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Strong brand and distribution capabilities are key drivers for successful alternative UCITS

By James Williams

It has been an encouraging first six months of 2012 for the alternative UCITS market. A couple of years ago total assets in these products were around EUR80billion. Now, according to Alix Capital, a Geneva-based firm whose UCITS Alternative Index Global tracks performance – and fund inflows – total assets in this space have grown to EUR129billion.

And whilst the USD2.1trillion hedge fund industry has only attracted USD20billion in net inflows for 1H12, Alix Capital notes that ‘Newcits’ have attracted a similar volume, with inflows of EUR9billion recorded in Q2 alone.

Admittedly, it is still a small space by comparison to the offshore market. But these figures suggest that growth is building, slowly but surely.

Some of the better performers in 2012 include the Renaissance Ottoman Fund (Emerging Market), an equity fund managed by Aziz Unan focusing primarily on Turkey, the Middle East and Russia and which is up 21.5 per cent YTD, and the Thames River Global High Yield Bond (Fixed Income), which is up 18.90 per cent. Another notable performer has been the Odey UK Absolute Return fund which, according to the Absolute Hedge database managed by London-based consultancy Kepler Partners, is up 19.3 per cent.

These are all impressive returns but within a wider context it has to be said that alternative UCITS still slightly underperform their hedge fund counterparts: understandable given the leverage limitations under UCITS rules. The UCITS Alternative Index Global is slightly down -0.33 per cent for the year. By comparison, the HFRI composite index for hedge funds is up 1.84 per cent.

Louis Zanolin, co-founder of Alix Capital, observes that the majority of inflows have been going to one or two strategies favoured by investors in today’s volatile market environment: “Inflows have been going mainly to fixed income and macro funds this year; macro has grown by 25 per cent year-on-year.”
One trend that does seem to be developing is the profusion of small sub-EUR50million funds, struggling to raise assets, whilst the very biggest and best managers attract the lion’s share. According to Zanolin, only 4 per cent of alternative UCITS manage more than EUR1billion in assets, whilst only 17 per cent manage over EUR100million.

Much like the offshore world then, the space is highly bifurcated. The big are getting bigger. However, it isn’t just a stellar cast of hedge fund managers that attracting assets. The more traditional asset management houses are proving equally adept, if not more so. Standard Life Investments’ Global Absolute Return Strategies (GARS) fund is now one of the biggest in the space with approximately GBP11.3billion in AUM. Few hedge fund managers come anywhere near that.

One blue chip hedge fund that has had particular success is Man GLG. Speaking with Hedgeweek, Rhodri Mason, Head of UCITS Management Product Structuring at Man Group comments: “The GLG European Equity Alternative, in particular, has been successful; we only launched that for Pierre [Lagrange] last July and we’re already very near capacity having raised USD1billion.”

Continues Mason on the asset raising theme: “I would say nearly all our equity and fixed income long/short funds have done well and many of our long-only funds as well.”

Performance will always be a key driver of a fund’s long-term success. Year-to-date, the GLG European Equity Alternative fund is up almost 5 per cent according to Simon Savage, the fund’s co-manager, leveraging on the core stock picking strengths of the team.

Says Savage, via email: “We have been pleased with the speed of asset raising in the fund. We believe that our long, successful track record in this strategy combined with the benefits of an onshore regulated fund structure have been very attractive to investors. To date the fund has successfully achieved both capital growth and a level of capital protection, and the ability to access those strengths in UCITS format has proved an appealing formula.”

Perhaps unsurprisingly, given the success of SLI’s GARS fund, Jupiter Asset Management decided earlier this year to migrate its three existing hedge funds onshore, and restructure them under the UCITS brand.

Richard Pavry, Jupiter’s head of investment trusts, said that the reasons for moving into a SICAV structure – called the Jupiter Global Fund – were to take the funds to the next level in terms of size by attracting new investors, “as well as to satisfy our existing investors. When Jupiter put the proposal forward it was voted through by 99 per cent of shareholders.

“By moving these funds into a UCITS format we can now market to other institutions. It’s the advised market that we are looking to market to, as opposed to selling directly to the retail market.”

Not that Pavry thinks that all asset management houses are suddenly going to drop their Cayman funds in favour of onshore vehicles: “I don’t think it’s an inexorable trend. With the funds we have this is something that works for Jupiter but it may not necessarily work for other asset managers.”

Interestingly, one such hedge fund manager doing exactly the same is London-based Prodigy Capital Partners, founded by David Robinson. The firm’s Cayman incorporated Asia & Emerging Markets fund (PFS Prodigy Capital Partners fund) and UK UCITS-compliant counterpart are to be merged into a single Luxembourg SICAV.

This represents the first example of a trans-national merger, but could well be the sign of things to come if hedge fund managers, under AIFMD, decide that it’s no longer cost-efficient to run both offshore and onshore vehicles. Says Robinson: “This is one of the first re-domiciliations of a Cayman fund to Luxembourg. The proposed merger of the UK fund into the SICAV will also be the first one that’s taken place in the UK.”

“It’s difficult for smaller shops to raise assets and the only way they see themselves growing AUM is to set up UCITS clones or transfer completely onshore.”

David Robinson, Prodigy Capital Partners
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Looking beyond the alternative UCITS universe

Interview with Rhodri Mason, Head of UCITS Management at Man Group

What are some of the benefits of QIFs that managers should be aware of?
The key benefit is that QIFs give you Cayman-style investment flexibility, while speed to market can be significantly quicker than UCITS; QIFs can be authorised by Ireland within 24 hours. However bear in mind that QIFs have a minimum investment of EUR100k and SIFs of EUR125k.

How will AIFMD potentially increase adoption of QIFs?
One of the potential upsides of the Directive is that for the first time it will introduce a UCITS-style passport for European hedge fund structures from July 2013. So for managers looking for a European regulated fund structure with good speed to market, a high degree of investment flexibility, and a pan-European passport, QIFs and SIFs could be the answer. However, we first need to see where the level 2 guidance of AIFMD ends up on points like depositary liability and delegation.

QIFs already have more AUM than alternative UCITS; around EUR400 billion. Could AIFMD negatively impact the growth of alternative UCITS?
I doubt it. For now UCITS remains the normal default option if you want an onshore regulated product for retail and regulated institutional investors. However, you are starting to see more of a nuanced picture between product types rather than what has in the past been quite a binary distinction between UCITS and Cayman.

I do think that for certain institutional investors who don’t need daily liquidity, but want the perceived security of supervision by an EU regulator and like the investment flexibility of a QIF, these could become a ‘third way’ to satisfy the EU investor base.

Why would a manager launch an alternative UCITS if they could replicate their Cayman fund in an onshore regulated QIF for institutions?
I think the key message is we still don’t yet know how the challenging parts of AIFMD will look. Assuming they aren’t too onerous it will then be a case of horses for courses. In product development, it’s going to be a case of thinking ‘Who exactly is my investor base and what product structure best serves their needs?’

Take a manager in July 2015 (when Cayman funds might passport to Europe under AIFMD) who wants to sell a strategy globally. To do so, the answer could be: a US master/feeder structure for US distribution; another Cayman for the rest of the world; a QIF for European institutions and then a UCITS for retail investors.

This is dependent on AIFMD having a favourable outcome. If depositary costs end up being 150 basis points, will managers still want to use QIFs?
I believe it is incumbent on the industry to keep depositary fees at acceptable levels in order to allow this EU initiative of AIFMD compliant fund structures to become a success. The question is where will depositaries end up; it’s basically a case of scenario modelling.

What’s your gut feeling?
I am optimistic. I think under AIFMD QIFs should continue to be a useful tool for hedge funds and how they get to market. For global firms like us, we are well positioned to meet investor demand for particular product solutions including AIFMD compliant products for EU institutions, whatever AIFMD ultimately looks like.

*QIF used in the interview refers to both QIF and SIF fund structures.*
Robinson confirms that the new UCITS platform will be branded the ‘Boutique Platform’, and will serve as a springboard for external managers to launch their own sub-funds. The platform is due to go live and receive approval from the CSSF any day now and has already got two high quality fund managers ready to join.

“One is a European long/short fund, the other is a US high-yield bond fund. They’re very well known managers so that’s encouraging. Our own emerging markets fund will become the first sub-fund on the platform,” says Robinson.

The platform will differ from the large banking platforms like Morgan Stanley’s FundLogic Alternatives, and Deutsche Bank’s Platinum by supporting small managers who may already have Cayman funds, or are simply looking to establish UCITS funds but can’t afford the costs involved. To that end, the ‘Boutique Platform’ will offer a turnkey solution to these managers for a flat fee of around EUR25,000. This will cover startup costs, local fees, directors and auditing. Citi is to be appointed the depositary and custodian, Andbanc the administrator.

“It’s about wanting to give smaller fund managers a chance in what is a brutal world. We want to help, build strength in numbers, and essentially develop a ‘club’ that fosters growth and gives these managers real independence,” adds Robinson. “It’s difficult for smaller shops to raise assets and the only way they see themselves growing AUM is to set up UCITS clones or transfer completely onshore.”

Man Group is an example of a large manager who has decided to properly invest and develop its own UCITS platform. Mason confirms that the platform is seeing good growth and now has over USD10billion in UCITS assets, spread across roughly 35 funds. As mentioned, the GLG European Equity Alternative has enjoyed significant success, particularly amongst institutions. Thanks to the power of brand, Man seems to have bridged the divide between the offshore and onshore markets, offering top-drawer alternative investment strategies on the one hand, and developing a robust distribution network on the other.

“I have to say one of the trends we’re seeing in the industry is a convergence with traditional asset managers. What that means is that some of the things that drive sales and asset raising are more like traditional asset management drivers. We are rightly very conscious of performance in the hedge fund industry but actually what also drives asset raising is the power of brand: quality of distribution network, quality of operating platform and the ability to market and engage with investors.

“To date we’ve been successful because we’re not only selling performance, we’re selling the quality of our governance and risk controls and the amount of resources we’re able to dedicate to our UCITS business.”

Distribution is undoubtedly a key requisite. If a hedge fund manager can partner up with the right platform and develop a strong synergy, the results can be compelling. According to Gavin Ralston, global head of product at Schroders, the firm’s dedicated UCITS platform, GAIA, has been one of the more successful platforms. Last year the platform onboarded credit giant CQS’s credit fund – named the Schroder GAIA CQS Credit fund – joining two other London-based luminaries, Sloane Robinson and Egerton Capital. The platform also houses two internal Schroder funds.

Confirms Ralston: “I think I’m right in saying that we’ve raised the highest assets per manager of any of the platforms. That’s testimony to the fact that we put the full weight of Schroders’ distribution machine behind each fund. We treat every external fund as if it were one of our own internal funds. We ask that every manager gives us USD1billion of capacity to ensure there’s good commercial potential both for the manager and for us.”

CQS has enjoyed particular success since it launched last year, with Ralston stating that “jointly we’ve done a good job raising assets. It’s now at USD600million.”
Total assets on GAIA are roughly USD1.5 billion. Net inflows through June this year are USD400 million, much of which is European wholesale investor capital coming from the UK and Switzerland.

When asked what Prodigy’s Robinson hopes to achieve with the new platform within the next 12 months, he says: "We are aiming to launch two sub-funds within Q3 2012. Our aim is to then launch one or two funds each quarter all the way through next year. We hope to have a total AUM of between EUR200 million and EUR600 million by the end of 2013." As well as the two external managers already confirmed, Robinson is also in discussions with two further managers.

Clearly, there’s no lack of desire for hedge fund managers to launch UCITS vehicles. After all, it opens up an entirely different investor base, as CQS is discovering. But Ralston makes an interesting point by saying that some high quality managers are still reluctant to commit to the liquidity terms that UCITS requires.

"I think their concern is that if the UCITS fund has better liquidity terms than their offshore fund, there will be some cannibalisation (that is, assets being liquidated in the Cayman fund and re-invested in the UCITS) but it’s not something we’ve seen with the external managers on GAIA."

Ultimately, UCITS represents an additional funding channel for managers. Throw the AIFMD-compliant QIF/SIF structures into the mix, and it seems plausible that going forward, rather than Cayman suffering, managers will consider all three investment structures to achieve truly global distribution.

Mason confirms that Man already has five or six funds that have been structured appropriately to target specific investor groups. The GLG European Equity Alternative fund is a great example of where the firm has taken a successful strategy, first launched as a Cayman vehicle, and subsequently developed a US master/feeder fund for US investors, and a UCITS fund for global investors ex-US. Each one of these structures aims to run pari passu. So could a QIF become the fourth leg, as it were, to target European institutions who may not need full daily liquidity under a UCITS structure?

"That’s interesting. Under AIFMD managers may say to clients ‘We’re at capacity in our UCITS fund but would you be interested in looking at an alternative EU-regulated structure?’ It would definitely be something that the industry could look at," says Mason.

Adds Zanolin: "Liquid strategies that can be implemented in a UCITS structure will over time be increasingly offered – those that aren’t will either remain offshore or become QIFs."

In conclusion, Ralston states that the key to being successful is the amount of "distribution bandwidth" given to funds on the platform.

"We put all the operational structure in place for the manager, but more than that we offer a strong sales push. I think if you talk to the managers on our platform they would recognise that as something we brought to them."
**Success factors for distribution in Switzerland**

**Interview with Daniel Haefele of ACOLIN Fund Services in Zurich**

**Why should fund managers in the UK consider Switzerland?**
The Swiss financial centre is attractive to both international and domestic investors alike. As of the end of 2010, assets under management in Switzerland totaled around Sfr5,500bn, of which slightly more than half were invested by foreign clients. At the same time, competition is intense: more than 670 banks and securities dealers sell almost 7,500 funds.

**Which market segments should fund managers target?**
Market entry is fastest if you have a sales strategy detailing your target groups and the appropriate products for them. Swiss pension fund trustees, for example, have different requirements and incentives to portfolio managers in private banks. Differentiating between wholesale (into wealth management) and institutional clients is essential for any business plan.

**Is it necessary to have a UCITS range of products?**
Private placements with institutional investors are certainly possible with non-UCITS funds, however, pension funds in particular have stepped up their demands as to the regulation of funds they would invest in. Today, trustees in the board of a pension fund will more often than not ask for completely transparent and regulated financial products.

**Which products will sell in Switzerland?**
Daniel Haefele: Currently, there is a lot of demand by Swiss investors for global asset allocation modules. Also, many clients are searching for a substitute for fixed income strategies which reduce volatility. With regards to the types of funds being launched, there are a couple of key trends. One is the desire to replace traditional bond funds with Emerging Market high yield, local currency products and fixed income absolute return funds. Switzerland has traditionally been a hub for Emerging Markets. On the equities side, specialised US and European equity funds are gaining momentum.

**Is cross-border distribution an option?**
From our experience, a committed sales professional in Zurich or Geneva can work wonders in the Swiss market given sufficient time and resources. To build awareness and create interest for your products, you will need about a year. You can expect to see inflows once you have an (institutional) client base who you know personally. If you target retail clients, you will have to invest in branding and establishing a reputation, as well as spending time building trust with advisors.

**What do fund managers need to get started and to maintain the relationships?**
For successful market entry, having the distribution network up and running quickly is crucial. You can expect to generate demand from investors within the banks, but if your distribution network is not set up correctly you will not gather assets.

ACOLIN helps asset managers develop new markets for UCITS funds – cost-effectively and quickly. We offer a range of distribution administration services, acting as your Swiss legal representative, providing access to a pre-existing network of distribution agreements and offering sales and marketing consultancy services. Our distribution management services offer access to distributor platforms and our sales support opens the doors to potential clients. ACOLIN will manage the distribution administration for you, while you can focus on managing money and building long term relationships with investors.

**What would be the first step for a fund manager looking to set-up distribution in Switzerland?**
Get a clear picture of the Swiss market and define a focused market entry strategy. We would certainly love to help. Please contact ACOLIN either in our Zurich or our London office to discuss your distribution strategy.
Sell-side, buy-side or issuer, at BNP Paribas Securities Services, dealing with complexity is our speciality. We can help you find your way.
Partnership and product innovation are key in Asia

Interview with Andrea Cattaneo and Margaret Harwood-Jones at BNP Paribas Securities Services

A recent survey released this April by BNP Paribas Securities Services in conjunction with consultancy group Knadel found that the three key Asian markets – Hong Kong, Singapore and Taiwan – met or exceeded the expectations of 75 per cent of European asset managers currently distributing UCITS funds there.

Despite this, some commentators have suggested that these markets, in particular Hong Kong, are becoming more difficult to gain access into.

Speaking with Hedgeweek, Andrea Cattaneo, head of asset manager solutions at BNP Paribas, confirms this trend for two main reasons. Firstly, regulators are wary about UCITS using derivatives strategies – ie the famous “Newcits”. Secondly, the crisis is not playing in favour of European strategies and products. Nevertheless, Cattaneo affirms that in order to be effective at selling UCITS funds in Asia, managers need to be dedicated and have a solid network, and cites three trends developing in the region.

“Firstly, despite the changing environment, it remains true that it is easier to establish funds in these three cross-border centres than in the rest of Asia. Secondly, we see a trend in emerging markets – Malaysia, Thailand and South Korea – for new opportunities in the future through sub-products. The third large trend we’ve identified is that some markets, like Japan, are more resistant to direct distribution of foreign products than others.” Cattaneo notes that a recent study by Sumitomo bank found that over 80 per cent of money allocated by Japanese investors to offshore funds goes into UCITS funds through indirect distribution flows.

“To be effective in Asia, asset management companies need to be committed. There are different ways of achieving this. Large firms like Fidelity have been in Asia for many years, building their own sales capability and network. For mid-tier asset managers, the key word is ‘partnership’; identifying the right partners in these Asian markets is crucial as they can help achieve sales targets.

Moreover, some Asian asset managers are looking to Europe as a market for distributing their own products.

“Therefore, mid-tier and boutique asset managers in Europe and Asia, each offering different capabilities, can leverage on these differences to help grow their businesses together and identify reciprocity.”

The market share of cross-border products in Asia has grown from 21 per cent in 2001 to 43 per cent in 2011. Cattaneo notes that around 13 per cent of UCITS funds are sold outside Europe, with Asia accounting for 9 per cent of the market.

“There is a strong appetite on the part of Asian investors to invest in UCITS. There’s no doubt that UCITS is a popular, well-understood brand in some of those leading markets in Asia,” comments Margaret Harwood-Jones, Head of Client Segments – Asset Managers & Alternative Investments at BNP Paribas Securities Services.

“It’s almost in a class of its own: Asia would struggle to develop an equivalent passport.”

Expanding on the passporting point within the context of Asia’s fragmented, multi-jurisdictional marketplace, Harwood-Jones adds: “Are you going to waste time and energy working through the complexity of establishing a pan-Asian passport? Or is it smarter and brighter to use something that is already tried and tested: for us, we think that encapsulates the UCITS story in Asia.”

Concludes Cattaneo: “For European managers, innovation of products is key if they want to penetrate the Asian market and access distributors, otherwise competition will be extremely tough.”
Distribution bridge between Asia and Europe strengthens

By James Williams

One thing above all else is guaranteed when discussing developments in the alternative UCITS space: it polarises opinion. Much like the wider financial markets, where people argue their case with equal validity as to the likelihood of a sustained recovery or further descent into the abyss, the regulated alternatives market is much the same.

On the one hand people will point to sustained AUM growth over the last few years, which according to Alix Capital has seen assets increase from around EUR80billion to EUR129billion, as a clear sign that momentum is building. Furthermore, alternative investments research firm, Brighton House Associates, recently reported that at the end of Q1 2012, some 24.5 per cent of the hedge fund mandates collected by the firm specified an interest in UCITS funds.

On the other hand, others say that compared to the overall UCITS market these funds represent a tiny percentage and are still yet to take off.

Never the twain shall meet it seems.

Speaking with Hedgeweek, Dermot Butler, CEO of global fund administrator Custom House Group, says that none of the firm’s hedge fund managers have yet to open UCITS funds: “This is largely because hedge fund UCITS are often too restrictive with regard to replicating their strategies under the UCITS regulations and are noticeably more expensive to both set up and operate,” says Butler, who adds:

“It is our opinion that for a UCITS to be an attractive to a hedge fund manager it must:
1. Enable that manager to utilise his investment strategy without restriction;
2. Have good distribution, which is why many managers contract with UCITS platforms because the operator of the platform has distribution capabilities;
3. Ensure the net returns only differ marginally from the net returns on their non-UCITS European funds.”

What does seem apparent is that the types of hedge fund managers launching these vehicles are large global blue-chip names that have the operational weight needed to either launch internally, as Man GLG has done, or be attracted onto the leading bank platforms like Morgan Stanley’s FundLogic Alternatives or Deutsche Bank’s Platinum platform.
The Brevan Howard’s and CQS’s of this world are doing a great job raising assets, but there are plenty of managers, particularly those in the US, who are yet to adopt the UCITS wrapper as an alternative conduit for asset raising.

“For the biggest managers, if there’s no need to actually create such a structure then why even think about it? If you’re seeking assets from different investor types then it might be something to consider but if you are a well-performing manager with a robust infrastructure and sound strategy, then I would question the need to create a legal entity wrapper like UCITS,” comments Zeynep Meric-Smith, AIFMD leader for asset management at Ernst and Young.

Not that this is the sole preserve of the billion-dollar boys club. Some smaller managers are establishing funds and, going forward, will find it easier from a cost perspective as more platforms like the one being launched by David Robinson’s Prodigy Capital Partners look to support them by offering a turnkey solution. But it seems that, right now, it’s more a case of looking into things and asking questions as opposed to taking concrete action.

Adds Meric-Smith: “Their interest is to understand the opportunities, but once they’ve weighed up the costs and benefits, the number who take further action is actually very limited.”

Margaret Harwood-Jones, Head of Client Segments – Asset Managers & Alternative Investments at BNP Paribas Securities Services, takes a more bullish stance, overall. In her opinion, the growth in this space is evident and that alone should be greeted as good news given the challenging market environment in which the fund management industry, at large, continues to operate in.

“What I’m seeing – and what I hope the market is encouraged by – is a greater systematic use of UCITS in the alternatives space; that is a constructive and positive development. Growth is there, and it will remain in perpetuity; I think it’s fantastic for managers in the alternatives space to recognize that they’ve got another opportunity to structure investment performance for their clients,” asserts Harwood-Jones.

One of the concerns when the AIFMD was formulated was that the hedge fund industry would see an exodus of managers. Migration into the UCITS space might have been the first signs of this happening but whilst it’s undeniable that managers are taking a more holistic approach to the regulatory environment, there’s little evidence, if any, that managers are turning their backs on the Cayman Islands and moving completely onshore.

“Many people thought there would be a rush to bring funds to an EU domicile. That hasn’t happened anywhere near to the extent people thought. I don’t see it becoming a huge trend across the industry,” says Gavin Ralston, global head of product at Schroders.

In Meric-Smith’s view, it again boils down to the size of the manager and the ultimate aims of that manager long-term as to whether they decide to offer an onshore regulated vehicle. Large managers, who are better placed to tap into European institutional money, are widening their product range with UCITS and non-UCITS structures; they can afford to do it. Smaller managers may not need to take advantage of the fund passport and choose to remain with a national private placement regime.

“There’s no clear trend that smaller and mid-sized managers are launching these onshore structures. Unless an investor specifically says ‘We can only invest in a UCITS structure’, there’s no impetus for them to go down that path. It’s just another additional cost,” says Meric-Smith.

Moreover, the fact that institutional money is by-and-large going to the blue-chip players, means there’s even less of an incentive for smaller managers.

Butler states that for many non-institutional investors the offshore fund is still a perfectly acceptable investment vehicle: “There are

“Hedge fund UCITS are often too restrictive with regard to replicating their strategies under the UCITS regulations and are noticeably more expensive to both set up and operate.”

**Dermot Butler, Custom House Group**
Luxembourg consolidates its position as alternative UCITS hub

By Olivier Sciales

The European Union’s Alternative Investment Fund Managers Directive is finally on the way to become law next July, at least in Luxembourg and other EU countries with ambitions to attract a larger share of the continent’s alternative investment business. However, the grand duchy is already benefiting for the preference among some hedge fund managers for a regulated structure that is already in place and benefits not only from free distribution throughout Europe but widespread acceptance elsewhere in the world – UCITS.

The drive toward use of the UCITS regime for alternative funds, despite its constraints regarding diversification of assets, restrictions on the use of leverage and the obligation to replicate the economic effect of short-selling through derivatives, has certainly been spurred by the glacial pace toward completion of the AIFM Directive since it was first proposed in spring 2009, but it has now taken on a life of its own.

Even after the formal adoption of the directive last June, numerous uncertainties remain regarding the number of EU member states that will adopt it by the deadline of June 22, 2013, and how this will impact the ability of managers and funds located in countries that have transposed the legislation to take advantage of the single market it is supposed to create for funds aimed at sophisticated investors.

Fund promoters, managers, service providers and investors are still in the dark, too, about the detailed rules that will spell out how the directive’s broad outlines will be implemented in practice, due in the form of a directly-applicable regulation whose finalisation by the European Commission has been delayed. Further additional rules, recommendations, standards and guidelines are due from the European Securities and Markets Authority and national regulators.

Against this backdrop, what the UCITS regime offers is certainty – with the proviso that consultation is already underway on the next iteration of the regime, to be known as UCITS V, even though the previous version only came into effect last year. And as the leading domicile and servicing centre for traditional retail funds, Luxembourg has become a natural choice for many providers of alternative UCITS.

Global political and regulatory developments over the past three years, as well as the evolving attitudes of institutional investors, have convinced many managers of alternative funds that for European investors at least, they need to be able to offer an onshore alternative to the traditional offshore fund structure domiciled mostly in the Cayman Islands, but also in the British Virgin Islands, Bermuda or the Channel Islands.

While there has been some incidence of redomiciliation of offshore funds in onshore jurisdictions through the actual transfer of an existing legal structure, for the most part promoters or managers see onshore funds as a complement rather than an alternative to their existing offering. The successful implementation of the AIFM Directive might provide a suitable regulatory framework for this at some point in the future, but for now UCITS funds tick enough of the boxes to appear the best choice.

For a start, they offer a well-established passporting mechanism developed over more than two decades to enable funds established in one EU jurisdiction to be marketed in another with a minimum of legal formalities and red tape. The implementation of the UCITS IV Directive in July 2011 streamlined the cross-border authorisation process further by imposing a maximum...
waiting period of 10 days after a manager’s submission of an application for cross-border marketing and curbing the ability of EU countries to delay or reject the distribution for funds from other member states.

A further advantage is the widespread familiarity with the UCITS framework of regulators and investors, both institutional and retail, in countries well beyond Europe, especially in East and South-East Asia, South America and the Middle East. While concerns have been raised about whether regulators in these jurisdictions might be less comfortable with funds offering alternative strategies, to date the appetite for UCITS has remained strong.

To a large extent this global awareness of the UCITS brand is associated with Luxembourg, which is home to 72 per cent of all funds worldwide authorised for distribution in other countries. So familiar has the French expression Sicav – open-ended investment company – become among investors in Europe and beyond that many funds in English speaking Malta have ‘Sicav’ in their name, and Ireland has drawn up plans to offer Sicavs as an alternative corporate structure to public limited companies.

The crisis of the past four years has affected the fund industry through performance volatility and increased investor caution, but it has not shaken Luxembourg’s position as the dominant centre for UCITS funds. At the end of June 2012 UCITS made up almost half of the distinct legal fund entities domiciled in Luxembourg, with 1,841 (most of them umbrella structures) out of 3,867, while UCITS assets of EUR1,762.87bn accounted for just under 80 per cent of the total of EUR2,224.48bn for all Luxembourg funds.

The grand duchy is home to management companies with local fund services relationships for most fund groups, whether from Europe, the US or Asia, with international ambitions. Its position as a marketing and distribution hub is bolstered by its experienced, skilled and multilingual workforce, service providers ranging from administrators and custodians to auditors, as well as law firms with expertise and network connections in key distribution markets.

It’s logical that managers using Luxembourg as a centre for the structuring, servicing and marketing of traditional funds should draw on its capabilities for alternative UCITS too. Hard and fast statistics are hard to come by, largely because there is no standard definition of what constitutes an alternative UCITS, but most estimates suggest that the country is the leading domicile for the sector.

Alternative UCITS have been growing rapidly over the past three years, although they still account for well under 10 per cent of the assets of the hedge fund industry as a whole, and probably less than 3 per cent of the total value of all UCITS funds, which amounted to EUR5,849bn at the end of May, according to the European Fund and Asset Management Association.

Geneva-based Alix Capital, which compiles the UCITS Alternative Index, says the assets under management of 776 single-manager UCITS hedge funds and 78 funds of alternative UCITS funds surveyed by the firm amounted to EUR129bn at the end of June, an increase of 7.5 per cent from EUR120bn in the previous quarter and of 18.3% since mid-2011 (funds of funds represent a very small proportion of the sector’s assets at some EUR3bn). Alix Capital says Luxembourg has a 45.7 per cent share of the market, ahead of France with 18.5 per cent and Ireland with 17.4 per cent.

Naisscent Capital, another Swiss-based research provider and funds of funds manager, says there were 1,018 single-manager alternative UCITS funds and 120 funds of funds at the end of June. In October last year the firm said a “best guess” at the sector’s assets was somewhere between EUR80bn and EUR120bn, because not all the funds it surveyed reported assets under management. At that time, Naisscent said that of approximately 1,000 single manager funds, 555 were domiciled in Luxembourg, 225 in Ireland and 130 in France.

PerTrac, a data and research technology provider, reported that the combined assets of 1,210 alternative UCITS funds – a sample compiled from various fund databases widely used in the industry – stood at EUR149.94bn at the end of October 2011, with Luxembourg the domicile of 49.92 per cent of funds, Ireland of 18.84% and France of 11.90 per cent. The variation between these figures indicates the difficulties in obtaining a precise statistical profile of the sector, but all point to Luxembourg’s central role in the development of an industry that is still in a
stage of early and vigorous growth.

The grand duchy’s leading position as a centre for both traditional and alternative UCITS funds has been bolstered by its determination to transpose European legislation into its national law early, in order to give fund providers the maximum amount of time to prepare. For example, the UCITS IV Directive was adopted by Luxembourg’s Parliament in mid-December 2010, the first EU member state to do so and more than six months before the July 1, 2011 deadline.

The legislation was also used as a housekeeping exercise to update other areas of Luxembourg’s funds regime. At the end of June, the grand duchy was also the domicile of 581 non-UCITS funds established under Part II of the 2010 legislation, with assets of EUR202.4bn, as well as 1,445 Specialised Investment Funds with EUR259.2bn in assets – largely alternative investment vehicles set up under a lighter-touch regulatory regime introduced in February 2007.

The SIF legislation was revised in March this year, incorporating changes that already bring the regime into line with various provisions that the AIFM Directive will impose from July 2013. The full transposition of the directive into Luxembourg law is scheduled for the third quarter of 2012, as part of a fresh package of funds legislation that will also create a vehicle equivalent to the Anglo-Saxon limited partnership within the country’s civil law framework.

The grand duchy’s readiness to respond early to the requirements of international lawmakers as well as the needs of the industry will doubtless be seen again when UCITS V comes forward for adoption. In the new legislation, the European Commission has raised the question of whether the directive should make changes to the framework that has enabled managers to offer alternative strategies through UCITS funds.

Concerns have been raised that funds following complex strategies and investing in exotic derivative instruments may be offered to investors that do not understand them and for which they are not suitable, although alternative UCITS often impose minimum investment requirements significantly higher than those customary for mainstream long-only funds in order to discourage retail investors.

Some industry members worry that unfavourable publicity for alternative UCITS could damage the regime’s reputation as an assurance of best practice and risk control for funds aimed at the general public. In addition, it could hamper the ability of managers to distribute their products in other parts of the world (in many of which fund markets are much more dynamic than Europe’s) where regulators have up to now been happy to accept the EU seal of approval as a quality guarantee.

So far there has been little evidence of mis-selling, and the risks of a fund ‘blowing up’ are mitigated by the UCITS regulatory overlay, notably limits on leverage, diversification rules and the requirement that funds must offer investors liquidity at least bi-monthly. In fact, Alix Capital reports that among the funds it surveys, 83 per cent offer daily liquidity and almost all the rest weekly liquidity.

Even before the UCITS V proposals have been finalised, the Commission is already examining issues that may be covered by a future UCITS VI directive. One key area on which it has requested industry feedback is eligible assets, the liberalisation of which in the early to mid-2000s led to the alternative UCITS boom. A July 27 consultation paper asks whether there is a need to review the scope of eligible assets and exposures, whether all strategies currently offered are in line with investor expectations of a UCITS-regulated product, and whether further rules are needed on the liquidity of eligible assets.

The Commission is inviting comment on the possible consequences of preventing funds obtaining exposure to non-eligible assets, for example by adopting a look-through approach for securities, investments in financial indices (notably hedge fund indices) or closed-ended funds. It is also asking about the impact of defining specific exposure limits and diversification rules at the level of a fund’s underlying assets.

The grand duchy’s ability to deliver a regulatory environment and servicing capability that inspires the confidence investors need.
many investors who would prefer not to be vulnerable to EU inspection - not because they have criminal intent or are tax dodgers but because they fear and do no trust bureaucratic oversight.”

Meric-Smith says that dual onshore/offshore domiciliation is likely to develop going forward but that the decision on whether to launch a UCITS fund or a QIF/SIF will depend on investor needs: “Do they specifically want a UCITS structure and if so can the hedge fund strategy easily fit into that? If not, then a QIF makes more sense.”

Michael Fergusson, Chair of the ALFI Hedge Fund committee, notes that far from being sold to retail investors, alternative UCITS funds are being targeted at the European institutional, HNW markets. However, he notes that asset flows to this sector from European pension funds over the last 12 months have been “modest”. In his view, their primary focus is the quality of the fund manager not the type of fund structure.

“I don’t envisage the likes of Schroders offering their alternative UCITS to a retail audience. Their target audience is the wholesale market. This is also true of markets like Asia and the Middle East - these products are being sold to wealth managers, not the broader retail space. Some global hedge fund managers have been very successful. They’ve raised significant assets in markets like Switzerland, mainly in the wealth management space,” comments Ferguson.

One of the major benefits of the UCITS brand is its global recognition. For hedge fund managers looking to diversify their investor base, not just in Europe, but globally, there are clear benefits to offering such a vehicle. And as Harwood-Jones is quick to point out, this is not just a case of European managers flooding, say, the Asian market to raise assets; increasingly, Asian managers are setting up structures in Europe to tap into European assets as well.

“The bridge is fully open and the direction of travel is two-way. If you look at who’s launching structures in Luxembourg, it isn’t just Europeans or Americans. There is now an increasing incidence of Asian players coming to talk to firms like BNP Paribas to help them overcome some of the distribution challenges they face. So the traffic is definitely flowing both ways and although the industry in Asia is still small compared to Europe and the US, that is changing and I think in the months and years ahead that pace of change will quicken,” says Harwood-Jones.

In June this year, Hong Kong-based Value Partners Group - one of the region’s largest asset managers with USD7.2 billion in AUM - rolled out its first UCITS-compliant fund: the Value Partners Greater China Classic Fund. There is a strong belief among managers that this is space worth infiltrating.

Indeed, one Singaporean hedge fund manager was quoted in the press as saying that by not offering a UCITS structure a manager would “miss out on a lot of the action”. The UCITS wrapper was, he said, a seal of approval and compared it to a restaurant receiving a Michelin star.

Stephane Diederich is the founder of Alpha UCITS, one of the oldest independent hedge fund UCITS distribution and structuring platforms. The firm has two distinct business models: asset raising and fund structuring. Diederich says that from an asset raising perspective it’s been a good year, confirming that assets YTD are “double what we saw last year”.

An awful lot of due diligence goes into identifying the right managers. As Diederich points out: “You live and die by the quality of your products. Since we started we’ve probably met 40 managers a year but I don’t think we could ever raise assets for more than six managers at any given time.”

Having a UCITS fund, then, is not a guaranteed golden ticket. Managers have to demonstrate operational and performance excellence, just as they do when raising assets offshore.

On the structuring side, Alpha UCITS launched its first external manager earlier
this year – New York-based GSB Podium Advisors, an equity statistical arbitrage fund. The fund is already at USD50 million. Says Diederich: “On the structuring side, we would like to have a larger critical mass but now that we’ve launched our first manager I believe a lot of the hard work has been done. We are now actively looking to launch further sub-funds and currently in discussions with about 10 managers.”

One of the big dilemmas facing managers is how the AIFMD will play out. What will its final format be? There is a distinct possibility that QIFs and SIFs, already enjoying substantial growth, will become the preferred choice of onshore vehicle because of their greater inherent flexibility and suitability for hedge fund strategies. Quite what impact this will have on the alternative UCITS space is open to debate.

Says Ferguson: “We’ve seen significant growth in QIFs/SIFs. They’re being used for every alternative asset class, in particular debt and infrastructure over the last nine months. I personally think the alternative UCITS space is going to reach a certain level and plateau out.” He says that with AIFMD on the horizon, managers might choose to wait before launching UCITS vehicles and that those managers who have already launched funds might decide to migrate to an AIFMD wrapper i.e. QIF.

“It is possible that the AIFMD will establish a brand quality for the alternatives world similar to what UCITS established for the traditional world. If it does, then onshore investors will likely take comfort investing in QIFs/SIFs which will be AIFMD-compliant,” adds Ferguson.

UCITS V is expected to overlap with AIFMD in certain areas as the EU Commission attempts to create a level playing field for UCITS and non-UCITS funds. The carrot being dangled in front of managers who choose to become AIFMD-compliant, either by moving completely onshore by establishing a dual vehicle, is that, like UCITS, they will be able to passport their fund across all 27 EU Member States.

Yet again, though, it will become a trade-off and will require managers to think carefully about their end objectives: should they go down the AIFMD-compliant QIF route, or stick to the established UCITS route?

“The environment is challenging, that’s clear, but we are quite confident that hedge fund UCITS are the future core allocation model into hedge funds for most European and Asian investors.”

Stephane Diederich, Alpha UCITS

“When you look at the entire provisions under the AIFMD it’s quite a small carrot in comparison to the number of sticks that the directive brings with it. For example, consider the depositary liability point: if you decide to take advantage of the passport it means you as a manager will have to comply fully with the Directive and that includes the appointment of an independent depositary whereas previously you might not have needed one. There are cost implications to this, which will ultimately trickle down to investors,” says Meric-Smith.

However, under UCITS V, managers will be subjected to the same depositary liability costs as managers under AIFMD. This could seriously impact performance of existing UCITS – particularly in emerging markets where there aren’t affiliated sub-custodians – and potentially put managers off launching funds.

Meric-Smith caveats this, by adding: “How liquid are the instruments being traded in those markets? If the answer is ‘Not very much’, then it’s highly unlikely a manager would be trading them in a UCITS fund in the first place.”

For now, alternative UCITS are an additional distribution tool for blue chip hedge fund managers but under AIFMD, the QIF structure could well start to become the preferred choice.

Concludes Diederich: “The environment is challenging, that’s clear, but we are quite confident that hedge fund UCITS are the future core allocation model into hedge funds for most European and Asian investors and we want to position ourselves as the specialist for asset raising and structuring in this space.”