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Control shift in GP/LP dynamic: Cambridge Associates



In the headiness of the bull market, institutional investors generally took on more risk and enjoyed fewer rewards than alternatives managers. But the crisis has provided an opportunity for both counterparties to redefine the balance in the LP/GP relationship, in which institutions are entitled to demand a true alignment of interests on returns, lock-ups and fees. Simon Mumme examines new research by US consultancy Cambridge Associates.

In a recent paper, Restoring Balance to GP/LP Relationships, Cambridge argues that a fitting alignment of interests between institutions and alternative asset managers occurs when a manager is rewarded for their skill, while the institution pays for the specified exposure and real value creation from their investment.

Institutions and managers share a common goal – earning attractive returns – but have different perspectives on it. Institutions are charged with the fiduciary obligations to invest and oversee capital prudently, while managers compete against peers in their pursuit creating personal wealth from their investment skill.

In the alternatives explosion – fuelled by broad institutional replication of the strategies used by top-performing US university endowments – gave plenty of negotiating power to the managers. Chasing outsized performance, institutions progressively allowed the terms of the typical GP/LP relationship to deteriorate and become skewed to favour GPs,

“In order to maintain relationships with sought-after managers (or to gain access to new relationships), LPs have often been faced with little choice but to accept this new order or terminate the relationship.”

However, as this occurred, the growing pools of capital put into alternative strategies pushed down the expected returns that made them attractive in the first place. But institutions, under pressure to not let key opportunities pass them by, were accommodating of terms put forward by GPs, who, in turn, understandably favoured more lenient investors.

“The result can become a creeping reluctance to push back, and an implied consent for terms to continue to drift,” writes Cambridge. But now, with many alternatives managers feeling the pressure of underperformance, redemption requests and slowing business pipelines, “there can now be a return to first principles in the alternative assets sector.”

As has been demonstrated, one episode of underperformance can wipe out years of investment gains. For this reason, the convention of paying performance fees to hedge funds for unrealised profits should be fiercely challenged by institutions. Particularly since managers usually receive fees a long time before returning capital to investors. Cambridge reckons that LPs can “push to have profits paid only on realised investments and/or only at such times when the GP has provided liquidity to its investors”.

The payout ‘waterfall’ – or timing of distributions from an alternatives fund – should also be altered to suit institutions. If a manager realises a loss at the end of the life-cycle of a private equity fund, for instance, institutions should be entitled to a “clawback” or the carried interest that the manager has been paid in the preceding years. Having the manager keep some portion of “paid carry” in an escrow account until the fund has returned all called capital would be “a key LP protection,” Cambridge writes.

Investors should also feel entitled to evidence showing that management fees reflect the true operational expenses of an alternatives firm. The small firms that marked the nascent of private equity required between 1 and 2 per cent of committed capital to run their business, Cambridge writes.

But now that their funds have grown, such a management fee would grossly exceed a small firm’s management costs. LPs “should cry foul,” since, for example, “a firm that is managing four times its prior capital now has the opportunity to earn up to four times the carried interest.” This principle certainly applies to firms that manage multiple funds.

While credit should be given to managers willing to put some skin in the game – it should be considered the “gold standard” for alignment of interests, writes Cambridge – these commitments also warrant analysis. Investors should expect full, detailed disclosure of each principal’s investment in their funds, and clarification of whether they are in cash, management fee offsets or in promissory notes.

While non-cash investments may be necessary for a fund in its early days, they often create a “free option” on performance for GPs, and should be resisted by investors.

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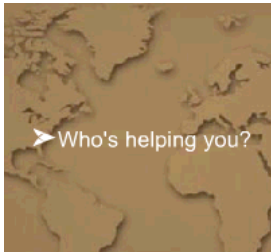
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"If these managers do not have a substantial portion of their wealth invested alongside their LPs, then the fund's future performance is similar to call option: limited downside, but a sizeable share of any potential gains."

Also, evidence that key performers in a firm are suitably rewarded should be provided since those that aren't may be tempted to move to "greener pastures". And if a co-owner of a firm sells their interest in the funds (sometimes called "monetising the brand"), a satisfying explanation detailing how they will remain engaged in the business after the transaction should be provided.

Turning to lock-ups, these should always reflect the liquidity of the underlying securities in a strategy. If a manager argues that a lock-up is crucial to the stability of their business, institutions can negotiate a declining fee schedule for the life of their investment. They should also favour managers that stagger redemption dates for investors – on the anniversary of their entry into the fund, for example – as this helps to keep the fund stable in the event that a substantial proportion of investors head for the exit.

Alternatively, managers that recognise the liquidity obligations of their clients can provide an automatic annual return – 5 per cent, for example – to prevent them from making sizeable redemptions to gain liquidity.

In turn, institutions should avoid making frequent, substantial investments in and redemptions from managers, since this can disrupt the management of the GP's portfolio.

In their reassessment of relationships with alternatives managers, institutions should acknowledge and reinforce good partnerships, and attempt to correct those that have strayed off-track or were imbalanced to begin with.

Institutions should also assess among themselves what is "reasonable and fair" in relationships with alternatives managers.

In summary, the GP/LP relationship should be "characterised by well-defined expectations, clear communication, fair compensation, alignment of interests, transparency, and mutual respect," writes Cambridge.

The managers that support the fiduciary requirements of their investors should benefit from retaining such "high-quality, long-term capital bases".

In the paper, Cambridge emphasises that outstanding alternatives managers are rare.

It points out that about one-fifth to one-quarter of the more than 2,500 private equity funds in the 1981-2003 vintage in its database generated returns of more than two-times their cost bases. And less than 5 per cent of the 1,000 firms it monitors have notched top quartile performance more than 50 per cent of the time.

Institutions should be aware that building a successful alternatives program is an exhaustive process requiring a skillful, well-resourced internal team.

"Success from this style of investing is not formulaic and cannot be achieved merely by including alternative investments in asset allocation targets.

"Success comes from exhaustive coverage of these markets, bottom-up analysis of investment opportunities, sophisticated oversight of total portfolio exposures and knowledgeable governance...there are no short cuts."

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