US managers look to add alternative UCITS products

UCITS remains the gold standard for global investors

Using fund platforms to access alt UCITS
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UCITS: A compelling distribution option for hedge fund managers

With investors concerned over the impact that a rising rate environment could have on their fixed income portfolios, the need to look for alternative solutions to hedge against, and even profit from, widening yields, is becoming paramount. James Williams explores how alternative UCITS, which continue to enjoy positive inflows, are proving an appealing option to investors looking to diversify their investments.

In the last few years, investors have continued to pile into fixed income to enjoy the last drops of yield compression, which have moved perilously close to zero. US 10-year Treasuries fell as low as 1.38 per cent in August but already, following the result of the US Presidential elections, they have widened out to 2.22 per cent. Whether this really is the end of the 30-year bull market remains to be seen. Either way, investors are nervous.

All of which is good news for Europe’s alternative UCITS market, which continues to grow. According to LuxHedge, a leading database and index provider that tracks developments in this market, total industry assets, as of October 2016, stand at EUR409 billion; that is up from approximately EUR260 billion two years ago.

“I see further growth for alternative UCITS,” says Andrew Dreaneen, Head of Schroder GAIA Product & Business Development.
Development, Schroders. “There is a genuine appreciation among investors that when the US Federal Reserve raises rates, they want to know what that will mean for their fixed income investments.

“At the same time, if you look at the supply/demand dynamics for UCITS, there are roughly USD9 trillion invested in UCITS products, 30,000 funds and only 800 alternative UCITS with approximately USD350 billion in AUM; a fraction of the total AUM. From an opportunity perspective, only 3 per cent of UCITS AUM is in alternatives. Even if investors only move 2 per cent of their traditional long-only capital in to alternative UCITS, that would represent USD200 billion of new assets. If their allocation moved to 10 per cent it would take the alternative UCITS industry to USD1 trillion, which we are very excited about.”

Benedict Peeters is CEO of LuxHedge. He agrees that a rising rate environment will soon become a wake-up call for European institutions, some of whom are already looking to protect themselves with inflation-linked products, and fixed income absolute return products.

“We are of the opinion that the alternative UCITS market is going to grow substantially over the coming years for reasons that relate to the fact that the fixed income markets are not yielding anymore. Investors are looking for alternative ways to generate returns and they want to invest in a way that is less correlated to interest rate movements. I believe the alternative UCITS market offers very good opportunities to do that.

“Look what happened on the back of the Trump victory. You can see how substantial the impact could be on longer-dated assets. If there is less ECB intervention in Europe, this will cause European bond rates to rise as well and the impact on investors’ traditional bond portfolios will be huge,” suggests Peeters.

As Europe’s alternative UCITS environment matures and grows, investors are looking towards fund platforms to seek out the best talent to allocate to, alongside their traditional allocations. And even though AIFMD is now three years in, giving European investors access to regulated hedge funds, there is still broad appeal for the UCITS wrapper, albeit one that imposes restrictions on hedge fund liquidity and concentration limits that one does not get with AIFMD-compliant funds.

Institutional investors who are looking for diversification in their portfolios often have difficulties investing in traditional hedge funds. By purchasing UCITS products, however, they typically have board approval, which might not be so straightforward when considering AIFs.

“The pension fund market is not interested in achieving the best return possible but in making sure that their assets deliver a return that they require to meet their liabilities. In such a context, purchasing alternative UCITS funds is an intelligent decision (to helping them achieve this),” adds Peeters.

26% annualised growth

Actual hardboiled figures for this marketplace are difficult to discern, although in keeping with LuxHedge’s figures, a recent survey by Deutsche Bank Global Prime Finance puts the total AUM figure at close to EUR400 billion.

This is still a drop in the ocean compared to the long-only UCITS market, and offshore hedge funds market (still hovering around the USD3 trillion mark) but as Deutsche Bank points out, the total value of assets invested in alternative UCITS funds has risen by 26 per cent annually since 2008.

The Deutsche Bank 2016 Alternative UCITS Survey found that nearly 70 per cent of all investors surveyed said that they allocate to alternative UCITS funds, with 58 per cent of investors confirming that demand came primarily from their underlying institutional clients.

Commenting on the survey, Anita Nemes, head of the Hedge Fund Capital Group at Deutsche Bank said: “Our survey results
suggest that growth is set to continue, with two thirds of alternative UCITS respondents expecting to increase their allocations this year. We are also seeing a growing number of hedge fund clients embrace UCITS as a growth strategy for their businesses, leading to an increase in new interesting fund launches.”

The survey also revealed that systematic equity market neutral and fundamental equity market neutral are the most sought-after strategies by alternative UCITS investors. Zadig Gestion Luxembourg has announced plans to launch the Memnon Market Neutral fund and as Spencer Rhodes, Alternative Investments Global Business Manager at Allianz Global Investors, tells Hedgeweek: “We have launched three new alternative UCITS funds so far this year: Market Neutral Equity Long/Short, Volatility Long/Short, and Absolute Return Covered Call Writing. We will launch two more by the end of the year: Multi Asset Long/Short and Multi Asset Opportunities, both of which are managed futures strategies.

“These are all low-net exposure, market-neutral strategies of various types.

“All of our funds are managed by in-house teams. We don’t package third-party managers, because we want to have full transparency into any strategy we sell, which allows us to do the appropriate risk management oversight.”

Allianz Global Investors currently manages roughly EUR19 billion in Alternative Investments, of which EUR10.2 billion are in liquid alternatives and hedge funds. Some EUR3.6 billion is held in alternative UCITS products.

**Fixed income arbitrage delivers**

Over the years, most new launches within the alternative UCITS space have tended to fall into three main buckets:

- Equity long/short;
- Equity market neutral;
- Fixed income arbitrage.

Indeed, if one looks at the AUM breakdown, by strategy, on LuxHedge, fixed income arbitrage funds account for approximately one quarter (EUR109 billion) of total alternative UCITS assets.

This is helped by the fact that performance in this strategy has been solid.

“We are also seeing a growing number of hedge fund clients embrace UCITS as a growth strategy for their businesses, leading to an increase in new interesting fund launches.”

Anita Nemes, Deutsche Bank

The Fixed Income Arbitrage UCITS index managed by LuxHedge is up +2.18 per cent YTD and is by far the best performer in what has proven to be a largely disappointing year, performance-wise, for the market. Other strategies in positive territory are CTAs (+0.84 per cent), global macro (+0.78 per cent) and volatility arbitrage (+0.58 per cent).

“It has not actually been that great a year in terms of performance,” concedes Peeters. “The growth this year has been from net inflows. The market has not seen an increase in value, as such and a lot of strategies this year have not performed as well as we would have expected.

“The LuxHedge Long/Short UCITS Index is down -2.78 per cent through October (having returned +2.90 per cent in 2015) and the Long/Short Europe UCITS Index is down -4.17 per cent (having returned +7.11 per cent in 2015).”

He believes the underlying reason for this has been a lack of decorrelation in the equity markets “but I think that is starting to change. Volatility is rising, correlations are decreasing so I think the next quarter’s performance for equity long/short funds will be better.”

The lack of direction or decorrelation has made it a tough environment for European stock pickers this year. More broadly, global equity long/short hedge funds have fared better. The HFRI Equity Hedge Index is up +3.48 per cent, compared to -2.78 per cent based on LuxHedge’s index.

Pinpointing why these differences in performance exist is not straightforward suffice to say that the number and quality of offshore funds far exceeds those in UCITS. It also should be stated that a broad index does not reveal the range of performance
According to Hedge Funds Research, hedge funds this year have experienced more than USD50 billion of net outflows, continuing a theme that began back in Q4 2015.

Prior to this, the industry had enjoyed a near constant quarter-on-quarter increase in net inflows, taking total industry assets beyond USD3 trillion. This year, it would appear institutions have taken pause for thought and questioned the value of their offshore hedge fund allocations.

By contrast, however, the alternative UCITS industry has continued to grow from strength to strength. According to Hedge Fund Research, this area of the market had USD200 billion in assets under management in 2015. Another source, Kepler Partner, puts the figures slightly higher at USD285 billion in AUM for 2015, rising to USD302 billion through Q3 2016.

This is welcome news to those operating UCITS platforms in Europe, one of the largest and best known of which is the GAIA platform operated by Schroders, which currently has approximately USD30 billion in alternatives, of which approximately USD15 billion is in alternative UCITS.

“At Schroders, if we look at our top 10 best selling funds year-to-date on our global platform, four of those are alternative UCITS. We feel we are well positioned in respect of alternative UCITS.

“With respect to the growth of the GAIA platform, between 2013 and the end of 2015 alternative UCITS AUM for the industry at large grew by 40% whereas the GAIA platform grew by 120%. In discrete periods we’ve seen strong growth,” explains Andrew Dreaneen, Head of Schroder GAIA Product & Business Development, Schroders.

Across Schroders’ alternative UCITS funds range, demand has been at its strongest for one of its own internally managed funds; the flagship European Alpha Absolute Return Fund, a low net European equity long/short fund managed by Lionel Rayon. The fund has attracted USD119 billion of assets with the majority of the growth in 2016. This particular fund does not sit on the GAIA platform, which primarily showcases external hedge fund managers.

The other three funds in the top 10, which are on the GAIA platform include: Schroder GAIA BlueTrend, a systematic trend following strategy with north of USD300 billion in net inflows; Schroder GAIA Two Sigma Diversified, which launched at the end of August 2016 and has already attracted more than USD400 million in net inflows; and Schroder GAIA Cat Bond, a catastrophe bond fund which has had roughly USD300 million in net inflows.

In addition to Schroder GAIA Two Sigma Diversified, the platform also onboarded Schroder GAIA Indus PacifiChoice, a pan-Asian equity long/short fund.

“We are continually working to build out our client offering through the GAIA platform, looking to partner with high quality hedge fund managers,” says Dreaneen. “In addition, investors are continually looking for alternative alpha sources across discretionary and systematic managers.

“In terms of Indus, we feel that there are few pan Asian equity long short strategies available to UCITS investors, and as the Asian markets are inherently inefficient, it provides an excellent back-drop for alpha generation. For Two Sigma, we have seen increased demand for both equity market
neutral and systematic macro strategies, so being able to offer a blend of these two strategies with a manager like Two Sigma, is an incredibly attractive proposition for investors.”

In order to capitalise on the growing trend among European institutions for regulated hedge funds, this year Schroders rolled out the Schroder GAIA II platform. By supporting AIFMD-compliant funds, it allows Schroders to bring clients a wider range of alternative fund strategies.

The first fund to launch on GAIA II was Schroder GAIA II NGA Turnaround, a long/short liquid distressed debt and equity strategy managed by New Generation Advisors. NGA manages USD800 million in assets and has one of the longest and most successful track records in the sector, investing over three full credit cycles.

Aside from broadening the strategy mix, another reason for setting up GAIA II is in response to an evolving regulatory environment. There might be instances in the future where some of the more sophisticated UCITS funds are required to be reclassified either within UCITS as more complex strategies or potentially move into a non-UCITS structure. By now having a non-UCITS platform, Schroders is prepared for any such eventuality.

Going back to the GAIA UCITS platform, Dreaneen sees the role it plays as two-fold. On the manager side, he says that Schroders has seen a notable pick-up in conversations it is having with non-European managers wishing to learn more about UCITS.

“Some have their own offices and sales teams in Europe and have gone it alone, but many managers prefer to rent a compartment on an umbrella platform or join a full support plug and play platform with proven distribution. Either way, the uptick in interest from US and Asian managers is encouraging and should eventually lead to more choice for investors” says Dreaneen.

On the investor side, the market potential for alternative (asset raising potential) is significant and cuts across all investor channels.

Two thirds of the total AUM in alternative UCITS is held by private banks and wealth managers. Demand for non-plain vanilla strategies (e.g. discretionary macro, systematic strategies) has increased noticeably and despite the mixed returns of the asset class “we’ve seen many allocators going from a 10% to 15 or 20% recommended allocation to alternatives, of which hedge funds form the majority of those allocations.

“In reality, many remain way below that level; typically a 5% or less allocation and only a handful of approved alternative UCITS funds, with a view to increasing that number to 20 or 30 funds through time. Therefore, I think the demand from the core investor is by no means saturated. There is still plenty of room for further growth going forward,” suggests Dreaneen.

Then there are the sophisticated retail, or ‘mass affluent’ investors. Intermediaries for these investors are looking to mimic the investment models being used by the private banks and advising their clients to look at actively managed, absolute return strategies.

“This is quite an untapped market and offers huge potential,” adds Dreaneen.

Finally, on the large institutional side, Dreaneen confirms: “We are receiving RFPs from some of Europe’s largest pension funds and beyond; Canadian pension funds, Asian Institutions and more notable interest from the consultant community than in the past. The institutional and mass retail channels are huge areas of growth for Alternative UCITS and Schroders is well positioned with a franchise of over 20 alternative UCITS funds and more than 800 distribution professionals globally.

“By channel, I would estimate 85% are intermediaries, which for us cut across asset managers, private banks, family offices and fund-of-funds; the core allocation mentioned above. And 15% are institutions; insurance companies and pension funds.”

From a geographical standpoint, GAIA’s investor base is approximately 75% Europe and 25% non-Europe, of which the majority are based in Asia Pacific and Latin America.

“There are challenges and opportunities in both the institutional and retail space although I think the core market will continue to dominate. The institutional and mass affluent markets are less mature but they are increasing in potential,” concludes Dreaneen.
within a strategy set: there will always be excellent performers and laggards in any index construct.

"I think it is very realistic for investors to aim for a 5 to 8 per cent return in their portfolio using alternative UCITS funds if they know how to pick them," says Peeters. "The consistency of performance still has to be monitored by the investor, however. They should not just pick 10 managers and stick with them. They need to dynamically manage their alternative UCITS portfolios."

Schroders has enjoyed great success with its GAIA platform over the years. One of the key features is to give investors access to the best external managers in the market, thereby overcoming some of the selection issues that investors face.

This year, the GAIA platform has added two unique strategies: Schroder GAIA Two Sigma Diversified and Schroder GAIA Indus PacifiChoice.

Dreaneen says that Two Sigma Diversified aims to deliver uncorrelated alpha, with controlled volatility, across a wide range of market conditions through the systematic application of fundamental, technical, event and alpha capture strategies to global markets: "It is a combination of US equity market neutral and global systematic macro trading strategies, with approximately 85 per cent of its capital allocated to equity market neutral and 15 per cent to macro trading strategies."

As for Schroder GAIA Indus PacifiChoice, the fund invests in equities and equity-related securities across the Asia Pacific region, including Japan, Greater China, Australia and India. The fund primarily targets large-cap companies that we believe have been significantly mispriced. The fund combines primarily bottom-up stock picking with macro awareness, which is vital in the Asian markets.

More US managers considering UCITS
Such is the strong level of demand among global ex-US investors for UCITS products that more US managers are looking to add alternative UCITS products to their business lines. Dreaneen thinks that there is still a lack of US managers, confirming that Schroders has spent a lot of time in 2016 engaging in a number of dialogues.

This is understandable if one considers a recent survey by Aquila Capital, which found that more than 75 per cent of investors surveyed said they expect the use of third party platforms by US and Asian asset managers to launch UCITS and AIFs to increase.

"We’ve had a dialogue in the past 12 months with approximately 100 US-based fund managers," states Dreaneen. "In the near term, asset flows will likely still go to existing funds that have built up a track record but in terms of new launches the number being launched by non-European fund managers should increase materially. We estimate that there are about 30 of the largest US hedge funds that could potentially do something with UCITS and we’ve talked to most of those. I would say approximately half of them are very active in wanting to find a solution and launch something, in some cases as soon as possible."

Aside from investor demand, another reason behind US manager interest in UCITS is linked to the fact that they have become acclimated to running their strategies in a more liquid ‘40 Act vehicle.

Dreaneen thinks that compared to ‘40 Act, UCITS has two main appeals that have contributed to increased numbers of launches.

Firstly, managers are able to offer their hedge fund strategies to investors without the need for significant customisation, and
are able to offer these products with similar fee structures. This, he says, improves the operational efficiency of product launches and provides investors with an attractive investment proposition, staying true to the offshore strategy.

"Secondly, the UCITS distribution opportunity is very attractive for US managers to help diversify their client base to a global audience (save US onshore investors) and cuts across all channels, whereas 40 Act is primarily retail," remarks Dreaneen.

To further underscore the level of interest among non-European asset managers, Mirae Asset Global Investments has announced that it plans to expand its European product range for UK investors. Chief Executive Officer Jung Ho Rhee said that the firm will focus on pushing its Asia Sector Leaders and Asia Great Consumer Equity funds. Last year, Mirae launched the Mirae Asset Next Asia Pacific Equity Fund, its first product to be co-managed with Daiwa Asset Management Co. Ltd. The Fund is a sub-fund of the Mirae Asset Global Discovery Fund SICAV, a Luxembourg-domiciled UCITS that currently houses 17 UCITS sub-funds.

**Full capacity**

Over at Allianz Global Investors, Rhodes says that the group continues to see strong demand for alternative UCITS, confirming that four of its strategies “hit full capacity in 2016”.

“Everyday I hear clients say they have a preference for strategies in UCITS vehicles, and not just in Europe. I’ve been to Asia three times this year to respond to demand there, specifically demand from Japan, Korea, China, and Hong Kong,” states Rhodes.

He sees alternative UCITS remaining popular, despite investors having a second option available to them with AIFMD-compliant funds.

On the retail side, many banks simply require regulated funds with regular liquidity. Therefore, new types of private funds will not change the demand for alternative UCITS from these channels.

“On the institutional side,” says Rhodes, “UCITS funds have been taking market share from Cayman-type funds over the past few years. It is possible that AIFs will begin to take market share from both Cayman funds and UCITS funds within the instructional channels. That said, the pie is growing, so I expect all of these vehicle types to continue to grow, even if they take a bit of market share from one another.”

He thinks it will come down to the type of assets that are being traded and the nature of the strategy. "If the strategy is UCITS-able, then clients will likely want it in UCITS. However, if the strategy needs longer-term capital, higher leverage, or more concentrated positions in order to work, then it will be in a Cayman fund or an AIF.”

**Square pegs, round holes**

In order to support investors across the entire range of hedge fund strategies, be they in a UCITS wrapper or an AIFMD wrapper, this year Schroders rolled out the GAI AII platform to sit alongside GAIA.

As Dreaneen explains, the Schroder team often comes across great managers but their strategy simply doesn’t work in a UCITS format. For more liquid strategies, there is the potential to launch a carve-out or differentiated strategy within UCITS; this is typically the case with macro managers and multi-strategy managers where a UCITS version of the fund will seek to replicate the liquid portion of the book and strip out the leveraged portion of the book. Under UCITS rules, a fund can only have up to 100 per cent in a single sovereign issuer. Therefore, if the manager is trading large leveraged positions in US Treasuries, they will often bump up against these concentration rules.

Commodities, too, are difficult to include in a UCITS fund.

“Our philosophy up until now has been not to try and put square pegs in round holes and try to shoehorn these strategies,” says Dreaneen.

“This led us to think about creating a
new platform structure that would allow us to replicate the strategy in full (or most of it) and not sell it to the broader UCITS market but sell it to investors as an AIFMD-compliant fund. If ESMA does not extend the AIFMD passport to Cayman and Bermuda, then outside of the UK, the Nordics and Switzerland, where managers are happy to still pursue private placement rules, it will be more challenging for them to market their offshore funds across Europe when compared to the flexibility Schroders have with GAIA II and its EU passport.

“The second reason we launched GAIA II is to increase the bandwidth of the strategies we can offer to clients. If, at some point, the European authorities decide to stop certain hedge funds being used under UCITS then it means we will have the infrastructure in place for clients to launch AIFs instead.”

Other platforms such as Lyxor Asset Management are also offering investors the choice to invest in UCITS funds or AIFs.

For the time being at least, the alternative UCITS market appears to be prospering even if performance has been disappointing in 2016. Fact is, the UCITS brand remains the gold standard among global investors and this is hugely appealing to fund managers. Schroders sells its GAIA funds in over 40 countries worldwide, and even though the AIF brand will take a long time to build, it will offer managers the same distribution capabilities on GAIA II.

“The main differentiation will be channel differentiation rather than geographic differentiation, says Dreaneen.

“Outside of Europe, we see the distribution potential for GAIA and GAIA II being broadly similar. European private banks with offices in Hong Kong and Singapore, for example, will still prefer UCITS funds but where we see some differentiation between the two platforms from a channel perspective is with respect to institutional investors.

“Some institutions feel that the UCITS construct is more prohibitive. The investment proposition of funds on GAIA II should be pari passu to their offshore funds in many strategies, which means investors will have the choice to allocate either offshore or onshore.”

For the alternative UCITS market to maintain its lustre, the quality of managers and consistency of performance still needs to be proven. Performance remains the one risk that could derail the growth trend. If investors’ first experience of investing in hedge fund strategies is not a positive one, it could stymie the level of net inflows.

“Managers have to prove that they can generate returns even when markets are down but I don’t see the growth that we have seen abating,” concludes Dreaneen.