Alternative Ucits 2011

Management talent and distribution key to success

Is Ucits the right strategy for managers?

Will QIFs and SIFs spoil the Ucits party?
In this issue...

03 Management talent and distribution key to alternative Ucits success
By James Williams

06 Are Ucits funds the right strategy?
By Olivier Sciales and Rémi Chevalier, Chevalier & Sciales

11 Investor complacency creeping into Ucits
Interview with Chris Hawkins, Gottex Fund Management

12 Alternative Ucits prosper but will QIFs and SIFs spoil the party?
By James Williams

15 Distribution at the heart of MontLake
Interview with Cyril Delamare, ML Capital
Management talent and distribution key to alternative Ucits success

By James Williams

“The growth rate in alternative Ucits is going to remain substantial for at least the next two or three years. That for me is very clear,” says Eric Bertrand, Director of Schroder GAIA, the firm’s Ucits platform.

Broadly speaking, most managers choosing to launch a Ucits do so either on a banking platform or on an independent platform such as GAIA. “The objective of GAIA is not to be like an investment banking platform,” adds Bertrand. “We want to offer a limited number of products that
are packaged and feel the same as any other Schroders products and also avoid duplications of strategies."

BAML’s UCITS platform, MLIS (Merrill Lynch Investment Solutions), is currently the industry leader, managing USD2.3bn in AUM. The firm saw alternative UCITS developing as a trend three to four years ago following the 2002 introduction of UCITS III. “To take alternative strategies and put them in a regulated wrapper was an idea we felt would really take off and it has. By the end of 2011 our target is to be approaching USD3-4bn in AUM,” explains Miriam Muller, Head of MLIS.

This is slightly less than the USD5bn that MLIS targeted at the start of 2011. Muller says the reason for this is that when new funds are launched, investors will wait to see how it performs, adding that “in the early stages we find asset raising can be on the slower side”.

The quality of fund managers joining platforms like MLIS illustrates the extent to which this asset class is maturing. Already this year, Och-Ziff, AQR and Graham Capital have joined MLIS, whilst Paulson & Co and Traxis Partners have joined Deutsche Bank’s Platinum platform.

Currently, 13 funds are available for investment on MLIS. Muller confirms that a further four managers are due to launch: two sector funds (financial, sustainable resources), a merger arbitrage fund and a US equity I/s fund. “In the pipeline we have five more managers at various stages of onboarding including: liquid emerging credit, liquid distressed debt, commodity equities and an FX fund,” explains Muller.

Despite the size and scale of banking platforms, George Cadbury, Director of Asset Management at Merchant Capital, which runs an independent platform, emphasises that they’re not trying to compete with the banks, just provide something different. “We offer an open-architecture structure and aim to combine the independence sought after by the manager with quality infrastructure support to allow scalability,” says Cadbury.

Full service administrators like BNY Mellon are starting to profit as front to back office support for “newcits” accelerates. “BNY Mellon generates a significant revenue stream from these funds through our presence in the key UCITS domiciles of Ireland and Luxembourg,” explains Mark Mannion, head of relationship management EMEA, BNY Mellon Alternative Investment Services. As well as offering a portfolio management system which provides real-time performance data to clients, Mannion says they also provide the options to outsource mid-office functions “such as trade matching and confirmation, settlement and collateral management”.

“The sector will continue to evolve with product innovation increasing the number of hedge fund strategies that can be accommodated within a UCITS structure,” adds Mannion. Muller concurs, stating: “Certainly, we do, we always have and we continue to see this as a sector with a future.”

Matrix Asset Management has been running alternatives UCITS since August last year when it rolled out the Matrix Asia UCITS, managed by Rupert Foster. It now has three funds on its platform, having last week launched the New Europe UCITS fund. The other fund – Lazard Opportunities Fund – was launched last October. "We have a
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Are Ucits funds the right strategy?

By Olivier Sciales and Rémi Chevalier

Continued uncertainty regarding the provisions of the European Union’s Alternative Investment Fund Managers Directive, despite its formal finalisation on June 8, remains an important growth driver for the growth of Ucits funds offering alternative strategies. With the drafting of Level 2 measures to implement the directive in detail still months away at best, the lack of clarity is strengthening the appeal of Ucits to institutions as regulated vehicles.

An increasing number of alternative managers are rolling out Ucits-compliant funds to complement their offshore offerings. They provide a clear, transparent way not only to attract investors across Europe through the regime’s passporting feature, but thanks to their recognition among global regulators managers can capitalise on the popularity of Ucits in regions such as East Asia, Latin America and the Middle East.

Luxembourg remains unquestionably the leading European centre for Ucits funds. Many of the biggest European and global fund groups have Luxembourg-domiciled management companies and well-established local fund services relationships, making the grand duchy a logical domicile and service centre for alternative Ucits; anecdotal evidence suggests that the jurisdiction is home to as much as 60 per cent of this market.

The country’s muscle in the fund sector is reinforced by a highly qualified and skilled workforce, famously international and multilingual, in all areas of fund services from custodians and administrators to auditors and lawyers. And the sector continues to grow, with the trend toward new administrators setting up shop in Luxembourg continuing into 2011, while existing service providers are adding to their staff.

But a key opportunity for the grand duchy lies in the increasingly international distribution of Ucits, which has made the French term Sicav – open-ended investment company – a familiar expression among retail investors across broad swathes of South-East Asia.

The signature in 2008 of a Memorandum of Understanding between regulators in China (CBRC) and Luxembourg (CSSF) offering access to Chinese institutional investors to invest in Luxembourg domiciled Ucits, as well as the registration of Lux-domiciled Ucits in Latin American countries (ie. Chile, Columbia) underscores the way Ucits has grown into a global brand, suggesting that over the coming years non-European investment will continue to increase as a share of aggregate assets under management.

Alternative Ucits remain a relatively modest proportion of this huge global pool of assets – some USD128bn as of the end of September 2010, according to one report (although other estimates range from USD100bn to USD400bn). These figures suggest that at most Ucits account for 10 per cent of total hedge fund assets and probably rather less, and an even smaller proportion of the total USD5.8trn in Ucits assets under management.

Figures are understandably sketchy given the difficulty in establishing a precise and uncontroversial definition of alternative Ucits – or ‘Newcits’ – a term much of the industry hates but seems condemned to live with.

Participants are also having to deal with media comment about the development of an alternative Ucits bubble, although the steady rather than spectacular growth in assets gives this theory little support; so far at least. And while hedge fund managers may look to replicate aggressive offshore investment strategies within these onshore vehicles, the Ucits regulatory overlay is robust enough to provide broad protection against catastrophic blow-ups.

However, there is certainly a danger that retail investors may become confused about the risk-reward profiles of funds that use complex derivatives such as swaps to evade...
some of the investment restrictions inherent in the Ucits framework. The difficulty for retail investors in grasping all the implications of such structures – for instance, the creditworthiness of swap counterparties – is if anything a greater concern than the actual level of risk involved in these transactions.

Improved communication can certainly help allay these fears, something that the latest revision of the regime, Ucits IV which came into effect on July 1, seeks to address with its replacement of the voluminous and inappropriately named ‘simplified’ prospectus with the stripped-down Key Investor Information Document.

Inevitably national supervisors and the new European Securities and Markets Authority (Esma) will continue to examine closely how managers are using Ucits funds as vehicles for alternative strategies. However, the proposal by the French regulator, the Financial Markets Authority (AMF), to divide the category into complex and non-complex Ucits, as part of the second Markets in Financial Instruments Directive (MiFID), could damage the brand, in particular by impeding cross-border distribution in Asia.

The biggest risk facing alternative Ucits is reputational rather than financial. With assets under management still modest and monthly inflows relatively small, the publicised risks of bubble developing seem exaggerated. To put matters in perspective, bubbles normally occur because of illiquidity and excessive leverage, as with the 1990s’ dot com boom.

A more relevant criticism is the relatively weak performance of alternative Ucits in 2010 compared with offshore hedge funds. For example, the Absolute Hedge Ucits Index underperformed the Dow Jones Crédit Suisse Hedge Fund Index by 6.84 percent in 2010. This could be influenced by start-up and first-year operating costs, since much of the sector is relatively new, but also by tracking errors relative to the managers’ comparable offshore funds because of Ucits investment restrictions and liquidity requirements.

The obvious question is whether a hedge fund manager running between USD15m and USD20m in an offshore fund really needs an onshore vehicle too. Unquestionably, managers for which the benefit is marginal are jumping on the Ucits bandwagon. Given the extra costs and the burden of retail-class risk management procedures, some of them might be better off establishing a Luxembourg Specialised Investment Fund (SIF) instead.

Managers launching alternative Ucits with the aim of targeting institutional investors should reflect on various questions before taking the plunge. First, a Ucits requires at least twice-monthly liquidity, and hence redemptions; can the investment strategy accommodate this? Does the manager have the operational staff and infrastructure to handle Ucits-style transparency and reporting? And do they really need a European passport; what extra benefits will it bring?

The Ucits structure suits some strategies better than others; equity long/short strategies fit the investment constraints better than most. There are certainly advantages in an onshore vehicle, but they’re not a catch-all solution for everyone. Managers need to assess all the factors carefully.

One positive point could be Ucits IV, the latest update of the directive, which came into effect across the EU at the beginning of July. The most obvious improvement is that streamlined procedures for authorisation of cross-border marketing offer fund managers quicker time to market. They may also benefit from efficiency measures such as the EU passport allowing management companies to provide services to funds in other member states and cross-border fund merger provisions, although time will tell how much.

Managers should also note a number of other regulatory developments. According to article 186 of Luxembourg’s legislation of December 17, 2010, which transposed Ucits IV into national law as well as introducing other updates to the country’s fund regime, Ucits established before the January 1, 2011 have until July 1, 2012 to replace their simplified prospectuses with the Key Investor Information Document (KIID).

During the next update of their fund prospectuses, and at the latest by 31 December this year, Ucits must also comply with Esma’s guidelines on risk management. Finally, May 2010 guidelines from Esma’s predecessor Cesr, the Committee of European Securities Regulators, make a distinction between money market funds and short-term money market funds, which will require the updating of the prospectuses of Ucits funds falling into those categories.
simple strategy: where we see demand, and where we have the in-house capability, we’ll produce products like the New Europe fund. For those clients looking for strategies, which we don’t manufacture in-house, we look to partner with other managers. We don’t manage convertible bonds in Matrix and are delighted to partner with Lazard,” explains the firm’s CEO of asset management, Angus Woolhouse.

Matrix’s clients, says Woolhouse, have a clear preference for absolute return funds with a stable profile and a flexibility for a manager to deliver returns whether the markets are going up or down. They listen to what their clients want.

In their recent Ucits barometer study, ML Capital found that 49 per cent of investors surveyed wanted exposure to US equity I/s managers. This is a clear trend and one that MLIS, as part of BAML, is able to act upon perhaps more effectively than others. “Certainly many of the managers we’re working with are US-based. That continues to be the trend for us. Of those in the pipeline, only one is not US-based,” says Muller.

Schroders have a mix of internal and external funds on GAIA. Egerton Capital, CQS and Sloane Robinson each have Ucits on the platform, whilst GAIA Opus Multi-Strategy, a Ucits fund of hedge funds, is managed by Schroders New Finance. “We have another internal fund that’s still in the seeding stage called QEP, a quant-managed equity market neutral fund,” says Bertrand.

“Next year we have plans to roll out more internally managed funds, perhaps one to three funds over the next 18 months. But external managers will remain the driving force for some time.”

With USD69.1bn in AUM, Man-GLG is the world’s largest hedge fund manager. The majority of its Ucits are long only, with 10 alternative Ucits in the GLG range, and four or five in Man. Last month, the firm launched its first joint alternative Ucits: Man-GLG Multi-Strategy fund. “We’re positioning it as a best-of-breed product across the alternative Ucits offering within Man-GLG, we think this is going to be a major initiative for us,” explains Rhodri Mason, Head of Ucits Management, Man Group. “Not only can it allocate to our existing funds but it has the flexibility to allocate to any future alternative Ucits we launch as well.”

Branding is a key exercise for hedge fund managers looking to raise assets for these funds. Competing with the likes of Schroders and Man-GLG is no easy task.

Schroders’ GAIA Egerton fund has already reached USD500m, whilst three of GLG’s funds are above USD500m. “These are Man AHL Trend, GLG Alpha Select Alternative and GLG European Alpha Alternative, which has now passed the USD1bn mark. Several more have hit USD100m,” adds Mason.

Mason believes that to succeed in this sector, you need to be able to do two things: firstly, you’ve got to have solid alternative investment management capability. Secondly, you need an industrial-strength operating and distribution platform that can handle additional risk controls around Ucits and offer a brand that retail investors will recognise. “There aren’t many that can point to doing both well and that’s why Man-

“We have a simple strategy: where we see demand, and where we have the in-house capability, we’ll produce products like the New Europe fund. For those clients looking for strategies, which we don’t manufacture in-house, we look to partner with other managers.”

Angus Woolhouse, CEO, Matrix Asset Management

“The sector will continue to evolve with product innovation increasing the number of hedge fund strategies that can be accommodated within a Ucits structure.”

Mark Mannion, head of relationship management EMEA, BNY Mellon Alternative Investment Services
GLG is so well positioned. That’s the key to unlocking success in the alternative UCits space,” notes Mason.

Skyline Capital Management, established by Geoff Bamber and Vernon West last year, recently launched a global emerging market l/s UCits on ML Capital’s MontLake platform. On branding, Skyline CEO Vernon West comments: “It gets you noticed: for an early stage manager it’s necessary but not sufficient to secure inflows. Once you’re on the radar it’s all about performance. As a hungry, focused emerging manager, Skyline expects to outperform its peer group over time.”

On asset raising, Matrix AM’s Woolhouse says: “It has been difficult for everyone, but we’ve raised assets ahead of our expectations and we are hopeful of doubling assets by the end of this year.”

Issues remain over the performance of these “Newcits”. “The market environment is difficult. I’m surprised about macro (-0.31 per cent) and CTA as well (-1.51 per cent), although fixed income funds are holding their ground (+1.32 per cent). Most of the commodity funds with a directional bias are suffering although they had a good run at the start of 2011,” comments Louis Zanolin, whose firm Alix Capital generates the UCits Alternative Index. “I’m surprised at the dispersion of returns. Some are doing okay but the majority are quite weak. It’s a strange environment.”

“We’re positioning the new Man-GLG Multi-Strategy fund as a best-of-breed product across the alternative UCits offering within Man-GLG, we think this is going to be a major initiative for us.”

Rhodri Mason, Head of UCits Management, Man Group

of our investors and we’re a little off that so far this year. China has been sold off aggressively by the marketplace and it was our largest single country exposure so we were disproportionately affected by that sell-off,” adds Woolhouse.

Tracking errors are inevitable with UCits and certainly impact on performance, to some extent. “There’s no issue having differences between portfolios of a flagship and UCits provided those differences are clearly articulated,” comments Bertrand.

He confirms that the performance between the Egerton UCits and its offshore flagship is very satisfactory and expects the same for the CQS fund over time. “For Sloane Robinson we expect the tracking error to be slightly wider than for Egerton. A small part of its flagship portfolio in emerging markets is invested in smaller, less liquid stocks.”

With everyone waiting for a blow-up, platforms like Merchant are taking significant steps to ensure they remain “one of the most technologically advanced and controlled” according to Cadbury. One such development is the employment of a pre-trade compliance system, an automated traffic light system informing managers whether impending trades are UCits compliant or not. “Pre-trade compliance will soon become an integral part of the industry in reducing susceptibility to a blow-up,” says Cadbury.

“There’s a place in investors’ portfolios for the full range of products,” concludes Muller. “I think there’s a confluence of long-only funds versus alternative investments and with our alternative UCits products we’re seeking to fill this niche.”

“It gets you noticed: for an early stage manager it’s necessary but not sufficient to secure inflows. Once you’re on the radar it’s all about performance. As a hungry, focused emerging manager, Skyline expects to outperform its peer group over time.”

Vernon West, founder of Skyline Capital Management
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Source: Towers Watson Top 50 FoFs 2010

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Funds of Ucits hedge funds are a recent product development: the Gottex Absolute Return Fund, a multi-strategy product, launched 7th July 2010. As such, few have had the chance to produce eye-popping returns because in the time they’ve existed, the markets have been sluggish. “I think when equity markets improve you’ll find returns starting to pick up and investor interest will grow,” says Chris Hawkins, Managing Director and Portfolio Manager of Gottex Absolute Return (Ucits) Funds.

Alternative Ucits funds are easily understood, regulated, and transparent. Consequently, some investors are allocating directly to managers rather than paying a FoFs adviser to construct portfolios. Such investor complacency creeping into the market is due, in part, to the lure of regular liquidity and the imprimatur that comes with what is viewed by some as a government-approved product.

But as Hawkins points out: “People think of Ucits III as highly liquid funds, but they’re only as liquid as the portfolio of assets they represent. It’s easy to stick a weekly liquidity tag on a fund in benign markets, but we’ve yet to see these portfolios get tested in a situation like ‘08 where the ability to liquidate efficiently becomes challenged.”

As the alternative Ucits asset class has grown it has created unwanted elements of risk, principally surrounding liquidity, that retail investors may not understand. “The law of unintended consequences is very powerful in a product like this,” explains Hawkins. “We suspect there’s a lack of recognition of true risk and over-reliance on the stated liquidity terms. We have some concerns that there are funds where the potential of a liquidity mismatch to occur is under-estimated by a proportion of their investor base.”

What FoF providers offer is the ability to manage and understand risk and undertake in-depth due diligence on underlying managers. Hawkins says that when potential new clients are told that the difference in their due diligence of Ucits hedge funds versus offshore hedge funds centres on liquidity issues, eyebrows are often raised. “Understanding liquidity profiles and what the impacts would be in anything other than benign markets takes some skill, particularly in more exotic strategies like credit and arbitrage strategies. We devote a lot of time to this,” confirms Hawkins.

The ability to actively allocate across managers is important. “We’re at the point now where the market is getting saturated and investors are getting confused. The process of being able to research enough funds will become valuable,” notes Hawkins.

Gottex’s own FoUHFs uses a multi-strategy approach, which, in Hawkins’ words, is in keeping with the firm’s culture and philosophy. Since inception it has grown from 10 to 20 underlying managers and currently manages EUR14m in AUM.

The alternative Ucits industry, says Hawkins, has a lot of equity beta. Given that investors who choose to pick funds tend to stick with what they know, it’s understandable why diversification through FoFs can be useful.

“If you own a cross section of the Ucits universe you end up with poor performance. As we’ve seen in May and June, equity beta can hurt you. But if you have exposure to strategies that investors typically don’t tend to be comfortable with, like our multi-strategy fund, you get real benefits of diversification.”

Hawkins confirms that the best performing strategy in the fund’s portfolio, to date, has been credit, providing what he calls a good “volatility dampener”.
The last twelve months have done a lot to consolidate peoples’ views of alternative Ucits. Fund managers have started to wake up to the obvious benefits of having an onshore vehicle and the value that the Ucits structure can bring.

Every month new funds are being launched, transforming a sector that was once the preserve of equity I/s strategies into one populated by more diverse, complex strategies including event-driven, global macro, credit and CTAs. The emergence of John Paulson, Barton Biggs of Traxis Partners and York Capital illustrates the depth of hedge fund talent embracing Ucits.

Net inflows into Ucits, YTD, are EUR51bn. Total industry AUM is EUR5.88trn, but "Other Ucits", including alternatives, still represent a tiny portion of the market: 6 per cent, equivalent to somewhere between USD300bn and USD400bn.

There are roughly 400 funds, growing in response to institutional demand for regulated hedge fund-lite products. "In the last two quarters 50 per cent of net inflows into hedge funds came from institutional investors and this trend is growing. They have a preference for regulated structures," comments Olivier Laurent, Head of Hedge & Structured Fund Group, RBC Dexia.

One of the catalysts behind this growth is a desire for managers to circumvent the AIFMD which, in 2018, will make it difficult to market offshore funds as private placement regimes. "It’s difficult to imagine European institutions going for Cayman funds because it won’t be possible to do active marketing. Over time, regulation will be a key driver for the growth of regulated structures," adds Laurent.

Peter de Proft, Director General of EFAMA, thinks the hype surrounding alternative Ucits
is cooling down: “There’s a much bigger rise in ETFs so things need to be kept in perspective. The growth of ETFs is much more important than alternative or AR UCits, call them what you will.”

“Absolute return funds use derivatives and are certainly not a new product consideration. They’ve been around for a long time,” adds Gary Palmer, Chief Executive, Irish Funds Industry Association (IFIA).

The size of alternative UCits, relative to the offshore funds they seek to replicate, remains surprisingly small. Paulson & Co, a multi-billion dollar fund manager, launched its DB Platinum IV Paulson Global Fund with around USD100m: tiny in comparison to the Paulson Advantage fund.

Assets remain modest for two reasons: firstly, overall performance is flat. The Alternative UCits Global Index has returned 0.17 per cent this year, while hedge funds are up 1.96 per cent: a significant 10-fold performance swing. The same was true last year. Secondly, although “Newcits” are being snapped up by retail investors, big institutions and their chequebooks remain largely in the shadows.

“It’s reassuring to have the protection of UCits but they didn’t go for it before because it’s not what they needed. Some say that ideally they wouldn’t invest in UCits but they have constraints that push them to do so,” comments Samuel Sender, Applied Research Manager at EDHEC-RISK Institute, whose research is sponsored by CACEIS as part of the research chair “Risk and Regulation in the European Fund Management Industry”.

Some worry that strategies are getting too complex. De Proft confirms that a recent meeting of the European fund classification working group was held at EFAMA to assess the different types of funds within the UCits framework. The French regulator AMF proposes to classify them into complex and non-complex UCits.

“The important phenomenon right now is that regulators are paying attention to investor protection, particularly retail investors. They’re assessing what type of funds are being sold to them, that the strategies are not too complicated to understand, and I think that’s very important,” says de Proft.

ESMA is currently looking into the issue, something EFAMA welcomes. “We have excellent relations with ESMA,” adds de Proft. “We have confidence they and national regulators will continue to enforce UCits requirements for all UCits managers in an adequate manner and maintain a level playing field.”

Fund centres like Ireland and Luxembourg are benefiting from the way the industry is evolving, and will continue to so under the UCits IV directive, which will encourage even more efficiency and transparency.

The evolution of the UCits framework has allowed Ireland to develop into a well-established domicile for internationally distributed investment funds, both in the UCits and more flexible QIF structure.

According to Palmer, unrivalled depth and breadth of expertise and experience are the hallmark of its industry, not to mention innovation: it was the first jurisdiction to introduce regulation for alternative investment (QIFs).

“We’re always looking to anticipate the next wave of industry requirements, whether that be thought leadership in the servicing of funds, or in the legal, regulatory and tax frameworks for product development,” explains Palmer, citing the development of its legal framework to provide tax certainty for UCits funds as a recent example.

The Association of the Luxembourg Fund Industry (ALFI) is pleased with the growth of UCits funds according to Deputy Director General, Charles Muller, although he admits some are more risky and less adapted to the needs of retail investors. “We believe that if these funds use the “UCits brand”, it’s because there’s currently no alternative providing a European passport,” explains Muller.

Luxembourg is the leading centre for cross-border fund distribution. According to Lipper-PwC figures, it’s home to over 75 per cent of “true” cross-border funds. “Luxembourg is truly international both in terms of asset management companies and workforce; half are foreigners. A quick implementation of UCits IV last December demonstrated our leadership role,” adds Muller.

With 80% of Ireland-domiciled funds being UCits, Palmer expects the increased attractiveness of UCits IV to provide a
MontLake delivers the optimal solution for hedge fund managers looking to launch their own UCITS fund. Coupled with the highest standards of corporate governance, operational excellence and superior client service, MontLake provides managers a fast and cost efficient route to market. MontLake’s key differentiator is its distribution strength, offering the largest independent sales network in the industry - setting the benchmark for alternative UCITS funds.

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A product from ML CAPITAL
Distribution at the heart of MontLake

Interview with Cyril Delamare

Come September, ML Capital’s dedicated UCITS platform, MontLake, is on target to have four funds operating on it, in what is so far turning out to be a good year for the Malta-headquartered firm. It was announced this month that Skyline Capital Management will launch a global long/short emerging market UCITS and follows the earlier announcements of DUNN Capital Management and New York event-driven manager, Para Advisors.

MontLake was launched in Q4 last year specifically to attract hedge fund managers like those listed above. “One of the key drivers of managers coming to us is they can see we have an in-house sales force working exclusively on MontLake. Few independent platforms, if any, can boast of having a dedicated 10-strong sales team. This is one of the platform’s key differentiating factors,” says ML Capital’s CEO and Head of Global Distribution, Cyril Delamare. As well as managing MontLake, the licenses, and handling compliance and risk management, ML Capital also acts as a fund manager’s distribution arm in Europe.

Delamare is quick to point out the value of this proposition. Notwithstanding the need for state-of-the-art technology and quality staff, just being a platform provider means you quickly become a commodity. “If you want to open up your business, distribution is where you bring in significant revenues and differentiate yourself with unique access to certain clients and demographics,” explains Delamare, who adds: “Distribution is at the heart of launching UCITS funds on MontLake. We’re not looking to be a hotel but a boutique that launches UCITS funds in response to investor demand.”

ML Capital has distribution offices in London and Geneva and operates in a number of core countries including: the UK, Ireland, France, Switzerland and Italy. Given that UCITS has been around a long time, distribution channels are well established. Delamare’s sales team in the UK, for example, targets IFAs, fund platforms and UCITS FoFs where retail investors dominate alternative UCITS.

By comparison, France has few IFAs. Much of the business is done with institutional investors such as pension funds. “It’s a completely different demographic and approach to selling products,” says Delamare. A fund manager that chooses MontLake knows that both sides of the investment market are therefore covered.

The real opportunity and challenge for alternative UCITS funds is to take market share from the well-established and marketed traditional fund houses. Delamare makes the point that the biggest alternative UCITS fund raisings last year were achieved by the behemoth mutual fund groups and not hedge fund groups. Branding is key to this.

Understanding exactly what strategies investors want saw the firm produce a UCITS funds barometer – a quarterly survey – earlier this year. “On the one hand it’s a tool that allows us to keep in contact with investors and on the other hand it’s market intelligence,” explains Delamare.

The same 50 investors representing different demographics investor types and countries take part in the survey. The last survey found that 49 per cent of investors wanted to allocate to US equity long/short managers. This market intelligence is helping ML Capital choose its next wave of fund launches, although Delamare admits that they’ve yet to find the right candidate in the US equity long/short space.

“UCITS now is a structure you need to have if you want to raise assets in certain demographics,” concludes Delamare.
“significant opportunity”: “We’ve been working with our Central Bank colleagues to ensure the requirements under UCITS IV are well understood. The industry over the last two years has been working towards that.”

De Proft thinks the KIID document is the key provision in UCITS IV: “It’s a clear document that will hopefully be the standard for all retail products.” He admits that it is too soon to decide how well the master/feeder provision will work, stating: “Co-operation between regulators is key and is already well established.”

The danger with alternative UCITS is that fund managers may be jumping on the bandwagon. The risk, moving forward, is that low quality managers will sell UCITS products with a high hedge fund fee structure. Although robust enough to protect against blow-ups, the possibility remains that the global recognition UCITS enjoys could become compromised. “The risk is that good quality guys remain unregulated hedge funds while those not able to survive could go for something that is easy to sell,” opines Sender.

De Proft is unconcerned about a blow-up because as gatekeepers of the UCITS brand “we’re looking at what’s going on in the market on a daily basis with ESMA and the regulators. We want to avoid possible accidents, that’s why all these exercises are being done.”

One emerging trend is fund managers using total return swaps (TRS) to replicate offshore strategies, rather than investing directly in the underlying securities. A recent report by Alix Capital found that 63 per cent of investors had reservations. A TRS is one of the methods of getting around UCITS limitations, given that managers are restricted by the assets they are allowed to invest in.

Unlike the flexibility of hedge funds, UCITS present two sorts of limitations: firstly, not all strategies (eg. distressed debt) can be packaged in UCITS; secondly, managers cannot directly access assets like commodities, nor can they directly short sell. They therefore rely on derivatives, which creates an added layer of costs.

“Some UCITS restrictions such as short-selling can be avoided with the use of derivatives. You can package a lot of things that way, but it comes with additional fees,” explains Sender. This isn’t altogether ideal for investors as it impacts on fund performance.

With the AIFM Directive looming large, another interesting trend is emerging: QIFs and SIFs being preferred to UCITS. RBC Dexia, in their last report, found that 77 per cent of fund managers who don’t yet have a UCITS would consider these alternative structures. Laurent says he was a little surprised by the percentage, but it could be that managers want to perfectly replicate their offshore strategies, which is possible with a QIF.

Tracking errors under UCITS are unavoidable given its limitations, but Laurent believes that one of the key advantages “Newcits” has over QIFs and SIFs is the ability to sell to retail investors. In jurisdictions like France, pension funds are restricted from investing in these non-UCITS structures. “For hedge fund managers it might make more sense to have a QIF, but the distributor may try to convince him to go for a UCITS structure instead,” says Laurent.

“In 2010 there was a 33% increase in the value of assets in Irish QIFs. If one looks forward and with the anticipation of AIFMD, it’ll provide a passportable non-UCITS product. Maybe in a number of years’ time we’ll be talking about an AIFMD non-UCITS product framework in the same way and with the same success as UCITS,” says Palmer.

The industry will likely see managers choosing co-domiciliation as the regulatory environment evolves, maintaining their offshore Cayman vehicles whilst at the same time running an onshore UCITS or QIF.

“Where I’m a little worried regarding sustainability of the Caymans model is for mid-sized hedge fund managers as they try to grow their onshore and offshore funds,” says Laurent. He concedes that some of these managers might move completely onshore to control costs. Alternative UCITS are set to dominate the industry as a portfolio diversifier, but they won’t eclipse the offshore market.

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