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### **Transition from Separate Accounts to a Fund**

Dear Investment Partner:

I started Saber Capital Management nearly six years ago as a business to manage capital through separate accounts. Since then, the business has grown to the point where it now makes sense to manage money inside of a partnership structure. Saber Investment Fund, LP is an investment fund that has been operating since January 1<sup>st</sup>, 2014, and it will replace separate accounts as the main investment vehicle for new Saber investors going forward.

There are pros and cons to the separate account approach, but generally speaking, from the standpoint of the investment manager, it is a low cost way to manage money, especially when the business is just starting out. Separate accounts don't require auditors, partnership tax returns, or third party administrators. However, the lower overhead does come with two drawbacks, one which is somewhat minor and one which is significant.

So, I made the decision to change to a fund structure for these two reasons:

First, it is simpler to manage money in one vehicle than in many different separate accounts. At the end of 2018, Saber Capital was managing over 80 different client accounts, and while the technology allows me to fairly easily manage these accounts using one strategy, it is still logistically easier to manage capital in one vehicle, especially given the fact that the third-party administrator and accounting firm handles much of the back office work such as onboarding new investors, calculating the fund's net asset value, distributing the quarterly statements, helping coordinate the audit each year, and preparing financial statements.

The second reason is really the main reason for my decision to transition from separate accounts to a fund structure: taxes. We were all paying higher taxes inside of separate accounts than we would have been had we been using the same exact investment strategy inside of a partnership. Saber manages \$24 million currently, and at this level the benefit of lower costs using separate accounts has been far more than offset by higher taxes.

#### **Your Tax Benefit**

The new tax law changed the rules regarding the deductibility of management fees. So, within a fund, the client doesn't pay tax on the gross return, he or she will pay tax on the net return. In a separate account, the client will pay tax on the gross return. This can have a meaningful tax drag.

Let's look at a simplified example. Assume someone is a high-income earner whose marginal tax rate, including state income tax, is around 43%. Let's also assume this client has invested \$250,000

in a separate account and pays an annual performance fee of 20% of the account's profits. Now, let's further assume that the account shows a gain of 20% one year (a \$50,000 gain). In this case, the performance fee would equal \$10,000 (20% of the \$50,000 gain).

In a separate account, the client can no longer deduct the \$10,000 fee. In a fund structure, the performance fee is technically not a fee, but an allocation from the LP's account to the GP's account, and that allocation is not taxable to the LP. The bottom line is the client would save over \$4,000 in this particular year. Obviously, for larger accounts the savings could be multiples of this amount.

The tax drag is made worse in the event that the account is fully invested, and a small amount of securities have to be sold in order to satisfy the performance fee. In a fund, no securities need to be sold, and thus no tax liability is incurred when fully invested. The performance allocation is simply shifted from the LP to the GP, making it a much more tax efficient transaction for both parties.

In my opinion, it no longer makes sense from a tax perspective to manage money inside of separate accounts, especially for higher income earning individuals.

### **My Tax Benefit**

It should be made clear that while the tax savings are not trivial for you as the investors, they are even more significant for my firm as the general partner, and thus for me personally as the investment manager. In separate accounts, Saber's performance fees flow through to me as earned income and are therefore taxed at ordinary income tax rates. But in a partnership, the performance fees are technically called a "performance allocation", and depending on the length of the investment holding, these gains are often taxed at capital gains tax rates. The difference in tax rates is meaningful. The highest tax rate for ordinary income is currently 37%, compared to the capital gains rate of 23.8% (this includes the ACA's 3.8% Medicare surtax). So, when Saber's portfolio has a strong year, the higher tax rate on the performance fee means a significantly higher tax bill for me.

The higher taxes associated with managing separate accounts were not significant when I started Saber Capital, especially considering the costs associated with running a fund. But at Saber's current level of assets, the benefit of lower costs using separate accounts has been far more than offset by much higher taxes.

The tax benefits on my end were the largest factor in my decision to make this transition, but after careful consideration, I do think it's a win-win for everyone (I wouldn't have made the decision had I thought it would be even a slight net-negative for investors).

### **Fee Structure**

To further that last point, I strongly believe the fee structure that the fund will use is significantly more attractive for investors.

As mentioned above, the fee structure for our fund is modeled after the partnership that Warren Buffett ran in the 1950's, prior to taking over Berkshire Hathaway. Investors in our fund will pay:

- No management fee
- A performance allocation of 25% of the profits over a 6% compounding hurdle

This is a very attractive fee structure for investors. Basically, you pay nothing for performance under 6%, and you only pay significant fees if there is significant performance (for example, I earn nothing for 6% returns, 1% for 10% returns, 2% for 14% returns, etc...). But importantly, I also have to recoup losses as well as any amount below 6% per year hurdle rate.

### **Compounding Hurdle Rate**

I think this last point is critical, as many funds use a hurdle rate, but very few funds have a hurdle rate that actually compounds. What this fee structure means is that your capital must earn 6% per year (compounded) from the most recent yearly high water mark before any performance compensation is paid. So not only do losses need to be recouped before fees begin accruing, but any deficit under 6% annualized returns have to be recouped as well. The high water mark is compounding at 6% per year.

For example, if you start with \$100,000 on January 1<sup>st</sup>, your capital account must reach \$106,000 by December 31<sup>st</sup> before any fees are earned. If the account ends the year at \$110,000, there will be a \$1,000 performance fee earned (25% of the balance over \$106,000). This is straightforward.

However, instead of a gain in that first year, let's assume the account dropped 10% to \$90,000. Since the account didn't end the year over \$106,000 (the 6% hurdle), there is no fee. But in addition, the account needs to recoup not only the \$10,000 loss, but now needs to exceed \$112,360 (6% over \$106,000). Let's assume in that second year, the account goes from \$90,000 to \$110,000, a 22% gain for the year. There would be no performance fee earned for the second straight year because the account was still below the \$112,360 threshold. In the third year, this hurdle compounds another 6% to \$119,102, and so on.

So, to summarize, the fee structure is very simple: your money must be growing at 6% per year from the previous high water mark for me to collect any compensation. Investors keep 100% of the profits up to 6%, and the profits over 6% get split: 75% to the limited partners; 25% to my firm as the general partner.

### **Summary**

I'm excited to have Saber Investment Fund open to outside investors, and I want to thank you for the trust you've placed in me as your investment manager. Many of you have been invested with me for a number of years, and it has been a real privilege to manage your capital. Please reach out to me with any questions on anything in this letter, or anything at all.

**Your Partner,**



**John Huber**

Managing Member

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