



## Participant Performance

A fund's performance reported by PMI reflects "the investment results of a single contribution at the inception of the fund with no subsequent additions or withdrawals." However, few investors fit this description, as many arrive after the fund's inception and may make additional contributions or partial withdrawals over extended periods of time. Because of the nuances of incentive calculations, net performance will often vary among investors and be different from the fund pro forma return itself.

There are two basic reasons: the "contingent" incentive allocation and the differing high-water marks among investors.

### The "contingent" incentive allocation

Fund and participant performance reported by PMI is net of all fees and expenses, including "contingent" incentive compensation to the fund manager. Industry standards require the reporting of net numbers, even though the incentive allocation is technically earned only at the end of a performance measurement period or upon the withdrawal of capital. Accordingly, capital accounts and returns are reported net of a "contingent" incentive – as if the investor had withdrawn from the fund at the end of the month and the incentive had been charged.

A subtle effect of this difference between gross and contingent net capital is that an investor who is above "high-water mark" will have more capital "working" than is actually reflected in the net capital account that is reported.

How does this affect performance among partners? Take, for example, a fund up 10% gross above high-water and with a 20% incentive compensation arrangement. A \$100 capital account at the beginning of the year would be worth \$110 gross, but the reported "contingent net" value would be \$108 (an 8% net gain) – which is what the investor would have received if he or she had withdrawn from the fund. In the following period, if the fund were up another 10% gross, the resulting capital accounts would be \$121 gross (110% X \$110) and \$116.80 net (\$100, plus 80% of the \$21 gain). If you divide the ending net number by the previous net number, the net gain is 8.15%.

However, a new partner arriving in the latter period would only have an 8% gain. The extra return to the pre-existing investor results from the \$2 of gross gain that is still working on the investor's behalf until it is deducted at the end of the performance measurement period.

What if the latter period above were a loss? The pre-existing investors have a gross-net cushion, while the new investor doesn't. If the latter month incurred a gross loss of approximately 9.1%, the investor would be back to even (9.1% X \$110 = a \$10 loss). The reported net loss would be the ending value of \$100 net divided by the previous net value of \$108, or -7.4%. However, a person coming into the fund in the latter month would sustain the entire 9.1% as a net loss.

### High-water marks

The high-water mark – the highest previous net capital account at a time when an incentive allocation occurred – is tracked investor-by-investor. Due to different entry times and the timing of subsequent additions, investors can have different high-water marks. Continuing the example immediately above (a loss in the second period), if the fund were up 10% gross in the third period, the investor who sustained the 9.1% loss in the second period will receive the entire 10% gain, since there is no incentive allocation until the investor exceeds his or her high-water mark. However, the original "pre-existing" investor will see an 8% net return because of the contingent incentive accrual (the entire amount of the gain is "above" high-



water).

Because high-water marks are seldom hit exactly on the nose at the end of a given month, during the crossover months, part of the reported performance will likely be gross and part net, which further complicates comparisons. Under certain conditions – lots of capital additions, and portfolio ups and downs, it may take many months of gains to get all of the investors above high-water mark. Moreover, going forward, each of those investors who had different high-water crossing points will have different “contingent” net versus gross relationships. Accordingly, performance will vary slightly until the end of the performance period and the incentive allocation is earned.

### **When is performance identical?**

Every investor who was above high-water mark at the time of the last charging of incentive compensation will have identical performance going forward until contributions occur. The exceptions, of course, would exist for accounts with different compensation arrangements, such as those of the fund manager itself (where fees would typically be waived).

### **How does Price Meadows calculate this?**

Fortunately, the math is easier than the explanations. We track each investor's high-water mark, adjusting it for capital additions and withdrawals. We track each investor's gross capital and determine its gain over high-water and therefore the contingent (or actual) incentive compensation. From that, we figure the net capital values. Each of these values – gross and net capital, plus high-water mark – is carried forward from each month to the next for each fund participant.

You will note that the performance differences addressed above are affected primarily by capital additions. What about withdrawals? When a partial withdrawal occurs, high-water marks are proportionally adjusted; plus, if the account is above high-water, the incentive is earned and paid on the partial withdrawal amount. The result is that the post-withdrawal capital and its related high-water mark retain the same proportionality as the pre-withdrawal values.

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