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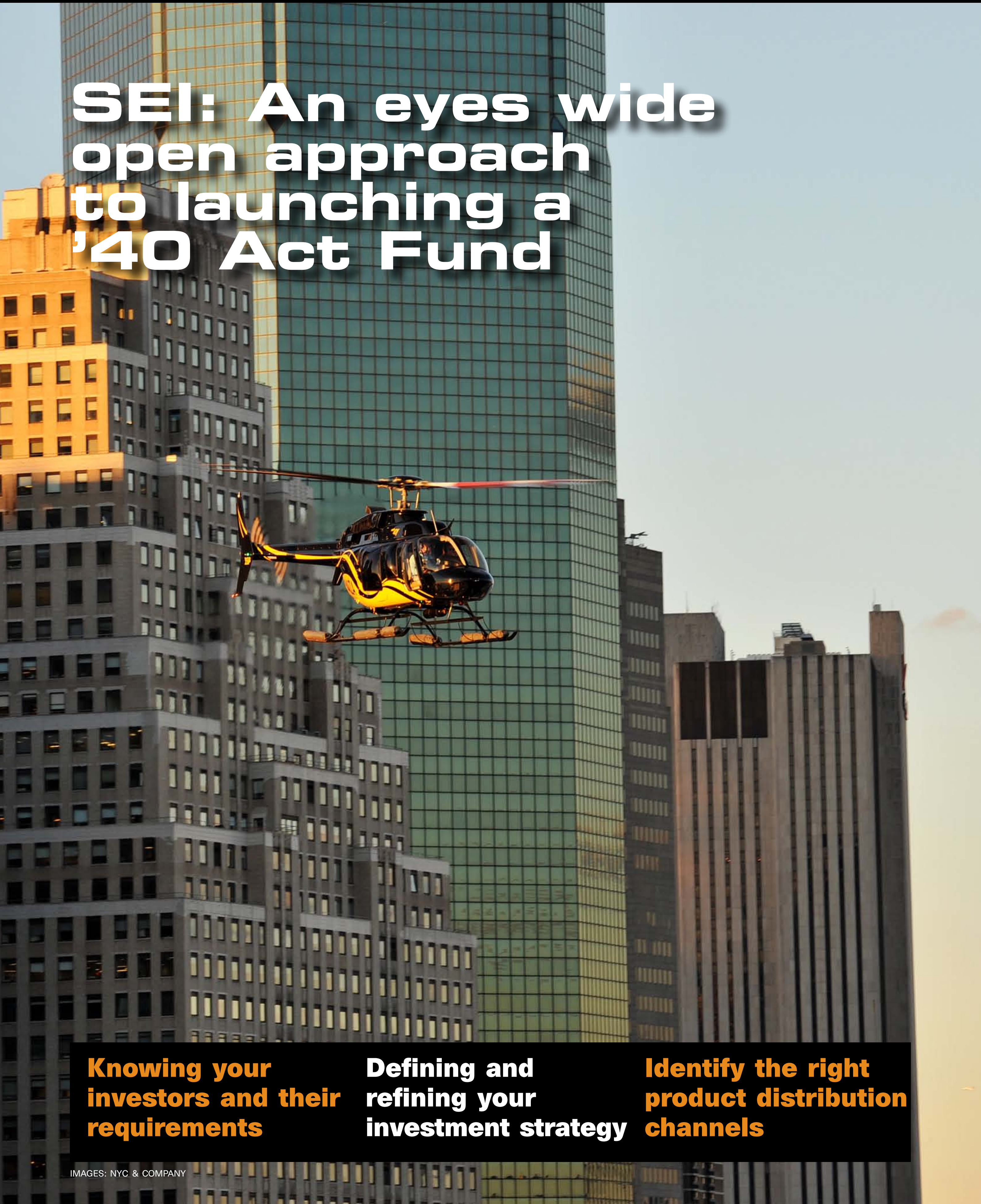

SEI: An eyes wide open approach to launching a '40 Act Fund

Knowing your investors and their requirements

Defining and refining your investment strategy

Identify the right product distribution channels

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SEI: An eyes wide open approach to launching a '40 Act Fund

By James Williams

Alternative mutual funds, also referred to as liquid alternatives or hedged mutual funds, are becoming a lot more popular with private fund managers. This has largely been driven by the requirement for hedge fund managers to register as investment advisers with the SEC. Prior to this, unregistered managers were not allowed to manage assets on behalf of US mutual funds. Now they can.

Last summer Fidelity's Portfolio Advisory Service invested USD1bn in the Blackstone Alternative Multi-Manager Fund, in addition to joining forces with Arden Asset Management to introduce a multi-manager alternative fund. This is a big opportunity for fund of hedge fund managers like Arden. By selling liquid alternatives as multi-manager '40 Act funds, it is helping to almost rebrand funds of funds, which have suffered a reputational hit since the financial crisis.

Aside from the multi-manager approach, single managers who have entered this space include Cliff Asness's AQR Capital Management, Highbridge and Carlye Group LP. The latter is currently planning to launch two products – the Carlyle Enhanced Commodity Real Return Fund and the Carlyle Global Core Allocation Fund.

As reported by the *Financial Times* in December 2013, total AuM in alternative mutual funds rose 45 per cent in the 12 months to 31 October from USD89.5bn to USD129.8bn. A report this month by *Strategic Insight* found that in the US, wirehouses saw the fastest growth in alternative fund adoption in 2013. Moreover, registered investment advisers (RIAs) were found to be the largest holders of alternative mutual funds with USD56bn in assets.

It is a seductive proposition for alternative fund managers to launch a '40 Act fund given that the size of the US mutual fund market is an estimated USD13trn.

"You have to be committed to doing it," says Jonathan Dale, director of distribution at SEI's Investment Manager Services division, a global provider of asset management, investment processing and investment operations solutions. "Those that are committed and prepared from the outset, and get their infrastructure in place for the long-term even though sales may be slow to start – those are the managers that tend to be the most successful."

To help EU managers deal with the complexities of launching such funds, SEI has produced a document entitled *Nine Key Considerations for European Managers Approaching the US Market*.

A few of the more salient points are presented here to give managers an insight into what is required before they should think about launching a '40 Act fund.

Jonathan Dale, director of distribution at SEI's Investment Manager Services division

Ross Ellis, Vice President and head of the Knowledge Partnership at SEI's Investment Manager Services division

Know your investor

What target market are you looking to tap into – Institutional, retirement or retail? What type of problem are you attempting to solve with a '40 Act fund? This is without doubt the most important question to consider as it will dictate all other aspects of the decision tree.

"It's important to start at the top. The manager has to be clear on the type of problem they are looking to solve for potential investors. The first step is to determine whether the focus will be on institutional, retirement or retail clients. Then next step is to break this down into investor sub-segment to determine whether they will be endowments and foundations, Ultra HNW investors, affluent or mass market investors," says Dale.

This will determine how best to package the product. For example, those managers wishing to focus purely on the retail investor will most likely need to establish an open-ended '40 Act mutual fund, a separately managed account or perhaps even an ETF. If the end investors are institutional, the manager might consider a registered private fund (known as 3(c)1 and 3(c)7 funds) which is structured as a collective investment trust and closed-ended.

One of the differences between a registered private fund and a '40 Act fund is that the manager is able to charge performance fees. Much like UCITS funds in Europe, a '40 Act fund will require the manager to offer daily liquidity and comply with leverage limits.

Ross Ellis, Vice President and head of the Knowledge Partnership at SEI's Investment Manager Services division, says that managers need to be careful that the LPs in their hedge fund are not compromised in any way, should a new fund be launched to tap into the US retail market.

He notes: "By definition, the private fund is exempted from '40 Act fund rules. Managers have to decide what it is they are trying to achieve: solve a specific problem for their investors or simply diversify their investor base and revenue stream? They need to ensure that they aren't cannibalising their hedge fund investors who typically pay them higher management fees as well as performance fees".

Whether a manager chooses to launch a '40 Act fund (or a '33 Act fund which offers slightly more flexibility by being closed-ended) will, broadly speaking, depend on the target investor.

"If the manager is looking for broad distribution flexibility then a '40 Act fund is generally going to be the best vehicle to do that," says Dale, noting that if they have limited or no experience in the US and are only looking to target a narrow band of investors (e.g. Ultra HNWs) then a private fund may be more suitable.

"It will allow you to start to build your brand story and relationships with RIAs," adds Dale.

What's your strategy?

Once the target investor has been identified, it is vital that managers think about their strategy. Will it be suitable for the target market or will it need to be significantly modified? For example, a statistical arbitrage hedge fund or one that is investing in distressed debt over a multi-year time horizon, is hardly going to work in a retail '40 Act fund structure.

Having said that, collective investment trusts and '40 Act mutual funds with target date durations are increasingly being favoured by consultants in the retirement

Targets, Packaging and Resources

Products: Global Macro; Statistical Arbitrage; Credit Arbitrage; Merger Arbitrage; Commodities; Distressed; Equity Long/Short; Market Neutral; Absolute Return; Managed Futures; Multi-Strategy

Market Segments	Packaging	Distribution Channels	Resources	Timing (approx.)
Target Market: Institutional				
Defined Benefit Taft-Hartley Endowments Foundations	Collective Trust ETF Limited Partnership Mutual Fund Separate Account	Direct Consultants Sub-advisory	Consultant Relations Team Key Accounts Portfolio Specialist	All Market Segments: 12-24 Months
Target Market: Retirement				
Consultant DCIO IRA	Annuities Collective Trust Mutual Fund Separate Account Mutual Fund Wrap	Consultants Retirement Analyst Teams Turnkey Asset Managers	Consultant Relations Team Portfolio Specialist DCIO Wholesaler Key Accounts Wholesaling	Consultant/DCIO: 36-60 Months IRA: 12-36 Months
Target Market: Retail				
Ultra HNW Affluent Emerging Affluent Mass Market	Annuities ETF Limited Partnership Mutual Fund SMA	Direct Family Offices Home Office Brokers RIAs	Key Accounts Portfolio Specialist Wholesaling	Home office/Broker/RIA: 36-60 Months Direct/Family Office: 12-36 Months

plan channel as they look for broader diversification via non-correlated strategies.

Entering the retail market requires a massive shift in mindset, especially for those managers who have no experience of running a UCITS fund in Europe. The US retail market, not to mention the registered investment advisers who sell products to their clients, is still in the early stages of understanding alternative strategies.

"Merger arbitrage is not that hard to explain conceptually – one company joins forces with another. But if you start talking about statistical arbitrage, complex credit strategies in distressed debt, volatility strategies, relative value strategies that perhaps involve three or four securities in one trade – those are more relevant for an institutional audience because they have the capacity to understand them and perform analytics around them," says Ellis.

Strategies like long/short equity, managed futures and multi-strategy are those most likely to work in a retail market.

Dale points out that if the strategy cannot comply with criteria such as strict liquidity rules and the use of derivatives and limited leverage under the '40 Act then it should not be considered for launch as alternative mutual fund.

"In the US we are starting to see more managers looking at a '40 Act closed-ended type structure (the '33 Act fund). This is not the same as a traditional closed-ended fund that launches as an IPO and sells shares on an exchange. It's basically a separate account-type structure where there are monthly subscriptions and quarterly redemptions. The liquidity provisions are less stringent and allow managers to do something a little more different from a strategy perspective.

"Not all fund platforms will allow these funds to be distributed, however, because of the technical aspects of trading that are involved," explains Dale.

One of the issues that has dogged certain managers in Europe when launching alternative UCITS products is style drift and tracking errors. This is because the strategy simply doesn't work well enough in such a regulated wrapper. If a manager tries to shoe-horn their strategy into a regulated structure, it tends to involve having to make too many compromises and modifications; hence the tracking error issue.

One significant piece of advice offered by Dale is that the manager should back-test a strategy if it has been modified via the offshore fund, and develop a track record.

"One of the things we've been talking to managers about is 'okay you're thinking conceptually about doing this but you can't just throw it out there and hope that the strategy works'. The manager should do lots of back-testing and run that amended strategy for an extended period of time to ensure that it does what it should be doing. Is it, for example, adding value in a non-correlated way?"

This is a critical point. Managers can't just jump into the US without evidence of the fund working. This will typically require having a three-year track record. They can't just launch a new fund and hope for the best.

"This applies to all managers, both US and European," says Ellis. "It's a distribution milestone that they have to meet. A three-year track record is often needed to meet the requirements and get on the radar screen of RIAs. Most advisers will want to know that strategy has been around for a good couple of years."

Distribution channels

For the ambitious manager, the first option is to go direct. In reality, this is a cost-prohibitive exercise for most managers and may not work unless they have one or two prominent LP institutional investors who can help introduce the manager to a select audience.

For the sake of simplicity, let's assume the manager is interested in a fully retail alternative mutual fund. There are a number of ways to begin but essentially the manager will need to have somebody that is going to be the owner of the key account relationship – i.e. with the Home Office.

In US parlance, the Home Office are basically the gatekeepers; research teams on fund platforms like Merrill Lynch, Morgan Stanley that act as key decision makers on product selection. All told, there are only a handful of intermediaries per channel that control the significant sums of assets split across the major wirehouses and RIA custodians e.g. Charles Schwab, Fidelity.

"The manager will need to narrow down those options and think about who are going to be their biggest advocates to help them to launch a '40 Act fund. Some of the firms that we talk to in Europe have good relationships with the wirehouses and that could be an area where the manager could look to get the product available as quickly as possible. But the downside to that is that a single wirehouse may have 15,000 – 20,000 advisers that the manager would need to connect with, so resources will inevitably be an issue" says Dale.

Then the question becomes – how will my sales structure be able to speak to that group? As referred to earlier, the fund strategy needs to have an established track record and be a certain size to pique people's interest.

"Our advise to managers is to be laser-focused on their distribution strategy and partner with one or two firms from the outset. Build advocacy within the Home Office or with a select group of advisers. At the wire level, you're going to want to set up shop where there are pockets of money; New York, Chicago, San Francisco, LA. That will require a vast wholesale force to service those clients effectively," comments Dale.

Also, make sure the fund is priced competitively to support the sale. Asset-based fees can range widely from 10 to 40 basis points depending on the channel the manager is targeting the fund in, as well as the selection of the appropriate share class. Who foots that cost? Does the manager take it out of the management fee (thereby lowering its revenue), add it to the fund (increasing the cost to the investor), or do a bit of both?

"If you add it on top, can you sell it competitively? Pick the intermediary you want to work with but understand how that relationship will work from a cost and revenue perspective," says Ellis.

Establish a brand identity

No manager hoping to break into the US will succeed without a strong brand strategy. They might be well-established in Europe but the best, and most conservative, approach is to assume that no-one has ever heard of you in the US.

It is therefore crucial to develop an effective marketing strategy that tells a story, shows the uniqueness of the firm and build education gradually with advisers. After all, the Home Office gatekeepers, some of whom require documented asset expectations from their RIA network, will base their decisions on what the RIAs are recommending.

The trick is to ensure that any new fund catches their eye and they understand it.

"If they haven't heard anyone asking for a particular strategy or particular fund, the manager is going to be sitting there waiting a long time. If they pique the interest of advisers by getting their message out into the market it'll help move things along," says Dale.

Not that this will necessarily mean establishing a huge sales force. In tandem with a good-sized sales team, working with a strong marketing and communications strategy can add real value to a manager's brand strategy. If the product is seen to be differentiated, and if the manager is only running a couple of strategies, it is a lot easier to build a brand as compared to a diversified manager looking to sell 10 different funds.

"It isn't in the platforms' interest to just keep adding more and more products," stresses Ellis. "Their job is to get products that investors are seeking and will sell. If the manager stands out from the crowd and is running a strategy that really is different from their peers and solves a certain problem, it will help. The competition is very tough and getting harder by the day."

Another factor in establishing the brand identity and getting buy-in from RIAs and wirehouses is the fund's track record. As mentioned above, any new fund will need to demonstrate a three-year track record; this is needed to get a Morningstar rating. Without a rating, the manager faces an uphill challenge getting on a platform. Having a sales force will be an expensive proposition, if not redundant, because if the funds aren't available for sale on the platform, they can't be sold to investors.

"Tie your brand awareness to the timeline that is set up for distribution in the US; that's typically going to require managers to have a three to five-year runway," says Dale.

For any European hedge fund manager that moves into the US alternative mutual fund space, the last thing they will want to target is an uneducated, relatively less wealthy and conservative investor (in industry parlance, often called generically "widows and orphans") getting mis-sold something with their name on it. Neither the fund manager, the platform or the adviser wants to be associated with the potential negative consequences of that.

"Any amount of money the manager might have earned up to that point will be washed away in an instant from bad press," adds Ellis. "Any time we work with a client to launch a product, we give them every piece of information and guidance possible to help ensure they are successful and are making informed decisions with their eyes wide open. Proper planning is essential to launch a '40 Act fund." ■

The Nine Key Considerations document can be read in full by clicking on the following link: https://www.seic.com/docs/IMS/SEI-IMS-9Considerations-EU.pdf