K&L GATES

Understanding Hedge Fund Fees: Implications for Hedge Fund Managers

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OVERVIEW

- Fee trends in the industry
- Management and performance fees
- Tiered fees
- The good, the bad and the ugly: Capital accounts, equalization, series, individual investor series
- “The horror! The horror!” Using hurdles
- Fulcrum fees
- Pining away for Lone Pine

BACKGROUND: GENERAL FEE TRENDS

- The current situation and immediate future
- More launches than closings for 3 consecutive quarters
- More redemptions expected for a variety of reasons, including:
  - Strong performance of S&P 500 YTD (+16.78%)
  - Investors' continuing cash needs / pressures from leverage providers
  - Challenging trading conditions -- volatility
  - Additional investors being freed from lockups
- Many funds still closing down; the rest need to retain old capital and attract new to thrive

GENERAL FEE TRENDS

- Need to consider MFN implications of cutting special fee deals
- Short term, downward pressure on fees, at least for larger invested amounts
- Capital inflows are increasing; yet fees don't increase (allocations to Chinese equities appear strong)

WHAT DOES THIS MEAN FOR FEE LEVELS AND STRUCTURES?

- Typical fee structure of 2%/20% with high water mark and no clawback: Can this be maintained? 2020 management fee rate average for new funds was 1.27%; existing funds 1.37%
- Carry is meaningless for many funds in the short term because they are below water; management fee base is sole support for the firm.
- This increases attractiveness of new money, which can often negotiate lower carry rates.
- Q: are any of your fund's new investors trying to buy out existing investors rather than subscribing to get the benefit of existing high water marks?

CURRENT ENVIRONMENT

- More managed accounts with customized liquidity and fees, motivated in part by investors not wanting to be affected by other investors' redemptions.
- Two-class system; star managers vs. everyone else; flight to quality and perceived safety.
- More "private equity light" and hybrid funds, incorporating the types of protections used in private equity funds.
  - Clawbacks
  - Hurdle rates
  - Realization-based carry for some less marketable asset classes

CURRENT ENVIRONMENT (CONT.)

- Smaller funds mean less ability to look to management fees as a profit center.
- Increased interest in modified carry structures that pay even if below HWM.
- Investors looking for slices of GP and management company in exchange for seed or rescue investments.
- Fee levels depressed by non-fee bearing PIKs; realization-based fees on side pockets; reduced fee offers to induce extended lockups and attract new money
- Unavailability (or reduced degree) of leverage lowers plausible return expectations for many strategies.
- More regulation is coming, and will add to operating expense.

CONTINUED PRESSURE ON TRADITIONAL FEE MODEL

- Institutional investors are leading the charge, along with asset allocators that view the ability to obtain lower fees as their "value add" to end clients
- New managers (even with a strong track records and other bona tides) are unlikely to get traditional standard fees
- "Founder" classes (lower fees in exchange for less liquidity or a large initial investment) are being offered for longer terms and are increasingly attached to limited capacity rights
- Seed investors require significant fee discounts / revenue sharing
- Discounted fees for large subscriptions
- Multiple classes with investors having the ability to trade lower fees for less liquidity

WHAT'S HAPPENING WITH MANAGEMENT FEES?

- Newly launched hedge funds are offering average management fees (1.27%) lower than previously recorded during prior 10 years, and simultaneously offering more restrictive redemption terms.
- The biggest trend identified relating to management fees is the growth of tiered management fees in founder share classes (specifically for equity funds).

BENEFITS OF TIERED MANAGEMENT FEES

- Tiered management fees encourage investors to make larger investments or let their assets grow in the fund to take advantage of lower management fee rates available at certain investment thresholds. Is it fair for investors?
- Primary benefit of offering a tiered management fee structure is attracting capital and addressing the concerns of institutional investors.
- The first question for managers contemplating a tiered management fee is **what the fund's break-even point is.**
- Where a tiered management fee provision is complex, **managers should consider including an example** with the description of the tiered structure, so investors really understand how the management fee will be charged.

CALCULATING PERFORMANCE FEES; ALLOCATING PERFORMANCE FEES

Two distinct aspects of incentive fee ("Performance Fee") calculations:

1. How should these fees be calculated in general; and
2. How should these fees, once calculated, be allocated among various investors in the same fund.

HERE'S WHERE, THE PROBLEM STARTS....

How fees once calculated should be allocated among investors is primarily a matter of arithmetic.

- **Fairest result: Performance Fee paid by each investor reflects the investment experience of that investor** - the problem is doing so while maintaining a uniform NAV per Share.
- Performance Fees should be allocated based on the performance of each individual investor's investment.
- That is the "automatic" result in partnership accounting.
- Offshore, beneficial interests in funds are quantized into "Shares," there is an archaic affinity for having all Shares - or at least Shares issued at the same time - have an equal value. (But- why have shares at all since they don't trade?)

BALANCE SHEET VS. INCOME STATEMENT PERFORMANCE FEE CALCULATIONS

There are two different methods of calculating Performance Fees:

1. **income statement** (cumulative trading profit); and
2. **balance sheet** (highest NAV).

- The latter is preferable in all circumstances in which increases in the NAV of an investment determine the Performance Fee due, including in the case of calculations involving hurdle amounts.
- The former is preferable in any situation in which the increase in NAV does not determine the Performance Fee - for example, in futures funds in which interest income is often excluded in calculating the Performance Fee (although remaining a component of NAV) - or in funds in which the Performance Fee is determined by performance relative to an index rather than solely on the basis of NAV increases. Income statement calculations are also preferable when notional equity is used because reductions in notional equity do not correlate to reductions in NAV, so that a balance sheet approach is unable to account successfully for such reductions.

BALANCE SHEET VS. INCOME STATEMENT WHICH IS BETTER?

- The advantage of the balance sheet approach is that the NAV automatically "remembers" previous redemptions and their associated Performance Fees (if any). Each intra-Performance Fee period redemption triggers a Performance Fee as well as a proportionate reduction in the High Water Mark ("HWM") and a dollar-for-dollar reduction in NAV automatically maintaining the correct relationship between actual NAV and the HWM.
- In an income statement calculation, the period-end Performance Fee calculation needs to specifically account for the fact that if an interim redemption has been made, a Performance Fee was paid with respect to the applicable portion of the cumulative profits to the date of redemption.

THE SIMPLEST WAY

The simplest means of accounting for Performance Fees is to treat the Fund itself as the client and ignore the individual investment experience of investors.

An "overall fund" Performance Fee has the obvious unfairness for investors with Loss Carryforwards being diluted by new subscriptions being accepted that are not subject to Performance Fees until the Fund's overall Loss Carryforward has been earned back. In addition, when Shares are acquired at a price reduced by the accrued Performance Fee and subsequent losses reduce the Performance Fees, the existing investors are subject to economic dilution because they share the Performance Fee reversal with the new Shareholders, whereas in fact the reversal should have been allocated only to the Shareholders that were invested in the Fund when the Performance Fee accrued.

LOSS CARRYFORWARD DILUTION EXAMPLE

Day One

- 10 Shares issued at $100 per Share

Day Two

- Losses of 10% per Share
- NAV per Share $90

Day Three

- 100 Shares issued at $90

Day Four

- Gains of $200
- NAV per Share [$91.81 – Performance Fee]
- Performance Fee of $20, paid by shares issued at $100 as well as by those issued at $90

PERFORMANCE FEE REVERSAL EXAMPLE

Share issued at $100 → Increases to $110

New Share issued at $108 ($110 minus the $2 accrued Performance Fee)

Loss of $20

Fund capital

- $110 plus $108=$218
- $218 minus $20=$198
- NAV per Share=$99

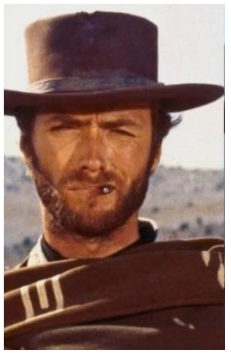
The Share issued at $108 has lost $9; the Share issued at $100 but which rose to $110 has lost $11. This is commonly referred to as the later issued Share "sharing in the Performance Fee reversal." What is really happening is that the later issued Share is being permitted to buy into the same pro rata share of the Fund's portfolio for a price reduced by a contingent liability (the accrued Performance Fee), which, in fact, disappears. Alternatively, the situation can be described as the later-issued Shares acquiring 50% of the risk of the Fund but only putting up $108 rather than $110.

UP, UP AND AWAY?

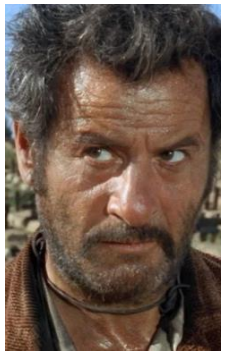
- While it may seem primitive to use an overall Performance Fee calculation, this is clearly the simplest approach, and it is only if a fund has significant downside volatility that there is a material economic dilution from an overall Performance Fee calculation. ***If a fund is always up, an "overall fund" Performance Fee will always be perfectly fair, assuming that Shares are sold at a NAV reduced by the accrued Performance Fee***. [$100 to $110; New Share at $108; No change to the end of the period; $218 GAV, Performance Fee, $216 NAV, $108 per Share]. Some sponsors have reasoned that if they have material downside volatility they will shortly be out of business anyway, so why not use the simplest calculation method?
- In some cases, sponsors have themselves absorbed a portion of the economic dilution risk of an “overall fund” Performance Fee calculation by agreeing to give investors a "free ride" - i.e., Shares bought at a NAV below the HWM NAV per Share pay no Performance Fee until the HWM per Share has been exceeded. However, this does not address the economic dilution resulting from Shares being purchased at a NAV reduced by a Performance Fee that is subsequently reversed due to losses (the benefit of the reversal being properly allocated only to the Shares against which the Performance Fee was accrued).

THE GOOD, THE BAD, AND THE UGLY

Partnership Accounting



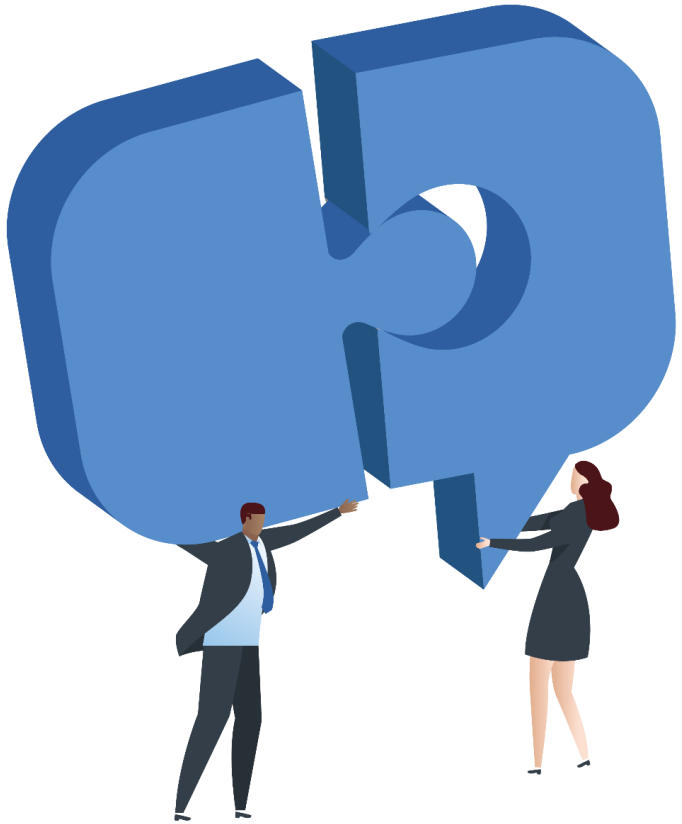
Series Accounting



Equalization Accounting

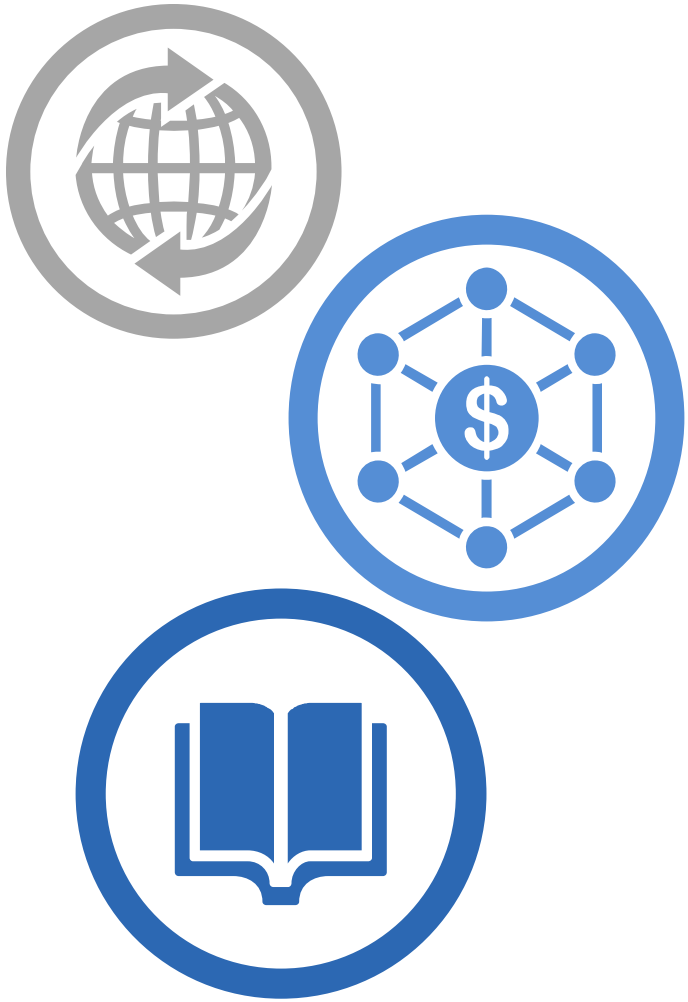
A GENERAL FRAMEWORK

Partnership accounting provides for perfectly equitable allocations of Performance Fees (however calculated) among investors, as each investor has its own capital account and the Performance Fee is calculated based on each investor's individual investment experience in the Fund - irrespective of how many different times an investor makes capital contributions to the Fund. Series accounting - whether single or monthly series - calculates Performance Fees equitably with respect to each investment, but not with respect to each investor.



SOME HISTORY

Why are offshore hedge funds generally set up as corporations rather than partnerships? The offshore arm of the hedge fund industry dates from the late 1960's. Then, the jurisdiction of choice was the Netherlands Antilles, which had a favorable tax treaty with the U.S. The treaty benefits applied only if the fund was set up as a corporation. Through the late 1980's and the 1990's, when the benefits of the tax treaty no longer existed, hedge funds were also set up in the British Virgin Islands, Bermuda, Cayman Islands and elsewhere. Following the model of the 1960's, they continued to be set up as corporations as the European investor was most comfortable with this structure. **But now, we have partnerships!** Hong Kong, Singapore, China, Japan, Cayman, Luxembourg, Ireland, and so on.



PARTNERSHIP ACCOUNTING

- Partnership accounting is **completely fair accounting** because the accounting for each partner's capital account is processed irrespective of the accounting for any other partner's capital account.
- Profits and losses are allocated pro rata among the cash capital account balances (Gross Asset Value, not NAV) and the Performance Fees then calculated separately with respect to each partner. While certain funds distinguish different capital contributions made by partners for lock-up purposes, very few do so for Performance Fee calculation purposes.
- Issues in partnership accounting relate solely to the calculation of the Performance Fee - not the allocation of Performance Fees among different investors – **each investor effectively having its own discrete Performance Fee**.

THE WORLD (OF) SERIES

Series accounting is divided into **equalization** (a single series) and **monthly series** (a new series issued each month, subject to consolidation of all series above their HWM as of the end of each Performance Fee calculation period). These accounting systems are fundamentally the same, except that equalization, rather than issuing a new series each month, restates ↕ the number of Shares held by each investor as of the beginning of each month so that all Shareholders' investments in the Fund are expressed in terms of the longest outstanding series of Shares.

INDIVIDUAL SERIES ACCOUNTING

- **Individual series accounting is effectively using partnership accounting for offshore funds**. Each investor receives an individual series of Shares which is accounted for exactly as a partnership capital account, without the "noise" of having to maintain a uniform NAV per Share.
- **Downside**: the audited financial statement footnotes for the offshore fund will have to list each individual series (although not, of course, identifying the investors).
- **Unexpected Boon**: With individual series, you can make virtually any restructuring changes you want without need of a vote. Each investor - for voting purposes owning his/her own class of Shares - simply decides (as a "majority of one") whether to go into whichever options you may offer.

MONTHLY SERIES ACCOUNTING: PROS AND CONS

- **Advantages:**
  - Avoids the need for the Equalization Credits and Performance Fee rebate because each series is essentially treated on a stand-alone basis, irrespective of the Performance Fees or Loss Carryforwards accrued with respect to other series.
  - Eliminates the potential inequity of calculating Performance Fees in the same manner with respect to Shares issued at different times by calculating Performance Fees separately with respect to Shares issued at different times. Each month when new Shares are issued, they are each issued at a nominal initial value – often $1,000. The Performance Fee is then calculated separately with respect to each monthly series. At the end of each Performance Fee calculation period (whether a quarter or a year), Shares above their HWM pay the applicable Performance Fee, and all Shares are then restated in terms of the NAV per Share of the longest outstanding series. The HWM per Share attributable to the longest outstanding series becomes the HWM per Share of the consolidated series.

MONTHLY SERIES ACCOUNTING: PROS AND CONS

- **Disadvantages**:
  - Can lead to multiple series outstanding (each of which must be identified in the financial statement footnotes);
  - Blind to the fact that the same investor may acquire Shares more than once, which can lead to the investor getting a "bad taste in its mouth," and
  - Investors are subject to having the number of Shares they own restated at the end of each Performance Fee calculation period.

MONTHLY SERIES-SAMPLE DISCLOSURE

- While the Advisor believes that the series-consolidation system is a relatively simple procedure and is fair to all parties, there are several disadvantages associated with this method of accounting. First, the series of shares and consolidation method can be quite **cumbersome**, because many funds pay incentive fees only once a year and this means that, if a fund is a heavily traded, expanding fund, then by the end of the year it could have 12 (for monthly periods) separate series in issue. If a fund is having a losing year, then it is possible that **up to 24 (for monthly periods) series** would be issued, before the next accounting period is finished.
- The other obvious disadvantage of the series-consolidation method is that it is **not possible to publish a single net asset value** per share or unit, because each series (or sub-series, where applicable) had its own net asset value. There is no real problem in publishing several different net asset values, but it could be **confusing** to some Unitholders, particularly if they make several investments into the fund over a period of time and so end up with holdings that have different net asset values.

EQUALIZATION

EQUALIZATION ACCOUNTING

Equalization is monthly series accounting except that a **single series of Shares** is maintained. As a result, the accounting mechanism must "remember" the NAV at which all Shares are issued, so that appropriate adjustments can be made so that, although all Shares have the same NAV per Share and, accordingly, the same HWM and Performance Fee accrual (otherwise the Shares issued at different times would have - at least potentially- different NAVs), no investor investing only once in the Fund pays a Performance Fee greater than that which is due based on the investment experience of such investor's own Shares.

Because maintaining a uniform NAV is the goal of equalization, equalization must confront the issues of:

1. accrued Performance Fees causing the NAV per Share to be less than the cash value per Share at the date of a subscription; and
2. the necessarily uniform HWM per Share used to determine the uniform Performance Fee accrual, per Share being materially different from the subscription price (which should be the HWM) of new-issued Shares.

Equalization addresses clause (1) by requiring investors to invest not just the NAV per Share but the Gross Asset Value per Share (the difference constituting the "Equalization Credit" or "Equalization Deficit"). Equalization addresses clause (2) by redeeming Shares in the case of Shares issued below the uniform HWM per Share in order to pay the Performance Fees due on these Shares.

EQUALIZATION ACCOUNTING (CONT.)

Because equalization needs to "remember" the issue price of Shares issued at a NAV reduced by an accrued Performance Fee during Performance Fee calculation periods, equalization really is very much monthly series accounting. Monthly series "remember" the issue price of all Shares, because monthly series calculate the Performance Fee separately with regard to each series.

Equalization calculates the Performance Fees paid on the New Shares separately from that paid on other Shares, but rather than having monthly series "remember" the issue price of New Shares restates ↕ the number of Shares held so that all Shares maintain the same NAV.

The horror....of using hurdle rates

https://www.youtube.com/watch?v=VKcAYMb5uk4

- Increasing number of managers integrating hurdles in performance comp structure. Minimum rate of return that must be met before manager can earn performance comp.
- Hurdles can be
  - fixed percentages
  - Index-based percentages
  - Alpha rates (i.e., not market beta)
  - The Red Queen's Hurdle Rate (based on 7% CPI implied investment cash rate of 7% real rates. See https://seekingalpha.com/article/4413679-red-queens-hurdle-rate)
- Minor nuances in hurdle structures can lead to very different results

Source: Jon Tenniel from Lewis Carroll's *Through the Looking-Glass*

GETTING OVER THE HURDLE ....

How fees should be calculated is primarily a business question.

- What performance is appropriately subject to a Performance Fee?
- Is it performance as calculated only during the current Performance Fee period; is it cumulative performance?
- If cumulative, does the calculation begin at the inception of the Fund, an investor's initial admission into the Fund, or as of each new investment by the same investor? If cumulative year over year, keep the hurdle rate base separate from HWM, otherwise performance below hurdle still can entitle manager performance comp. in later years if hurdle is cleared on cumulative basis.
- Is performance measured relative to a benchmark (even if the benchmark declines)?
- Does performance only “count” towards the Performance Fee calculation if it is over a "high water mark"?
- Does performance only count if it is over a hurdle amount, and, if so, should the hurdle amount itself be a “soft” or “hard” hurdle?
- Should hurdles be calculated separately with respect to each year or cumulatively over the course of an investment? etc.

WHAT IS THE HURDLE RATE TRYING TO DO / BE?

- Is the proposed Hurdle Rate a "cynical Trojan horse" marketing scheme?
- Is the proposed Hurdle Rate an accounting convention simplifying the exclusion of a particular component of potential Trading Profit which is not supposed to be included in the profit on which the Incentive Allocation is paid (i.e., interest income in futures funds)?
- Is the Hurdle Rate supposed to avoid the insult to investors of paying the GP for performance in a year which is below the “no brainer rate”?
- Is the Hurdle Rate a temporary benefit to induce existing investors to transition to a restructured fund, but which is supposed to be eliminated, and retroactively, after a limited "holiday" period? Is the Hurdle Rate a proxy for other uses of capital that the investor could have employed rather than investing in the Fund?
- Should the Hurdle Rate be always effective, or should outperformance in one year potentially eliminate any practical' effect for the Hurdle for years to come?
- Is the Hurdle Rate Year-to-Year or Cumulative? Cumulative sounds more "investor - friendly," but backfires if there is a "home run year."
- If there is a Hurdle Rate in place, should the unpleasant individuals who chose to redeem be able to benefit from it, or are they back to a standard HWM calculation?

TAKE CARE ....

- A 5% cumulative hurdle measured from the last date an Incentive Fee was paid; New Trading Profit measured from the highest previous NAV at the end of an Incentive Fee Calculation Period.
- The Fund makes 4% each year for 10 years; then in year 11 makes 50%. While the Fund is **WAY** over its cumulative hurdle rate, unfortunately we measure the cumulative hurdle from the last time an Incentive Fee was paid, so that it equal's 55% while the year 11 New Trading Profit is measured from the most recent high NAV. At the beginning of Year 11, as 55>50, no Incentive Fee. **THIS IS NOT JUST A DRAFTING BUT A CONCEPTUAL MATTER**.
- It is common to calculate New Trading Profit from the "**PREVIOUS HIGHEST YEAR-END LEVEL OF NEW TRADING PROFIT**" because **without a Hurdle** that would also have been the point to which all Incentive Allocations to date would have been "paid up" so that it made sense to start calculating New Trading Profit from $0. However, that is by **no means necessarily the case**.

TAKE FURTHER CURE ….

- Assume a year-to-year hurdle with the loss carryforward account measured from the last time an incentive fee was paid.
- Assume the hurdle is 5% and the Fund makes 4% for 4 years; simplifying the math, the Fund is at 116 and has never paid an incentive fee. If in year 5 the Fund makes 4.99% and then loses 20.99% in year 6, there is **NO LOSS CARRYFORWARD BALANCE**; However, if in year 5 the Fund makes 5.00001 % and then loses 21.00001 % in year 6 there is a 21.00001 % Loss Carryforward Balance.
- Just because a $0.01 Incentive Fee is paid at an Incentive Fee Calculation Period-end, **BY NO MEANS** means that the **FULL** Incentive Fee that would then have been due on an HWM basis is then paid.

WHOOPS !

- The proposal is that those investors who agree to restructure have the benefit of a 5% cumulative Hard Hurdle Rate for 2 years. However, the HWM is defined in the standard manner.

- In the first 2 years, the new fund invests so that the HWM does not move up. As the “good investor” who has stayed in the new fund for 2 lean years approaches the end of Year Two, he/she is punished for staying in by **giving up the benefit of the 10% cumulative Hard Hurdle**.

- Year One and Year Two: as the HWM will not have increased, the investor will pay an Incentive Fee on $1 of profit. Should the HWM have increased by the Hard Hurdle even though there were no profits (the same analysis would apply to a Soft Hurdle, but it would not be an HWM increase of 10 (but a "carryover" by the Preferred Return of 10 which would have been created).

HURDLE RATES AND BENCHMARKS

- Certain Performance Fees incorporate a "hurdle rate" mechanism, intended to reduce or reverse the Performance Fee if performance during the current Performance Fee calculation period does not exceed certain levels.
- There are two types of hurdle rates - "**hard hurdles**" and "**soft hurdles**." Hard hurdles are dollar-for-dollar deductions from the profits achieved during a calculation period; "soft hurdles" censor the payment of a Performance Fee that would result in the performance recognized by the investor during the calculation period not equaling at least the hurdle rate.
- For example, if the hurdle rate is $5, the profit (assume over the HWM) is $10 and the Performance Fee percentage is 20%, with a hard hurdle the Performance Fee would be $1 - i.e., 20% of $5 ($10 minus $5) - while with a soft hurdle the Performance Fee would be $2 as after reducing $10 by $2 the return for the period ($10 minus $2) would still exceed $5.
- **With a "soft" hurdle, a performance fee is charged on the entire annualized return if the hurdle rate is cleared. With a "hard" hurdle, a performance fee is only charged on returns above the hurdle rate.**

HARD VS. SOFT HURDLES

Hard hurdles are rare, and tend to surface only in the context of strategies which involve retaining a significant amount of cash in reserve (for example, futures funds' margin deposits) which generate a return for which the sponsor is clearly not responsible. **Most hedge funds'- and all private equity funds' - hurdle rates are soft hurdles**, the difference being that soft hurdle amounts in hedge funds typically reset to $0 at the beginning of each year, whereas in private equity funds the soft hurdles cumulate through the years until the investor's capital is returned. (When hurdle rates cumulate through the years, the issue of how frequently they compound becomes relevant. Annual/semi-annual is market. Compounding also begs the question of whether distributions are credited first against capital - on which a preferred return occurs - or against the preferred return - on which a preferred return will not itself accrue until a compounding date occurs.)

BENCHMARK PERFORMANCE FEES

- Institutional accounts often base the hurdle rate only as of the beginning of the Performance Fee calculation period, without regard to intra-period profits or losses. Benchmark Performance Fees are often calculated on the same basis. In these cases, when intra-period redemptions are made, the hurdle rate base is not reduced by the dollar amount of the redemption period but rather by the percentage of the BNAV for the current period proportionate to the redemption. For example, if the hurdle rate base was $1 million and the Fund had increased to $1.2 million when $600,000 was withdrawn, the hurdle rate base would be reduced to $500,000 (i.e., by 50%, as was the NAV), not to $600,000.
- Hurdle amounts in hedge funds - as opposed to private equity funds - are typically reset to $0 as of the beginning of a Performance Fee calculation period. In private equity funds, the hurdle rates (preferred returns) compound until the capital commitments on which the hurdle amount is being calculated have been returned.

HURDLES

It is important to think in terms of hurdle **amounts** rather than hurdle **rates**. A hurdle **rate** will be a percentage of some sort that does not change when there are redemptions or additions. However, additions and redemptions directly affect the amount that must be earned to achieve performance subject to a Performance Fee. When thinking about the Performance Fee calculation, one needs to refer to amounts not percentages. When an investor redeems 50% of its account on June 30, that does not reduce the hurdle rate, but rather the base to which the hurdle rate is applied. The base to which the hurdle rate is applied is adjusted and the hurdle amount calculated year-to-date proportionately reduced. As redemptions and subscriptions are themselves dollar amounts, not percentages, trying to describe a Fund's hurdle rate accurately in terms of hurdle rates rather than hurdle amounts derived from hurdle rates is an "apples and oranges" proposition.

THE HURDLE RATE ANOMALY

In a mark-to-market world in which hurdle rates are calculated on a year-to-year basis, there is an anomaly. If a sponsor has a 5% hurdle and earns 4% a year forever, he will never receive a Performance Fee; however, if the sponsor initially loses 10% and then earns 15%, the sponsor will receive a Performance Fee even though his/her inception to date performance is worse than if such sponsor had earned 4%.

Year One	Return
BNAV $100	4%
ENAV $104	No Performance Fee
Hurdle Rate $105	

Year Two	Return
BNAV $104	%4
ENAV $108.2	
Hurdle Rate Level $109.20	

Lose $10 in Year One and Year Two Hurdle Rate	Return
BNAV $90	15%
ENAV $103.50	
Hurdle Rate Level $94.5	

Hurdle Rate $109.2	
$108.2	No Performance Fee
$103.5	Performance Fee 20% ($3.5)

OUTPERFORMANCE OF BENCHMARKS

- In portable alpha and certain other institutional products, the Performance Fee is calculated based on “outperformance” of an index. The Performance Fees unilaterally have to be calculated on an income statement rather than a balance sheet basis. This is because cash flows in and out of the Fund affect the future profits and losses which will be generated for the investors. There is no balance sheet HWM because performance is not based on the amount in the Fund but rather on outperformance of the Benchmark.
- **Benchmark Performance Fees are calculated in a manner similar to hurdle rates**; there are distinct periods during which the "base" to which the index is applied remains included. These periods are defined by additions and redemptions as well as by the profit and loss of the Fund.
- During each Benchmark Period, the return produced by multiplying the Performance Fee base by the change in the index is determined and applied to the profit and loss.
- In certain cases, Benchmark Performance Fees are calculated year-to-year; in certain cases, they are cumulative. In either case, if a redemption is made, any shortfall between the performance of the Fund and the indexed performance should be reduced pro rata as the Fund has less capital with which to earn back such shortfall. Whether Performance Fees are paid or crystallized but not paid upon redemption is a matter of negotiation, not mechanics. Many institutional accounts may pay redemption fees annually and terminate, rather than having to adjust the cash balance. This is particularly true in the case of institutions which make their own margining arrangements and need the flexibility to move cash around on a daily basis.

FULCRUM FEES

- **How we get paid**
- We get paid in two ways. The first is the basic fee, which is, like it sounds, pretty basic. It's calculated and paid each month at an annual rate of 0.95% of the average daily assets for the month.
- The second element of how we get paid is through a performance adjustment called a fulcrum fee. Fulcrum fees are unusual in the mutual fund industry. Most funds charge the same fees whether they perform well or not. We didn't think that was quite right. So we adopted a fee structure that pays us more when the funds outperform their respective benchmarks and less when they fall short of those benchmarks. This ensures that our management team's goals are aligned with yours by providing an incentive for the team to consistently achieve benchmark-beating returns -- not just to pump up the funds' assets.

FULCRUM FEES (CONT.)

- **How is the fulcrum fee determined?**
- Here's where it gets more complicated. Once a fund is at least a year old, we compare its performance to the performance of its index over a rolling 36-month period (or since inception for funds less than three years old), then adjust the basic fee up or down depending on how much the fund beat or lagged its benchmark. (Full details on these calculations are available in our Prospectus.) To rule out performance differences that might just be random, we do not make a performance adjustment when the fund's performance is within 3 percentage points of its index's performance.

FULCRUM FEES

How Sextant Fulcrum Fees Are Calculated

Each month, the Sextant Funds' 12-month trailing total investment returns are compared to the total return of their corresponding Morningstar categories. If a fund outperforms or under performs the total return of its category, the base administrative fee is increased or decreased according to the fee structure table shown below

Sextant Fund	Morningstar Category
Growth Fund	Large Growth Funds
International Fund	Foreign Large Blend Funds
Core Fund	Moderate Allocation Funds
Global High Income Fund	Tactical Allocation Funds
Bond Income Fund	Long-Term Bond Funds
Short-Term Bond Fund	Short-Term Bond Funds

"The fulcrum fee has two components: a base fee which represents the midpoint of the entire fulcrum fee; and an incentive adjustment. The incentive adjustments must be symmetrical — hence the term 'fulcrum.'" Andrew Donohue, Former Director of Investment Management, U.S. Securities and Exchange Commission

Sextant Funds' Fulcrum Advisory Fee Structure

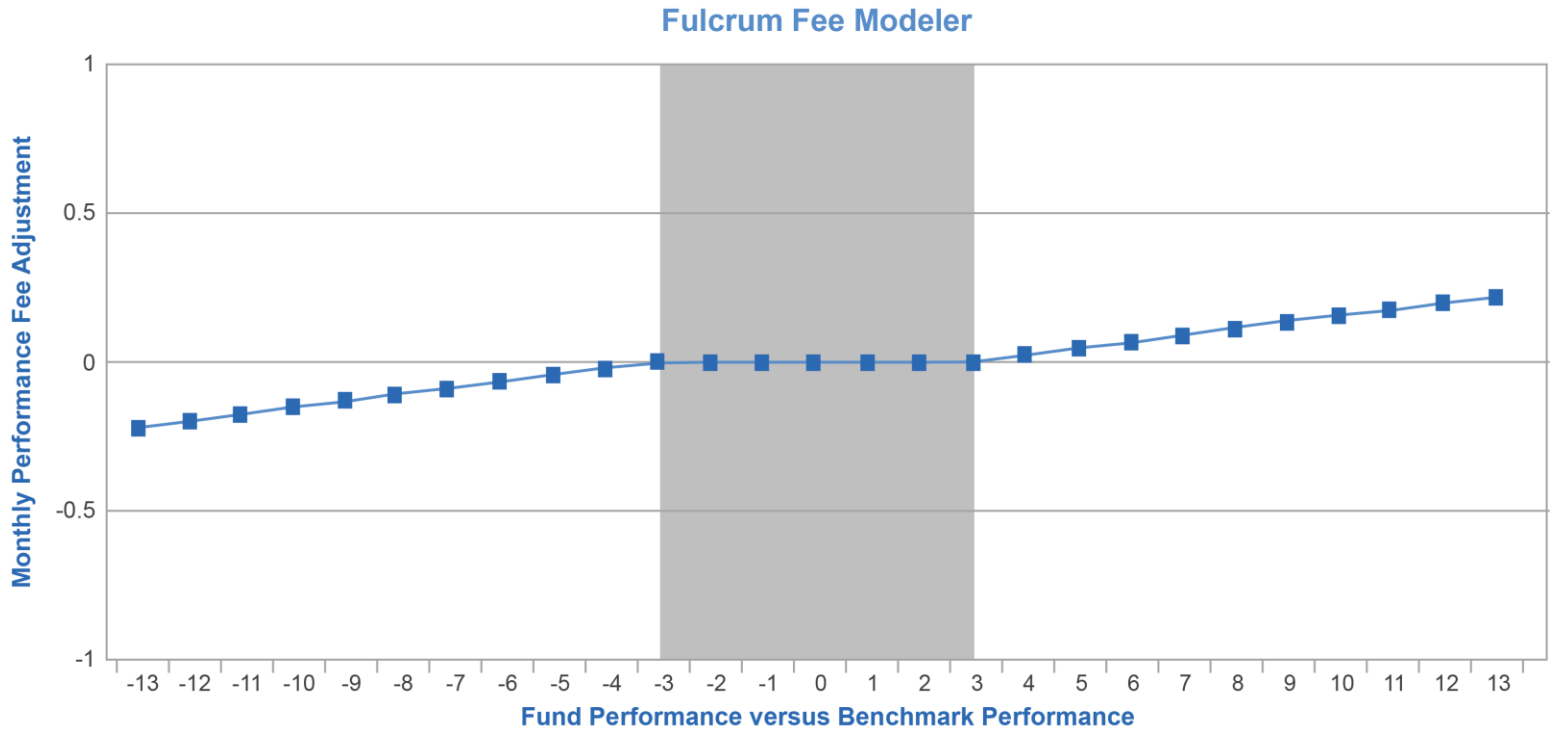
	Base Fee Annual rate	Performance Adjustment annual rate			
		<1% more or less than benchmark	1-2% more or less than benchmark	2-4% more or less than benchmark	>4% more or less than benchmark
Growth Fund International Fund & Care Fund	0.60%	0.00%	+/- 0.10%	+/- 0.20%	+/- 0.30%
Global High Income Fund, Short-Term Bond Fund & Income Fund	0.60%	0.00%	+/- 0.10%	+/- 0.20%	+/- 0.30%

VISUAL REPRESENTATION OF PERFORMANCE ADJUSTMENT

Visual representation of performance adjustment

The interactive graphic below shows how the performance adjustment affects the total fees charged for the Funds. Please note, because the fulcrum fee must be applied against the average daily net assets during the whole period during which the fund's performance is compared to its index, the dollar amount of the performance adjustment may actually be more or less that 0.20% annually of the Fund's average net assets during any given month.

Place your mouse on any of the dots to see the performance adjustment based on the fund's performance against its benchmark.



DON'T GET HUNG UP ON THIS!

LONE PINE

- Lone Pine Performance Fee calculations are made on a standard HWM basis. However, in any year in which a profit is recognized, even if such profit does not exceed the HWM, a Performance Fee is paid. But the below HWM Performance Fee is typically at 50% of the standard Performance Fee percentage, and any "through the end of the year" loss below the HWM results in an increase in the HWM by 150% to 200% of the amount of such loss.
- If the HWM were increased only by the amount of the loss below the HWM, the investor would come out mathematically the same if profits in excess of the HWMs are achieved, but would not be compensated for the risk of below HWM Performance Fees being paid.
- Each time there is a loss during a year – even if such loss only serves to reverse gains below the HWM previously recognized – the Performance Fee will be paid on any profits in the next year, even if such profits only serve to earn back prior below the HWM losses.

LONE PINE MODEL

Year One			Year Two		
BNAV	AUM	ENAV	BNAV	AUM	ENAV
$100	$100	$90	$90	$110	$110

In the scenario at the end of Year Two, the sponsor would collect 10% of $90-$110 or $2, whereas if a standard HWM approach had been used, the sponsor would receive 20% of $100-$110 or $2. Because of the risk premium associated with paying below HWM Performance Fees, the HWM increased not from $100 to $1.1.0 but to $115 or $120 (the latter "200% of losses" increase in the HWM is increasingly becoming' market). This means that the sponsor gives up 50% of the Performance Fees on results above what would have been the HWM in return for receiving Performance Fees below the HWM (and, hopefully, being able to retain employees!).

Note: it is not profits below the HWM generating Performance Fees that result in increases in the HWM, but simply losses below the HWM. This is because, if a Lone Pine fund's NAV per Share went $100 - $90; $90 - $100; $100 - $90; $90 - $100, a 10% Performance Fee would be calculated on both $90 - $100 moves, even though this amounts to double-counting the Performance Fee on the same increases in the NAV per Share.

LONE, PINE SAMPLE DISCLOSURE

For example, assume a Limited Partner initially contributes $10,000,000 to its Capital Account and the Capital Account declines to $9,000,000 at the end of Year One. At the end of Year One, the High-Water Mark will be increased by 250% of the Net Loss to $11,500,000. If in Year Two, the Capital Account recovers to regain its initial: $10,.000,000 NAV, a Performance Fee Allocation of $100,000 will be made at the end of Year Two, and the High-Water Mark will be reduced by the amount of the allocation made to the General Partner to $1· 1,400,000. If in Year Three, the NAV of the Capital Account increases to $13,000,000, the Limited Partner would have made, on a conventional 20%/High-Water Mark calculation, a Performance Fee Allocation of $600,000 at the end of Year Three. In the case of the Fund, the Limited Partner will have made a Performance Fee Allocation of $100,000 for Year Two, plus a Performance Fee Allocation for Year Three equal to $150,000 (10% of $11,400,000 minus $9,900,000) plus $320,000 (20% of $13,000,000 minus $11,400,000), for a total of $570,000.

OUR LATEST THOUGHT PIECES

How to Crossover to a Hybrid Fund – Part 1

How to Crossover to a Hybrid Fund – Part 2

How to Crossover to a Hybrid Fund – Part 3

How to Crossover to a Hybrid Fund – Part 4

Thank you.

K&L GATES