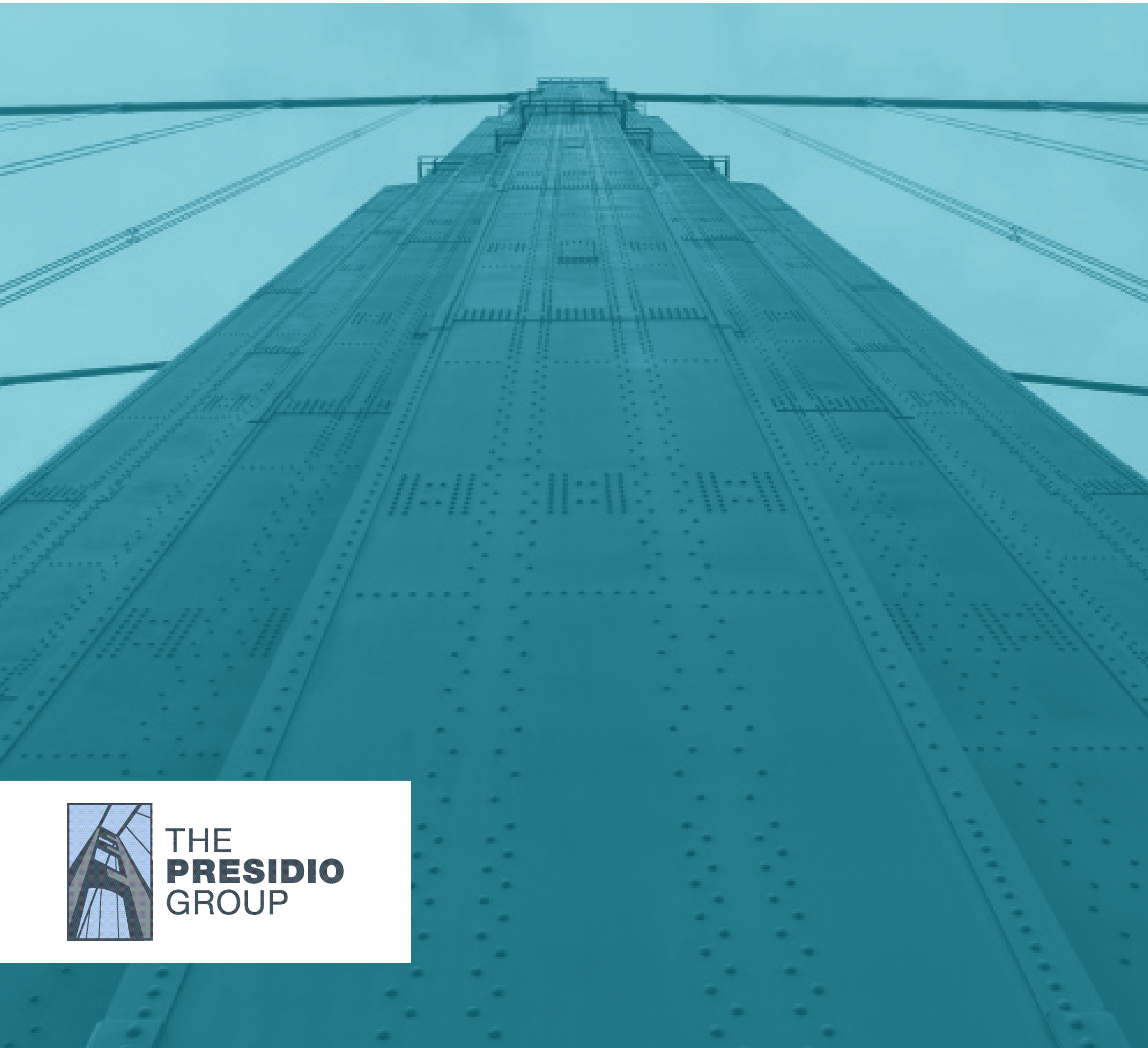
TERMS: YOU CAN'T ALWAYS GET WHAT YOU WANT

(But it doesn't hurt to ask)



THE PRESIDIO GROUP

Negotiation is a key part of the investment process at The Presidio Group. Our vetting of current and prospective investment managers goes beyond the basic understanding of strategy and performance. Even when we identify investment funds that deliver on those criteria we then engage in another level of vetting that focuses on negotiating key terms of an agreement with a given firm.

What a fund costs is obviously a key term, and we often negotiate for a fee structure that is most advantageous for our clients. But fees are really the low-hanging fruit. We also spend a lot of time looking at terms that may not be front-of-mind, but that we have found can deliver considerable value.

The key terms beyond fees that we focus on are **investment minimums, redemption rights, transparency,** and **access to the portfolio manager.** Our experience has proven that not only is there value in negotiating the best terms for each factor, but when appropriate, drilling down on these less popular issues has helped us steer clear of disappointing outcomes down the line.

This paper will delve into the key issues, including fees, that we seek to negotiate, as well as explain scenarios where seemingly inflexible terms for our clients can be advantageous.

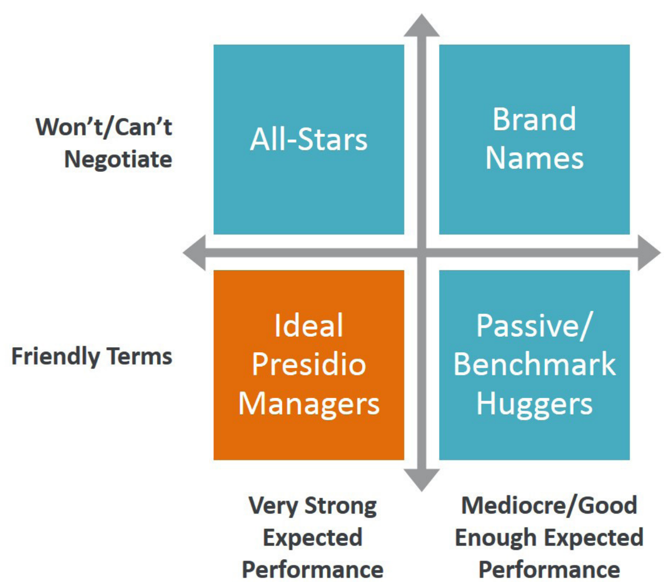
THE BEST AND WORST NEGOTIATING PARTNERS

We have a wide menu of investment management structures we can invest in, and each one has a distinct flexibility in adjusting terms. As we explained in our previous paper *Are Limited Partnerships Worth It?* the flexible structure of LPs makes negotiating key terms more practical than with mutual funds.

	Mutual Funds	Separate Accounts	Limited Partnerships
Minimums	**Negotiable**	**Negotiable**	**Negotiable**
Fees	Non-negotiable	**Negotiable**	**Negotiable**
Liquidity/Redemptions	Non-issue	Non-issue	**Negotiable**
Anytime access to see underlying holdings	Generally unavailable	Non-issue	**Negotiable**
Quarterly calls with portfolio managers	Negotiable, but often unavailable	**Negotiable**	**Negotiable**

To be sure, even though they have flexibility to do so, not all limited partnership managers are open to negotiation. Quite often, the popularity and reputation of "All-Star" managers allow them to be pricemakers rather than price-takers. We are wary of firms that leverage their reputation as a rationale for not negotiating with us. While prestige is often the result of impressive performance, it needs to be accompanied by client-friendly terms. With rare exception, Presidio is reluctant to invest in funds with All-Star performance where the structure of key terms such as liquidity, fees and redemption policy are tilted in the manager's favor. Those funds put the "limited" in limited partner.

Brand name firms—All-Star or not—are usually amongst the least willing to negotiate as their reputation and recognition are often enough to attract assets. They rarely offer the chance to talk about terms despite presenting investors with a stable of mediocre funds that perform no better than an inexpensive index fund.



By contrast, an ideal Presidio manager offers reasonable terms up front, or is at least open to discussion during our diligence process. We have found that a manager's behavior in these early stages is a valuable window into how they will interact with us if we were to invest with them. After all, a manager can be expected to put on their best face during the honeymoon period of fundraising. An unwillingness to negotiate terms from the get-go suggests a potential misalignment in their goals and ours, and that disconnect is only likely to get worse over time.

In the following sections we will discuss the major areas where we may negotiate terms with investment managers.

INVESTMENT MINIMUMS

Many of the compelling managers we are interested in have stated investment minimums of at least $1 million. In some cases the minimum can be $10 million. Those high entry hurdles would be a deal breaker for many of our clients.

Through negotiation we are often able to get the required initial investment down to a range of $250,000-$500,000, thereby obtaining access for most of our clients.

We are able to do this for a couple of reasons. First, from the investment manager's perspective, the aggregate dollars they will receive from multiple Presidio clients will often far exceed their stated investment minimum. Moreover, investment managers know that while they may have dozens of accounts from Presidio clients, on a practical level they only have to service and "deal" with the internal team at Presidio. That's of great operational value to managers who want to devote maximum hours to managing money, not clients.

Pushing for lower minimums helps us ensure that we are significant clients for our concentrated lineup of managers, which in turn helps lubricate the negotiation on the next term: fees.

FEES

This is the most visible and quantifiable term we examine. There is one unifying principle to how we evaluate fees: the value provided by the fund should more than compensate for its cost. That is, are we getting our money's worth?

We spend a lot of time selecting firms that right off the bat offer reasonable fees, or that are amenable to negotiating their fee structure. Given that we aggregate money from many Presidio clients, the total dollar value of our investments often gives us leverage to negotiate significantly lower fees for our clients than they could obtain if they invested in these managers directly.

One prominent type of fee is the management fee. This flat, annual charge exists to cover a manager's essential costs such as: employee compensation, technology, and office space. It's important to understand that management fees should not be about delivering a significant profit to a manager. They are compensation for operational costs. Once managers know Presidio's inflows will be sizeable, they are often willing to reduce fees for our clients since they understand the addition of many clients will not materially add to their operating costs, when aggregated through a Presidio relationship.

Another important fee that is part of many limited partnership agreements is "carry", which is a profit-sharing levy. When we invest in funds that charge carry it is because we believe that allowing the manager to share in the profits is an appropriate incentive that can drive outperformance. This is particularly the case for distinct investment strategies where most of the performance is extracted through skill. We are not interested in paying carry for a highly liquid, common-place investment strategy that closely tracks a broad benchmark. There is simply no reason to pay an incentive fee to a manager who is providing a market exposure that can be cheaply attained through a low-cost mutual fund or exchange traded fund.

Agreeing to carry in concept is not the full story. In certain situations, particularly where we are a sizable investor, or the investment firm is not yet established, Presidio has succeeded in negotiating the carry fee. We have negotiated subtler terms as well, such as instituting a minimum return before profits are shared ("hurdle rate"), different carry payout structures, and limiting expenses beyond the management fee. Such improvements can lead to higher net profits for our clients.

We have walked away from funds that have been unwilling to adjust fees appropriately. An example is a manager for whom we were an early investor in their initial fund. We disagreed vehemently with the terms proffered for a subsequent fund that included untenable fee conditions—a full management fee for 10 years, profit sharing with no hurdle rate, and a poorly structured carry calculation. We pushed back and ultimately declined to approve the new fund because too many of its terms were not justified. That, combined with other insights gleaned during our due diligence, suggested that the management team might have been more interested in collecting fees than a business model that generated value for clients.

LIQUIDITY/REDEMPTIONS

The process to take money out of a fund is something we vet prior to our initial investment. While you may be familiar with the rapid on-demand redemption structure of mutual funds and exchange traded funds, limited partnerships often have more restrictive rules about when money can be redeemed, and how much can be redeemed at a given juncture. There are some investment funds that can tie up investor money for years or even decades. A restrictive policy is not patently wrong; the point is that we make sure we understand a firm's redemption policy and that it is aligned with the underlying strategy and liquidity of its assets. That investigation needs to happen before a penny is invested.

CASE STUDY: LIQUIDITY

A case study in the negotiation of fund terms is a limited partnership where Presidio was a lead investor. As our clients comprised more than half of the fund's assets we knew we had ample negotiating leverage. We pushed back on many terms and won significant concessions for our clients. The investment minimum was reduced, the fee structure was improved to our client's benefit, space in the fund was reserved for our clients, and other investor protections were introduced[1]—but one thing we never asked for was increased liquidity. Our assessment was that liquidity-on-demand was inconsistent with this particular manager's strategy (trading in complex, distressed assets with a longer-term time horizon).

A fund of funds investing alongside Presidio took a different tack. They chose to negotiate for a high degree of liquidity and demanded the ability to sell their holdings back to the fund at their own discretion. However, they agreed to only be allowed to exit at the lower of cost or fair value. They essentially guaranteed themselves either no return or a negative return, all to make sure they could have their money back on demand. And on top of that, they agreed to pay a higher management fee to the manager!

We highlight this as a reminder that while liquidity is important there are many situations where less liquidity is desirable. Seeking out liquidity above all else can result in compromises that only decrease expected return.

[1] We also negotiated a longer cap call lead time; a narrower mandate of target holdings; limits on use of debt, particularly recourse to the fund; restricting distribution to LPs of in-kind holdings rather than cash; and a stronger key man provision, protecting us if the nascent fund's portfolio manager could no longer actively run the fund.

Unlike investment minimums and fees (where, generally speaking, the lower the better), there are no set rules on liquidity. It may seem intuitive to presume more fund liquidity is always better, and there are many examples where we have negotiated for liquidity guarantees or a quicker redemption option. But there are also instances where accepting limited investor liquidity is necessary and key to a given investment strategy.

That is, illiquidity can be a virtue, not a vice, for specific strategies. For example, venture capitalists and activist equity managers often make strategic investments that can take many quarters—or years—to play out. They need assurance that investors are willing to commit capital for an extended period. It makes little sense to negotiate for short-term redemption rights if it will undermine a manager's ability to execute.

A less obvious reason for a restrictive policy is to deal with a liquidity crunch. These typically arise in times of crisis when assets that are easily traded in "normal" markets can't be sold at a reasonable price. That often coincides with some investors wanting to redeem their shares. To satisfy these redemption requests a manager can be forced to sell assets far below their fair value, which hurts the interests of the fund's remaining shareholders.

To deal with this risk, managers can temporarily reduce investors right to redeem from the fund, a restriction known as a "gate" on redemption. These gates are usually "lifted" when market conditions return back to normal. Another option managers have is to put certain illiquid investments into "side pockets" (illiquid pools within otherwise liquid funds). These side pocket investments can remain for very long periods even after an investor has redeemed fully from a fund's liquid assets. Gates and side pockets can protect investors from harm when flightier investors rush for the exits. When used appropriately, gates and side pockets can mitigate two risks: (1) getting left holding a disproportionate share of a fund's most illiquid assets when other investors flee in times of panic; and (2) being forced to sell good securities that are temporarily marked down in the midst of market stress.

Gates and side pockets most frequently come up in alternative investment strategies ("alternatives"). We believe that alternatives give clients access to unique asset classes, a highly valuable addition to any portfolio, but side pockets and gates are unavoidable aspects of most alternatives. How unavoidable? In a recent study of hedge funds of funds (HFOF) we found one HFOF we have followed for years that began shutting down in 2009 still had more than 50 side pockets in early 2015. Another HFOF that goes out of its way to avoid illiquidity has several dozen side pockets left over from long-ago terminated funds. In short, there is practically no way to avoid side pockets completely while participating in alternatives, but we believe, on balance, the advantages some alternatives provide are more than worth it.

When negotiating a manager's ability to gate or use side pockets, we assess whether the fund manager is really looking after a client's best interest. Presidio takes this seriously and uses a few tools to assess their motivations and client alignment, in order to protect clients:

- First, we focus on independent, employee-owned firms. While this does not guarantee that a manager will act in LPs' best interests, we fear managers who answer to outside shareholders are more likely to take "short-term greedy" steps like imposing gates even when they are not strictly necessary, so as to protect existing fee streams.

- Second, we observe our managers over (hopefully) a long period of time and note how they treat investors' interests versus their own. As an example, we greatly respect managers who have the courage to tell us when market conditions are such that it's best NOT to invest with them, despite the obvious effect on their current fee stream. We are far more receptive when conditions change and they come back to us encouraging we add to their fund.

- We look at the ability to remove the fund manager down the line, a drastic but important protection that can keep a manager's behavior in check.

- Finally, we limit client exposure to investment funds that have the ability to impose these restrictions.

"ANYTIME ACCESS" AND QUARTERLY CALLS WITH PORTFOLIO MANAGERS

Understanding a manager's motivation for making specific portfolio moves and monitoring for any shifts in management culture are two important ways we protect our clients. To that end, we consider the quarterly review we have with managers as vital.

Portfolio transparency and access to management enables us to dig deeper into portfolio moves so we can assess whether we agree that the changes are warranted. Most often those conversations solidify our confidence in a manager and strategy. But there are also times when those conversations have raised a serious concern about a shift in strategy or execution, and have led to our reduction in client exposure to that manager, or even outright termination.

Access to management is also an important form of transparency that gives us insight into cultural shifts at an investment firm that are often a part of the normal firm life cycle. A significant majority of our decisions to stop investing with a given

CASE STUDY: ALIGNMENT IN TERMS

When the financial crisis hit in late 2008, Presidio had a strong relationship and many clients invested with Whitebox, a multi-strategy credit manager. Whitebox had many qualities we look for in a manager: significant insight into markets, a willingness to take interesting positions when the current price significantly undershot the fundamental value and an openness in discussing those opportunities with us. As market fear rose, Whitebox spent time educating us about the significant undervaluation of convertible bonds, an asset they had expertise in trading and that comprised a significant amount of the fund's assets. They expressed enthusiasm that convertibles were "cheaper than ever", yet they were unable to take advantage of the opportunity as fully as they would have liked, given that they were simultaneously having to deal with large redemption requests from other investors. Instead of being able to double down on a historically cheap opportunity, Whitebox faced the need to sell into a market at discounted prices simply to meet redemptions. To prevent this from happening in the future, they instituted "gates" that restricted redemptions from the fund until markets calmed.

While this might have put off many investors, we were in agreement with their actions as we had an active dialogue with Whitebox and a strong understanding of their motivations. When Whitebox soon thereafter launched an illiquid fund to invest in convertible bonds, the fact that we had developed a deep understanding of their approach, and had valuable access to management gave us confidence to invest client assets. Moreover, we were pleased that, even without negotiation, the firm had built in a client-friendly fee structure that properly incentivized the manager to return capital quickly. A good opportunity with a trusted manager, matched with appropriate terms and alignment of interest, is precisely the kind of outcome Presidio seeks.

fund occur when we sense there is a cultural shift that is not in our clients' best interests. These are often subtle hints we pick up through ongoing discussions with management. For example, when strong performance drives asset growth we become especially attuned to how the firm plans to manage that growth. It not only can impact the operational complexity for managers, but also can ultimately dilute its ability to stick with the very investment strategy that drove its success. We find that most firms eventually reach a "maturity" point where we need to part ways. The trick is seeing the signs before they show up in poor performance. It's our ongoing access to management that gives us this leg up.

We often have to negotiate our way to the level of disclosure and communication we deem necessary to protect our clients. We actively pursue agreements that spell out how often a fund will share portfolio holdings with us, as well as how often we will be able to talk to management. We have chosen not to invest client money in countless managers who refused to give us that access.

FINAL THOUGHTS

When thinking about terms of engagement with a particular investment firm, there is a strong temptation to focus solely on fees. At Presidio we take a more holistic view that drives us to negotiate on a variety of key terms, not just fees.

Access is imperative, as it helps us monitor the investment process and management culture of those we have entrusted with client money. While terms are important, they only really have meaning when managers are transparent and thoughtful in crafting them, and are open to negotiation. Our aim in negotiation is not to drive the hardest of bargains, but more importantly to make sure that how a fund operates—its core principles—is aligned with the best interests of our clients. Many investment firms do a terrific job right off the bat. But in those instances where we see an opportunity—and a need—to better protect our clients, we will not be shy about negotiating on your behalf. ■

FOR MORE INFORMATION, CALL US AT
877.449.1999

SAN FRANCISCO OFFICE
415.449.1000

DALLAS OFFICE
214.855.2200

WASHINGTON, D.C. OFFICE
301.298.1601

thepresidiogroup.com

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