What is Equalisation?

In the context of alternative investment and hedge funds – indeed any open ended fund that pays incentive or performance fees – “Equalisation” means an accounting methodology, designed to ensure that not only the investment manager is paid the correct incentive fee, but also that investor only pay based on their respective uplift and that the incentive fees are fairly allocated between each investor in the fund.

The Equalisation process is an accounting methodology which enables each individual investor, or group of investors, who invest in a fund over the course of its lifetime to be individually assessed for their own incentive fee liability and charged accordingly. If this can be achieved, this will eliminate the problem of one investor being penalised to the advantage of another.

Two examples which illustrate the need for equalisation are described below:

Free Ride
Free-riding would be considered the primary justification for equalisation. An example demonstrates how it occurs and why it needs to be avoided. An investor buys a share in a fund for $100, and the NAV per share rises to $110, so the investor must pay $2 as an incentive fee (2% of the $10 profit). If the NAV per share falls to $100 again, and a second investor buys a share, he will only have to pay an incentive fee after the NAV exceeds $110. They get a free ride by not paying an incentive fee when the fund increases from $100 to $110, but the original investor doesn’t.

Claw Back
The claw back scenario is an equally important rationale for equalisation and relates to the accrual of an incentive fee as the value of the fund increases. If new investors subscribe to the fund and subsequently the value of the fund decreases, the incentive fee accrued will reverse and benefit all investors in the fund. This benefits the new investors even though they have not born the cost of the incentive fee yet.

What are the Objectives of Equalisation?

There are several different Equalisation Methodologies employed to address any potential inequities that may arise in the calculation and allocation of incentive fees between the investment manager and investors. These include the Series of Shares approach as well as a number of different “Equalisation Methods”. The objective of all of these methods is to try and ensure:

i. the equitable allocation of incentive fees between each investor in a fund, to ensure that the Investment Manager is paid the correct amount and that each investor pays the amount that it should be paying and is not subsidised by, or does not subsidise another investor;
ii. that all investors have the same capital risk per Share;
iii. that there is a single NAV per share;
iv. that the published NAV accurately reflects the fund’s performance; and v. that the method used should be easily understood by all parties including the investors.

It must be noted that nobody has yet produced a perfect Equalisation Method that meets all of these objectives and each of them have pros and cons that appeal in different degrees to investment managers and investors in different parts of the world.
Method used by Peter Partnership Fund: Equalisation Share Adjustment Method

The equalisation share adjustment method is one of the most popular methods used in the industry and particularly outside of the USA.

With **High Water Mark** clause, if a Participating Share decreases in Net Asset Value during any Performance Period, and during a subsequent Performance Period increases in Net Asset Value, there will be no Performance Fee payable with respect to any increase in Net Asset Value occurring while the Net Asset Value of such Participating Share is less than its highest previous Net Asset Value, adjusted for any distributions. The Performance Fee will be determined as of the last day of each Performance Period.

Deficit Subscription Adjustments

In the case of a subscription made at a time when the NAV per Share is less than the Peak NAV per Share (“Deficit Subscription”), the Shareholder is required to pay a Performance Fee with respect to any subsequent appreciation of those Shares. With respect to any appreciation of those Shares from the NAV per Share at the date of purchase up to their current Peak Net Asset Value per Share, the Performance Fee will be levied by redeeming for no consideration an amount of Shares having a Net Asset Value equal to the Performance Fee Rate multiplied by any such appreciation (a “Performance Fee Redemption”).

The proceeds attributable to any Performance Fee Redemption will be paid to the Investment Manager as a Performance Fee. With respect to any appreciation attributable to the remaining Shares subject to the Deficit Subscription from gains in excess of the Peak NAV per Share, the Performance Fee will be calculated and levied in the same manner as all other Shares in the Fund. Performance Fee Redemptions are employed to ensure that the Fund maintains a uniform Net Asset Value per Share for all the shares in issue in the Fund.
Deficit Subscription Illustrations.

The following table illustrates the operation of the Deficit Subscription procedure in each of the following three scenarios:

1) Share appreciation to $110 at the next month;
2) Share appreciation to $100 (equal to High Water Mark price) at the next month; and
3) No change in Share value.

Deficit Subscription Purchase Date Information:

Purchase price (Gross NAV/Share) = $90
High Water Mark = $ 100
Hurdle Rate = 6% annualized, calculated monthly (0.487% compounded monthly)
Performance Fee Rate = 20% of the returns in excess of Hurdle Rate, with High Water Mark.

<table>
<thead>
<tr>
<th>NAV Scenario (change from $90)</th>
<th>Purchase Price</th>
<th>Gross NAV at next valuation date</th>
<th>Purchase Price + Hurdle Rate</th>
<th>High Water Mark + Hurdle Rate</th>
<th>Total Performance fee due from Deficit Subscription Investor</th>
<th>Portion of Performance Fee to be paid by deduction from Gross NAV</th>
<th>Portion of Performance Fee to be paid by redemption of Shares from Investor</th>
<th>NAV (net of all fees)</th>
<th>% of Shares Redeemed for Performance Fee</th>
<th>New High Water Mark</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appreciation past Peak NAV</td>
<td>90</td>
<td>110</td>
<td>90.44</td>
<td>100.49</td>
<td>3.91</td>
<td>1.90</td>
<td>2.01</td>
<td>108.10</td>
<td>1.86%</td>
<td>108.10</td>
</tr>
<tr>
<td>Appreciation to Peak NAV</td>
<td>90</td>
<td>100</td>
<td>90.44</td>
<td>100.49</td>
<td>1.91*</td>
<td>-</td>
<td>1.91</td>
<td>100.00</td>
<td>1.91%</td>
<td>100.49</td>
</tr>
<tr>
<td>No Change</td>
<td>90</td>
<td>90</td>
<td>90.44</td>
<td>100.49</td>
<td>0 *</td>
<td>-</td>
<td>-</td>
<td>90.00</td>
<td>0.00%</td>
<td>100.49</td>
</tr>
</tbody>
</table>

* Deficit Subscription will still apply in this situation to future periods until NAV reaches or exceeds Peak Net Asset Value at the end of another measurement period when a Performance Fee is due or until units are redeemed by investor.