Liquid Alternatives 2015
EU and USA opportunities for managers and investors

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Liquid alternatives market continues to evolve on both sides of the Atlantic

By James Williams

As the level of convergence continues to rise amongst traditional long-only fund management houses and hedge fund managers, the liquid alternatives space has emerged to become one of the most dominant structural developments in the funds industry. In Europe, the alternative UCITS space continues to attract managers yet as James Jardine-Paterson, Business Development at Dalton Strategic Partnership observes, this is still very much a young industry. “There’s a lot that can still develop. For example, we’ve launched an enhanced UCITS fund that offers the same strategy as our flagship Melchior European Absolute Return UCITS Fund but with almost double the leverage.

“When we first entered this space, low leverage and low volatility appealed to investors. Over the last five years, we’ve noticed a rising interest among investors for a higher return profile and greater tolerance for risk. Generally speaking, that requires more sophisticated clients who understand how that fits within their portfolio,” says Jardine-Paterson.

Lyxor Asset Management bided its time before exploiting the liquid alternatives trend but in the last couple of years it has enjoyed significant traction in the Lyxor Alternative UCITS platform, which offers alternative UCITS funds in a managed account format to institutional investors. The platform now has EUR1.6 billion in AUM. There are nine
funds in total, six of which are external managers including the likes of Winton Capital, Chenavari, TIG Advisors and Canyon Capital Advisors.

“ARMA 8, a multi-strategy fund, and Epsilon Managed Futures fund are both internal single managers and we also have an internal multi-manager fund called Lyxor Select Edge,” says Daniele Spada, Head of Lyxor MAP. “UCITS is the area today where we are focusing our selection process and putting a lot of effort into our onboarding capabilities. We have another US equity manager in the pipeline with a focus on special situations, which will launch by the end of Q3 2015, and we also working to onboard a global macro manager.”

For Europe’s alternative UCITS industry to consolidate its growth, managers who are running strategies in the EUR100 million to EUR1 billion range need to attract assets. Currently, the likes of Standard Life Investment’s GARS fund, which has approximately GBP25.9 billion in AUM, dominate the market. However, as mid-sized hedge fund managers continue to build strong track records and larger funds start to soft close, the opportunities could be substantial.

London-based Skyline Capital Management launched the Skyline UCITS Fund in 2011 on the MontLake Platform, managed by ML Capital. The fund, which pursues a global emerging markets long/short equity strategy, has grown its AUM to USD180 million. Since inception, the fund has generated total returns of 47.4 per cent compared to 10 per cent on the MSCI EM Index.

Obviously there were significant headwinds in 2014 given the Russia crisis in Ukraine, which impacted Skyline’s Eastern European book; both in equities and FX.

“FX was a driver of negative performance in the fund during 2015. The Russian Ruble and the Brazilian Real caused large movements in emerging market currencies throughout the course of the year. Then, specifically in the second half of the year, we had to deal with the crude oil sell-off, which hit emerging market oil exporters,” explains Harinder Hundle, Partner at Skyline Capital.

This led Skyline to make adjustments to the strategy to further protect the downside.

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James Jardine-Paterson, Dalton Strategic Partnership

This was achieved by reducing the fund’s gross and net exposure through an adjustment in beta calculation, which has meant that realised volatility in the strategy is now less than half the index on a YTD basis – 7 per cent versus 15 per cent.

“We’ve basically dialled back risk in the portfolio to 2010-13 levels,” says Hundle. “The other big change we’ve introduced is event risk currency hedging on EM currencies. We started doing that from 1st January 2015 and it has made a meaningful difference to volatility and returns.”

Hundle says that despite recent volatility there is significant upside potential in emerging markets, noting that it is important for investors not to take a homogenous view of the asset class. “We are paying close attention to the big rotation out of commodity export-driven economies to domestic consumer-driven economies. China has seen a huge movement of labour from farming to urban but that supply is reducing.

“This has led to wage inflation and increased the level of conspicuous consumer spending. Outbound EM travel is a big theme with the portfolio.

“We also like the automation sector in China as it becomes more robotics-focused and productivity improves. We are investing in robotics companies going into China,” confirms Hundle.

India is actually the biggest single country weighting in the fund. According to Hundle, India will move to a higher level of growth than China and will be more of an infrastructure story – essentially what China has been doing the last 30 years.
Buyer beware –
addressing modern risks

By Robin Sarkar

In the case of liquid alternatives, investors would be especially smart to pay heed to an age old piece of advice: buyer beware. That’s because, despite their differences when compared with traditional alternative investment vehicles, liquid alternatives present higher risk factors, such as the use of leverage and illiquid securities, than do conventional mutual funds. As investors consider whether liquid alternatives make sense for their portfolios in light of their particular investment goals, they should educate themselves about, and monitor, the risks that underlie these funds.

For example, it’s critical to be familiar with a fund’s investment structure and to identify the risk elements it presents. Liquid alternatives require active management, calling for investors to focus carefully on suitability and experience. In addition, investors should understand a fund’s expense ratio and the components of its fee structure to determine their potential impact on performance. Liquid alternatives also point to the value for investors of turning to risk analytics tools tailored to the unique features of these funds in light of the specific requirements of each portfolio. This is especially important given the inadequacy of risk measures applied to conventional investments.

The UCITS alternatives market already provides a useful opportunity to review lessons learned from investors’ experience with liquid alternatives so far in Europe. These risk-related lessons, addressed in UCITS V, emphasise the importance of ensuring independent and conflict-free depositaries with custody of a fund’s assets, tightening up due diligence rules for depositaries, clarifying compensation policies for fund managers, and revisiting sanctions for violations.

This increased use of alternative investment strategies by registered funds is also catching the regulators’ attention. Over the last five years, alternative strategies have grown significantly – more than 30% in the past year and projected to account for 14% of total mutual funds and the wider UCITS market in Europe over the next five to ten years. Another trend is the growing use of derivatives, both in volume and complexity.

In December 2014, Mary Jo White, Chair of the Securities and Exchange Commission, spoke at The New York Times DealBook Opportunities for Tomorrow Conference. She highlighted upcoming enhancements to risk monitoring in support of the SEC’s long-standing mission to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation.

The SEC has regulated the US asset management industry since the passage of the Investment Companies Act in 1940, and White emphasised that evolution is necessary to keep up with market trends and lessons learned from the past financial crisis. The SEC will continue to assess the industry and ensure that firms are addressing the risks of modern portfolio composition.

As the SEC reviews these new strategies and products, they’re recalibrating the rules to address potential risks. In her speech, White set the stage for regulatory changes in 2015 to address modern concerns such as liquidity risk, leverage limits, market exposures, enhanced reporting and fund disclosures, and board oversight obligations.

The Office of Compliance Inspections and Examinations (OCIE) has been conducting national sweep exams of large fund managers and advisors managing registered alternative funds, as a first step towards enhanced regulation. The goal is to gain
insight into how fund managers are planning and executing their own risk management framework procedures within the 1940 Act recommendations around key areas like liquidity, leverage, disclosure and board oversight duties.

While White foresees significant work before final rules are in place, the SEC’s Guidance Update on risk management in changing market conditions reveals potential enhancements. In their update, they review several systematic risks, such as potential interest rate increases, reduced market-making capacity and resulting liquidity issues that might arise.

European regulators are similarly putting pressure on fund managers to explain to investors that liquidity in the fixed income market is low. The UK’s Financial Conduct Authority (FCA) issued a warning last July asking investors to consider various risk factors associated with corporate bond funds, including their ability to withdraw money during difficult market conditions. BaFin, the German regulator, stated in April it recognises that low liquidity in bond markets could have a severe impact on the liquidity profile of a corporate bond fund. The Authorite des Marches Financiers, France’s financial regulator, highlighted the current exceptional market conditions to compliance and risk officers at a March industry convention.

Hedge fund managers are advised to consider the potential market volatility when planning mutual fund strategies, and should consider portfolio composition, concentrations, diversification and liquidity. Fund managers should plan to meet redemptions during both normal and stressed market conditions and assess potential fund liquidity over 1-day, 5-day, and 30-day periods. It is also important to communicate with oversight committees or fund directors, to keep them informed of risk exposures and the liquidity position of the fund, and the fund’s ability to manage through a potential crisis.

State Street can help directly address several of the regulators’ key concerns leveraging our proprietary Global Exchange risk management platform. Our liquidity risk reporting solution allows clients to assess overall fund liquidity and their ability to meet potential funding liabilities, such as redemption requests, in both normal and dislocated markets. Reports are tailored to meet specific requirements, and detailed background information on the outcomes of each test is provided to deliver additional insight into the impacts of different types of liquidity events.

Our turnkey solution manages the data aggregation, data quality and delivery of these oversight reports on a daily basis, providing timely and easy to consume transparency across all strategies. These reports can be used to help fund advisors in multiple ways ranging from investment decision support to effective board communication.

With over $3 trillion of assets processed across client portfolios, we attribute our success, in part, to a service model that equally emphasises end-to-end data management, advanced and evolving technology and client customisation supported by seasoned investment, risk and data management professionals.

As the OCIE finalises all of the information from the recent sweep exams, it appears Chair Mary Jo White and the SEC will be translating recommendations into commission action.

In May 2015, the SEC proposed new rules and forms as well as related amendments to various existing rules and forms to modernise the reporting and disclosure of information by registered mutual funds. The Proposed Rules include two new reporting forms (Form N-PORT and Form N-CEN) and requires more frequent detailed disclosure of holdings information including but not limited to information about the pricing of securities, repurchase agreements, securities lending, counterparty exposure and terms of derivative contracts.

The SEC also requires information relating to certain risk metric calculations that measure a fund’s exposure and sensitivity to changes in market conditions including changes in asset prices, interest rates and credit spreads. State Street is committed to providing industry-leading solutions to these new reporting proposals across several thousand in-scope mutual funds that we service, including over 40% of the US liquid alternatives market.
“India is still playing catch-up. It offers plenty of upside,” adds Hundle.

The beauty of liquid alternative funds is the ease with which they can pull out of markets during periods of dislocation.

In 2014, there were four significant sell-offs when equity markets dropped sharply, during which the Melchior fund did not participate, which was a function of net exposure management and short alpha. Whilst being largely market neutral during 2014, straight after each of the sell-offs the fund built a net long position to benefit from the subsequent rebound.

“It was about being flexible with the net which is something we’ve always believed in,” says Jardine-Paterson.

Currently, the fund has a 13 per cent net short exposure to the market.

“The fund’s net exposure is as much a function of single stock opportunities as it is a wider expression of our macro views. For example, our net short position at the start of June 2015 was as much a reflection that the portfolio manager, Leonard Charlton, had concerns about global markets as it was that the number of short ideas we were finding suggested significant alpha opportunities from our shorts,” adds Jardine-Paterson.

On the long side, stocks such as Pandora, a Danish jewellery company, have done well whilst at the sector level, the food and beverage sector contributed to some good shorts in 2014, according to Jardine-Paterson. As well as generating alpha on the long and short side, the Melchior European AR fund also uses a tactical trading overlay.

A good example of this was Shire, which became the focus of a potential takeover in Q3 last year.

“Having held as a long position for fundamental reasons since November 2013, when the bid was announced we significantly reduced our position and took profits. A month later the bid collapsed and at that point we bought the stock again as we believed the fundamentals remained intact,” recalls Jardine-Paterson.

Over the last four years, there’s been little for the eurozone to shout about.

Earnings revisions have been largely negative but according to Stefano Girola, who co-manages the OYSTER Market Neutral Fund with Giacomo Picchetto at SYZ

“We’ve basically dialled back risk in the portfolio to 2010-13 levels. The other big change we’ve introduced is event risk currency hedging on EM currencies.”

Harinder Hundle, Skyline Capital

Asset Management (Suisse) SA, there are early signs that this trend is turning.

"Q1 showed some very encouraging earnings potential," says Girola. “There are a number of stocks in southern European markets that we didn’t touch before but are now recovering and becoming part of our investment consideration. Retail banks feature strongly in the portfolio for example. We are long banks such as KBC, a Belgium bank, and short Irish banks.

“Another theme that has worked well this year is asset gathering businesses. In Italy, 10-year government bonds have fallen to low levels and this has led to a huge amount of money flowing into mutual funds. Companies such as Anima and Fineco Bank are collecting a lot of new assets from retail investors and we’ve done well out of these trades,” comments Girola.

The OYSTER Market Neutral strategy looks to identify alpha opportunities by focusing on stocks where the team believes that consensus earnings are too low (and therefore expect a future upgrade) and shorting stocks where it believes the earnings numbers on the Street are too high.

As part of the investment process the team uses various models that score companies listed on the STOXX 600 Index based on three factors:

• The change in consensus earnings over three months
• P/E multiples
• Price momentum.

“We prefer stocks whose price has gone up over the last three months together with earnings. We never buy stocks where consensus earnings have gone up in the last three months but the stock has gone down. We need to see a correlation in place between price movement and earnings expectations movement,” says Girola.
Lyxor Asset Management operates the largest commingled hedge fund managed account platform (MAP), but over the last couple of years it has made inroads to build out a similar offering in the UCITS space.

The Lyxor Alternative UCITS platform has seen its stable of funds grow to nine in total – six external single manager funds, two internal single manager funds and one internal multi-manager fund. Through May 2015, the platform had a combined AUM of EUR1.6 billion.

At the end of 2014, Capricorn Capital Partners launched the Lyxor/Capricorn GEM Strategy Fund – a global emerging markets long/short strategy. Then, in March 2015, the Lyxor/Corsair Capital Fund, a US long/short equity strategy, became the first to offer daily liquidity on the Lyxor platform.

The latest fund, which launched 19th June, is the Lyxor/Chenavari Credit Fund, a long/short credit fund with a European focus.

"Over the last 12 months we’ve looked to add funds in strategies that were under-represented in the overall UCITS investment universe to offer diversification benefits that investors won’t find elsewhere," explains Daniele Spada, Head of Lyxor MAP in Paris.

"Our strategy is one of quality not quantity. The funds we select are based on what we think could work effectively in the current macro market environment and into which investors will want to allocate."

This is all part of Lyxor’s long-term strategy to offer global investors the opportunity to invest in multiple fund structures that best suit their needs; these could be traditional hedge funds, onshore AIFMD regulated funds or alternative UCITS. All three are important areas but Spada confirms that a great deal of focus is going into expanding its UCITS managed account fund range.

“It is a strong area of growth but we are also working to offer our investors AIFMD-compliant funds. We launched our first AIFMD-compliant CTA manager – Quantmetrics Capital – at the end of 2014 and we are preparing to launch another two funds,” confirms Spada, stating that both the UCITS and AIFMD platforms are complementary to its hedge fund MAP.

“With respect to UCITS, it allows us to enlarge our investor base. Some institutions are happy investing in our traditional MAP but others are finding out more about the UCITS funds we offer. These are strategies that are of interest to large institutions,” adds Spada.

“We are looking for best-in-class investment managers in strategies that we favour in the UCITS space,” notes Spada. “We have to make sure that the manager and the strategy we are considering have the characteristics to perform well in a UCITS environment. We don’t want to force a manager to modify their strategy too much in a way that would hinder their investment edge. That’s why the recent additions are managers that were not previously on our Lyxor MAP.”

The Lyxor Alternative UCITS platform is undoubtedly going to be an important growth driver moving forward as investors – both private banking clients and large institutions – look to add alternative strategies into their portfolio mix.

But as Spada notes in conclusion, it’s not just investors who are driving demand: “Managers who were previously reluctant are speaking with us to discuss the possibility of co-launching and co-distributing a UCITS vehicle on our platform. They realise that they can target a new investor base through a UCITS version of their programme.”
Currently, the fund is up 2.5 per cent. However, like Dalton Strategic Partnership it also runs a higher octane, leveraged version of the strategy, which has an 8 per cent (rather than 4 per cent) volatility target. This fund is up 6 per cent YTD.

“Historically, we’ve made 40 per cent of the alpha on the short side since the fund’s inception,” adds Girola.

Growth in the liquid alternatives space is not limited to Europe, where the market is being driven by single manager funds. In the US, the ‘40 Act alternative mutual fund market is also growing rapidly – indeed with more than USD300 billion in AUM it has overtaken Europe’s alternative UCITS market – and is largely dominated by blue-chip asset managers such as BlackStone, Fidelity and Neuberger Berman offering multi-manager products. These typically comprise 10 to 15 hedge fund strategies where each manager is appointed as a sub-advisor.

These products are targeting the retail market – unlike alternative UCITS which are still the preserve of institutional investors – and whilst they are a fantastic opportunity for regular investors to get hedge fund exposure, these products are watered down, ‘hedge fund-lite’ versions of offshore strategies.

“Fee compression is happening due to the growth of liquid alternatives,” says Brad Balter, CEO of Balter Capital Management, which is disrupting the ‘40 Act alternative mutual fund space by targeting institutional investors – not retail investors – who want genuine hedge fund performance in a more liquid format.

“When a hedge fund goes to 1.5 and 17 if you do the math it is still too one-sided in favour of the hedge fund manager. So the way fee compression has to happen is through liquid alternatives. When you construct one of these liquid alts how do you ensure that you are offering the same thing to the end investor? That’s where we come in.

“Our determination when entering the market was this: we can’t do this unless we’ve got a minimum of USD100 million in each fund. Second, the manager has to agree to pari passu the strategy or convert their fund. We started our first fund in 2014 – Balter Long/Short Equity Fund – which focuses on the small-cap market,” says Balter.

The fund comprises four managers - Apis Capital Advisors, Madison Street Partners, Midwood Capital Management and Millrace Asset Group – but the plan is to launch a series of single manager alternative mutual funds going forward.

Indeed, on 27th May 2015, the firm launched the Balter Discretionary Global Macro Fund, which is sub-advised by Willowbridge Associates.

“The fund is unlevered. It is such a low volatility strategy that Willowbridge opened up a 3x leveraged version. That’s what most of their hedge fund investors want. So our pitch to Willowbridge was, ‘Listen, the unlevered version is perfect for the liquid alternative market and if prospective investors want to get more juice out of the strategy they simply invest in your offshore strategy’.

“That’s a nice symbiotic relationship. It allows Willowbridge to justify having both the hedge fund and the liquid alternative. It took us three years to source and implement this strategy.

“What is particularly interesting is that some investors are asking if they can put say USD20 million in the hedge fund and another USD30 million in the liquid alternative. That’s fine with us,” comments Balter.

If others decide to pursue a similar strategy to Balter and bring true hedge fund products in a ‘40 Act liquid wrapper to the US institutional market, it could mark the next evolution of its funds industry.

Watch this space.
Delivering value as volatility grows

Interview with Stephane Berthet

With increased volatility starting to buffer equity and bond markets, investors have taken reassurance from the fact that the FundLogic Alternatives platform may provide the fund strategies needed to navigate the uncertainty.

Since the start of June, German bund yields have climbed from 0.53 percent to 0.815 percent, reaching a YTD high of 0.99 percent on 10th June. Global equity markets have seen a sell-off and although still in a six-year bull cycle, are starting to get a little toppish.

According to Stephane Berthet, Head of the FundLogic Alternatives platform, investors realise that potentially neither their equity or fixed income returns are going to be as strong as they have been over the last five years.

“The way investors are expressing this concern is rotating out of long-biased equity long/short strategies into more defensive strategies. With respect to the fixed income and credit markets, credit spreads have tightened and analysts believe there could be more downside risk than upside gains; like equities, investors are looking for more credit spread neutral exposure or hybrid strategies,” says Berthet.

There is a range of funds on the FundLogic Alternatives platform that fit the bill. On the equity long/short side, there is the MS Ascend UCITS Fund, which is a US equity long/short manager with a low net bias.

In fixed income, one fund that has been attracting attention is the MS TCW Unconstrained Plus Bond Fund; a strategy managed by Metropolitan West Asset Management LLC that uses a top-down, bottom-up approach to select mispriced bonds across multiple fixed income asset classes.

On the hybrid side, the Salar Convertible Absolute Return Fund (SCARF) is a low volatility convertible bond strategy managed by Ferox Capital LLP.

All of these funds are proving useful to investors and indicate the careful consideration that goes into selecting the most appropriate strategies for the platform.

“There has to be a clear alignment of interests with us and our investors. It’s about striking the right balance in terms of what investors are looking for and what we need to diversify the platform further,” says Berthet. “Clearly we don’t want to position the platform like a fund supermarket. Our aim is to have around 20 to 22 funds.”

Currently, FundLogic Alternatives has approximately USD2.7 billion in AUM spanning 16 funds. Four new funds have been onboarded since last June, with the most recent addition (in February) being the MS Tremblant Long/Short Equity UCITS Fund, adding to the platform’s coverage of global long/short equity managers.

Berthet confirms that two further funds are in the process of being onboarded; one a CTA fund, the other a global macro fund.

As Berthet confirms, the best performing fund YTD is up over 20 per cent; MS Dalton Asia Pacific UCITS Fund, an Asia Pacific long/short equity fund.

“If you were to take an equally-weighted view of all the funds on the platform, the performance was 11.5 percent in 2013, 6.7 percent in 2014 and we are already in the region of 4.5 percent as at June 2015. So performance-wise it’s very attractive,” confirms Berthet, who says he’s confident that the platform could reach USD4 billion by year-end.

“We have a solid pipeline, we are seeing a lot of appetite from investors. One can never predict the future but we feel we are well on track to where we want to be,” concludes Berthet.
The liquid alternatives space, which by definition includes alternative UCITS funds in Europe and '40 Act registered alternative mutual funds in the US, is not only attracting strong inflows. According to latest research from Preqin, the average alternative mutual fund returned 4.36 per cent in 2014. This compares to returns of 3.78 per cent for the average hedge fund (www.hedgeweek.com/2015/04/24/222190/preqin-survey-finds-wealth-managers-increasingly-choose-liquid-alternatives).

The average alternative UCITS returned 1.45 per cent but if one considers performance at the strategy level, CTAs and equity market neutral funds held up well; according to Alix Capital, who run a series of alternative UCITS indices, their UAIX CTA returned 19.74 per cent, whilst the UAIX Equity Market Neutral returned 4.65 per cent.

From an AUM perspective, a report by Deutsche Bank (From alternatives to mainstream: Part Two) noted that liquid alternatives had enjoyed a CAGR of approximately 40 per cent since 2008. Specifically, '40 Act alternative mutual funds grew by 18 per cent in 2014 to over USD300 billion having grown 60 per cent in 2013. The bank’s report forecast that alternative UCITS had the potential to represent 30 per cent of hedge fund assets by 2019; it was approximately 11 per cent in 2014.

By end-2014, Alix Capital reported that alternative UCITS had enjoyed their strongest year in terms of asset growth, noting that inflows totalled EUR70 billion - a year-on-year increase of 37 per cent - to reach total AUM of EUR260 billion.

Looking ahead, a report by PwC (Alternative Asset Management 2020:...

Discussing these growth trends, Bob Kern, Executive Vice President at US Bancorp Fund Services, confirms that they have enjoyed both a 40 per cent growth in liquid alternative assets under administration and a 40 per cent growth in the number of funds being serviced.

“Long/short equity and long/short credit are the main trends in the open-ended fund space,” says Kern, who suggests that the growth of ‘40 Act alternative mutual funds in the US has been driven by a defensive posturing by managers as well RIAs and investment consultants.

“Learning from 2008, no one wants to get caught again by being over-invested in traditional assets. In my view, the main drivers of growth are: diversification, allocation and defensive hedging,” says Kern.

The demand among European institutions for UCITS vehicles is something that US managers increasingly find when they come over to do road trips. Anecdotally, Hedgeweek has heard that large European pension plans are also approaching US managers and asking them to establish an AIFMD-compliant fund-of-one, but for many managers, AIFMD is still too new. As such, the UCITS format is an attractive counterpoint to their offshore master feeder.

“Time and again, we hear many European investors are saying to US managers that unless they have a UCITS fund they simply can’t invest in their strategy,” says Andrew Dollery, Director, Origination & Structuring, Societe Generale Prime Services. He adds: “I think there is also a slight push factor with respect to AIFMD. There is still a perception among many US managers that registration is complex, and that it can be quite onerous to raise capital in Europe through AIFMD passporting. Managers are still a little unsure of the marketing rules. The last point I’d add is that over the last four years the level of awareness and knowledge among managers with respect to the structuring and branding of UCITS has grown.”

One interesting driver of appetite that might explain the growth in liquid alternatives is a desire among investors to look for bond-like returns in alternative asset classes. There are growing concerns over how traditional equity and bond portfolios will perform in the coming years as QE programs are phased out and market volatility starts to rise; indeed, last month alone saw German Bund yields rise from 0.53 percent to 0.815 percent, reaching a YTD high of 0.99 percent on 10th June.

Spencer Rhodes is Alternative Investments Global Business Manager at Allianz Global Investors. The firm has approximately USD7...
OYSTER market neutral
Market neutral strategies, as their name suggests, are non-directional in nature. As Joseph G. Nicholas, founder and chairman of HFR Group, states in his book “Market Neutral Investing: Long/Short Hedge Fund Strategies”, market neutral strategies seek to neutralise “certain market risks by offsetting long and short positions in instruments with actual or theoretical relationships”.

Co-managed by Giacomo Picchetto and Stefano Girola, SYZ Asset Management (Suisse) SA, the objective of OYSTER Market Neutral is to deliver a performance of Libor+500 basis points over a cycle, with a volatility below 6 per cent. This is achieved by generating alpha on both the long and short side such that the overall net bias (longs versus shorts) - or market exposure - is as close to zero as possible.

Market neutral strategies have proven popular with investors in recent times. At the end of 2014, Alix Capital, which runs the UCITS Alternative Index suite, reported that the combined inflows into equity long/short and equity market neutral strategies totaled EUR23 billion.

Since inception, OYSTER Market Neutral has returned 18.1 per cent. Over a three-year period, the fund ranks 7th out of 48 peers according to Morningstar.

Central to Picchetto and Girola’s investment thesis is that alpha can be generated by anticipating revisions of earnings estimates, as opposed to merely building pair trades in the portfolio; i.e. going long one security and taking an equivalent short position in a similar security within the same sector or industry.

The team believes that consensus estimates suffer some structural biases that can be exploited by rigorously evaluating the assumption provided by market analysts on the Street.

According to Picchetto, the main structural biases include the following:
• Estimates tend to be too cautious for companies with strong business models
• Sell-side can “fall in love” with their companies
• Analysts don’t want to appear too hawkish and lose management contact
• Preference to use actual company results to change numbers rather than anticipating
• Denial: when economic cycle turns, companies stick to their guidance until a new budgeting process is in place.

Moreover, it is the belief of Picchetto and Girola that cost cuttings in brokerage houses
could potentially lead to under-coverage, particularly in the mid-cap space, thereby providing a further source of price inefficiency.

The investment process is a multi-stage one. It begins with ideas’ generation; the team, for example, engages in over 800 corporate meetings and conference calls each year. A quantitative filter is then applied to screen 1,500 European stocks on a weekly basis using a multi-factor approach. This includes 3-month earnings changes, price to earnings multiples and price momentum signals.

Stocks are then ranked and modeled using 3-year history and 3-year forecasts before entering into discussions with prospective companies. The team also engage in consensus analysis and talk to both bearish and bullish sell-side analysts to compare their assumptions.

Valuation and technical analysis helps to assess the valuations and get the timing right so as to avoid buying “overbought” or “oversold” stocks. If a stock has outperformed the market by +/- 10 per cent in one month, the investment is often delayed.

The OYSTER Market Neutral Fund comprises between 110 and 170 positions with a gross exposure that ranges from 50 to 200 per cent depending on market volatility. The higher the volatility the lower the gross exposure. Pre-trade simulations are used to back-test the portfolio over the previous six months to measure the potential impact of volatility on the portfolio. In addition, the team monitors the beta and correlation of the portfolio against single countries, sectors, style, market caps, currencies and commodities, to try and avoid unwanted bets.

OYSTER Flexible Credit

OYSTER Flexible Credit is an unconstrained European corporate credit long/short strategy. The fund is managed externally by Paris-based Eiffel Investment Group SAS; a specialist in running long/short and long-biased credit strategies. The firm was established in 2008 by Founder and CEO, Fabrice Dumonteil. Running the credit team is CIO, Emmanuel Weyd, who is also lead portfolio manager of OYSTER Flexible Credit.

Credit long/short is another key diversification strategy for institutional investors as they look to protect their fixed income allocations from rising interest rates. According to an eVestment report, over the last two years alternative credit strategies have attracted USD95 billion.

The aim of OYSTER Flexible Credit is to generate a net annualized return of 8 per cent by holding a relatively concentrated portfolio of 30 to 40 bonds. Since the team started trading the strategy in 2011, it has generated cumulative net returns of 42.5 per cent (annualized 11.6% p.a.). In 2014, the Fund returned 6.60 per cent and is currently up +3.55 per cent on a year-to-date basis.

Eiffel Investment Group uses a bottom-up approach using proprietary fundamental research to identify mispriced or misunderstood credit instruments. Only bonds, CDS and convertibles are held in the portfolio.

Like the OYSTER Market Neutral Fund, the investment process begins with idea generation. Typical themes in the Fund include corporate refinancing, M&A activity, and financials (i.e. growth of iTraxx Financial CDS indices from 25 to 30 names).

The team relies on involvement with the primary market and often has one-on-one meetings with management teams of corporate issuers, in addition to monitoring secondary markets. This process helps the team reduce the universe of 1,000 European corporates and financials to a portfolio of 30 to 40 positions.

Alpha generation is derived from a variety of drivers:

- Event Driven / Special Situations: represents the core of the portfolio and is generally constituted of long positions (cash instruments or CDS) which are catalyst-driven investments with a 3 to 9 months timeframe
- Carry: capturing higher coupon
- Value: buying at a discount to intrinsic value
- Trading: benefiting from flows and momentum on situations that the team has generally analysed in depth
- Market overlay: flexible market exposure, mainly through short on CDS indices to protect capital in stress periods but also to possibly amplify gains in constructive markets.

Typically, the size of each position represents 4 to 5 per cent of total AuM. From a risk management perspective, short-dated out-of-the-money puts are used to protect the portfolio during periods of market stress. Indeed, risk management is taken very seriously in the Fund, and is applied at both the position level and portfolio level.

At the position level, each position has both a target price and a stop-loss. It is also given a liquidity rating. A liquidity score is also given to the portfolio, which is stress tested to see how the VaR changes in extreme market environments.

The Fund itself is unconstrained, meaning that the team is able to allocate freely across different sectors, European countries, ratings and capital structures. Net credit exposure ranges from -25 per cent up to +150 per cent.
platforms is the Dublin-domiciled FundLogic Alternatives platform run by Morgan Stanley and headed up by Stephane Berthet. He says that whilst they have seen a bit more volatility in returns and performance dispersion among funds running similar strategies, performance this year has been broadly in line with investors’ expectations. “You can’t compare these funds to the long-only space where investors have been enjoying a bull market and outsized returns. To be frank, this type of comparison always gets made from time to time,” observes Berthet. “This year will be interesting in that equity markets are becoming more volatile and challenged, which will create a tougher environment for long-only strategies. It’s this type of market where hedge fund managers can add value. Looking at the performance of the platform today, the vast majority of funds are in positive territory. The best performing fund – MS Dalton Asia Pacific UCITS Fund – is up nearly 20 per cent.”

Over at Allianz Global Investors, Rhodes confirms that their two best performing funds this year are, coincidentally, their flagship funds. The first is Discovery Europe, a European equity long/short market neutral fund which has already returned +6.73 per cent (through 30th June). “The second flagship strategy is called Structured Alpha which launched in 2005. It’s a volatility arbitrage strategy trading listed US index options. It’s had a strong first half of the year and is up +3.45 per cent through 30th June and has a 3-year volatility of only 1.09 per cent,” confirms Rhodes.

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According to research by Preqin, 53 alternative mutual funds launched in the US...
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In prime position to support CTA UCITS funds

Interview with Andrew Dollery

Five years ago, UCITS funds weren’t exactly a prominent blip on the radar screen at Société Générale Prime Services, but over the last two years, excluding managed accounts, they have accounted for approximately 50 per cent of all new funds onboarded by the business in Europe.

Andrew Dollery is Director, Origination & Structuring at Société Générale Prime Services. He looks after many of its UCITS fund clients and is also actively involved in the structuring and servicing of ‘40 Act funds, as well as hedge funds and managed accounts.

“It is relatively easy to launch a UCITS fund. We even see start-up managers launching these funds as opposed to offshore funds. I would therefore argue that UCITS, broadly speaking, is an opportunity for everyone. That said, it is statistically true that the market is quite brand and cost sensitive, with a large percentage of inflows going to larger, well-established managers. “Winton Capital is a perfect example. They have raised a lot of money in their UCITS products because people gravitate towards the brand as well as the long-term track record,” says Dollery.

Dollery notes that US managers are keen to establish not only UCITS funds in Europe but are looking to have a ‘40 Act fund for the US domestic market as well.

“We see US managers launching both types of funds. The rationale is that they have two products for US investors – a Delaware LLP feeder fund into a Cayman master fund for institutional investors and a ‘40 Act fund for more retail investors – whilst for the rest of the world they opt to launch a UCITS fund. It’s a global distribution play,” suggests Dollery.

Société Générale Prime Services has a strong heritage in providing execution, clearing and financing to Hedge Funds & CTAs since it assumed full ownership of Newedge in May 2014. Indeed, with a 12 per cent market share it is the world’s leading execution and clearing broker of listed derivatives.

This makes the firm well suited to support CTAs who wish to introduce a UCITS product. One of the core principles of a UCITS fund is having a liquid portfolio that is able to meet the Dealing NAV restrictions, so in that sense trading futures contracts works well for CTA UCITS. However there are two main hurdles managers need to be aware of:

“The first relates to commodities exposure, the second relates to bond concentration; because of the way these funds trade and model risk, they sometimes end up having high nominal exposure to bond contracts even if the portfolio risk is relatively low,” explains Dollery, who continues:

“With respect to commodities, managers either strip them out altogether and trade the rest of the portfolio directly. Or, if they make up a material portion of the strategy, managers often use a certificate solution to gain access. This involves a bank, like Société Générale, issuing a certificate to the fund which references an underlying managed account within which commodity futures are traded.

“That allows managers to indirectly trade commodity contracts and effectively transfer the exposure through to the UCITS.”

As a prime services business, Dollery says that liquid alternatives are one of the key drivers of the bank’s future growth:

“Our clients are looking to launch these structures, or become a part of them, and it is becoming an increasing share of the business we do.”

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in 2014. By far the biggest demand for these products is coming from FoHF managers, accounting for 62 per cent of investors surveyed by the research firm.

Asked whether Morgan Stanley had grand designs on tapping into this growth dynamic, Berthet is quick to point out that it is a different market catering for a different audience and that there are no plans to develop FundLogic Alternatives in the US.

“The ‘40 Act alternative mutual fund industry is mainly driven by multi-manager products whereas in Europe alternative UCITS funds are predominantly single manager products. Also, the ‘40 Act fund market is much more retail than it is in Europe. To run multi-manager products you need to assume fiduciary responsibility for selecting funds, which I don’t think we as an organisation are contemplating at this time. We help some multi-managers with their offering, so we are participating, just indirectly,” says Berthet.

The multi-manager arrangement is interesting in that it allows US managers to indirectly participate in the ‘40 Act space without cannibalising their existing offshore investors. They are appointed as sub-advisors, and whilst they have to adhere to stringent liquidity and risk management guidelines they aren’t steering the ship on their own, as is the case for single managers running UCITS.

US managers are less likely to launch ‘40 Act products on their own, therefore, at least for the foreseeable future. It also doesn’t help that the regulators are paying far greater attention. The SEC is checking that managers are doing exactly what they say on the tin and are sticking to the rulebook.

Back in February this year the US regulator hit Water Island Capital LLC with a USD50,000 penalty for improper handling of alternative mutual fund assets. The firm was holding millions of dollars of cash collateral with broker-dealer counterparties instead of the funds’ designated custodial bank.

“The whole industry needs to be cognisant of any changes that regulators could introduce in the future,” warns Dollery. He says that managers need to be aware that for alternative UCITS, most unencumbered assets and cash tend to sit with the custodian rather than with the prime broker directly. For strategies that trade on margin, this could lead to concentration issues on the balance sheet of the custodian. A manager cannot hold more than 20 per cent of their fund in cash on the balance sheet of a single credit institution.

“You tend to find that in the UCITS space, in particular for CTAs and global macro funds that trade mainly through derivatives, they have to diversify their exposure by opening deposit accounts at a number of banks. Or they buy short-term bonds or money market funds; some sort of treasury management solution.

“Another challenge for managers entering this space is structuring their fund and portfolio to remain compliant: commodities exposure; OTC counterparty limits; establishing custodial relationships and possibly pledge accounts; managers might need help wrapping those considerations together,” comments Dollery.

From a liquidity management perspective, a manager needs to keep 5 per cent cash to cover redemptions in a liquid alternatives fund whereas in a hedge fund they might be fully invested. It is a cashflow management issue.

“So this is no cakewalk. Whilst investor demand is clear, managers have to make sure they are launching one of these funds for the right reasons.

In conclusion, Redwine thinks that the same sort of stress testing common to fixed income funds could eventually apply to those running liquid alternatives: “Those strategies that are a little less liquid and incur a run on the fund could have a significant impact on performance, so don’t be surprised to see stress testing become best practice.”

Joe Redwine, US Bancorp Fund Services

“Those strategies that are a little less liquid and incur a run on the fund could have a significant impact on performance, so don’t be surprised to see stress testing become best practice.”