CION INVESTMENTS

Your Five-Minute Guide to Understanding Incentive Fees

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Compensation for a fund manager generally has two components: a **management fee** and an **incentive fee.**

A **management fee** is typically calculated based on a straightforward percentage of assets.

The calculation of an **incentive fee** is based on performance and, as a result, requires more explanation.

Incentive fees are intricate for good reason: They are designed as an ongoing performance incentive and structured to control expenses. These fees align the interests of shareholders and the fund manager by allowing the fund manager to participate in the excess income beyond the hurdle rate.

This short guide describes how incentive fees can be calculated in a variety of return scenarios.

For the purposes of this example, we will assume the example fund being analyzed has a **hurdle rate** of 6% and an **income split** of 85-15. The same general principles apply regardless of the actual hurdle rate and income split.

WHAT IS AN INCENTIVE FEE?

An incentive fee is an ongoing performance incentive based on net investment income, or NII.

When the NII exceeds a certain percentage, i.e., **the hurdle rate,** the investment manager participates in the upside of that excess income. This excess income is split between shareholders (who receive 85%) and the manager (which receives the remaining 15%).

Note that the incentive fee is entirely contingent on performance. If the NII is below the hurdle rate, no excess income is generated and the manager would not earn any incentive fees. In that case, shareholders receive 100% of the NII.

WHAT IS THE HURDLE RATE?

A hurdle rate is a performance benchmark. It is the minimum NII that shareholders must earn prior to the investment manager participating in the income upside.

We continue our example with a hurdle rate equal to 1.50% per quarter or an annualized hurdle rate of 6.00% that is calculated and payable quarterly. The percentage will be based on the adjusted capital, i.e., the gross proceeds from the sale of shares minus both share repurchases and returns of capital.

HOW IS THE INCENTIVE FEE CALCULATED?

In summary, if NII exceeds the hurdle rate, then an incentive fee is earned by the manager. We detail the specifics of this example below.

NII consists of interest income, dividend income, and any other income accrued during the quarter, less operating expenses. Operating expenses include the management fees, expenses reimbursed, interest expenses and distributions paid on preferred shares. Please note that the incentive fee itself is not included as an operating expense.

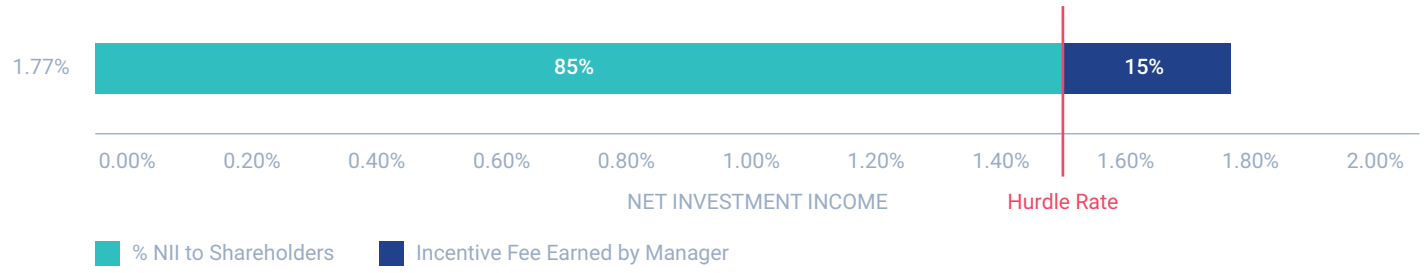
Bottom line: To earn an incentive fee, the investment manager must not only exceed the hurdle rate, but must do so after accounting for operating expenses.

BASIC EXAMPLE #1 – NET INVESTMENT INCOME IN EXCESS OF THE HURDLE RATE RISKS

In this case, NII exceeds the hurdle rate for the quarter and the desired income split of 85:15 is achieved.

Incentive Fee Split Above Hurdle Rate

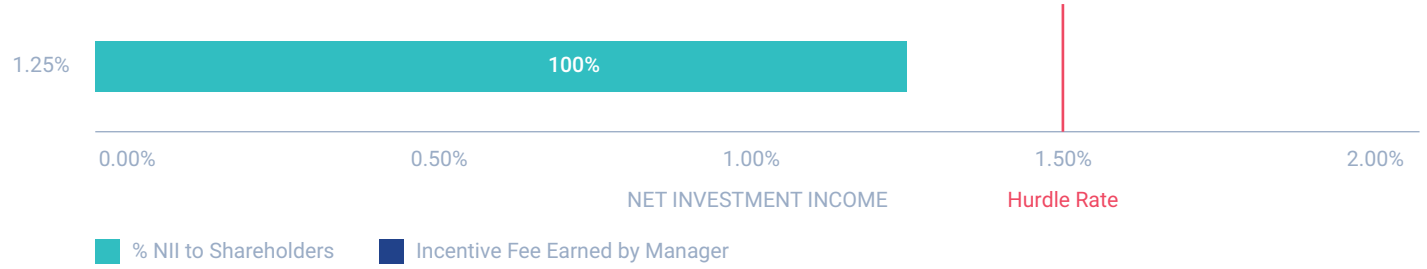
BASIC EXAMPLE #2 – NET INVESTMENT INCOME BELOW HURDLE RATE



Because NII is below the hurdle rate, shareholders earn 100% of income. The manager would receive no incentive fee.

Incentive Fee Split Below Hurdle Rate

SLIGHTLY MORE COMPLICATED EXAMPLE #3 – INTRODUCING THE "CATCH-UP"



The final subtlety of an incentive fee is the "catch-up" feature.

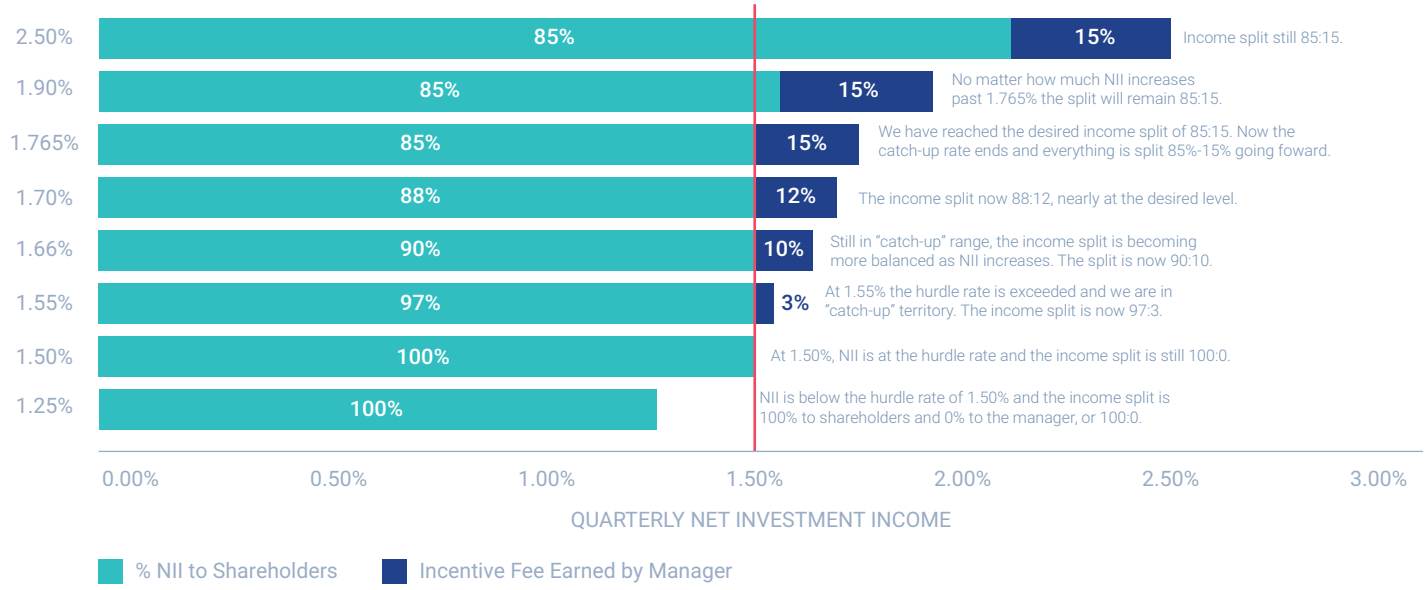
The manager doesn't earn the full 15% incentive fee by simply meeting the hurdle rate. Until the manager earns enough net investment income to meet the hurdle rate AND also earn enough in excess of that to reach 15%, the manager earns something less than 15%. It is within this range — after the start of the hurdle and before the full 15% is earned — where the "catch-up" feature applies.

The catch-up rate is implicated only in the specific circumstance where NII is in the range of 1.50% through 1.765%. Within that range, the manager receives 100% of NII in order to reach the desired NII split, hence the name "catch-up."

Why 100%? Note that until the hurdle rate is met, the investment manager receives 0% of the net investment income, a 100:0 income split as in Example #2 above. To achieve the desired 85:15 income split, a manager earns 100% of the NII (after the hurdle rate is met) until the income split shifts from 100:0 to 85:15. The chart below shows the shift through a range of returns as the desired income split is achieved.

From Below Hurdle Rate to Above How Incentive Fees are Split

The chart above shows how the income split shifts as NII increases, starting from the bottom up.



1.25%: At first, NII is below the hurdle.

1.50 – 1.765%: As NII rises, it is in excess of the hurdle and the manager begins to earn an incentive fee. This allows the catch-up to kick in, but is not enough for the manager to earn a full 15%. As the NII continues to increase, the income split becomes less lopsided and closer to the desired 85:15 income split, which is achieved at 1.765%.

>1.765%: Finally, once the 1.765% threshold is reached, the desired 85:15 income split is attained and the division along those lines continues regardless of how high NII goes.

To learn more, please contact your financial advisor.