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# An Explanation of Private Market Fund Fees

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In September 2022, Preqin published the results of its institutional investor survey, which focused on private fund fee terms and conditions. The survey results showed that transparency around fees, rather than the amount of fees charged, were of primary concern. Of the institutional investors surveyed, 59% indicated that transparency at the fund level required improvement, while 80% noted they have either frequently or occasionally decided not to invest in a private fund, due to the proposed terms and conditions.[1]

With investors focused on fee transparency, there is a compelling case for why advisors should better understand the unique characteristics of the asset class, as well as the fees charged by private market fund managers to investors.

## FUND STRUCTURE

Private market funds are generally structured as limited partnerships. The manager of the fund is called the general partner (GP) and the investors that commit capital to the fund are called limited partners (LPs). The GP invests the fund's capital, manages the portfolio of investments, and executes exit events. LPs are passive investors who receive distributions from the fund.

## INVESTOR ELIGIBILITY

Importantly, investors must qualify to participate in private market investments. Many funds require qualified purchaser status.[2] The minimum commitment level required to invest directly with GPs typically ranges from $5 million to $20 million, reflecting the fact that private markets have historically been the domain of large, sophisticated investors. However, over the past several years, private market funds registered under the Investment Company Act of 1940 (The '40 Act) have become available to accredited investors. These funds, with minimum commitment levels as low as $25,000, have expanded dramatically.[3]

## MANAGEMENT & INCENTIVE FEES

Private market fund managers charge their investors an annual management fee, typically 1%–2%, which goes to support overhead costs, such as investment staff salaries, due diligence expenses, and ongoing portfolio company monitoring. Management fees may be calculated differently depending on the type of structure. For example, private market funds limited to qualified purchasers generally calculate the management fee based on percentage of invested or committed capital, while private market funds registered under the The '40 Act and available to accredited investors typically base the management fee off the net asset value (NAV) of the fund. In addition, registered private market funds typically charge for operating expenses, in addition to the management fees.

GPs also collect performance fees, known as carried interest, which traditionally represent 10–20% of any value appreciation or aggregated profits generated by the fund.

However, in order for GPs to begin receiving carried interest, most private market funds must first achieve a stated hurdle rate, also known as the preferred return. This is the minimum annual return that LPs are entitled to before the GP may begin receiving carried interest. While the typical hurdle rate in private equity is 8%, it is often 6–7% in the case of private credit funds, which usually have lower target returns than buyout funds. Note that venture capital funds do not typically offer a preferred return.

## FUND DISTRIBUTIONS

Distributions from private market funds typically follow a waterfall structure. A standard distribution waterfall flows according to the hurdle rate, a catch-up rate, and the carried interest rate. In the first phase of a fund's life, when returns have not exceeded its hurdle rate, all distributions are allocated to LPs. Once a fund exceeds its hurdle rate, what is commonly referred to as a catch-up provision takes place wherein the GP typically is paid a higher proportional amount (ranging from 50–100%) until it has caught up to the profit percentage already distributed to LPs. For example, once the fund reaches its hurdle rate and has delivered that to LPs, 50–100% of the next distributions will be allocated to the GP until the GP's own return equals the prespecified share of profits. Once this occurs, the remaining profits generated by the fund are then distributed according to the original schedule, or 80%–90% to LPs and 10–20% to the GP.

## CLAWBACKS

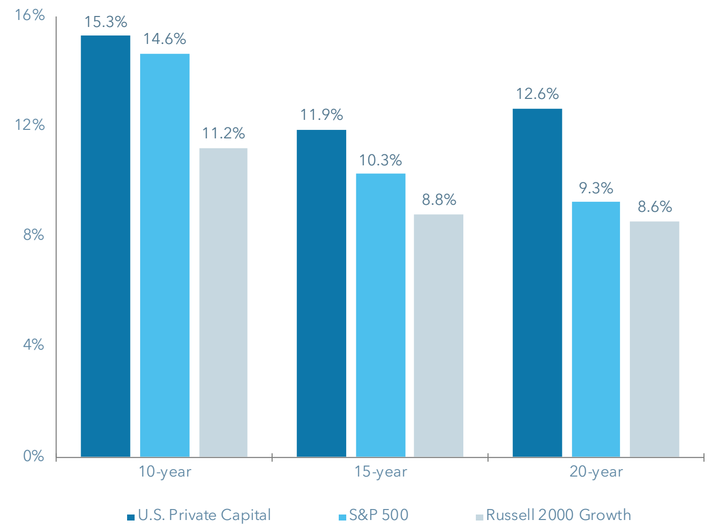
It is also worth noting that many private market fund agreements generally include clawback provisions, which require GPs to hold a portion of carried interest collected over the life of the fund in escrow to account for scenarios under which the overall performance of the fully liquidated fund dips below the hurdle rate. This allows for the recovery of any excess carried interest that the GP may have retained to ensure that LPs receive their net hurdle rate.

## ALIGNMENT OF INTERESTS

Private market firms are focused on delivering outsized returns for their investors and have structured their fees in a way that enables them to participate in that upside. As Exhibits 1 and 2 illustrate, private markets have consistently outperformed most major public asset classes over the past 20 years, indicating that this profit sharing arrangement has historically proven to be a critical and worthwhile incentive that helps align the interests of managers and investors. It is important to note, however, that past performance does not guarantee future results and there are key differences between private and public markets, including higher level of risk and illiquidity in private markets.

When viewed in this context, there is a convincing argument for advisors and their high-net-worth clients to consider an allocation to private markets. Private market funds offer the possibility of strong performance and may be a valuable addition to a well-diversified portfolio, but they also carry some significant risks that make them appropriate only for certain types of investors. Advisors should learn as much as possible about the mechanics of private market funds, the associated fee structures, and the potential benefits and risks before taking action.

**Exhibit 1:**
**U.S. Private Equity vs. U.S. Public Equity Returns**
*Private and public market horizon IRRs (%)*




*Source: Pitchbook, iCapital Investment Strategy, as of December 16, 2022. Note: All return data is as of March 30, 2022. For illustrative purposes only. Private Capital is a composite of all private market funds on the Pitchbook platform. Private Capital includes private equity, venture capital, private credit, real estate, real assets, fund of funds, and secondaries. Horizon IRR is a cap-weighted pooled calculation that shows the IRR from a certain point in time. Historical IRRs are included solely for the purpose of providing information regarding private market industry returns and returns of other asset classes over certain time periods. While investments in private market funds provide potential for attractive returns, they also present significant risks not typically present in public markets, including, but not limited to, illiquidity, long term horizons, loss of capital, and significant execution and operating risks. Past performance is not indicative of future results. Future results are not guaranteed.*

**Exhibit 2:**
**Global Private Equity vs. Global Public Equity Returns**
*Private and public market horizon IRRs (%)*


*Source: PitchBook, Bloomberg, iCapital Investment Strategy, as of December 16, 2022. Note: All return data is as of March 30, 2022. For illustrative purposes only. Global Private Equity is a composite of all private equity funds on the PitchBook platform. Horizon IRR is a cap-weighted pooled calculation that shows the IRR from a certain point in time. Historical IRRs are included solely for the purpose of providing information regarding private market industry returns and returns of other asset classes over certain time periods. While investments in private market funds provide potential for attractive returns, they also present significant risks not typically present in public markets, including, but not limited to, illiquidity, long term horizons, loss of capital, and significant execution and operating risks. Past performance is not indicative of future results. Future results are not guaranteed.*

## END NOTES

1. The 2022 Preqin Private Capital Fund Terms Advisor, September 20, 2022, https://www.preqin.com/insights/research/reports/the-2022-preqin-private-capital-fund-terms-advisor.
2. A qualified purchaser is generally defined as an individual with at least $5 million in investable assets or a company with at least $25 million of investable assets.
3. An accredited investor is generally defined as an individual with a net worth over $1 million, either individually or jointly with their spouse, excluding the value of their primary residence, or annual income exceeding $200,000, or $300,000 for joint income, for the last two years with expectation of earning the same or higher income in the current year.

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iCapital

60 East 42nd Street, 26th Floor
New York, NY 10165
212.994.7400

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