



*Independence*

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Trinity Fund Administration Limited

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# Equalisation

Version 1.0

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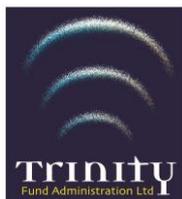
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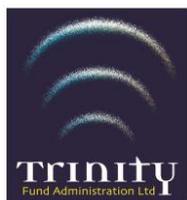
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<b>Content</b>	<b>Page</b>
<b>What is Equalisation</b>	3
<b>What are the Objectives of Equalisation</b>	3
<b>Methods:</b>	
<b>Series of Shares</b>	4
<b>Simple Equalisation</b>	5
<b>Equalisation Factor / Depreciation Deposit Approach</b>	5-6
<b>Equalisation Share Adjustment Method</b>	6-8
<b>Conclusion</b>	9



## What is Equalisation?

In the context of alternative investment and hedge funds – indeed any open ended fund that pays incentive or performance fees – “Equalisation” means an accounting methodology, designed to ensure that not only the investment manager is paid the correct incentive fee, but also that investor only pay based on their respective uplift and that the incentive fees are fairly allocated between each investor in the fund.

The Equalisation process is an accounting methodology which enables each individual investor, or group of investors, who invest in a fund over the course of its lifetime to be individually assessed for their own incentive fee liability and charged accordingly. If this can be achieved, this will eliminate the problem of one investor being penalised to the advantage of another.

Two examples which illustrate the need for equalisation are described below:

### Free Ride

Free-riding would be considered the primary justification for equalisation. An example demonstrates how it occurs and why it needs to be avoided. An investor buys a share in a fund for \$100, and the NAV per share rises to \$110, so the investor must pay \$2 as an incentive fee (2% of the \$10 profit). If the NAV per share falls to \$100 again, and a second investor buys a share, he will only have to pay an incentive fee after the NAV exceeds \$110. They get a free ride by not paying an incentive fee when the fund increases from \$100 to \$110, but the original investor doesn't.

### Claw Back

The claw back scenario is an equally important rationale for equalisation and relates to the accrual of an incentive fee as the value of the fund increases. If new investors subscribe to the fund and subsequently the value of the fund decreases, the incentive fee accrued will reverse and benefit all investors in the fund. This benefits the new investors even though they have not born the cost of the incentive fee yet.

## *What are the Objectives of Equalisation?*

There are several different Equalisation Methodologies employed to address any potential inequities that may arise in the calculation and allocation of incentive fees between the investment manager and investors. These include the Series of Shares approach as well as a number of different “Equalisation Methods”. The objective of all of these methods is to try and ensure:

- i. the equitable allocation of incentive fees between each investor in a fund, to ensure that the Investment Manager is paid the correct amount and that each investor pays the amount that it should be paying and is not subsidised by, or does not subsidise another investor;
- ii. that all investors have the same capital risk per Share;
- iii. that there is a single NAV per share;
- iv. that the published NAV accurately reflects the fund's performance; and
- v. that the method used should be easily understood by all parties including the investors.

It must be noted that nobody has yet produced a perfect Equalisation Method that meets all of these objectives and each of them have pros and cons that appeal in different degrees to investment managers and investors in different parts of the world.

We will now look at the various industry leading methods which Trinity's systems employ.

## Series of Shares Method

This, in many peoples opinion is the most user-friendly and simplest of the Equalisation Methods. It requires the fund to issue a new Series of Shares ("Series") each time there is a subscription. Every month, when calculating the NAV per Share, the correct incentive fee accruals, if any, are applied to each of the Series separately.

The first Series of Shares, which are issued when the fund is launched, is usually known as the "Lead Series". The objective is to consolidate each of the subsequent Series issued into the Lead Series, at the end of every accounting period, providing an incentive fee has been paid for each of the Series, including the Lead Series. This may be quarterly, half-yearly, or annually.

### *How does it work?*

By way of example (see Table 1), let us assume that Investor A purchases 1,000 Shares at the launch of the fund, at €1,000 per Share. This will be the "Lead Series" of Shares. *(For this example we are assuming that the incentive fees are being paid quarterly).*

Let us then assume that at the end of the first month the Gross NAV ("GNAV") (the NAV before deduction of incentive fee) per Lead Share has risen to €1,100 and therefore the NAV will be €1,080, net of €20 / 20% incentive fee. At this time Investor B subscribes €1 million for 1,000 Series II Shares at, again €1,000 each.

At the end of the second month, the value of the fund has risen by a further 10%, so that GNAV for the Lead Series is now €1,210, whereas the GNAV for Series II is now €1,100. The NAVs for the Lead Series will now be €1,168 and, for Series II €1,080, net of 20% incentive fee accrual. At this stage Investor C subscribes a further €1 million for 1,000 Shares of Series III at €1,000 per Share.

Let us now assume that, at the end of the third month, the NAV has yet again risen by a further 10%, so that:

- a) The GNAV per Share of the Lead Series is €1,331, which translates to a NAV of €1, 264.80;
- b) The GNAV of Series II is €1,210, equalling a NAV of €1,168; and
- c) The GNAV for Series III is €1,100, equalling a NAV of €1,080.

Thus, at the end of the first quarter and because a new High Water-Mark ("HWM") has been reached and each of the Series of Shares have paid incentive fees, the Series II and Series III Shares can now be consolidated into the Lead Series. This means that, in effect, the owners of Series II and Series III Shares will sell, or exchange their Shares for Lead Series Shares.

Therefore, Investor B's Shares are worth €1,168.00, which equates to 923.46616 Shares at the NAV per Lead Series, at €1,264.80 each. Similarly Investor C will effectively liquidate his 1,000 Shares for €1,080,000 and effectively invest those proceeds of that liquidation into the Lead Series at €1,264.80 per Share, to receive 853.890 Lead Series Shares.

If at the end of the third month the value of the fund has declined by say 4%, then the Lead Series and Series II would still be profitable and could be consolidated. However, the Series III would be showing a loss, at GNAV of €960 and so would not be consolidated. The Series III would remain in existence until a new HWM had been achieved, which would put the Series III into profit.

**TABLE 1 – SERIES OF SHARES METHOD**

i	Investor A buys 1,000 Lead Series Shares at €1,000 per Share
ii	End of first month, GNAV per share has risen 10% to €1,100
iii	NAV published at €1,080 (€1,100 less €20 incentive fee)
iv	Investor B now buys 1,000 Series II shares at €1,000 per share
v	End of second month, value of the fund has risen by further 10% so that: (a) GNAV of Lead Series is now €1,310 = NAV €1,168; and (b) GNAV of Series II is now €1,100 = NAV €1,080
vi	Investor C buys 1,000 Series III Shares at €1,000 per Share

vii	End of third month, fund value has again risen by 10%, so that: (a) GNAV of Lead Series is now €1,331 = NAV €1,264.80; (b) GNAV of Series II is now €1,210 = NAV €1,168; and (c) GNAV of Series III is €1,100 = NAV €1,080
viii	As it is the end of the quarter and new HWM has been achieved, the incentive fees are paid.
ix	Series II and Series III Shares are then consolidated into Lead Series
x	Thus: (a) Investor B exchanges 1,000 Series II Shares, now worth US\$1,168,000, for 923.466 Lead Series Shares, at US\$1,264.80; and (b) Investor C exchanges 1,000 Series III Shares, now worth US\$1,080,000, for 853.890 Lead Series Shares

### *Advantages*

Relatively simple method

Investors can see how it works and can see that it is fair to all parties

### *Disadvantages*

Many funds only pay incentive fees once a year and this means that the Series of Shares Method can be quite cumbersome. i.e. if a fund is a heavily subscribed, expanding fund, then by the end of the year it could have twelve (NAV calculated monthly) or 52 (NAV calculated weekly) or even 260 (NAV calculated daily) separate Series in issue.

It is not possible to publish a single NAV per Share, because each Series had its own NAV which can be confusing to shareholders, particularly if they make several investments into the fund over a period of time and so end up with holdings that have different NAVs.

It can be administratively time consuming and therefore expensive to list several Series of Shares on the Stock Exchange because it will be necessary to apply to list each Share in issue

## **Simple Equalisation**

One of the first of the share adjustment methods of Equalisation, The procedure is to calculate the performance fee and allocate it fairly between each investor or group of investors at the end of each accounting period. As investors will have come in at different levels this will mean calculating different NAVs per investor. However, in order to get a common NAV for all the shares in the fund, the lowest NAV's calculated on an investor by investor basis is selected to become the NAV of the fund.

Shareholders with a higher individual NAV per share are then issued Equalisation Shares, so that the total number of Shares issued to that investor (i.e. original shares purchased plus any EQ shares) times the new NAV for all Shares in the fund will enable the investment for those investors to be kept constant.

### *Advantages*

Relatively simple to calculate the NAV for each shareholder

Single NAV per share for the fund

### *Disadvantages*

NAV does not accurately reflect the fund performance because it is continually discounted

The addition of EQ shares to investors on what may seem like an arbitrary basis can leave investors confused

## Equalisation Factor / Depreciation Deposit Approach

Under this approach each investor invests at the NAV, plus either the Equalisation Factor or the Depreciation Deposit depending on whether the NAV of the fund has increased or declined from the last high water-mark.

If the NAV has risen during the period, then a new subscriber would invest the equivalent of the GNAV (Gross Net Asset Valuation), to place the same amount of money at risk as the existing shareholders, the difference between the NAV and the GNAV being the Equalisation factor. If the fund maintains its performance, the Equalisation factor paid will be refunded in shares, at the end of the incentive fee calculation period.

If however, the fund subsequently loses value the Equalisation will be lost for that period, but is refundable, in the future, if the fund recovers. This avoids the claw back scenario.

If, on the other hand, the fund's NAV is at a discount to the high watermark at the time that an investor makes a subscription, then the investor will be required to pay at Depreciation Deposit. If the fund starts to improve and recoup its losses, then the Depreciation Deposit becomes payable to the manager as a performance fee. This avoids the 'free ride' scenario. This method was popular many years ago in the US but is rarely employed these days

## Equalisation Share Adjustment Method

The equalisation share adjustment method (Eq) is one of the most popular methods used in the industry and particularly outside of the USA.

Under an Investment Management Agreement, the Investment Manager will receive an annual performance fee (the "**Performance Fee**") with respect to the fund, accrued monthly but paid annually as of the end of each financial year or as of any earlier date on which Participating Shares are redeemed

There will be a loss carryforward for each Participating Share, so that if a Participating Share decreases in Net Asset Value during any Performance Period, and during a subsequent Performance Period increases in Net Asset Value, there will be no Performance Fee payable with respect to any increase in Net Asset Value occurring while the Net Asset Value of such Participating Share is less than its highest previous Net Asset Value, adjusted for any distributions. The Performance Fee will be determined as of the last day of each Performance Period.

If an investor subscribes for Participating Shares at a point in time when the NAV per Share is not equal to the highest NAV per Share at which the Performance Fee has been calculated with respect to outstanding Participating Shares (the "**Peak Net Asset Value per Share**"), certain adjustments are made to reduce inequities that may otherwise result to the subscriber or to the Investment Manager

### *Deficit Subscription Adjustments*

In the case of a subscription made at a time when the NAV per Share is less than the Peak NAV per Share (a "**Deficit Subscription**"), the Shareholder is required to pay a Performance Fee with respect to any subsequent appreciation of those Shares. With respect to any appreciation of those Shares from the NAV per Share at the date of purchase up to their current Peak Net Asset Value per Share, the Performance Fee will be levied by redeeming for no consideration an amount of Shares having a Net Asset Value equal to the Performance Fee Rate multiplied by any such appreciation (a "**Performance Fee Redemption**").

The proceeds attributable to any Performance Fee Redemption will be paid to the Investment Manager as a Performance Fee. With respect to any appreciation attributable to the remaining Shares subject to the Deficit Subscription from gains in excess of the Peak NAV per Share, the Performance Fee will be calculated and levied in the same manner as all other Shares in the Fund. Performance Fee Redemptions are employed to ensure that the Fund maintains a uniform Net Asset Value per Share for all the shares in issue in the Fund.

### Deficit Subscription Illustrations.

The following table illustrates the operation of the Deficit Subscription procedure in each of the following three scenarios, assuming a 20% Performance Fee Rate, after a Deficit Subscription purchase of Participating Shares at €90 per Share when the Peak NAV per Share was €100:

- (1) Share appreciation to €110 at the next Performance Fee calculation date;
- (2) Share appreciation to €100 (equal to Peak NAV per Share) at the next Performance Fee calculation date; and
- (3) no change in Share value.

#### Deficit Subscription Purchase Date Information:

Purchase price (Gross NAV/Share) =	€ 90
NAV/Share at purchase date =	€ 90
Purchase date Peak NAV/Share =	€ 100
Performance Fee Rate =	20%

NAV Scenario (change from €90)	Gross NAV at next valuation date	Total Performance fee due from Deficit Subscription Investor	Portion of Performance Fee to be paid by deduction from Gross NAV	Portion of Performance Fee to be paid by redemption of Shares from Investor for no consideration (Performance Fee Redemption)	NAV (net of all fees)	# of Shares (per Share owned) redeemed from Investor for no consideration
Appreciation past Peak NAV	110	4	2	2	108	0.018
Appreciation to Peak NAV	100	2	0	2	100	0.02
No Change	90	0*	0	0	90	0

\* Deficit Subscription will still apply in this situation to future periods until NAV reaches or exceeds Peak Net Asset Value at the end of another measurement period when a Performance Fee is due or until Shares are redeemed by investor.

### Premium Subscription Adjustments

Similarly, in the case of a subscription for Participating Shares ("**Premium Shares**") made at a time when the Net Asset Value per Share exceeds the Peak Net Asset Value per Share (a "**Premium Subscription**"), the investor is required to pay for each Premium Share an amount in excess of the then current NAV per Share equal to the number of Premium Shares multiplied by the relevant Performance Fee Rate multiplied by the difference between the then current Net Asset Value per Share of the Participating Shares (before accrual of the Performance Fee) and the Peak Net Asset Value per Share (an "**Equalisation Credit**").

The Equalisation Credit, which is added to the NAV per Share to determine the offering price for Participating Shares, ensures that all Shareholders in the Fund have the same amount of capital at risk per Share. At the date of a Premium Subscription, the Equalisation Credit per Premium Share will equal the accrued Performance Fee per Share due with respect to the Participating Shares of the Fund that have been outstanding since the last Performance Fee calculation date (the "**Maximum Equalisation Credit**").

The additional amount invested as the Equalisation Credit will be at risk in the Fund and will therefore appreciate or depreciate based on the performance of the Fund subsequent to the Premium Subscription, but will never exceed the Maximum Equalization Credit.

In the event of a decline in the value of the Premium Shares, the Equalisation Credit due to the Shareholder will also be reduced by an amount equal to the number of Premium Shares multiplied by the relevant Performance Fee Rate multiplied by the difference between the NAV per Share (before accrual of the Performance Fee) at the date

of the original purchase and the new lower NAV per Share. Subsequent appreciation in the value of the Premium Shares will result in a recapture of any Equalisation Credit lost due to such prior reductions, but only to the extent of the previously lost Equalisation Credit up to the Maximum Equalisation Credit.

After a Premium Subscription is made, on each subsequent Performance Fee calculation date that the NAV per Share of the Participating Shares (before accrual of the Performance Fee) exceeds the prior Peak Net Asset Value per Share, that portion of the Equalisation Credit equal to the relevant Performance Fee Rate multiplied by the excess per Share, multiplied by the number of Premium Shares, is applied to purchase additional Participating Shares for the Shareholder at a price equal to the new Net Asset Value per Share (after payment of the Performance Fee).

Additional Participating Shares will continue to be so purchased until the Equalisation Credit, as it may have appreciated or depreciated in the Fund after the Premium Subscription is made, has been fully applied. If the Shareholder redeems Premium Shares before the Equalisation Credit has been fully applied, the Shareholder will receive additional redemption proceeds equal to the Equalisation Credit then remaining multiplied by a fraction, the numerator of which is the number of Premium Shares being redeemed and the denominator of which is the number of Premium Shares owned by the Shareholder immediately prior to the redemption.

### *Premium Subscription Illustrations*

The following table illustrates operation of the Premium Subscription procedure, assuming a 20% Performance Fee Rate, in four scenarios after a Premium Subscription for Participating Shares at a purchase price of €140 per Share when the Peak NAV per Share is €100:

- (1) Share appreciation to €150 per Share at the next Performance Fee calculation date;
- (2) no change in NAV per Share;
- (3) limited depreciation to €120 per Share at the next Performance Fee calculation date (but with NAV per Share still above the Peak NAV per Share of €100); and
- (4) greater depreciation in NAV per Share to €100 per Share (equal to Peak NAV per Share).

### **Premium Subscription Purchase Date Information:**

Purchase Price (Gross NAV/Share) =	€ 140
Peak NAV/Share =	€ 100
NAV/Share (after Performance Fee accrual) =	€132
Equalization Credit/Share (140-100) x .20 =	€ 8
Performance Fee Rate =	20%

NAV Scenario (change from US\$100)	Gross NAV* at next valuation date	Total Performance Fee due per Share	Portion of Performance Fee due from Premium Subscription Investor	Portion of Performance Fee due applied to Equalization Credit	NAV (net of all fees)	# of additional Shares purchased (per Share owned) with Equalization Credit for benefit of Premium Subscription Investor	Amount of Equalization Credit remaining at valuation date	Amount of Equalization Credit subject to potential recapture if NAV declines after Premium Subscription and then increases at a later valuation date to the NAV at date of Premium Subscription**
Appreciation	150	10	2	8	140	0.057	0	0
No Change	140	8	0	8	132	0.061	0	0
Limited Depreciation	120	4	0	4	116	0.034	0	4
Depreciation to Peak NAV	100	0	0	0	100	0	0	8

## *Advantages*

Produces one single NAV for the fund so it is more efficient to calculate  
Changes are reported regularly, so investors can track changes, instead of one annual adjustment which may be harder for investors to comprehend

## **Conclusion**

It is essential to ensure that the Equalisation method chosen complies with the Fund's offering and statutory documents. Many, if not most, Investment Management Agreements state that the Investment Manager will be paid an incentive fee of up to 20% of net profits.

Each of the different methods have their pros and cons so the choice of which method is appropriate for a particular fund is dependent on several different variables. This is usually dictated by a combination of market needs and to a large extent, the Method that the Fund Manager and his targeted investors are most comfortable with.

Thus, if a loss occurs, the Investment Manager has to recoup the total loss before any further incentive fees can be paid. What must be made clear is that, if an investor redeems during a draw down period and thereby accepts a portion of the loss, the amount of loss that the Investment Manager has to recoup will be reduced pro rata.

The employment of any one of the aforementioned equalisation methods will go a long way to ensuring that the investment manager is paid the correct incentive fee, that the fee is fairly allocated between each investor in the fund and that that the investors only pay based on their respective uplift.

At Trinity we have elected to utilise specialist software that automates the Equalisation process. With our systems, Trinity is able to provide Equalisation on an automated basis, utilising both the Series of Shares, the Equalisation Share Adjustment Method as well as hurdle rates, because we believe that these methods achieve most of the key objectives, although none can be described as completely investor friendly, or easy to understand. But you can't have everything!

