of the investment world. These strategies include additional risks, are illiquid, and require extensive oversight.

NMAA's role for most investors is to serve as an engine of extra growth (with returns above those of public equities) in a portfolio with a long time horizon. Endowed institutions, such as universities or foundations, often have mandates to exist in perpetuity, and many have the ability and willingness to sell liquidity to a degree that other investors cannot. However, investors should not assume that just because an investment is made through an illiquid vehicle or in a private security that it is inherently more likely to realize an outsized return. Rather, successful outcomes are driven by selecting the highest-quality firms and remaining ever mindful of the current risk-reward trade-offs inherent in their particular strategy. Selecting high-quality firms is no small challenge—even for LPs that have ample staff and resources to devote to the search—and these manager selection risks and macro risks can create quite a headwind in assembling a successful NMAA program.

Hedge Funds

The term "hedge fund" spans a broad range of investment strategies that often have little more in common than similar fee structures and liquidity terms. In advising our clients, we seek hedge funds that can deliver equity-like returns over the long term, but have lower volatility than public markets and a less-than-perfect correlation with those markets. While the underlying investments are typically in public/liquid securities, investors are not looking for public markets exposure (beta). In the aggregate, hedge fund strategies have become more correlated with the market over time (Exhibit 6). Finding those managers that

can earn returns from finding and exploiting inefficiencies or mispricings that are not completely tied to the movement of the markets requires critical analysis of their overall strategy, deep knowledge of their specific markets, and exhaustive examination of historical returns.

Equity-like returns that are imperfectly correlated with public markets are an attractive means of lowering the overall volatility of a portfolio. While most of our clients have very long time horizons, many also derive a significant portion of their operating budgets from the investment returns generated by their endowments. As such, there is a high value to finding investments that dampen the volatility of returns.

Basic Principles in a GP/LP Relationship

A true partnership respects and balances the needs of both parties. LPs and GPs do have a common interest, earning attractive returns, but have different perspectives on this goal. LPs have the fiduciary obligations of prudent investment and comprehensive oversight of their institutions' capital; GPs have the challenge of managing their business in competitive markets while looking to translate their investment acumen into personal wealth creation. These two different perspectives can be brought together through a fairly negotiated deal that supports both an LP's fiduciary obligations and the GP's success.

Investors hire alternative investment managers primarily to add excess returns (NMAA) or diversification (hedge funds) to their portfolios. These goals are both valuable and hard to achieve; it is thus appropriate that truly skilled managers earn a premium for their talents. A proper alignment of incentives comes when the GP is rewarded for its skill, and the LP pays only for the exposures it seeks and for actual value creation. Investments structured as a "free option" for GPs are fundamentally unfair and do not represent an appropriate sharing of risks and returns. (Alignment of incentives also extends to the nonfinancial terms of the partnership, further detailed below.)

LPs can demonstrate they are good partners to GPs by measuring performance over an appropriately long time horizon and undertaking the substantial homework required to identify the drivers of a GP's returns by understanding their given market, strategy, team, and portfolio. Armed with this knowledge, LPs can better identify whether performance (good or bad) is a result of macroeconomic conditions, market conditions, or a manager's skill. (Recognizing good performance is particularly challenging for NMAA investments in the interim period—when capital has been invested, but gains have not yet been realized—and the GP is returning to raise fresh capital.) Only a well-informed LP can assess a track record to determine whether the GP is executing well, and then have the confidence to support a new fund or make the right hiring/firing decisions.

GPs justifiably value investors that can appropriately manage their own portfolios' exposures so as to not cause undue trauma to a manager's business. For example, fund withdrawals from hedge funds for periodic rebalancing are necessary and generally understood by managers, but investors should avoid using their hedge fund portfolio as a liquidity account. Frequent large additions to and withdrawals from individual funds should be avoided, as they are disruptive to the management of the portfolio and the fund manager's

business, which is ultimately not in the interest of the LP. (We discuss below ways GPs can increase the reliability of their LPs.)

Institutional LPs will increasingly look to GPs that understand and accommodate LPs' fiduciary obligations, including preparations for annual audits, assurances of proper governance, and managing total portfolio risks (all are discussed in further detail below). With this in mind, relationships need to find a way to balance required disclosures with confidentiality.

In sum, the GP/LP relationship should be characterized by well-defined expectations, clear communication, fair compensation, alignment of interests, transparency, and mutual respect.

Going Forward

In the next two sections we discuss several specific areas where there is room for improvement. Any material modifications of existing terms will involve trade-offs and negotiation with GPs, and often consensus among a fund's other investors. LPs should push for terms that reflect fairness and balance. Some issues, such as a proper alignment of interests, are fairly universal, but we also include particular recommendations for both hedge funds and NMAA managers.

In recent years many investors have become increasingly reticent to raise concerns with GPs, as they worry about getting and/or maintaining access to sought-after investment opportunities. In this environment, with the increasing attractiveness of other opportunities across the capital markets and the significant reduction in available LP capital, these concerns should abate for all but the most access-constrained opportunities. If LPs can individually and collectively engage with GPs in the spirit of crafting long-term partnerships, this could be a unique opportunity to improve the status quo.

The areas we discuss do not constitute an exhaustive list of issues in GP/LP relationships. Rather, we provide some examples of areas where we do not see alignment of GP and LP interests and some thoughts on how re-alignment could occur. While most of the areas we identify are standard business terms, documenting changes or negotiating custom terms can become legally complex. LPs are well served by having the advice of experienced legal counsel in making modifications to LP agreements. Additionally, in Exhibit 7 we include a summary of questions to be considered when evaluating key terms.

NMAA Strategies: Areas for Improvement

Private investing is characterized by the long time it takes to realize gains. While a typical ten-year fund life with the potential for outsized returns may be an attractive trade-off for a perpetual institution like a university, ten years can be a sizable portion of an individual's investment career. Consequently, some GPs, aided by LPs' eagerness for access to funds, have pushed terms and found ways to generate income sooner. They are now much less reliant on successful realizations for the opportunity to create wealth.

Going forward we see four related areas on which to focus improvements: (1) fee income of all types (compensation), (2) fund sizes and the pace of capital deployment, (3) transparency, and (4) other terms that diminish the alignment of interests between GPs and LPs.

GP Compensation

The most notable area for reform is in how GPs are compensated. Carried interest is intended to align a GP's personal financial gains to those of its investors, and the typical 20% rate provides GPs with an opportunity for substantial wealth creation. As noted, alternative investment strategies are challenging to successfully execute well; however, this profit-sharing opportunity should serve to attract the most confident and capable investment talent. Firms that focus on earning carried interest as opposed to generating fee income are sending a clear message to the marketplace in their confidence to generate strong returns.

Excessive management fees are the opposite in terms of alignment—they are essentially money "off the top" from LPs to GPs, before value has been realized. LPs are certainly willing to pay reasonable fees to cover the firm's expenses while its staff seek out and manage investments. At the advent of the private equity business, when funds were much smaller, 1% to 2% of committed capital was a meaningful approximation of a small firm's actual operating costs. Today, however, when management fees often do not bear any relation to a firm's reasonable operating expenses, LPs should cry foul (see Appendix A for estimates of the impact of fees). For example, a firm that is managing four times its prior capital now has the opportunity to earn up to four times the carried interest. It would require very compelling evidence to show that the firm's expenses have grown to justify a fourfold increase in management fees. The same argument holds for a firm that is simultaneously drawing full fees from multiple funds. A firm that is actively cutting its costs by laying off staff without a concomitant reduction in management fees is also likely at odds with the best interests of its LPs (particularly if it comes at a time when portfolio companies may need more support, rather than less). All of these concerns could be easily allayed by GPs sharing operating budgets with their LPs.

Fee splits are another point of friction. The basic premise should be that any income generated as a result of managing an investor's money should first accrue to the benefit of the investor, with profits shared when generated. The whole litany of fees itemized in some LP agreements—deal fees, monitoring fees, consulting fees, director's fees, etc.—arise directly from the GP managing LPs' money. As such, the LPs deserve the full benefit of those fees until the GP has turned a profit on invested capital. Otherwise GPs are being compensated for activities other than generating great returns (while these activities can be important to an investment's success, they are in and of themselves not "success" deserving of additional compensation).

"Premium carry" or "premium economics" are terms most often heard in reference to venture capital funds, and typically take the form of higher carried interest and/or management fees. Some GPs' track records and potential future returns are so attractive that it may be worth acceding to these terms. While LPs should be suitably skeptical about demands for higher (risk-free) management fees, they may find it reasonable to pay increasing carried interest for increasingly attractive performance. These terms, however, should come as a trade-off for LP protections such as a higher preferred return, a firm hurdle, or having the

"premium economics" kick in only after the achievement of a certain multiple (for example, if the fund returns 3 times or better, then the GP is entitled to 30% carried interest). LPs that previously acceded to "premium economics" with firms whose track records in their flagship product merited such a decision are justified in pushing back on attempts by these firms to port those special terms to new and/or less proven strategies these firms might offer.

Firms demanding "premium" terms often do so citing a record of strong prior performance, with the implication that past strong performance is likely to result in strong performance in the future. Outstanding funds are relatively rare. For example, only one-fifth to one-quarter of the more than 2,500 vintage year 1981–2003 funds in our database were able to return more than 2 times their cost basis (Appendix B). Appendix C looks at data on firms and finds very few firms with consistent outstanding track records. Far from the "top quartile," less than 5% of the nearly 1,000 firms in our data set could claim to have been in the top quartile more than 50% of the time. As such, investors should not just accept that strong performance will be repeated, with the very small exception of those firms that have demonstrated a successful track record and continue to operate under similar conditions that have fostered this success in the past.

All of the above terms are financial in nature, readily quantifiable, and so should be reasonably negotiable by two parties acting in good faith. In circumstances where LPs are not able to win concessions on the level of the fees, they should push GPs to at least agree to clear and full annual disclosures of the total income earned from these arrangements.

Waterfalls and the Determination of "Profits"

Determining when a fund is deemed to be profitable and subject to carried interest is surprisingly imprecise. The most conservative view would be to require a fund to return all capital invested by an LP before a GP is entitled to its 20% share of distributions. As investments made in an NMAA fund's portfolio may take years to come to fruition, the fund itself might see eight or more years pass before it has returned invested capital. The order and timing of distributions from an NMAA fund are collectively known as its "waterfall."

There are innumerable variations on waterfalls, and GPs and LPs should expect to heavily negotiate these provisions. The first such issue is ensuring that a firm returns all capital called from its LPs, including calls for the payment of management fees. GPs understandably want to share in the profits from early successes and have pushed to allow for the possibility of earlier payments. As a guiding rule, if the waterfall provides for early payouts, LPs should get something in return. That something is a clawback—the right to demand the return of previously collected carried interest if the fund ultimately is realized at a loss. Although rare, having the GP maintain some portion of paid carry in an escrow account until the fund has returned all called capital is a key LP protection. Joint and several liability of the clawback account is a further protection, and puts particular pressure on the firm's top performers. LPs should be aware of the after-tax structure of most clawbacks, and other language that can affect the amount or certainty of any clawback.

A preferred rate of return is also appropriate for most NMAA strategies as it recognizes that LPs make investments with the expectation of substantial returns. While reasonably common in buyout funds, preferred rates of return are more rare in venture capital funds. As an example, consider a venture capital firm without a preferred return where an $800 million fund earns a disappointing 1.1 times multiple. This team would still receive $16 million in carried interest. Preferred returns come with a catch-up provision for a GP once the preferred rate has been achieved, whereas a hurdle rate does not have a catch-up and incentive fees are paid only on excess returns. Hurdle rates are certainly more LP friendly, but we do not advocate them for NMAA funds. Unlike a hedge fund, there is no investable passive exposure an NMAA fund can be expected to exceed, nor do NMAA funds hold substantial amounts of cash (more on hurdles in the Hedge Fund: Areas for Improvement section).

“Skin in the Game”

The size of a GP’s investment in a fund is a clear marker of conviction in its ability to earn attractive returns and to act as a “principal” investor whose interests are aligned with those of its LPs. Substantial GP commitments can also add to organizational stability, since a large personal investment makes it increasingly distasteful for an individual to leave a firm prematurely. Also, if individual partners’ financial success is tied to the performance of the entire fund, investors will have greater assurance that the partners collectively will maintain a rigorous internal investment process and will seek to avoid unnecessary risks in every investment in the portfolio. A large GP investment is perhaps the single best way to lessen conflicts imbedded in other partnership terms (with the notable exception of fee income), and should be considered the gold standard for alignment of interests.

Young fund managers may not have yet amassed appreciable wealth, so investors should look to the proportion of the GP’s personal assets that are in the fund rather than an absolute amount. For more experienced managers, it is reasonable to infer that the incentive value of carried interest declines in proportion to their personal wealth. If these managers do not have a substantial portion of their wealth invested alongside their LPs, then the fund’s future performance is similar to a call option: limited downside, but a sizable share of any potential gains. GPs should be prepared to provide full, detailed disclosure of each principal’s investment in the funds, and whether those investments are made in cash, by management fee offsets, or in promissory notes. Noncash investments, while sometimes necessary for firms still developing their track records, often create a “free option” for GPs on fund performance, and should be resisted by LPs.

Tying fund performance to the investment team’s compensation through a proper sharing of the firm’s profits is critical for retention. Top performers who do not feel they are getting a fair share of the firm’s earnings will leave for greener pastures, and LPs should receive detailed information on how profits are shared among employees. Likewise, LPs deserve the assurance that comes from having top performers specified in a fund’s “key person” provisions. Yet these provisions have been increasingly watered down. For example, a requirement that a fund manager devote as much time to a partnership (or series of partnerships) as the manager deems necessary is essentially meaningless, and offers no protection to an investor. Fund documents should contain behavior that is clearly identifiable as acceptable or unacceptable and cover an appropriately narrow group of fund personnel.

The complete or partial sale of a GP's interest in its firm or funds presents a clear conflict with LPs. In some corners, this is described as "monetizing the brand," whereby GPs can turn their successful prior track records (for which they have already earned carried interest) and cachet as astute investors into current cash. While it is to be expected that successful GPs will seek to realize some of the equity value built up in their firm's brand, investors should press to understand how GPs will remain actively engaged in the business after such a liquidity event and to ensure that there remains a proper alignment of incentives.

Fund Sizes

A fund should be sized to appropriately match the underlying market, the strategy within that market, and the size and experience of the investment team. (For example, investors should be rightfully skeptical of a regional private equity firm raising a fund that is close to the size of all private equity exits ever achieved in that region.) Markets have changed dramatically in recent months and investors are justifiably questioning whether their NMAA funds are appropriately sized. Likewise, investors should be wary of the potential for strategy drift—straying into areas where a firm has less experience and/or expertise—at those firms whose traditional investment strategies are now out of favor (e.g., a large-cap buyout shop deciding to deploy its fund into distressed debt securities).

There has been an exodus of capital from the public markets and valuations have taken a sharp fall. This correction sows the seeds for the possibility of a future recovery, and significantly improves expected returns for stocks. Entry prices will fall in the private markets as well, but the speed and degree of that fall will likely be slowed by the significant capital overhang. Prequin, an alternative assets research and consultancy group, recently estimated that more than one trillion dollars ($1,000,000,000,000) of "dry powder" awaits deployment by fund managers. Appendix D provides a breakdown of an estimated five hundred billion dollars ($500,000,000,000) of dry powder from funds we actively track. While the dearth of available leverage may have slowed the deal-making environment in the near term, it is clear that there is plenty of capital to support prices and that it will take years to burn off these excesses in NMAA.

GPs now have the opportunity to respond to these excesses by proactively reassessing their place in the markets, narrowing their focus, engaging with their LPs, and appropriately reducing fund sizes.

Investment Pace, Fundraising and Product Proliferation

Compensation in NMAA strategies is intended to reward investment managers for the successful realization of investments, not merely the raising and deployment of funds. The fast pace of new investments and fund raising in recent years shows that this basic premise is under stress. As institutional investors continue to deal with the "denominator effect" and increasingly attractive opportunities elsewhere, fund managers can respond in kind by, at least temporarily, providing relief through reduced fund sizes or slowed capital deployment. To this end, we have already seen a few high-profile funds take action, and expect more will be willing to act similarly in the months ahead.

So when should an NMAA manager come back to market with its next fund? There is no universal answer for all strategies. The simple principle, though, is that a manager should wait until there is demonstrable progress in the portfolio companies of the current fund. If the companies are too young to have shown real progress, the portfolio will likely be ill-served by the GP investing in even more companies. If an LP feels it is in jeopardy of missing exposure to a vintage year, it can simply try to find an additional high-quality manager.

The raising of funds in adjacent or unrelated strategies also requires a close look. There are certainly circumstances where the raising of separate funds in complementary strategies can benefit both funds (e.g., a bank loan fund alongside a traditional high-yield fund), but the new fund should be able to stand on its own merits. A firm can overcome potential conflicts in this area by having adequate capital invested in each strategy to align the investment team with the LPs in that specific product, and by ensuring that management fees collected across the firm's products tie fairly to the firm's costs. A particularly jaundiced eye needs to be cast on firms that tie commitments between funds, reserving access to a firm's flagship product only for those that also commit to the firm's less proven or lesser quality products. This behavior impacts an LP's ability to manage the exposures in its own portfolio, and may be viewed as GPs looking to earn additional management fee income and/or diversify their bets to other sectors or strategies. Appendix E illustrates how raising and deploying large funds locks in substantial income for GPs, regardless of the performance of those investments.

Reporting and Transparency

Clear reporting from GPs to their investors enables LPs to be more reliable partners and is a key element in managing their own portfolios. As noted above, institutional investors have fiduciary obligations to provide oversight of their investments and their total portfolio exposures. To support this, LPs need transparency in the due diligence process and ongoing reporting that gives a meaningful account of the exposures in the fund. While GPs may have competitive concerns about sharing this information, the fundamental basis for a partnership is trust. LPs are bound by confidentiality agreements and, more importantly, they recognize that in an access-constrained world, maintaining their reputations as trusted partners is essential.

We also noted the complex web of fees, fee offsets, and waterfall distributions that is common in most limited partnership agreements. As part of the increasing standards for good oversight, LPs should look to GPs to provide a clear and detailed accounting of the flows in and out of LP capital accounts, and any items of GP compensation that do not flow through such accounts. Likewise, concerns over outsized fee income causing a misalignment of interests can quickly be resolved by disclosure of a firm's management company operating budget.

Institutional LPs manage portfolios with increasingly complex liquidity requirements. Funding capital calls can be a significant piece of that puzzle, and GPs can greatly help their investors by providing regular (even if informal) guidance as to the timing and scale of capital call activity.

Finally, the current implementation of FAS 157 will provide a real life example of how well funds are able to provide the disclosures needed for their LPs to produce GAAP financials.

Tax Issues

The LP base for NMAA investments has become increasingly heterogeneous and GPs' various business and personal tax priorities make them less attentive to their LPs' tax situations and preferences. NMAA investments are becoming, at a minimum, much more complicated from a tax perspective and potentially much less tax efficient for certain classes of LPs. GPs need to have an appreciation of how expected returns for LPs are impacted by matters such as unrelated business taxable income (UBTI) and effectively connected income (ECI). If GPs accept investors that are subject to various provisions, firms will need to appropriately set expectations about potential tax liabilities in advance, and consider offering tax-efficient vehicles.

Hedge Funds: Areas for Improvement

Investors look to hedge funds to add value through superior risk-adjusted returns, and should be prepared to compensate managers for truly skilled performance. Too often, however, investors end up paying high fees for low value added. Many of the principles of fair play in NMAA investments discussed above also apply to hedge funds. As with NMAA, excessive fund sizes, meaningful co-investment from GPs, "key person" provisions, and product proliferation are critical concerns. If a GP's core strategy is out of favor, investors are wise to monitor funds for strategy drift and the investing of capital into areas where the GP has less expertise or experience. Similarly, if a particular strategy focuses on a portion of a market that is readily swamped by excess capital, it will clearly impair expected returns. Fee considerations are consistent with NMAA managers: a hedge fund managing ten times the amount of capital (and drawing ten times the management fees) compared to three years prior, with virtually the same team, needs to make a compelling argument that its investment opportunities and costs have similarly scaled.

Again, GP investment in a fund is a clear indicator of conviction and is the single most credible way to demonstrate a proper alignment of incentives. GPs should be ready to disclose actual amounts invested in funds. Simply stating that "we have most of our liquid net worth invested" is not adequate. "Key person" provisions should cover top performers, those top performers should have an appropriate proportion of the firm's profits, and LPs should receive detailed information on how those profits are shared within the firm. Finally, raising multiple funds in multiple strategies is troublesome for the same reasons that apply in NMAA. Each product should be designed to stand on its own, and investors should not be pressured into making commitments to multiple funds to gain access to a firm's flagship offering.

Looking specifically at hedge funds, we see the greatest opportunity for improvement in more closely tying compensation to value creation, which includes the use of high-water marks (or modified high-water marks), introduction of hurdle rates, and reasonable management fees. Other issues for consideration include transparency, gates, and liquidity provisions.

Paying for Value Creation

Determining when and how much value creation has occurred at a hedge fund is usually not obvious and takes considerable analysis. LPs must do extensive work to verify the drivers of a hedge fund's track record so as to have a reasonable expectation of how the fund may create value in the future. If that potential is attractive to the LP, then the fund documents should ensure the GP is paid upon achieving value creation, and not when it falls short.

Typically, hedge fund incentive fees are not tied to outperformance of a benchmark or hurdle rate. However, since incentive fees are intended to reward managers for generating alpha, the introduction of hurdle rates into hedge fund fee structures should be considered. For example, an investor should not pay carried interest on returns from a hedge fund's cash balances; a hurdle would prevent this.

As we have seen in recent months, years of value creation can be swamped by one period of sharp underperformance. This reveals another consistent challenge in hedge fund compensation schemes: the convention of paying incentive fees on unrealized profits. The reasonable question can be asked: Should hedge fund managers be paid carried interest at times other than when LPs have the option to redeem? While LPs are usually given the protections of a high-water mark, the fact remains that under the typical hedge fund structure the GP collects incentive compensation in advance of the LP receiving even a return of capital. To better align incentives, LPs can push to have profits paid only on realized investments and/or only at such times when the GP has provided liquidity to its investors.

High-water marks provide critical protection for LPs and are preferable to limited-duration "loss carry-forwards." They can, however, introduce instability into a hedge fund, as conventional wisdom would say that a firm too far below its high-water mark will see an exodus of its staff to other funds where they can "reset" to a new high-water mark. To mitigate this risk, a few prominent hedge funds have introduced a modified high-water mark, which typically provides for a reduced rate of carried interest to be earned until such time as a fund has exceeded its high-water mark. Often, carry is cut in half until the fund has earned back 200% or more of the amount below the high-water mark. This structure is in the interest of LPs that intend to remain invested in a fund over the long term, and represents a fair trade-off; the LPs pay the manager a partial incentive fee when the fund is below its high-water mark and the GP is better able to retain staff following a period of underperformance.

Finally, as with NMAA strategies, management fees present a challenge to hedge funds. They are sources of revenue not aligned with generating superior performance for investors, in particular when they bear little or no relation to a firm's reasonable operating expenses.

Governance, Reporting and Transparency

The recent Madoff scandal is a chilling reminder to LPs of the importance of fund governance and transparency. Institutional investors have a fiduciary obligation to provide oversight of the investments they make, and not doing so (particularly in the current environment) is not acceptable. LPs are driven by these

fiduciary duties, and are not looking to front-run trades or otherwise exploit knowledge of a fund's activities. By understanding investors' fiduciary duties, GPs can find appropriately responsive ways of balancing disclosure and confidentiality.

Reporting should enable the kind of return analysis described above, as well as provide sufficient information for investors to manage the exposures in their portfolios. If a manager cannot or will not provide verifiable evidence of its investment activity and exposures, a fiduciary has no choice but to pass on the investment. Likewise, an investor needs to have transparent access to a fund's trading and back office functions to identify any potential operating risks. Having well-informed investors is always in a fund manager's interests. Conversely, an investor that does not understand a fund's exposures or drivers of returns is not likely to be a reliable partner in times of stress or to recognize true value creation.

The implementation of FAS 157 presents a real time test of how well funds can provide sufficient disclosures to their LPs in support of their annual audit processes. Likewise, having a reputable fund administrator that can provide independent valuation and transparency to LPs improves fund oversight and can smooth compliance with evolving audit standards.

Gates, Notification Periods and Side Pockets

Lock-ups and/or restrictive gate provisions may become increasingly common, as the hedge fund world is currently living through the biggest wave of redemptions in its history, with estimates ranging from about $400 billion to $518 billion for 2008. A great many surviving funds will undoubtedly consider moving to more extended lock-ups. Our view is that the length of any lock-up should reflect the liquidity of underlying securities in a fund's investment strategy. Managers involved in high-velocity short-term trading in highly liquid securities have little reason to argue for extended lock-ups, whereas for funds focused on illiquid strategies, such as investing in thinly traded or deeply distressed companies, lock-ups are more sensible.

If a firm is seeking an extended lock-up to stabilize its business, then an LP could reasonably negotiate a declining fee schedule based on the duration of the lock-up. LPs essentially pay a higher price for more liquidity, a fair proposition to which several prominent hedge funds have agreed. A variation on this would be a prenegotiated penalty for an early redemption request to be paid to the fund as compensation for the disruption, while still enabling an out for a truly strained LP.

Likewise, hedge funds should be cognizant of how unnecessarily long notification periods for redemptions—particularly during turbulent and uncertain times, like last fall—provide a greater incentive for investors to exercise the option to redeem. Funds are wise to understand the liquidity needs of their investors, and LPs should look favorably on managers that stagger redemption dates over the course of the year (for example, by tying redemptions to the anniversary of an LP's investment), as this increases the fund's stability. GPs and LPs should also be wary of the potential for moral hazard imbedded in a long notification period for a fund that is near or under its high-water mark as it can create an incentive for inappropriate risk taking.

Gates are necessary and valuable tools if they are used to protect investors from a "run on the bank." They should not be used as tools to simply delay the winding down of a fund. Fund documents should provide LPs the right for a final liquidation in line with the firm's underlying investment strategy, which, in the vast majority of cases, is one year or less. The percentage of withdrawal requests that trigger the gate should also be consistent with the liquidity of the fund's holdings. Careful consideration needs to be given to fees charged when a fund has closed its gate. Whether it is market conditions or an issue with the underlying fund that causes a gate to be closed, investors are justifiably frustrated when they pay management fees on an investment that has failed to meet its stated liquidity terms. At the same time, investors do not want to provide an incentive for the fund to dump the assets in a "fire sale." There is no generic solution, but a fair compromise needs to be made based on the individual fund's circumstances. How a fund deals with such a conflict will serve as an enduring example of its good faith in working with LPs.

In recognizing the liquidity needs of its clients, funds with longer lock-ups might be well served by fund documents that automatically provide an option for a nominal return (say 5%) of capital each year. Many institutional investors have annual payout requirements and need to raise cash for distributions in addition to normal rebalancing. By providing this condition, GPs are less likely to get a full redemption request from an LP merely seeking liquidity or rebalancing.

Side pockets are another area of potential tension. When a fund makes an investment in an illiquid security, it can often designate it as a "side pocket" or some other form of designated investment with restrictive liquidity terms. The definition and treatment of these investments are key provisions of a fund's governing documents. There should be a clearly defined purpose for them, a cap on the total allowable amount, and clear disclosure of any future funding commitments. As these investments are akin to creating a private equity investment within a hedge fund, the basic principles of a private equity investment apply, including the payment of profits only upon realization.

Investors typically hire hedge funds for their prowess in the public markets, and should be cautious of the potential for side-pocket investments to creep outside of a fund's core competency and/or negatively impact the fund's liquidity. Caution is also warranted around placing investments in side pockets after a redemption request has been made. This should only be done if the conditions around that specific investment have materially changed during the notification period, and so avoid the appearance of a fund merely trying to stem redemptions.

Conclusion

These are indeed unusual times, and investors are questioning many long-held assumptions about how to deploy their valuable capital. Investments with high fees and/or illiquidity face a high hurdle, particularly in light of the increasingly attractive expected returns in the public markets. We encourage investors to affirm their reasons for investing in these asset classes and to evaluate their current and prospective relationships to focus on managers that deliver the exposures they seek.

While we believe managers in these strategies should be fairly compensated, the time is ripe to identify GPs that want to act as true partners and to squeeze out any excesses that may have developed in recent years. NMAA investors should engage with their GPs to rationalize fund sizes that may not appropriately reflect investment opportunities, address inappropriate fee arrangements, and rein in other terms that dilute proper alignment of incentives. Investors in hedge funds should likewise work with their managers to ensure they are getting proper value for the fees they are paying and adequate protections during times of underperformance.

We encourage LPs to engage with one another and their GPs in addressing these issues. While there are no one-size-fits-all answers, it is clear what questions need to be asked to start the conversation.

It has taken many years for partnership terms to deteriorate to their current state, and it may take several years for them to improve, given the long-term nature of partnerships and the continuing flows of new capital still chasing past returns. Investors should look for areas where good faith trade-offs can be made, but also should be willing to walk away from opportunities where the terms do not make sense.

EXHIBITS

Exhibit 1

ANNUAL PERFORMANCE OF VARIOUS ASSET CLASSES (%)

1998–2007
U.S. Dollars ($)

1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
U.S. Venture Capital 26.76	U.S. Venture Capital 273.66	U.S. Venture Capital 29.60	Absolute Return Strategies 9.88	Absolute Return Strategies 4.36	MSCI ACWI 34.63	U.S. Private Equity 24.21	U.S. Private Equity 25.73	U.S. Private Equity 27.73	U.S. Private Equity 18.82
MSCI ACWI 21.97	Long/Short Equity 48.66	Absolute Return Strategies 12.44	Long/Short Equity 2.43	Long/Short Equity -3.18	Long/Short Equity 24.82	MSCI ACWI 15.75	Long/Short Equity 12.43	MSCI ACWI 21.53	U.S. Venture Capital 16.36
U.S. Private Equity 14.32	U.S. Private Equity 33.91	Long/Short Equity 6.66	U.S. Private Equity -9.50	U.S. Private Equity -6.13	U.S. Private Equity 24.44	U.S. Venture Capital 15.75	MSCI ACWI 11.37	U.S. Venture Capital 17.81	Long/Short Equity 16.33
Long/Short Equity 3.86	MSCI ACWI 26.82	U.S. Private Equity 1.75	MSCI ACWI -15.91	MSCI ACWI -18.98	Absolute Return Strategies 16.52	Long/Short Equity 10.96	U.S. Venture Capital 8.23	Absolute Return Strategies 13.33	Absolute Return Strategies 13.17
Absolute Return Strategies -2.43	Absolute Return Strategies 16.90	MSCI ACWI -13.94	U.S. Venture Capital -39.08	U.S. Venture Capital -31.89	U.S. Venture Capital -2.42	Absolute Return Strategies 10.33	Absolute Return Strategies 7.28	Long/Short Equity 12.61	MSCI ACWI 12.18

Spread of Returns Between Highest- and Lowest-Performing Markets by Year

1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
29.2	256.8	43.5	49.0	36.3	37.1	13.9	18.4	15.1	6.6

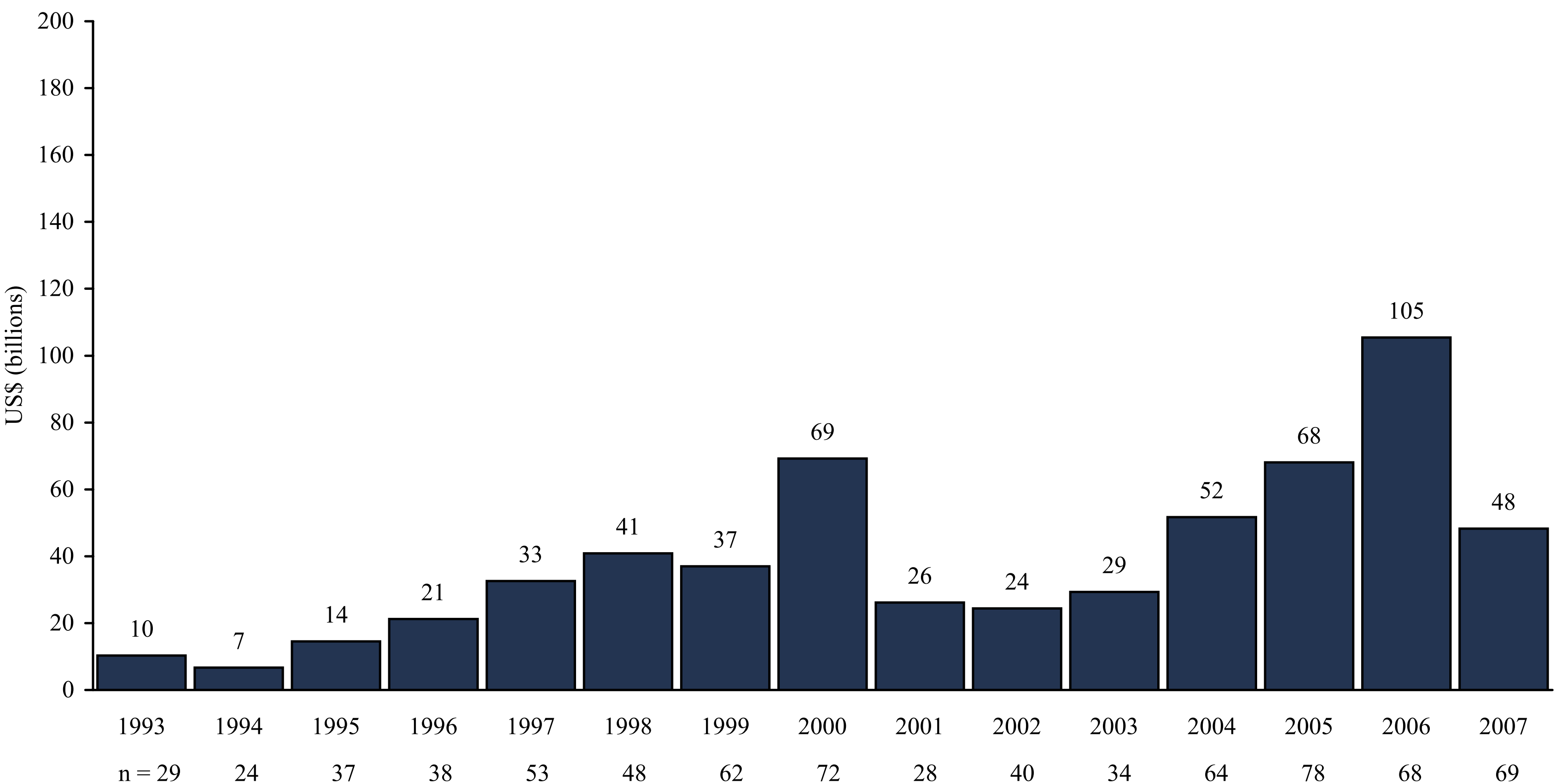
Sources: Cambridge Associates LLC Investment Manager Database, Cambridge Associates LLC Non-Marketable Alternative Assets Database, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Annual performance based on limited partner end-to-end returns for U.S. venture capital and U.S. private equity managers (not vintage-year returns) and on mean returns for long/short equity and absolute return managers. U.S. private equity returns include distressed securities managers. Chart is sorted by performance in each year.

Exhibit 2

PRIVATE EQUITY CAPITAL CALLED BY VINTAGE YEAR

1993–2007



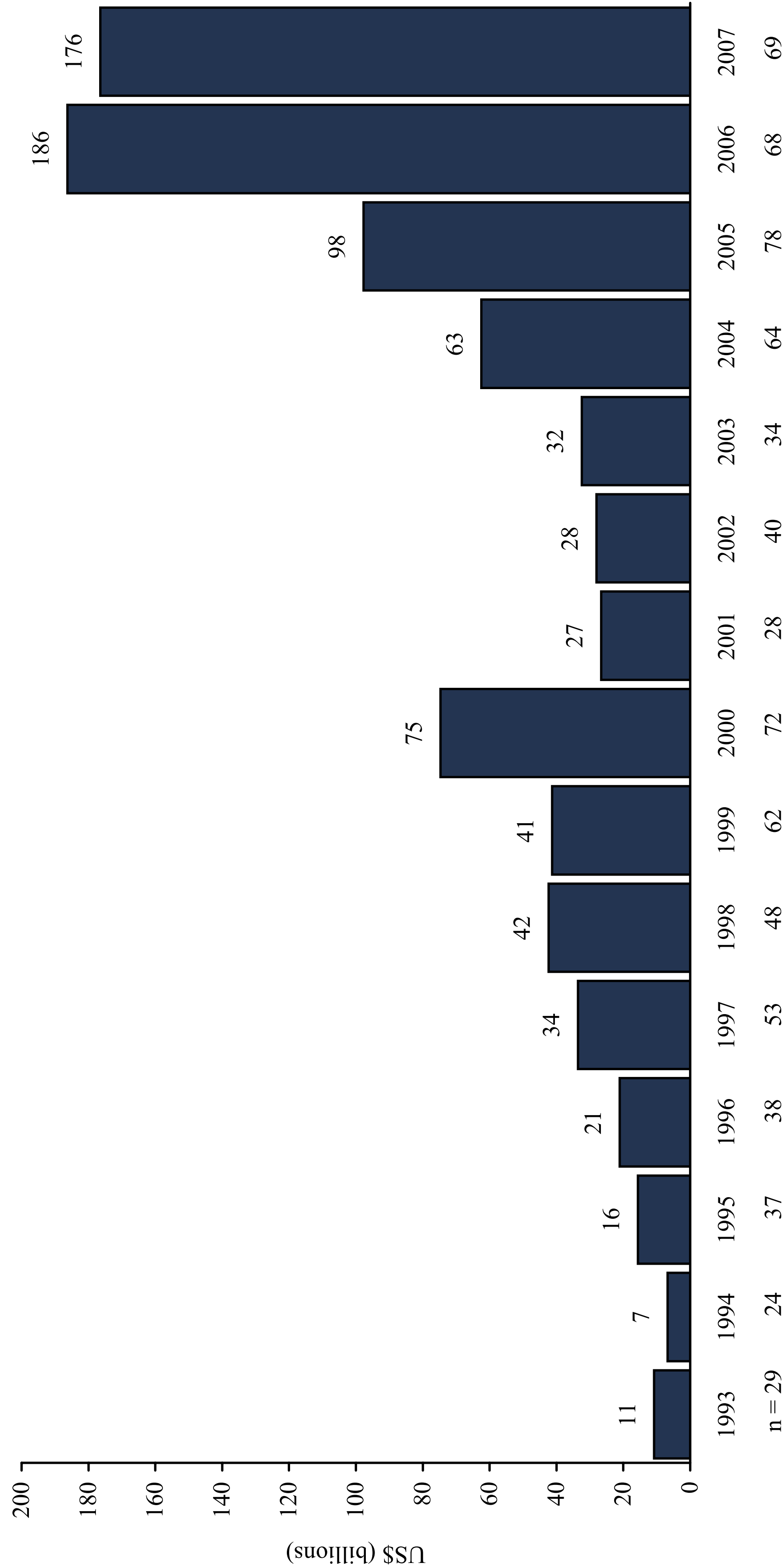
Source: Cambridge Associates LLC Non-Marketable Alternative Assets Database.

Notes: Data are as of September 30, 2008. Includes U.S. buyout, distressed, energy-related, growth equity, and mezzanine strategies.

Exhibit 3

PRIVATE EQUITY FUND RAISING BY VINTAGE YEAR

1993–2007



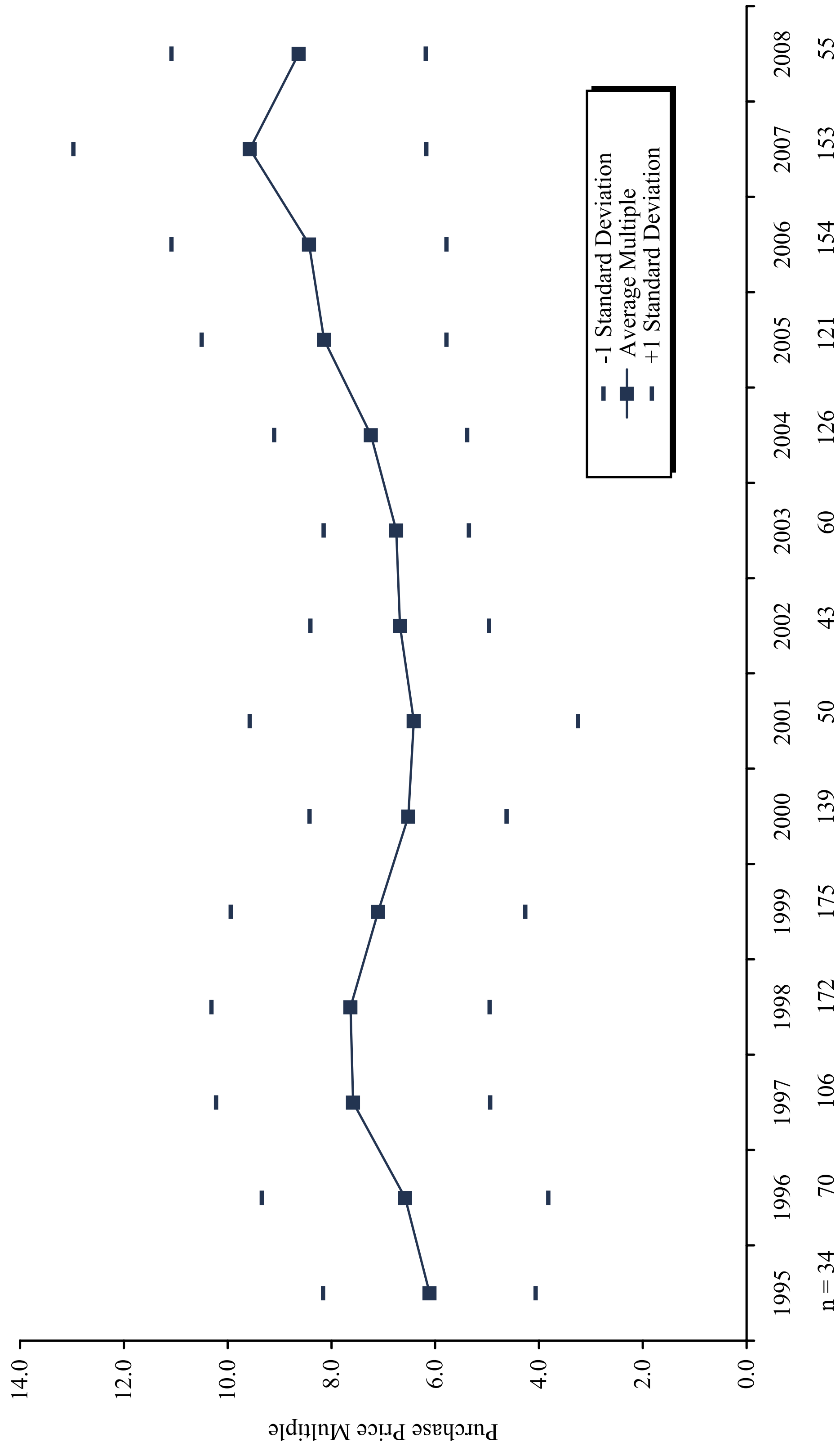
Source: Cambridge Associates LLC Non-Marketable Alternative Assets Database.

Notes: Data are as of September 30, 2008. Includes U.S. buyout, distressed, energy-related, growth equity, and mezzanine strategies.

Exhibit 4

PURCHASE PRICE / EBITDA

1995–2008

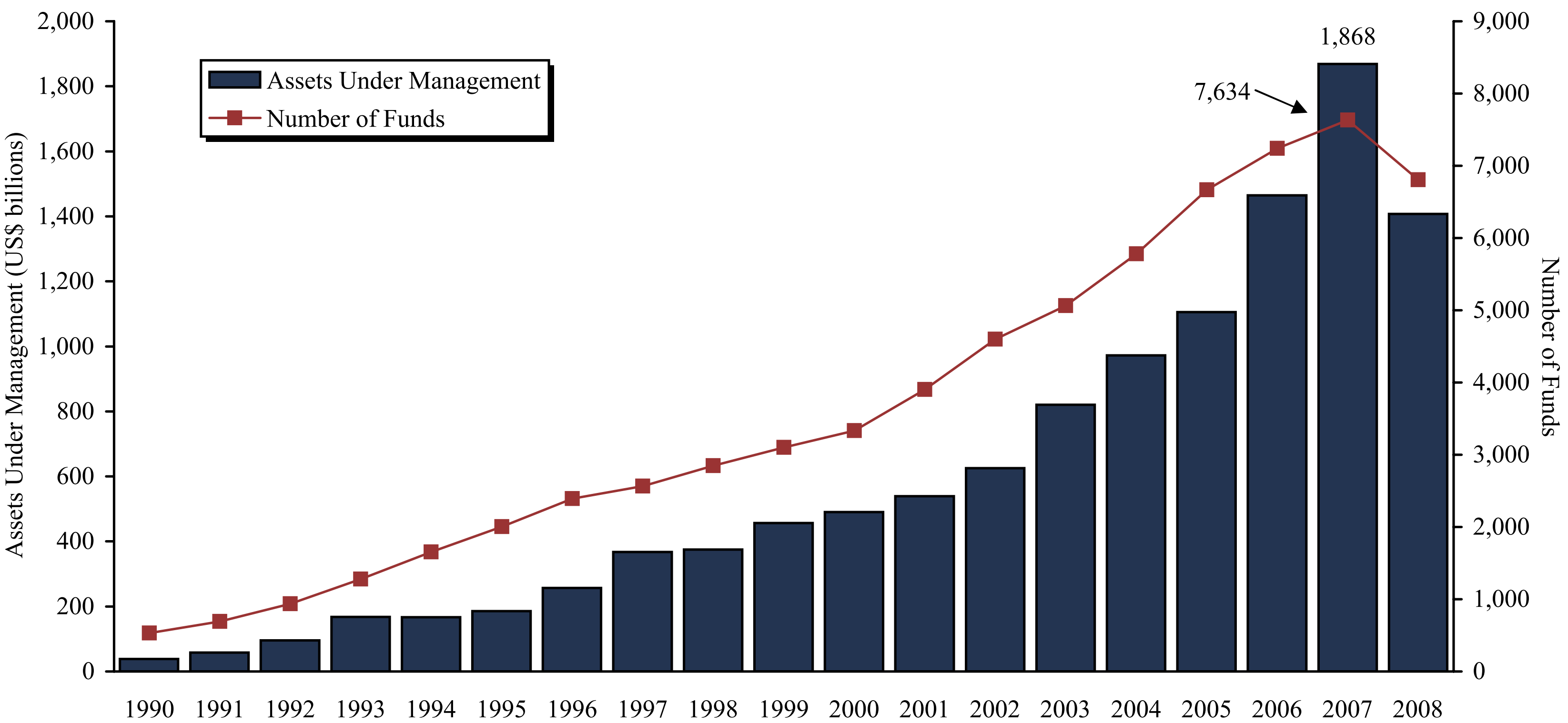


Source: Standard & Poor's Leveraged Commentary & Data.

Exhibit 5

GROWTH IN THE HEDGE FUND INDUSTRY:
ASSETS UNDER MANAGEMENT AND NUMBER OF FUNDS

1990–2008

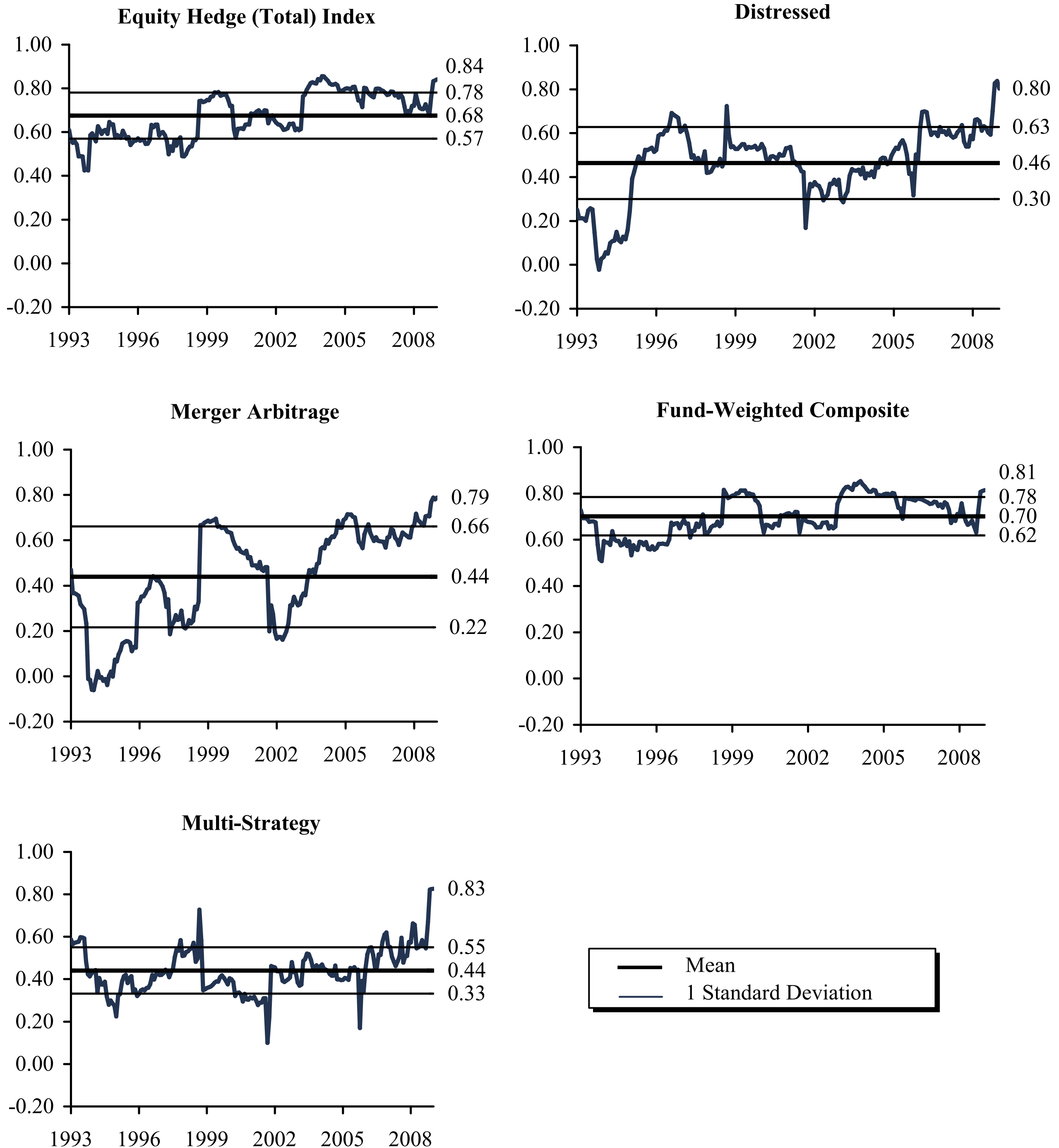


Source: Hedge Fund Research Inc., *Global Hedge Fund Industry Report –Year End 2008,* January 21, 2009.

Exhibit 6

36-MONTH ROLLING CORRELATIONS BETWEEN VARIOUS HFRI INDICES AND THE S&P 500

January 1, 1990 – December 31, 2008



Sources: Hedge Fund Research, Inc., Standard & Poor's, and Thomson Datastream.

Exhibit 7

TERM SHEETS – QUESTIONS TO CONSIDER

We recognize that there are no one-size-fits-all term sheets, and instead include a list of questions for LPs to consider when evaluating a fund's terms. This is by no means an exhaustive list, but is meant to summarize many of the key issues we raise in this paper. **As always, LPs should work with qualified legal counsel in reviewing the terms of any partnership.**

NMAA Funds: Questions to Consider

Fund Size	• Does the targeted fund size match the investment experience and the size of the team? • Does the fund size match the expected opportunities in the underlying strategy?
GP's Commitment	• Does it provide meaningful "skin in the game"? • What proportion of the GP's net worth does the commitment represent? • Is it a cash commitment or is it a management fee offset or a promissory note?

Distributions	• Do LPs get first priority for a full return of all called capital including management fees?
	• Is there a preferred rate of return?
	  o Is it a hard hurdle?
	  o If not, what are the catch-up provisions?
	  o Is it a simple or compounded rate?
	• What is the justification for carried interest in excess of 20%?
	• Are "premium" terms tied to multiple hurdles or other protections?

Management Fee	• What is the total management fee stream from all funds? • Do those fees line up with the firm's reasonable operating costs? • Do management fees appropriately step down after the termination of the investment period? • What is the compensation earned by the firm's partners from noncarried interest sources (e.g., salary, discretionary bonus, management company profit-sharing)?
Other Fees	• Are there any fees generated by the investment activity of the fund (e.g., transaction, monitoring, consulting)? • Is there any reasonable basis why fees earned through the investment and management of LP capital should not accrue 100% to the benefit of LPs? • Is there a sufficient reporting mechanism in place to identify fees earned and what splits, if any, are taking place?

Exhibit 7 (continued)

TERM SHEETS – QUESTIONS TO CONSIDER

NMAA Funds: Questions to Consider (continued)

Investment Period & Fund Term

- How does the implied investment pace match the current opportunity set, the resources of the team, and the size of the fund?
- Does the investment period terminate upon the raising of a future fund?
- Does the term of the partnership match with the underlying investment strategy?

GP Clawback

- Is the clawback on the full or after-tax amount of distributions?
- Is it a joint and several liability of the fund's partners?

Key-Man Clause

- Are the named key persons demonstrably responsible for the firm's prior successes?
- Is a violation of this term objectively observable or is it vague or left to the judgment of the GP?
- What protections are offered to the LPs in the event of violation of the key person provision?
- Does it provide for an automatic standstill or does it require a vote of the LPs?
- What are the allowable outside activities by key persons?

Closing

- How much time is allowed between the first and last closings?
- How are LPs in later closings treated compared to participants in the first close?
- What are the risks if the fund does not reach a sufficient size by the final close date?

Successor Funds & New Strategies

- Under what circumstances can the GP begin raising a successor fund?
- If the provision includes credit for capital invested, committed, or reserved for existing investments, are those amounts specifically identified by portfolio company?
- Do the documents allow the firm to use some or all of the firm's investment team in managing other funds?

Takedown

- What is the notice period for capital calls?
- Are there any limits on the pace or size of capital calls?

No-Fault Divorce / Termination

- What are the options for the LPs to terminate the investment period, remove the GP, etc?
- What are the provisions for removing a GP for cause?

Side Letters

- Are they allowed?
- If so, can they be disclosed to all LPs?

Exhibit 7 (continued)

TERM SHEETS – QUESTIONS TO CONSIDER

Hedge Funds: Questions to Consider

Fund Size

- Does the targeted fund size match the investment experience and the size of the team?
- Does the fund size match the expected opportunities in the underlying strategy?

GP's Commitment

- Does it provide meaningful "skin in the game"?
- What proportion of the GP's net worth does the commitment represent?
- What method does an LP have of monitoring the level of GP commitment and withdrawals?

Management Fee

- What is the total management fee stream from all funds?
- Do those fees line up with the firm's reasonable operating costs?
- What is the compensation earned by the firm's partners from noncarried interest sources (e.g., salary, discretionary bonus, management company profit-sharing)?

Liquidity Provisions

- At what intervals are LPs allowed to redeem capital?
- Does this period match up with the liquidity of the underlying investment strategy and portfolio holdings?
- Are there different share classes with different liquidity terms?
- Are unnecessarily long lock-ups compensated with lower fees or carried interest?
- Is there a gate, and how does it function?
- What management fees will be charged on investments held back after by a gate or held in a liquidating trust?
- What portion of redemptions are held back pending completion of the firm's annual audit?
- Is there any reason why the firm's strategy could not accommodate providing LPs the option for an annual 5% partial redemption to support spending needs?

Notification Period

- Is the notification consistent with the liquidity of the underlying investment strategy and portfolio holdings?
- Does the length of the notification period contribute to or detract from the fund's stability?

Exhibit 7 (continued)

TERM SHEETS – QUESTIONS TO CONSIDER

Hedge Funds: Questions to Consider (continued)

Key-Man Clause

- Are the named key persons demonstrably responsible for the firm's prior successes?
- Is a violation of this term objectively observable or is it vague or left to the judgment of the GP?
- What protections are offered to the LPs in the event of violation of the key person provision?
- Does it provide for an automatic standstill or does it require a vote of the LPs?
- What are the allowable outside activities by key persons?

High-Water Mark

- Is there a modified high-water mark?
- If so, what are the terms of that modification?
- Is there a substantial portion of LP capital that is subject to a different high-water mark?

Other Funds & Separate Accounts

- Are there any separate accounts?
- If so, what kind of disclosures are provided?

Side Pockets

- Under what circumstances can a GP designate an investment for side pocket?
- What is the overall limit on side-pocket investments?
- Do any of the side pockets create a need for future capital calls?
- Are all management fees and carried interest deferred until realization?
- What is the maximum allowable term of a side-pocketed investment?

APPENDIX A

ESTIMATING THE ECONOMICS OF PRIVATE EQUITY STRATEGIES, PART I

Appendix A

ESTIMATING THE ECONOMICS OF PRIVATE EQUITY STRATEGIES, PART I

Below we present 15 years of data from the 769 private equity partnerships we track in our non-marketable alternative assets (NMAA) database, including buyout, distressed, energy-related, growth equity, and mezzanine private equity strategies. Our database should be considered a subset of the entire NMAA universe, but we believe it captures a significant percentage of institutional quality funds raised and therefore provides strong directional guidance on the shifting economics of NMAA investments. The table below shows fund raising, invested capital, and distributions by vintage year.

U.S. Private Equity

As of June 30, 2008 (US$ billions)

Year	Number of Funds	Total Fund Raising	Invested Capital	Limited Partner Distributions	*Estimated Management Fees*	*Estimated Carried Interest*
1993	29	$11.2	$10.7	$22.8	*$0.8*	*$3.0*
1994	23	$5.9	$5.9	$8.5	*$0.4*	*$0.6*
1995	36	$15.2	$14.1	$25.7	*$1.1*	*$2.9*
1996	41	$21.0	$21.1	$28.8	*$1.6*	*$1.9*
1997	54	$32.2	$31.2	$37.8	*$2.4*	*$1.7*
1998	57	$44.9	$43.5	$52.7	*$3.4*	*$2.3*
1999	61	$38.6	$35.0	$48.7	*$2.9*	*$3.4*
2000	76	$74.6	$68.9	$74.5	*$5.6*	*$1.4*
2001	34	$28.2	$27.2	$39.7	*$2.1*	*$3.1*
2002	41	$27.8	$23.1	$23.2	*$2.1*	*$0.0*
2003	35	$31.2	$27.8	$14.9	*$2.3*	*$0.0*
2004	68	$68.1	$54.8	$16.5	*$5.1*	*$0.0*
2005	92	$107.3	$66.7	$5.3	*$8.0*	*$0.0*
2006	69	$182.3	$85.3	$2.8	*$13.7*	*$0.0*
2007	53	$102.8	$21.0	$0.7	*$7.7*	*$0.0*

Source: Cambridge Associates LLC Non-Marketable Alternative Assets Database.

Fund raising increased 16-fold from 1993 to 2006. In the past three vintage years (2005–07) the $392 billion raised roughly equals the $398 billion raised over the prior 12 years. The pace of deployment has also sharply accelerated, as private equity managers invested $255 billion over the past five vintage years (2003–07), only slightly less than the $280 billion invested in the preceding ten years (1993–2002).

To estimate the impact of fees, we make the simplifying assumptions that these funds earned 1.5% annual management fees for five years, and no fees in the later years of the partnerships (which obviously errs very much on the low side). Using these assumptions, management fees in 2006, when

fund raising topped $180 billion, were more than $13 billion over five years ($180 billion * 1.5% * 5 years), regardless of fund performance. This analysis ignores any estimated management fees earned in the later years of partnership, as well as the myriad transaction, monitoring, director, and other fees that provide additional sources of income for general partners (GPs).

To get a sense of how fees stack up versus carried interest, we assume GPs received 20% of the industry's cumulative distributions in excess of the cumulative costs. For example, the 183 funds raised between 1993 and 1997 have called $82 billion of limited partner (LP) capital and returned $123 billion in distributions to LPs. Assuming 20% of realized profits to date went to GPs (i.e., a 4:1 distribution) implies they have earned $10.2 billion of carried interest ([$123 billion - $82 billion] ÷ 4 = $10.2 billion) and at least $6.4 billion of management fees. This analysis excludes various additional transaction fees.

Funds in the most recent five or six vintage years are too young to have been fully realized, so it not fair to judge their performance yet. We can, however, see that GPs will collect at least $28 billion in management fees alone from funds raised in the last three years, which is more than the estimated $20 billion of total carried interest earned to date for all funds raised since 1993.

APPENDIX B

RANGE OF RETURN MULTIPLES FOR NMAA STRATEGIES

Appendix B

RANGE OF RETURN MULTIPLES FOR NMAA STRATEGIES

Most assessments of non-marketable alternative asset (NMAA) performance are made relative to a benchmark or a peer group. While there are compelling reasons to do this, it can also be instructive to see how often NMAA funds have delivered attractive absolute performance.

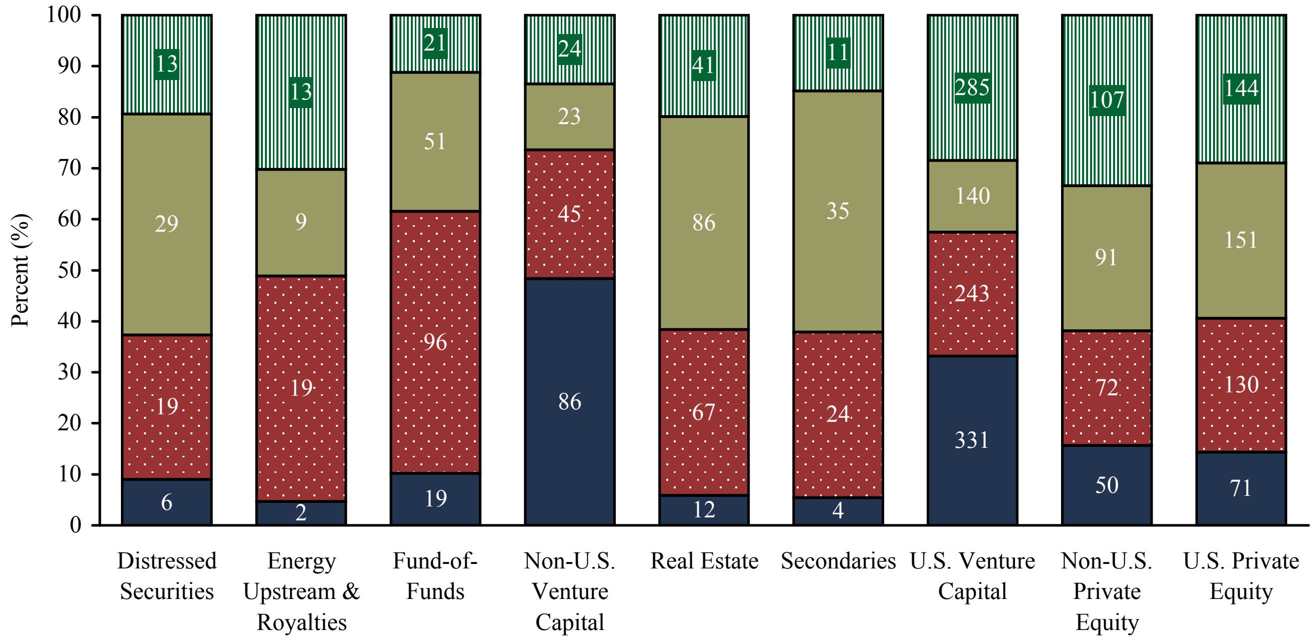
We currently track more than 2,500 partnerships that are at least five years old (1981–2003 vintage years) across all NMAA strategies. The top panel of Exhibit B-1 shows the range of total (realized and unrealized) return multiples across these strategies. In the aggregate, roughly 26% of partnerships show total returns exceeding 2 times their cost basis. If we look for how many funds have actually distributed to limited partners more than 2 times paid-in capital (bottom panel of Exhibit B-1), that overall number falls to 21%.

Exhibit B-1

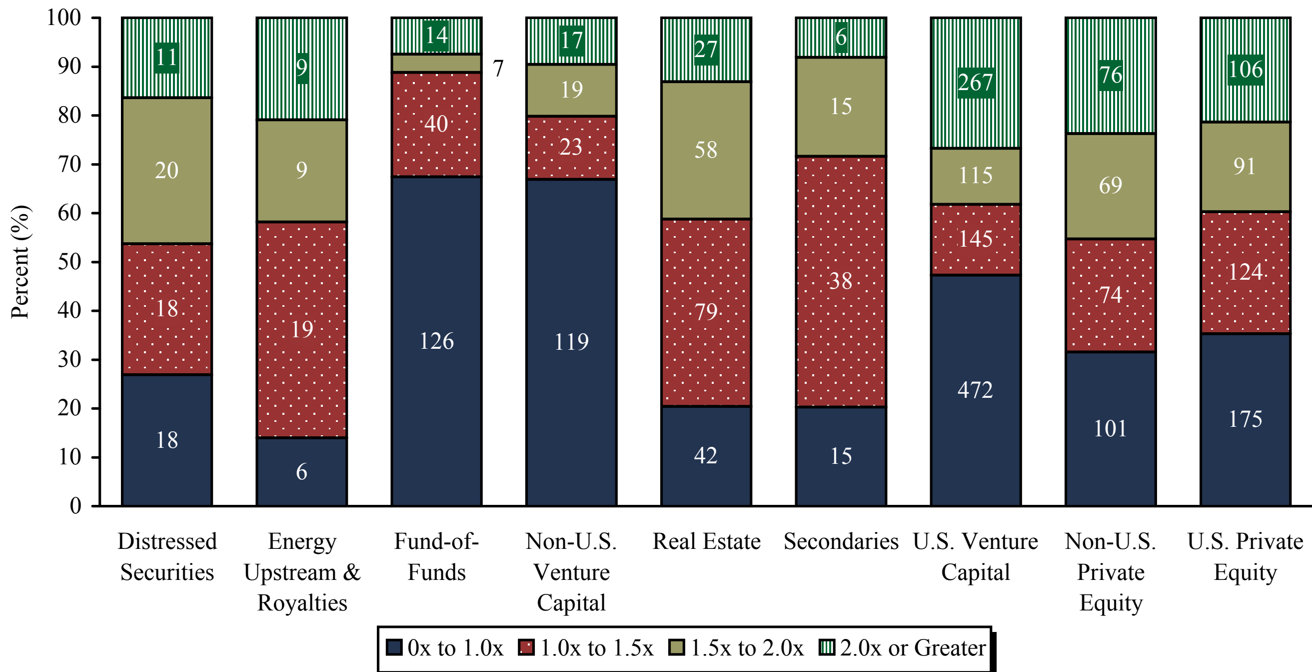
RANGE OF NMAA RETURN MULTIPLES

1981–2003 Vintage Years

Total Value to Capital Paid-In



Distributed Capital to Paid-In Capital



Source: Cambridge Associates LLC Non-Marketable Alternative Assets Database.

Notes: Data are as of September 30, 2008. Numbers in bars represent the number of funds returning that multiple.

APPENDIX C

PERSISTENCE OF OUTSTANDING PERFORMANCE IN NMAA STRATEGIES

Appendix C

PERSISTENCE OF OUTSTANDING PERFORMANCE IN NMAA STRATEGIES

While many non-marketable alternative asset (NMAA) managers have raised funds with strong performance, only a select few have demonstrated an ability to repeat superior performance. Therefore, when evaluating potential NMAA commitments, limited partners (LPs) should not pay out high fees on the presumption that outstanding performance will be repeated. When considering whether to accept “premium” economics, or even incentive fees of 20% for that matter, without a preferred return or some form of graduated carried interest, it is important to consider the degree to which LPs can expect a strong track record to translate to high returns net of fees in subsequent funds.

For purposes of this appendix, we look at persistence in returning at least 2.0 times paid-in capital to LPs as well as persistence in producing top quartile vintage-year performance.

We track roughly 950 firms across all NMAA strategies that raised at least one fund between 1981 and 2003. The table below show how many funds a firm has raised against the number of its funds that have generated at least 2.0 times paid-in capital. The table shows that such performance is relatively rare. Only one-third of firms have ever raised a fund that returned more than 2.0 times paid-in capital, while only 6% have done so more than twice. Among firms that have raised at least three funds, only 10.8%, or 36 firms, have hit the 2.0 times multiple for better than 50% of their funds. More than one-third of these firms are no longer actively fund raising.

Funds Returning At Least 2.0 Times Paid-In Capital

# Funds > 2.0x	Number of Funds Raised							
	One	Two	Three	Four	Five	Three +	Six +	Total
None > 2x	90.2%	80.4%	59.8%	36.6%	21.7%	35.0%	13.1%	68.4%
One > 2x	9.8%	16.9%	26.2%	39.0%	37.0%	28.7%	19.2%	18.2%
Two > 2x		2.7%	12.1%	20.7%	34.8%	18.9%	17.2%	7.3%
Three > 2x			1.9%	3.7%	4.3%	8.1%	20.2%	2.9%
Four > 2x				0.0%	2.2%	4.8%	15.2%	1.7%
Five > 2x					0.0%	2.1%	7.1%	0.7%
More than 5						2.4%	8.1%	0.8%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
# of Managers	387	225	107	82	46	334	99	946
> 50% Hit Rate	-	-	14.0%	3.7%	6.5%	10.8%	15.2%	3.8%

Source: Cambridge Associates Non-Marketable Alternative Assets Database.

Notes: Data set includes 2,570 funds across 15 distinct strategies raised by 946 managers between 1981 and 2003. Data are as of September 30, 2008.

Similarly, if we look at the degree to which managers are able to repeatedly deliver top quartile vintage-year funds, we find that while roughly 40% of firms have managed a top quartile fund, only 6% of managers have done so more than twice, and among managers raising at least three funds, only 14%, or 39 firms (35 of which are still actively fund raising) have raised top quartile funds more than 50% of the time.

Funds Ranking in the Top Quartile by Vintage Year

Number of Funds Raised

# Funds in Top Quartile	One	Two	Three	Four	Five	Three +	Six +	Total
0 Top Quartile	76.1%	65.7%	48.0%	30.0%	29.0%	31.5%	11.8%	59.1%
1 Top Quartile	23.9%	28.9%	36.3%	38.6%	41.9%	34.8%	26.3%	28.7%
2 Top Quartile		5.4%	11.8%	22.9%	16.1%	16.1%	15.8%	6.5%
3 Top Quartile			3.9%	8.6%	9.7%	9.0%	15.8%	2.9%
4 Top Quartile				0.0%	3.2%	3.9%	13.2%	1.3%
5 Top Quartile					0.0%	3.2%	11.8%	1.1%
> 5 Top Quartile						1.4%	5.3%	0.5%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
# of Managers	372	204	102	70	31	279	76	855
> 50% Hit Rate	-	-	15.7%	8.6%	12.9%	13.4%	17.1%	4.6%

Source: Cambridge Associates Non-Marketable Alternative Assets Database.

Notes: Data set includes 2,121 funds across nine distinct strategies raised by 855 managers between 1981 and 2003. Vintage-year quartile rankings reflect rankings within individual strategies. Within strategies, for vintage years in which there were less than eight funds for a particular strategy that vintage year has been excluded. Data are as of September 30, 2008.

With so few firms able to point to such indisputably superior track records, LPs should be reluctant to agree to “premium economics” or to share 20% of profits without a preferred return or some form of graduated carried interest, with the very small exception of those firms that have demonstrated a successful track record and continue to operate under similar conditions that have fostered this success in the past

APPENDIX D

UNFUNDED CAPITAL COMMITMENTS

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UNFUNDED CAPITAL COMMITMENTS

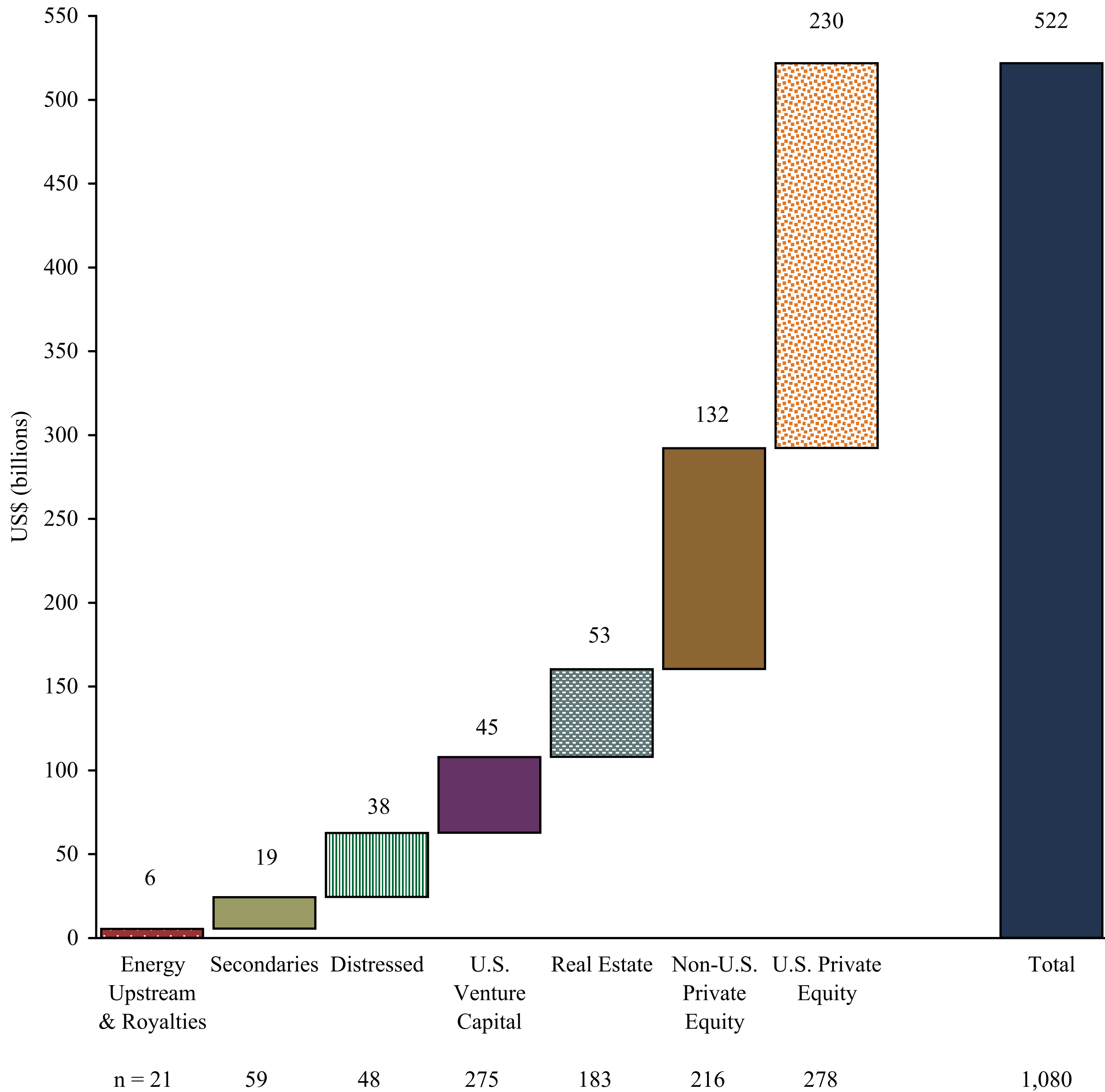
There remains an enormous amount of unfunded capital commitments in non-marketable alternative asset strategies. That excess capital may decrease the speed and degree to which prices reset in the private markets, and serve to dampen potential returns. Exhibit D-1 shows a rough approximation of this overhang by looking at the undrawn capital commitments from vintage years 2003–08 (i.e., those that at September 30, 2008, were likely still to be in their investment period).

If the credit markets stabilize and even a 1:1 debt-to-equity ratio is available to these U.S. and non-U.S. private equity funds, it is nearly three-quarters of a trillion dollars worth of deal-making capital ($362 billion of equity capital plus an equal amount of debt). These data are only from funds for which we actively track cash flows, and so the true totals should be expected to be in excess of what is represented here.

Exhibit D-1

UNFUNDED CAPITAL COMMITMENTS

2003–08 Vintage Years



Source: Cambridge Associates LLC Non-Marketable Alternative Assets Database.

APPENDIX E

ESTIMATING THE ECONOMICS OF PRIVATE EQUITY STRATEGIES, PART II

Appendix E

ESTIMATING THE ECONOMICS OF PRIVATE EQUITY STRATEGIES, PART II

As we have pointed out in this paper, management fees are a form of compensation to general partners (GPs) that is poorly aligned with the interests of limited partners (LPs). We also mentioned the various other income GPs collect through transaction, monitoring, director, and other fees. This practice is most common at the higher end of the market.

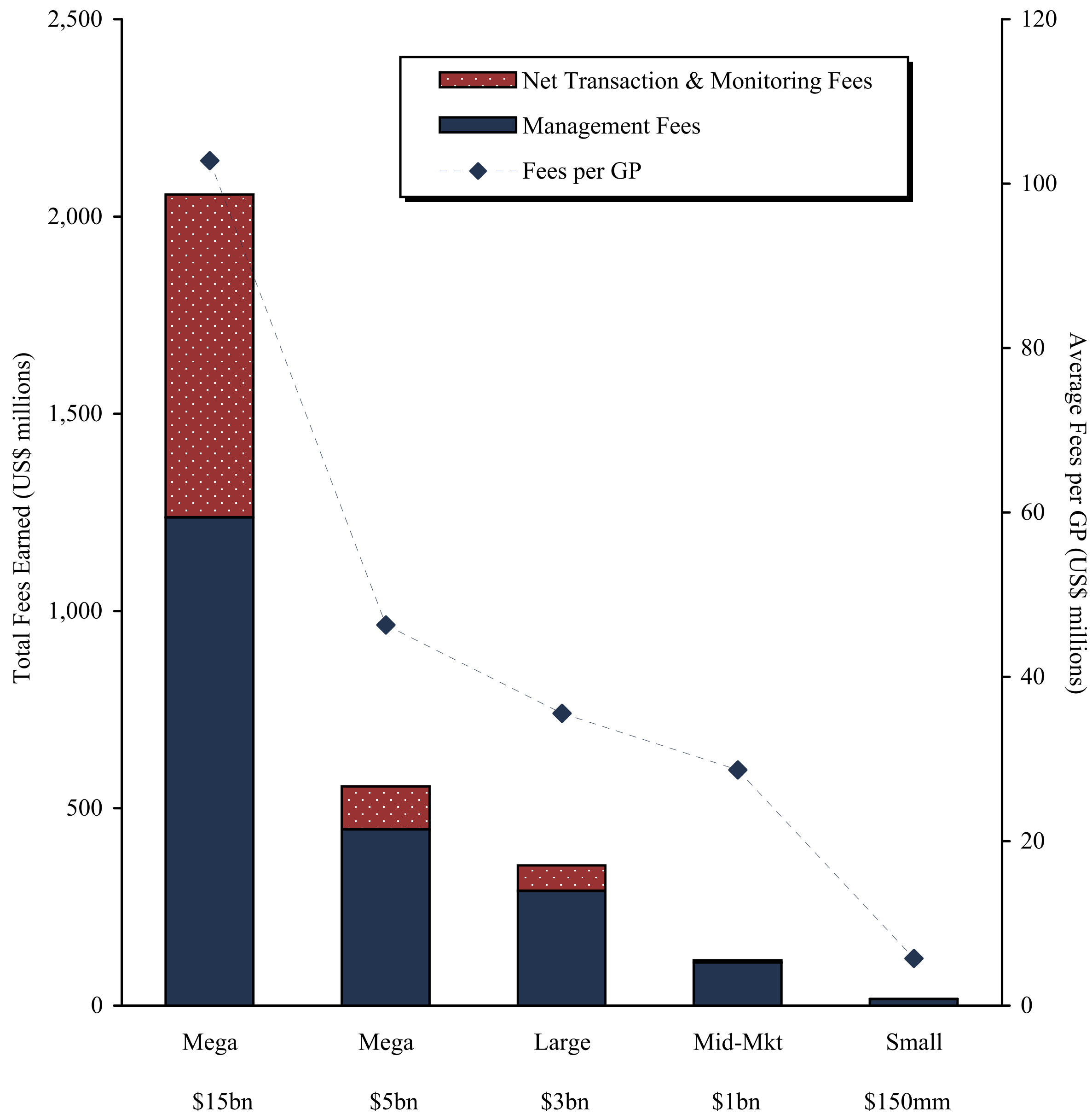
Exhibit E-1 is based on taking representative multiple examples of funds in each category, extrapolating from industry standards and the specific terms of the agreements. Transaction and monitoring fees are based on assumed total transaction sizes (using a roughly 2:1 debt-to-equity ratio) and a 50/50 split to offset management fees. As can be seen, the closing and investing of these funds generates substantial wealth for the GPs, regardless of the fund's ultimate performance.

A $15 billion fund could generate more than $2 billion worth of fee income that, when divided by a typical number of GPs, would average in excess of $100 million for each of the fund's GPs. Likewise, a $3 billion fund could be expected to generate $36 million of fees per GP during its life.

While these private equity firms obviously have headcount and operating costs that come out of management fees, the implied level of net fee income guaranteed to GPs regardless of actual future performance is clearly at odds with the best interests of LPs.

Exhibit E-1

TOTAL FEES EARNED AND AVERAGE FEES PER GENERAL PARTNER



Source: Cambridge Associates LLC calculations.

Notes: Calculations are based on taking representative multiple examples of funds in each category, extrapolating from industry standards and the specific terms of the agreements. Transaction and monitoring fees are based on assumed total transaction sizes (using a roughly 2:1 debt-to-equity ratio) and a 50/50 split to offset management fees.