You're Paying What?
Breaking Down Long/Short Fund Fees

Lately we've fielded a lot of questions about fund fees. It seems both advisors and clients alike are finding fee disclosure confusing and there's a lack of clarity around what investors are actually paying. This can become even more of a challenge for long/short equity funds.

For many years FINRA has had a requirement in place where gross expense ratios must be prominently positioned close to mutual fund performance (displayed on retail marketing material). Many mutual fund companies also opt to display their net expense ratios and net with limitation expense ratios. However, recently FINRA has started enforcing a rule that requires the net with limitation expense ratio to be less prominent and placed in a footnote below the gross expense ratio. This is where the confusion begins.

The gross expense ratio is important because it gives investors an understanding of the total fees involved with managing the fund. The gross expense ratio thus includes all fees incurred by the fund including management fees, 12B-1 fees, administrative costs and operating expenses. Net expense ratios typically reflect any fee waivers and/or expense reimbursements the fund might have in place. Finally, the net with limitation expense ratio is exclusive of certain indirect investor expenses, such as acquired fund expenses and interest expenses on short sales. It is these expenses that can make long/short equity fund fees difficult to understand.

Long/short equity funds typically include non-operating costs, such as the aforementioned acquired fund expenses and interest expense on short sales, as a line item in their prospectus. Let's consider these further.

- **Dividend expense on short sales:** This "fee" is to account for the expense of any dividends paid on a stock you are borrowing to short. This amount is calculated as an expense even though as the borrower, you will remit that dividend payment back to the owner of the stock when you close your short. We purposely have "fee" in quotes, because most would agree that it is not a fee in the traditional sense, and you certainly could never count dividends received on your long side as "Fee Credits."

- **Interest expense on short sales:** While a cost to the portfolio, it is not a separate cost to the investor. Like dividends on short-side securities, this fee will be reflected in the returns achieved as a higher cost to borrow, and would decrease the overall return of the fund. At 361 Capital, we use this as part of our decision-making process regarding which stocks to short. The cost to implement is a consideration, as it is for many managers, and if the cost is more than the potential benefit, then we will not implement the short. Even though this is not a fee, it must be disclosed as such for funds with short positions.

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- **Acquired fund fee:** This is a line item that must be accounted for if a manager uses other underlying funds (mutual funds or ETFs, for example) to account for the operating expenses of those funds.

Therefore, the gross and net expense ratios prominently displayed on retail marketing material include these non-operating costs, causing confusion in the fees paid for a long/short equity fund.

Since the net with limitation expense ratio excludes certain indirect expenses, we believe that this ratio provides the most transparency into the actual expenses the investor will pay.

To find out if your long/short equity fund has a net with limitation expense ratio, you can look at a fund's prospectus. Immediately below the Fees and Expenses table, in the footnote, is where a contractual limit would typically appear if the fund has an agreement in place. It's important to understand that these limitations are the result of a contractual or voluntary agreement by the Adviser and are subject to the terms stated in the prospectus.

While you've heard this many times before, it's important to always look at a fund's prospectus* as part of your due diligence process. Carefully review its Fees and Expenses table before deciding on whether to include or exclude a fund from your consideration. It is the only way to truly understand the potential expenses of the fund. Purely conducting your diligence based off the gross or net expense ratios can create a missed opportunity if the fund breaks internal fee thresholds due to a disclosure requirement.

For additional viewpoints:
Call 866.361.1720 or visit 361capital.com.

About 361 Capital

361 Capital is a leading boutique asset manager focused on alternative and behavioral-based equity solutions that seek to deliver meaningful alpha, manage risk and offer diversification potential to investor portfolios. Founded in 2001, we offer a suite of investment products including Long/Short Equity, Managed Futures, Macro, as well as Small, Mid and Large Cap Equity.

*Since prospectuses tend to be a look back to the previous year, you should also consult the most recent Annual or Semi-Annual Report for more recent fiscally calculated expense ratios.

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