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MPERS
Investment Management Fees – Part II

This white paper expands on the previous paper, Investment Management Fees – Part I, regarding the reporting of investment management fees in MPERS' financial statements and Comprehensive Annual Financial Report (CAFR). This paper will also discuss accrual accounting and what that means for reporting investment management fees.

There are essentially two primary components to the fees for MPERS' investment portfolio: 1) management fees, and 2) performance fees.

Management fees are fixed fees and are relatively straightforward. These fees are a percentage of assets under management or based on committed capital. These types of fees exist in both public and private investments. For public investments, these are often the only fees that will be paid. Management fees are higher for actively managed funds versus passively managed funds. As a reminder, a passively managed fund is a fund in which the manager is mirroring an index such as the S&P 500 Index. For private investment structures, management fees will vary depending on the underlying strategy but can approach (and even exceed) two percent of assets.

The second type of fees are performance fees. Performance fees are a part of most alternative investment structures where investors (the limited partners) partner with investment managers (the general partners) to invest funds according to the rules of the partnership agreement. Unlike public investment structures (where the investment manager can only buy, sell, or hold the underlying security), the general partner of a private investment portfolio typically has complete authority to effectuate change on the underlying investment. This can include firing the management of the company or expanding into new lines of business or geographic regions. As compensation for their skillset in managing the investment portfolio, the general partners may be entitled to a percentage of the underlying profits of the investment (referred to as carried interest or performance fees). These performance fees are a powerful alignment-of-interests tool that encourages fund managers to perform at the highest level in order to maximize the returns.

Many public pension funds equate these performance fees to profit sharing and do not refer to them as investment fees so they do not include them in their financial reports as fees. While there is not an industry standard regarding whether this profit-sharing mechanism should be classified as a fee, MPERS has taken the conservative approach and reports any profit sharing with general partners as fees in financial statements. It is important to note that performance fees are not paid until such time as the fund manager has returned to the investor all of the capital invested plus any fees that were paid. Once that occurs, the performance fees will be paid if a specific hurdle rate (or preferred rate) is realized, say eight percent for example.

After that point is reached the investor (MPERS) and the fund manager (general partner) share the profits on an 80/20 ratio. That is, MPERS receives 80% of the profits and the fund manager receives 20%.

Many people have heard the term “2 and 20” as it relates to fees, which refers to the two percent fixed management fee along with the 20% performance fee (carried interest) associated with the underlying investment. To better describe how these performance fees work, we offer the following simplified example of a “2 and 20” fee structure. While we typically do not pay a full two percent management fee, the scenario below is a reasonable result of a private equity investment and would be one in which MPERS would be completely satisfied with the outcome.

Assume MPERS made a $10 million dollar investment with ACME Investment Company for a finite one-year investment period that started July 1 and ended June 30 of the following year. The contract calls for a two percent management fee and a 20% performance fee over an eight percent hurdle rate.

MPERS’ invested capital		$10,000,000 (a)
Management fees paid		$ 200,000 (b)
Total paid-in capital	(a) + (b)	$10,200,000 (c)
Fund return (gross of fees)		15% (d)
Total sale proceeds	(a) x (d)	$11,500,000 (e)
MPERS’ return of paid in capital		$10,200,000 (c)
8% hard hurdle paid to MPERS		$ 800,000 (f)
Total proceeds paid to MPERS before profit sharing	(c) + (f)	$11,000,000 (g)
Remaining proceeds	(e) – (g)	$ 500,000 (h)
Manager’s share of remaining proceeds (20%)	(h) x 20%	$ 100,000 (i)
MPERS’ share of remaining proceeds (80%)	(h) x 80%	$ 400,000 (j)
Total proceeds received by MPERS	(g) + (j)	$11,400,000

With this example, ACME’s ability to generate a 15% gross return results in MPERS receiving back all invested capital, including all fixed management fees paid to ACME, and then receiving 80% of the return in excess of the eight percent hurdle rate (reminder: this common hurdle rate exceeds MPERS’ actuarial assumed rate of return). This would likely be deemed a successful partnership that worked out for everyone, but it is also a good example of why there are so many interpretations of what exactly a system pays in management fees. In order for ACME (fund manager) to earn the performance fee, ACME has to return all of MPERS’ investment ($10,000,000), the fixed management fee ($200,000), and outperform the hurdle rate (or preferred rate) of eight percent ($800,000). So if a management fee is paid that is ultimately returned, was a management fee actually paid? That is an ongoing industry debate about which MPERS has yet to receive any guidance.

Looking across the spectrum of public funds, there would be three different methods of reporting fees for this investment: 1) reporting only the base fee ($200,000), 2) reporting no fees because the base fee was returned and profit sharing is not considered a fee, or 3) reporting $300,000 in total fees, which includes both the base fee of $200,000 plus the profit sharing (performance fee) of $100,000. Absent further guidance from accounting standards boards, MPERS has chosen the most conservative route and would have reported $300,000 in fees for this example. The bottom line is that whatever method is utilized in reporting fees, the net-of-fee calculations produce the same result. In this case MPERS would have earned an 11.7% return, net of fees, which can be compared relative to what could have been earned by investing in the public markets or another investment strategy. If that decision added value to the investment portfolio, then the goal was accomplished and the System provided a valuable service to the beneficiaries.

Accrued Fees

As if the explanation of a “2 and 20” management fee is not challenging enough to understand, the reporting of performance fees becomes much more complicated once “accrued” fees are incorporated (or using an accrual accounting method) instead of simply focusing on “paid” fees. As a reminder, MPERS reports fees on an accrual basis in conformity with U.S. generally accepted accounting principles. But what does “accrual accounting” mean? It means that income and expenses are calculated and recorded during the period when income and expenses are earned, rather than when they are ultimately paid. The example above occurred during a single fiscal year (July 1 to June 30), making the management fee calculation relatively straightforward and easy to understand. In the example, the fees would all be accrued and paid in the same year since all the activity occurred in a single fiscal year. When the investment period covers multiple years, which is most often the case with alternative investment structures, accounting standards require the use of accrual accounting rather than cash basis accounting.

Accrual accounting uses the concept of “the matching principle” in the reporting of management fees. In the case of investment structures, this implies that if the underlying investment were to increase in value during a given year (generating an unrealized gain or revenue on the financials), then the expenses associated with those gains should also be recognized in the same period. The net result is that unrealized gains in the investment portfolio also result in unrealized performance fees that accrue based on the increased market value. These accrued fees are reported on MPERS’ financials and will increase or decrease in the future based on future investment performance, but are not actually paid until the underlying assets are sold. That is the primary distinction between accrual versus cash accounting; cash accounting only considers actual payments during a year, while accrual accounting attempts to match unrealized gains and unrealized expenses during the reporting period.