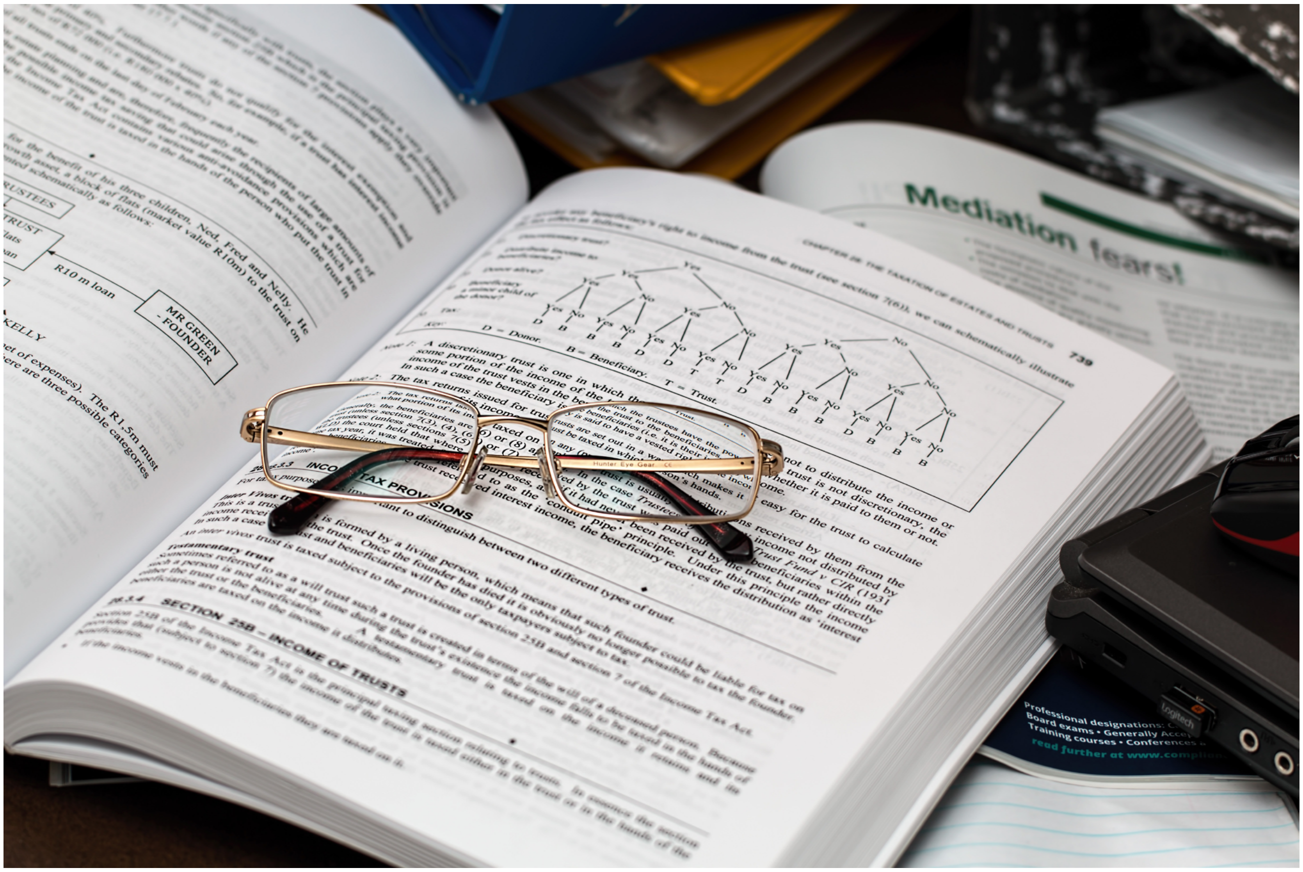

The Time Has Come for Standardized Total Cost Disclosure for Private Equity

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Given the level of detail and timing of private equity manager reports, can pension funds disclose investment costs in a consistent manner across the industry? What would full cost disclosure require of a pension fund? We found a good example of this in one of our benchmarking clients.

In 2013, the South Carolina Retirement System Investment Commission (SCRSIC) retained CEM Benchmarking Inc. (CEM)[1] to perform an independent review of South Carolina Retirement Systems' (South Carolina) investment costs and performance. SCRSIC naturally assumed that the costs benchmarked by CEM would match the investment costs that are reported in South Carolina's Comprehensive Annual Financial Report (CAFR). To their surprise, CEM could only benchmark about 50% of the investment costs reported in South Carolina's CAFR.

South Carolina invests more assets in alternative investments, such as private equity (PE), hedge funds and real estate, than many other U.S. public funds. Their allocation to alternatives of 30% as per their 2014 CAFR [1] compared to the CEM U.S. public universe average of 19% in 2013. Alternative asset classes, especially private equity, are typically more expensive and have more complex cost structures than public asset classes. This makes cost disclosure and cost benchmarking difficult at best. For the portion of costs that CEM can now benchmark for U.S. funds, CEM's analysis found that South Carolina's investment costs were in line with those of other public pension funds after adjusting for fund size and asset mix.

South Carolina's CAFR generated some negative press coverage that alleged their investment costs were unjustifiably high. However, after reviewing SCRSIC's cost collection process, we conclude that they are simply reporting more costs than other funds, rather than actually incurring more costs. CEM authored this paper to create momentum for improving investment cost reporting standards and disclosure, especially for private equity. Less than one-half of the very substantial PE costs incurred by U.S. pension funds are currently being disclosed.

U.S. Reporting Standards Allow Public Funds To Exclude Material Costs

To better understand this problem, we first examine accounting standards and practices for pension fund cost disclosure. State pension funds follow the Governmental Accounting Standards Series issued by GASB. Until recently, all state pension funds were subject to Statement No. 25 [2] from November 1994, which sets standards for financial reporting for defined benefit pension plans. Paragraph 29, footnote 12 states the following:

"Plans are not required to include in the reported amount of investment expense those investment-related costs that are not readily separable from (a) investment income (the income is reported net of related expenses) or (b) the general administrative expenses of the plan."

This footnote is ambiguous and permits a widely varying interpretation of what investment costs are "readily separable" from investment income and general administrative expenses of the plan.

In June 2012, GASB issued Statement No. 67 [3], which is an amendment to Statement No. 25. Paragraph 26 of Statement No. 67 states the following:

"Investment-related costs should be reported as investment expense if they are separable from (a) investment income and (b) the administrative expense of the pension plan."

Statement No. 67 makes two subtle changes in language from Statement No. 25:

- Statement No. 25 indicates that disclosing certain investment-related costs is not required, while Statement No. 67 makes no explicit mention of allowance for exclusions.
- The phrase "readily separable" is no longer present in Statement No. 67.

Statement No. 67 leaves it up to funds to interpret what costs are separable. This remaining ambiguity still allows very material costs that are netted from returns to be excluded from financial statements. In practice, the amended guidelines have not led to more transparent cost disclosure, especially for PE.

Private Equity Cost Structures Are Complex And Reporting Is Incomplete

Pension funds typically invest in private equity via limited partnership structures managed by a PE firm, the general partner (GP). Costs incurred by limited partners (LPs) (i.e., revenues to the GP) include a management fee, carried interest or performance fees, other fund-level fees, and portfolio company fees. Fund of funds structures include an additional layer of fees paid to the GP choosing the underlying investments. LPs also incur their own internal costs for monitoring of their external PE program.

Carried interest is typically based on gains above a preferred return over the life of the investment. Because the gains are not yet fully realized before the end of the investment life, carried interest will vary and is not easily calculated. Frequently, the LP's share of carried interest is not clearly disclosed on interim statements. However, accrued carried interest is commonly netted from returns.

Other fund-level fees include fees paid by the GP that are passed onto LPs. Examples include legal costs, audit costs, and taxes. Other fund-level fees are also often not reported in detail to LPs quarterly.

Portfolio company fees are paid by the portfolio company to the GP for advisory services, break-up, monitoring, funding, and similar services. Portfolio company fees shift dollars from portfolio companies to the GP, lowering future returns for LPs. The LP is typically entitled to a portion of portfolio company fees, which is commonly referred to by the industry as a management fee rebate or offset. Often, the LP share is not explicitly transferred, but is kept by the GP and used as payment towards a portion of the management fee. The residual fee amount, which is the full management fee less the LP share of portfolio company fees, is described as the net management fee. Only this amount is typically disclosed to LPs on capital call statements.

We believe that the LP share of portfolio company fees is misrepresented by the industry as a management fee rebate or offset. The net management fee amount does not reflect total management fees paid to the GP because the "rebated" amount is still an expense to the portfolio company and therefore an indirect cost to the LP. LPs actually pay the full management fee, and the portion of portfolio company fees kept by the GP is an additional cost. In other words, the fee rebate or offset gives the illusion of reduced fees for the LP when, in fact, it is a charge to the portfolio company. And, when the offset is not 100% for the LP, the un-rebated percentage has the effect of increasing GP overall revenue. Typically, only the net management fee is reported by pension funds.

Exhibit 1 shows an illustrative example of the relationships between full management fees, net management fees, and portfolio company fees.

Unfortunately, due to the difficulty of collecting all cost components and the lack of standardized cost definitions, many funds are unable to report full PE cost. As can be seen in Exhibit 2, very material costs are not being reported.

Exhibit 2 shows that carried interest, other fund-level fees, and portfolio company fees represent more than half of total PE cost. Public pension funds that do not report these costs are excluding substantial amounts. For a $3 billion PE portfolio, the average difference between what funds actually report and the estimated total PE cost is 202 basis points or $61 million.

PE fund of fund structures introduce additional layers of costs that include management fees and performance fees paid to the top-level manager. For our Dutch clients in 2012 and 2013, total PE fund of fund costs were 5.04%.[2] This means that fund of fund investors on average paid 1.22% more than direct LP investors due to these additional costs.

Full management fees	Portfolio company fees
165 basis points (bps)	50 bps

Assuming that the general partner is entitled to 20% of the portfolio company fees:	General partner receives 10 bps.	Limited partner receives 40 bps.

Typically reported management fees	=	Full management fees - LP share of portfolio company fees
	=	Net management fees
	=	165 bps - 40 bps = **125 bps**
Actual costs incurred by LP	=	Full management fees + GP share of portfolio company fees
	=	165 bps + 10 bps = **175 bps**

Exhibit 1 Illustrative example of management fees and portfolio company fees
Source: Author's calculations

(CEM Universe, 2012-2013)

	Median annual cost based on net asset value	Cost in $ millions based on a $3 BN portfolio
Full management fees[2]	1.89%	$56.7
Internal monitoring costs[2]	0.08%	$2.4
Carry/performance fees[2]	1.49%	$44.7
Other fund-level and portfolio company fees	0.36%	$10.8
Estimated total direct LP costs[3] (A)	3.82%	$114.6
Reported management fees[4] (B)	1.80%	$54.0
Difference (A-B)	2.02%	60.6

Exhibit 2 Private equity estimated full costs and reported management fees
Source: CEM Universe, 2012-2013

The U.S. Securities And Exchange Commission (SEC) Has Drawn Attention To PE Firms' Lack Of Cost Disclosure

In October 2012, the SEC's Office of Compliance Inspections and Examinations (OCIE) began conducting presence exams on PE firms as a result of the Dodd-Frank Act. In May 2014, OCIE released its results of the presence exams [4], which included findings on PE fees and expenses. OCIE found violations or material weaknesses relating to expenses paid for advisory services in more than half the examinations. Specifically, the adviser fees were paid by portfolio companies or the PE fund but were not sufficiently disclosed to LPs. OCIE also found instances of hidden fees such as accelerated monitoring fees, undisclosed administration fees not covered by the limited partnership agreements (LPA), excessive transaction fees beyond the limits set in the LPA, and fees paid to third-party advisers who did not adequately deliver their services.

Given the issues the SEC has uncovered, LPs should be concerned regarding the lack of transparency for PE costs. OCIE noted that while extensive due diligence is usually performed prior to investing, oversight during the life of the fund is not as rigorous. It is prudent for investors in a fiduciary role to proactively attempt to identify and disclose all fees paid for PE. This would help fiduciaries fully understand their PE fee structures, recognize how their PE costs compare to similar investors, and provide their stakeholders with needed transparency. However, for this to be achieved, standardized manager reporting is required. Mounting interest in verifying these costs from both the SEC and pension funds could move the industry towards improving and standardizing private equity cost disclosure.

South Carolina Has Developed An Extensive And Rigorous Process For Identifying And Reporting Private Equity Costs

As part of its cost validation process, SCRSIC makes a good faith effort to collect, check for reasonableness, and report full investment costs. They report net management fees, carried interest, and other fund-level expenses in the plan's CAFR.

The CAFR Schedule of Investment Managers and Fees shows two categories of fees – manager fees that were directly invoiced and manager fees that were deducted on a net-of-fee basis. The category of manager fees that were deducted on a net-of-fee basis is SCRSIC's best attempt to report fees that were netted from net asset value (NAV) and not readily separable. For comparison, fiscal year 2014 invoiced fees represented only about 8% of their total reported investment fees, which means all other costs were netted.

SCRSIC uses a detailed validation process that has been especially useful for capturing and disclosing PE costs during their fiscal year. SCRSIC has found that they cannot collect total investment costs using only manager statements due to timing and a lack of consistency. Managers' annual reports for PE are usually based on a calendar year, while South Carolina has a June 30 fiscal year end. And, the unaudited quarterly PE statements are not consistent across managers in their detail and/or depth of fee disclosure.

To correct the timing issue, the validation process is performed on a quarterly basis. SCRSIC provides a detailed capital account statement template for their PE managers to fill-out each quarter. The expenses portion of the template includes lines on which to report full management fees, the LP share of portfolio company fees which is used towards payment of the management fees, other fund-level fees, and accrued carry/performance fees that are deducted from NAV for the period. The capital account statement format ensures that the manager reconciles the costs associated with the change in NAV for the period. This provides SCRSIC with a first level of quality control for reported fee data. Based on other provided data such as contributions, invested value, and distributions, the expected full management fee and performance fee are compared to the partnership contract terms. SCRSIC reconciles their manual calculations from the contract terms to the fee amounts provided by the managers. If there are material discrepancies, SCRSIC asks for explanations and documents the changes for future validations.

While the vast majority of managers comply with the SCRSIC process, a few managers do not complete the template. For those accounts, SCRSIC manually collects data from statements that are provided and asks for any missing figures. Since this process is more manual, it is more time-consuming.

The ability to collect and confirm reasonableness of cost data from PE managers relies on a strong understanding of the partnership contract terms and constant communication with managers. As a result, implementing such a validation process requires resources. While SCRSIC has found that most of their managers are willing to complete the template, the main challenge is ensuring that all managers provide consistent data with formats and time periods that are specific to their validation process.

This extensive validation process that attempts to capture total investment costs demonstrates the point of this document: the need for standardization.

Since 2009, the Institutional Limited Partners Association (ILPA) has been developing private equity best practices and standardized reporting templates that emphasize providing transparency to LPs. Their templates are robust and include detailed investment fees and expense information. However, the best practices and templates are not mandatory standards enforced by a governing body and generally the industry has not adopted these to date.

Many pension funds do not undertake a detailed validation process perhaps because it is very manual and they may not have enough resources. SCRSIC has discussed cost reporting with other funds. They have found that funds implement different methods for cost reporting. For example, one fund told SCRSIC that they take a "report as it is reported approach," which means only explicitly disclosed or invoiced costs are reported. Given this view, it is not surprising that South Carolina's *reported* investment costs are higher than other funds.

Some Countries Require More Transparent Cost Disclosures

In the Netherlands, the Federation of Dutch Pension Funds introduced new reporting standards in 2012 [5] requiring Dutch pension funds to show full investment costs. These standards have been adopted by the Dutch central bank, De Nederlandsche Bank (DNB), with the expectation that all Dutch pension funds will comply with their 2014 financial statements. Specifically for PE, full investment costs include full management fees, performance fees, consulting fees, monitoring fees, and transaction costs.

Similar investment cost reporting standards have also been implemented recently in Denmark and Switzerland. Both countries' reporting standards have a stand-alone section or document devoted specifically to PE costs. Under these new reporting standards, the components of PE cost are explicitly defined and include management fees and performance fees as well as administration and transaction costs.

Cost Disclosure And Transparency Can Lead To Better Decisions

Clearly there currently are challenges with collecting full PE costs, but the exercise can yield benefits beyond improved disclosure and transparency. Understanding true costs can lead to lower costs through negotiation with managers. For example, greater understanding of portfolio company fees has led to a big change in the proportion of portfolio company fees distributed to LPs. Over time, this revenue sharing has shifted from a 0%/100% LP/GP split to an average closer to 85%/15%[5] today.

Additionally, understanding costs may lead to more efficient investment vehicle selection because high costs will materially impact PE performance. Exhibit 3 shows the net returns and value added for different implementation styles. Fund of funds underperformed internal investing by more than 5% and direct LPs underperformed internal by more than 3%.

Cost disclosure is the main focus of this paper. But costs are neither inherently good nor bad and should not be considered in isolation. Higher costs are justified if they produce higher returns. PE has been a strong performing asset class for some pension funds. For other funds the opposite is true – net PE returns have substantially underperformed public equity market benchmarks. CEM believes that the main performance differentiator between the two groups is implementation costs. Where costs are very high, performance suffers in lock step. PE fund of fund total cost averaged 5.04%. Net value added was 5.15% lower than low cost internal PE implementation. To maximize value creation, funds need to understand the impact of full costs on their decisions.

(CEM Universe, 2012-2013)

	Internal	Direct LP	Fund of funds
Annualized net return	12.21%	9.64%	7.15%
Annualized benchmark return[6]	8.69%	9.36%	8.77%
Net value added	3.52%	0.28%	-1.63%

Exhibit 3 Average annualized compound private equity net performance[7]
Source: CEM Universe, 1996-2012

When asked to comment on their current fee reporting practices, Michael Hitchcock, Executive Director of South Carolina Retirement System Investment Commission, responded, "RSIC believes that part of our duty to stakeholders and policy makers is the most complete fee transparency we can achieve. We are pleased to be a leader in this field, and we hope that our practices along with other plans' needs in this area help move the industry towards improving and standardizing private equity fee disclosure."

And momentum is building towards greater cost disclosure around the world. Christopher Ailman, CIO of California State Teachers' Retirement System, recently vocalized the need for cost reporting standards, especially within the alternatives space. As stated by Mr. Ailman, "We need someone to propose an industry standard, once posted everyone in the industry debates and then you issue a standard. And it becomes something we need to follow." [7]

CEM agrees with Mr. Ailman and we want to work with pension funds and interested parties to make this happen. With the support of the pension fund industry, we can make great strides in improving private equity cost reporting.

Endnotes

1. CEM is an independent global benchmarking and research organization located in Toronto, Canada, that has provided investment and administration benchmarking and research services to large pools of capital (including defined benefit and defined contribution pension plans, endowments, and sovereign wealth funds) since 1991. The CEM databases contain performance and cost information from more than 1,000 pension and sovereign wealth funds from around the world.
2. Data were provided by 29 Dutch funds in 2012 and 34 Dutch funds in 2013. Dutch private equity costs are representative of full costs since the Federation of Dutch Pension Funds developed full-cost disclosure guidelines effective 2012. Costs may be understated; not all funds have adapted to the new disclosure guidelines and an estimate is used for those funds.
3. Total shown is the sum of the median cost for each cost type.
4. Reported management fees are the fees provided by non-Dutch funds in the CEM universe for 2012 and 2013.
5. CEM collected limited partnership details, including the LP share of portfolio company fees, from funds that were able to provide this information for the 2013 data year.
6. CEM developed customized private equity benchmarks based on lagged, small-cap equity indices.
7. Adapted from "How Implementation Style and Costs Affect Private Equity Performance" by Alex Beath, Chris Flynn and Jody MacIntosh, 2014, Rotman International Journal of Pension Management [6]

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[1] South Carolina Public Employee Benefit Authority, "South Carolina Retirement Systems Comprehensive Annual Financial Report For the Fiscal Year Ended June 30, 2014," December 2014.

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[7] Personal communication, March 5, 2015.

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Andrea is a part of the Investment Benchmarking team that is responsible for producing the CEM Global Investment Benchmarking reports for defined benefit and defined contribution clients. As a Senior Analyst, she works with clients to ensure data quality is high and develops reporting solutions to meet client needs.

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