



# Emerging Manager Focus

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## OPINION

### Market Losses Create a Silver Lining for Loyal Investors

Ron Kashden, President of TKS Solutions

The credit crisis has caused a once in a lifetime reduction in the market. Through out all the pain and turmoil there exists a silver lining for investors who avoid reflexive redemptions and stay with their fund. The upside to investor loyalty is greater tax efficiency, lower investment management cost, and creative fee arrangements.

Sophisticated funds, in their effort to retain investor capital, are promoting these advantages to their investors.

By lowering the tax liability of their investors or passing through tax losses, funds are able to lessen the pain of the market downturn. A fund's tax effectiveness -which is a measure how a fund's investment return translates into investor's taxes owed - is increasingly crucial. Participants in on-shore partnerships are most directly impacted, because these taxes flow through the partnership and onto the partners. But with the rise of "fund of fund" investing, shareholder tax exposures have become more widespread. With this realization, tax-savvy funds have been focusing on optimizing each investor's tax allocation, to make sure that investors who stick with the fund receive greater participation in unrealized p/l.

Losses in the market have triggered many of the loss carry-forward ("LCF") charter provisions. While these provisions can make the month-end process more complicated, and will put a stress on management companies that lack sophisticated accounting systems, it is a boon for investors. During good times, an investor is paying a management fee plus an incentive fee. With the LCF in place, the incentive fee disappears until the investor has recovered their losses. In essence, the investor is employing a high quality team to manage their capital through the inevitable recovery - but at a discount. Investors who jump from one fund to another unwittingly lose the discount and end up paying "full price" for their new fund.

Creative fee structures are another tool that institutions are also deploying to retain investors. Several well-known shops have begun to offer investors either reductions in their fees or a tiered structure for a commitment to remain in the fund. Similar to the LCF discount benefit, this provides the investor with net returns they wouldn't receive from leaving the fund and shopping around for new management.

But all of these benefits are not without costs. The complex accounting involved means that the fund organization must have a high level of sophistication in its back-office operations. For example, optimizing tax allocations requires a firm (or their tax preparers) to have investment management tax software capable of handling layering. Most tax packages do not have necessary logic to perform the intricate allocations.

Fund back-offices that used spreadsheets for the straight-forward arithmetic of 20% incentive fee, may buckle under the strain of maintaining LCF balances for each investor. Similarly, the creative, but elaborate fee structures many funds are introducing can be a two-edged sword – enticing investors today, but losing them tomorrow when the IT infrastructure isn't in place to track multiple investor fees. But organizations that do have sophisticated partnership and shareholder accounting systems necessary to handle the fee and tax complexities can provide investors added value - even in this gloomy environment.

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