What is Equalisation?

The Equalisation process is an accounting methodology for open-ended funds that pay incentive or performance fees.

It is designed to ensure that:

- The investment manager is paid the correct incentive fee
- The investors only pay based on their respective uplift
- The incentive fees are fairly allocated between each investor in the fund

By using Equalisation, each individual investor (or group of investors) who invest in a fund will, over the course of the fund's lifetime, be **individually assessed and charged only for their own incentive fee liability.**

This process helps avoid the possibility that any investor or group of investors will be unduly advantaged or penalised.

Why Equalisation is needed

There are many scenarios and rationales for Equalisation, many having to do with new investors potentially gaining benefits over original investors.

Free Ride

If an investor buys a Share in a fund for $100, and the NAV (Net Asset Valuation) per Share rises to $110, the investor must pay an incentive fee. 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. The second investor gets a "free ride" by not paying an incentive fee when the fund increases from $100 to $110, but the original investor doesn't benefit.

Claw Back

If new investors subscribe to the fund, and subsequently the value of the fund decreases, the incentive fee accrued will reverse. This benefits all investors in the fund, including the new investors even though they didn't bear the cost of any incentive fee yet.

The objectives of Equalisation

There are several different Equalisation Methodologies that may be employed to address potential inequities between the investment manager and investors related to the calculation and allocation of incentive fees. The objectives are to try and ensure:

- Equitable allocation of incentive fees between each investor in a fund, to both ensure that the investment manager is paid correctly and that no investor or group of investors subsidises or is subsidised by another
- Equitable capital risk per investor per Share
- A single NAV per Share
- A published NAV that accurately reflects the fund's performance
- Easy comprehension of the Equalisation Method by both investors and investment managers

Types of Equalisation methodologies

No one Equalisation Method, including the popular Series of Shares approach, currently meets all of these above objectives perfectly. Each method has pros and cons with different degrees of appeal to investment managers and investors in different parts of the world.

Series of Shares

Most people consider this to be the simplest and most user-friendly of the Equalisation Methods. The fund must issue a new Series of Shares ("Series") each time there is a subscription. The first Series of Shares, which is issued when the fund is launched, is usually known as the "Lead Series". Every month, when calculating the NAV per Share, the correct incentive fee accruals, if any, are applied to each of the Series separately.

At the end of every accounting period (monthly, quarterly, or annually) there will be consolidation of each of the subsequent Series issued into the Lead Series, providing an incentive fee has been paid for each of the Series including the Lead Series. Each investor effectively sells or exchanges their subsequent Series Shares for Lead Series Shares, and the process repeats in the next accounting period.

This is a relatively simple method, as investors can see how it works and can see that it is fair to all parties. However, for funds that only pay incentive fees once a year, the Series of Shares Method can be quite cumbersome.

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.

A heavily subscribed, expanding fund could end up with several hundred separate Series in issue, which can be administratively time consuming and therefore expensive to manage.

Simple Equalisation

An earlier and simpler form of Equalisation calculates the performance fee and allocates it fairly between each investor or group of investors at the end of each accounting period. Since investors will come in at different levels, each NAV must be calculated separately. However, in order to get a common NAV for all of the shares in the fund, the lowest NAV's calculation on an investor by investor basis is selected to become the NAV of the fund.

Shareholders with a higher individual NAV per share are issued Equalisation Shares. The sum of their original Shares plus the Equalisation Shares times the new NAV for all Shares in the fund allows their investment to be kept constant.

There is only a single NAV share for the fund, and it is relatively simple to calculate the NAV for each shareholder, but the NAV will not accurately reflect the actual fund performance as it is continually discounted.

Equalisation Factor / Depreciation Deposit

Each investor invests at the NAV, plus either the Equalisation Factor or the Depreciation Deposit (calculated depending on whether the NAV of the fund has increased or declined from the last high water-mark). New subscribers must invest the equivalent of the GNAV (Gross Net Asset Valuation), to place the same amount of money at risk as the existing shareholders. The Equalisation factor is the difference between the NAV and the GNAV.

The Equalisation factor paid may be refunded in Shares at the end of the incentive fee calculation period if the fund is maintained. If the fund subsequently loses value, the Equalisation will be lost for that period, but is refundable if the fund recovers, preventing Claw Back. New investors must pay a Depreciation Deposit. If the NAV is at discount; if the fund improves and recoups its losses, then the Depreciation Deposit becomes payable to the manager as a performance fee, preventing a Free Ride.

This was once a popular Equalisation method in the USA, but is now rarely employed.

Equalisation Share Adjustment

Under an Investment Management Agreement, the Investment Manager will receive an annual "Performance Fee" with respect to the fund. This accrues monthly but is paid annually either at the end of each financial year generally or as of any earlier date on which Participating Shares are redeemed. There will be a loss carryforward for each Participating Share. The Performance Fee will be determined as of the last day of each Performance Period.

If an investor subscribes to Participating Shares at a time when the NAV per Share is not equal to the highest NAV per Share at which the Performance Fee has been calculated concerning 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 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.

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.

The equalisation share adjustment method (Eq) is one of the most popular methods used in the industry, particularly outside of the USA. This method produces one single NAV for the fund, so it is more efficient to calculate. Changes are reported regularly instead being rolled into one annual adjustment, making it easier for investors to track and comprehend the changes.

Conclusion

The Equalisation method chosen needs to comply with the fund's offering and statutory documents. Typical Investment Management Agreements state that the Investment Manager will be paid an incentive fee of up to 20% of net profits.

The best method to use will depend on many factors, including the **volatility of the fund, number of investors, and pace of growth.**

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