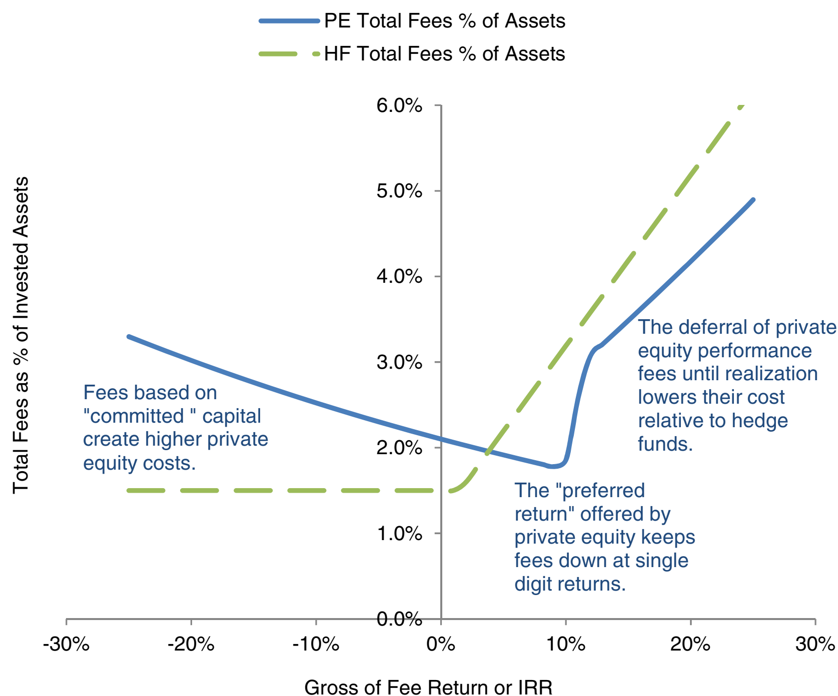
CLIFFWATER LLC

The Better Deal: Hedge Funds or Private Equity?[1]

Growing institutional interest in alternative investments has also brought attention to fees, which are higher and more complex when compared to fee structures for traditional asset classes. Fee structures also vary widely among alternative asset classes making apples-to-apples comparisons sometimes challenging, as is the case with comparing private equity and hedge fund fees. ***We show that neither private equity nor hedge funds****, two of the fastest growing alternative asset classes,* ***have a clear fee advantage over the other****. Though hedge fund fees will vary significantly from private equity fees at different levels of return, when we weigh outcomes by their likelihood of occurrence* ***we calculate a total fee cost of 3.53% for the typical hedge fund, equal to 32% of expected gross profits. We calculate a higher total fee cost of 3.73% for the typical private equity fund, but that fee represents a lower 25% of expected gross profits.***

Exhibit 1 compares hedge fund and private equity fees, as a percent of invested assets, over a range of return outcomes. Fees are shown on the vertical axis and include both management and performance fees. Return is shown on the horizontal axis and should be interpreted as the annualized return or IRR achieved over the duration of the fund/partnership, which we assume is 10 years.

Exhibit 1: Investor Fees for Hedge Funds and Private Equity Funds



[1] This paper is Part I of a series of Cliffwater research reports that address alternative investment fees.

© 2010 Cliffwater LLC. All rights reserved.

Hedge Fund Fees

The depiction of hedge fund fees in Exhibit 1 is straightforward. The 1.5% management fee and 20% performance fee is the most common hedge fund fee structure according to Hedge Fund Research Inc.[2] Total fees are limited to a 1.5% management fee until return, in excess of management fees, turns positive. Thereafter, a 20% performance fee increases total fees as a percent of assets.

Private Equity Fees

Private equity fees are considerably more complex and require a number of assumptions which are listed in Exhibit 2. These assumptions are intended to capture the likely partnership terms found in an institutional quality buyout partnership. Because private equity fees and invested assets vary significantly over the life of the investment partnership, our approach to measuring fees as a percent of invested assets at any given level of return is to sum the discounted value of all fees paid by the partnership over its life and divide by the sum of the discounted value of all invested partnership assets. We estimate fees and invested assets quarterly over the 10 year assumed partnership life and then discount the projected fees and asset values back to the initial investment date at an 8% rate, the assumed preferred return.[3]

Exhibit 2: Private Equity Partnership Assumptions

Partnership Term	Value	Description
Investment Period (yrs)	5	Time period over which investments are made
Fund Life (yrs)	10	Life of the fund
Max % Funded	90%	Amount of committed capital actually drawn
Avg. Holding Period	5	Length of time portfolio company is held
Carry Percentage	20%	Percent of profits owed to GP
LP Preferred Return	8%	Minimum return before manager earns performance fee
GP Catchup	80%	Percent of profits paid to GP after preferred return achieved
Mgmt Fee (Investment Period)	1.5%	Paid on committed capital
Mgmt Fee (Post-Investment Period)	1.0%	Paid on invested capital
Transaction Fees % of TEV	0.50%	Paid by portfolio companies to GP on Total Enterprise Value
Monitoring Fees % of Invested Capital	0.25%	Paid by portfolio companies to GP for management services
Fee Offset %	80%	Percent of transaction/monitoring fees reducing management fees
Avg % Leverage	60%	Percent of portfolio company debt used to determine TEV

Private equity management fees are two tiered, with a 1.5% annual fee on *committed* capital during the first five years when assets are drawn and invested, and 1.0% on *invested* capital in subsequent years. It is the practice of charging fees on committed capital in the early years that causes our measure of management fees as a percent of invested assets in Exhibit 1 to exceed 1.5% at lower levels of return. A related fee drag is the fact that most private equity partnerships never fully invest all assets committed to the partnership, and we assume for our example that only 90% of committed capital is drawn for investment.

High private equity management fees also come despite fee offsets. Private equity managers (GPs) reduce management fees by a large fraction of the transaction and monitoring fees they earn from the portfolio companies and we assume that 80% of any company fees earned by the GP are used to reduce management fees paid by the private equity investor.

Rows 1 to 3 in Exhibit 3 show our calculations for management fees and fee offsets for a range of gross private equity returns (IRR).

[2] HFR Market Microstructure Hedge Fund Industry Report, Second Quarter 2010.
[3] Using the preferred return as the discount rate is somewhat arbitrary, but 8% is close to the current cost of equity capital.

Exhibit 3: Private Equity and Hedge Fund Fees on Invested Assets at Various Levels of Return

		Gross Return						
		-10%	-5%	0%	5%	10%	15%	20%
	Private Equity							
1	Mgmt Fee	2.81%	2.55%	2.30%	2.09%	1.89%	1.71%	1.55%
2	+Offsets	-0.49%	-0.44%	-0.40%	-0.36%	-0.33%	-0.30%	-0.27%
3	Net Mgmt Fee	2.33%	2.10%	1.90%	1.72%	1.56%	1.41%	1.28%
4	+Carry	0.00%	0.00%	0.00%	0.00%	0.17%	2.72%	3.74%
5	Total Fee	2.33%	2.10%	1.90%	1.72%	1.73%	4.13%	5.02%
6	+NPV effect	0.20%	0.20%	0.20%	0.19%	0.13%	-0.64%	-0.85%
7	Total Fees	2.52%	2.30%	2.10%	1.92%	1.86%	3.49%	4.17%
	Hedge Funds							
8	Mgmt Fee	1.50%	1.50%	1.50%	1.50%	1.50%	1.50%	1.50%
9	+Carry	0.00%	0.00%	0.00%	0.69%	1.69%	2.68%	3.68%
10	Total Fees	1.50%	1.50%	1.50%	2.19%	3.19%	4.18%	5.18%
11	Difference (7-10)	1.02%	0.80%	0.60%	-0.28%	-1.33%	-0.70%	-1.01%

In row 1, private equity management fees exceed 1.5% for all levels of gross return. Offsets shown in row 2 provide an important reduction in fees. At an expected 15% gross private equity return, the estimated net management fee is 1.41% (row 3).

Unlike hedge funds where performance fees are earned on the first dollar of profit, private equity funds do not earn a performance fee until the investor first earns a preferred return, generally 8%, net of management fees. Afterward, 80% of profits are distributed to the GP to catch-up on profit distributions and thereafter the normal 20% GP split is reinstated. Row 4 shows performance fees (carry) as a percent of invested assets at different levels of gross return.

Some fees, particularly performance fees, are paid well after they are earned. For example, private equity performance fees can be earned over the life of the investment but not paid until the investment is sold. This is unlike hedge funds where performance fees are paid more frequently and do not require an asset sale. The deferral of fees is a benefit to investors and reduces the effective fee by the net present value (NPV) of the deferred amount. Row 6 in Exhibit 3 shows that the practice of deferring performance fees can be of significant value to investors and is something not often found in hedge fund fee structures.

Row 7 in Exhibit 3 shows total private equity fees as a percent of invested capital and equals the sum of management fees; fee offsets; carry; and the discount effect from deferring the payment of carry.

Fee Comparison between Hedge Funds and Private Equity

Hedge fund fees compare favorably to private equity in Exhibit 1 when investment returns are negative. While hedge fund fees remain at a constant percentage of asset market value, private equity fees climb as a percent of invested assets at lower returns because they are based on a fixed percent of committed capital even though asset values may decline.

The fee gap also favors hedge funds at a zero percent gross return, where hedge fund fees equal the 1.5% management fee but private equity fees total 2.10%.[4]

[4] We ignore the potential that hedge fund investors may pay a performance fee despite negative returns due to the lack of a "clawback" feature typically found in private equity partnerships. This added potential cost can be measured using simulation techniques rather than the simpler deterministic methodology used here.

The presence of a preferred return for private equity but not for hedge funds creates significantly lower fees for private equity compared to hedge funds at gross returns between 5% and 10%. At a 10% gross return private equity has a fee advantage of 1.33%. That advantage over hedge fund fees continues at higher levels of gross return.

Expected Fees

Exhibit 1 provides fee calculations across a range of returns but is silent on what fees to expect, which require assumptions for hedge fund and private equity expected return and risk. We assume expected annual returns, gross of fees, of 11% and 15% for hedge funds and private equity, respectively. We forecast annualized risk equal to 10% and 25% for hedge funds and private equity, respectively.

Weighting return and fee outcomes by their probability of occurrence gives an expected fee of 3.53% for hedge funds and 3.73% for private equity. While fees are higher for private equity, as a percentage of gross return they are lower. Private equity fees equal 25% of the expected 15% gross private equity return while hedge fund fees equal 32% of their expected 11% gross return.

Given our return and risk assumptions, our analysis suggests that private equity has higher fees, as a percent of invested assets, but because of its higher expected gross return, those fees represent a lower fraction of profits compared to hedge funds.

There is one final consideration. Ideally, investors are paying fees for profits generated by “alpha” rather than “beta.” Hedge fund profits supposedly are primarily alpha while private equity profits are more likely a combination of both. We do not attempt to quantify here the source of gross return but investors’ assessment of whether return is coming from alpha as opposed to beta should weigh heavily on evaluation of fees. The question of what investors get for the fees they pay is the subject of Part II in this series.

Sam Hagan
Stephen Nesbitt
Eli Sokolov

November 16, 2010