Reading 78

ALTERNATIVE INVESTMENT FEATURES, METHODS & STRUCTURES

1. (A) **fee structure and investor requirements.**

   Explanation

   A term sheet describes a fund's investment policy, fee structure, and investor requirements. The fund manager may provide other information such as management biographies through investor presentations and other legal documents and agreements.

   (Module 78.1, LOS 78.b)

2. (B) **leveraged.**

   Explanation

   Alternative investments tend to use more leverage and are typically less liquid and less transparent than traditional investments.

   (Module 78.1, LOS 78.a)

3. (C) **Fund investing.**

   Explanation

   Fund investing gives an investor access to a diversified pool of assets. Co-investing typically requires a larger investment amount. Direct investing provides the least diversification and requires the largest capital investment.

   (Module 78.1, LOS 78.b)

4. (C) **Little availability of performance information.**

   Explanation

   It is difficult to assess performance for alternative investments because historical return and volatility data is less available compared to traditional investments. Alternative investments typically have low correlation with traditional investments and managers have different information than investors.

   (Module 78.1, LOS 78.a)

5. (A) **Unique legal structures and tax treatments.**

   Explanation

   Compared to traditional investments, alternative investments have unique legal issues and tax treatments that are related to their legal structure and registrations. They often have lower levels of regulation and are less transparent than traditional asset classes. Alternative investments often employ high levels of leverage in illiquid markets.

   (Module 78.1, LOS 78.a)

6. (A) management fees.

Explanation

Hedge fund fee structures indicate management fees as a percentage of assets under management and incentive fees as a percentage of gains in value. A3 and 15 fee structure means a fund charges a 3% management fee and a 15% incentive fee.

(Module 78.1, LOS 78.c)

7. (B) diversification

Explanation

Perceived benefits of alternative investments include (1) risk reduction from diversification since alternative investments tend to have low correlations with traditional investments, and (2) possible higher returns from holding illiquid securities. Alternative investments are generally more difficult to access because of higher minimum investments and specialized knowledge.

(Module 78.1, LOS 78.a)

8. (B) assets under management.

Explanation

For hedge funds, management fees are calculated as a percentage of assets under management- typically, the net asset value of the fund. For private capital funds, the management fee is calculated as a percentage of committed capital.

(Module 78.1, LOS 78.c)

9. (A) 3.6%.

Explanation

The investor would receive the first 8%. The catch-up would allow the manager to receive the next 2%, so it catches up on earning 20% of the first 10% of gains. The manager will also receive another 20% of the 8% remaining after the catch-up, which is 1.6%. Thus, the manager would earn 2% + 1.6% = 3.6%.

(Module 78.1, LOS 78.c)

10. (C) Carried interest.

Explanation

The performance fee may also be called an incentive fee or carried interest. This fee is designed to incentivize management based on performance, and typically the fund must exceed a hurdle rate or preferred return before that performance fee is earned. Fund managers earn the management fee regardless of performance.

(Module 78.1, LOS 78.c)

11. (C) Clawback.

Explanation

A clawback provision requires the manager to return any periodic incentive fees to investors that would result in investors receiving less than 80% of the profits generated by portfolio investments as a whole.

(Module 78.1, LOS 78.c)

12. (C) management fee

Explanation

"2-and-20" denotes a 2% management fee and a 20% incentive fee.

(Module 78.1, LOS 78.c)

13 (A) Deal-by-deal waterfall

Explanation

With a deal-by-deal waterfall, profits are distributed as each fund investment is sold and subsequently shared according to the partnership agreement. With a whole-of-fund waterfall (or European waterfall), the limited partners receive all distributions until they have received 100% of their initial investment plus the hurdle rate.

(Module 78.1, LOS 78.c)

14. (C) Catch-up clause.

Explanation

A catch-up clause allows the manager to catch up on its performance fee after the hurdle rate is reached. A high-water mark disallows performance fees on gains that only offset prior losses. A clawback provision returns prior performance fees to investors if gains are reversed when deals are exited.

(Module 78.1, LOS 78.c)

15. (C) lower fees.

Explanation

Direct investing avoids outside manager fees, while fund managers charge fees.

Disadvantages of direct investing include lack of diversification, higher required investment amounts, and specialized knowledge needed to evaluate deals. Fund investing provides access to a more diversified pool of assets, and the investment amount is typically lower because the cost is shared with other investors.

(Module 78.1, LOS 78.b)

16. (B) higher fees.

Explanation

A hedge fund typically is more likely to use leverage, is less liquid, and charges higher fees than a traditional mutual fund.

(Module 78.1, LOS 78.a)

17. (B) **less liquidity of assets held.**

Explanation

Alternative investments typically exhibit several characteristics including less liquidity of assets held, relatively more concentrated portfolios, and less regulation and transparency.

(Module 78.1, LOS 78.a)

18. A) **direct investing**

Explanation

An investor has control over the investment through direct investing. The fund manager has control over the investments through fund investing, and the fund manager may share control with the investor through co-investing.

(Module 78.1, LOS 78.b)