Liquid alternatives: growth trajectory is just beginning

The importance of a well-crafted distribution strategy

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Alternative UCITS funds offer huge AUM potential for managers

By James Williams

In many ways, this is just the first stage of growth for alternative UCITS. There is still a huge amount of future growth potential yet to be realised. If one looks 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 3.8 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.

As reported towards the end of last year by Preqin, 35 per cent of the more than 100 investors surveyed in June said that they currently invest in liquid alternatives; either alternative UCITS or ‘40 Act funds. A further 16 per cent said that they planned to in the future.

The quality of alternative UCITS, generally speaking, is improving, as more hedge funds decide that if they want to participate in the European market they need to seriously consider having a UCITS structure.
This is proving highly beneficial to Europe's key fund jurisdictions – namely Ireland and Luxembourg, both of whom are seeing substantial traction for UCITS products. Over the last five years, Ireland has experienced an 81 per cent growth in UCITS funds, which, according to the Central Bank of Ireland figures, as of September 2017, total EUR1.77 trillion in AUM.

Last year USD30 billion of net new business went into alternative UCITS, this was dominated in particular by very strong flows into multi-asset absolute return funds. This year, says Andrew Dreaneen, Head of Liquid Alternatives, Schroders, there have been continued inflows. “Alternative risk premia strategies continue to be of interest, and one or two large fixed income houses have been raising a lot of money for UCITS income-oriented unconstrained fixed income funds, which continue to be very popular,” says Dreaneen.

Kepler Partners publishes a quarterly review on the alternative UCITS market. It currently tracks 569 funds managing GBP284 billion. In total, there were 19 new launches in Q3, which collectively raised GBP485 million in assets. The report notes that both Multi Strategy and Event Driven strategies have been particularly popular this year, with much of the growth in the Multi Strategy space coming from risk premia focused products; echoing Dreaneen’s comment.

The largest launch in Q3 was the Winton Diversified Fund (UCITS), which raised GBP148 million, followed by Prime Capital Multi Advisors UCITS with GBP106 million. Over the last 12 months, the three biggest fund launches have been: AQR Systematic Total Return UCITS (GBP368 million), MLIS Milburn Diversified UCITS (GBP179 million) and CZ Absolute Alpha UCITS Strategy (GBP163 million).

This is interesting for the fact that all three are prominent hedge fund managers, in a space that is characteristically associated with traditional asset management houses.

“CZ Capital launched their fund in June 2017 and it has effectively doubled the firm’s total AUM. The UCITS fund now has USD290 million. Prior to this, CZ was running USD340 million in total,” comments Georg Reutter, Managing Partner, Kepler Partners LLP. He says that over the past year, Kepler

“Across our total funds universe, the top 10 funds are all equity long/short funds, all of which are up by more than 20 per cent. The majority of these are emerging markets funds.”

Georg Reutter, Kepler Partners has tracked a total of 68 new launches in its database, raising in excess of GBP3.3 billion combined.

“The AQR launch was substantial, it was very timely,” adds Dreaneen. “It’s clearly something they’ve had a lot of success with in other structures – Cayman, US ‘40 Act – as have other big name managers such as Two Sigma, which joined GAIA last year.

“We’ve hard closed three of the seven funds on GAIA. Two Sigma raised just over USD1.5 billion in five months, which is a record for the platform. The other two funds are Schroder GAIA Egerton Equity and Schroder GAIA Cat Bond. Investors can fill out an expression of interest form to apply for future capacity. We have a significant amount of pent-up demand for these products.”

Reassuringly, alternative UCITS have had a decent year, performance-wise, in 2017. The AH Equity Long/Short Index is up 6.4 per cent YTD, while the AH Multi Asset Index is up 5.5 per cent.

“Performance has been decent and there’s been some good launch activity but it hasn’t been a ‘wow’ year. Equity long/short funds have done well, particularly those with exposure to Emerging Markets and China. Out of the top five funds, performance wise, two have China in the fund name; the best performing fund, year-to-date, is the BANOR SICAV Greater China Long Short Equity Fund, which is up 55.7 per cent.

“Across our total funds universe, the top 10 funds are all equity long/short funds, all of which are up by more than 20 per cent. The majority of these are emerging markets funds,” explains Reutter.

Dreaneen confirms that the best performing fund on GAIA in 2017, up 21 per cent, was the Indus PacificChoice fund, a
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ML Capital is an independent European regulated fund structurer that is rightly well known for its MontLake UCITS and MontLake QIAIF platforms, the success of which has seen firm-wide AUM grow to EUR5 billion since its inception in 2009.

However, ML is more than that. With a newly established footprint in Luxembourg that takes the firm beyond its Dublin home base, ML Capital can support fund managers in Europe’s two main fund jurisdictions in a far-reaching capacity that goes beyond being just the operator and investment manager of MontLake. As Cyril Delamare, CEO of ML Capital, articulates, the firm is a fund solutions provider from an operational and management company perspective.

“When a manager is looking to launch a product, we start with a clean slate,” says Delamare. “ML will tailor the product from a strategy perspective, but also from an investor perspective. It’s all about helping them to structure the product, such that it will be compatible with asset raising and distribution from the start.”

Fund managers can choose to join the MontLake UCITS platform or use ML Capital’s management company services (‘MLC Management’) and structure dedicated standalone platforms or single funds.

“An increasing number of established fund managers want support, not only in terms of structuring their product at the pre-launch phase but also ongoing support, post-launch. That is something we’ve really focused on over the last couple of years and enjoyed some good momentum. We don’t just set the fund up for them and say, ‘Good luck’. We support them on an ongoing basis to ensure their product is always at the level expected by investors – whether from a point of view of structure, regulation, passporting or market intelligence,” says Delamare.

ML Capital’s service offering is greater than the sum of its parts. For all the funds it works with, the ongoing objective is to ensure that each of them remains at the top end of their service capability; that applies equally to funds on MontLake UCITS and to standalone funds/platforms. Delamare says that the platform is perfectly suitable for a fund of any size, large or small.

“There is a misconception in the market that a platform offering is made only for emerging, nascent managers. Fund managers who use the platform are those who don’t see the benefit of having their own platform, because they have no real intention of launching a suite of UCITS funds. They get the economies of scale, the support, and the quality of a platform, as well as the benefit of being with other fund managers, which gives them more visibility in the marketplace.”

“Those who use our management company to support their ongoing dedicated platforms tend to be managers who have the ambition, or the capacity, to build a family of UCITS funds,” explains Delamare.

In 2017, ML Capital’s overall AUM grew thanks to a number of fund launches, with Delamare confirming that it was an even split between MontLake funds and standalone funds. This has helped ML Capital grow its ManCo services business, attracting some sizeable AUM to complement organic growth on the platform.

“We offer different services to your typical management company. We call our service, ‘management company plus’ – this means operating the fund structure on an active basis. Fund managers can delegate everything from an operational perspective to ML Capital, leaving them to focus on managing their strategy and raising assets for the fund. It’s a different model to your traditional management company, which we’ve learned from having operated the MontLake UCITS platform for many years,” concludes Delamare.
product and managed account-based offering, to a broader service offering where Lyxor’s managed account platform has become a centre point of expertise, providing clients with research, selection, products and infrastructure services in order to help them with fund investments across different asset classes,” says Spada.

Fee structuring is a focal point with hedge fund managers who act as partners on the Lyxor managed account platform. “When we launch a new fund on our platform, we seek to offer our investors a genuine hedge fund strategy, in a liquid and transparent format with the lowest possible fee structure.”

Daniele Spada, Lyxor Asset Management

UCITS platforms seizing the opportunity
Prominent asset managers, such as Lyxor Asset Management, see long-term value in alternative UCITS and consider them an important revenue driver as managers look to develop global distribution strategies, combining both onshore and offshore versions of their strategies.

Four years ago, the bulk of Lyxor’s business centred on offshore commingled funds. Nowadays, says Daniele Spada, Head of Lyxor MAP, Lyxor has moved to a larger range of funds that include liquid, regulated and transparent Irish-based UCITS funds.

“There has been a shift from a pure pan-Asian equity long/short fund. The best performing fund in Schroders’ internally managed stable of liquid alternative funds was the Schroder ISF Asian Total Return fund, up 38 per cent.

“It was a great year in the industry for emerging market long/short funds. Several of the top 20 best performing hedge funds are either EM, China or India long short funds, several of which were up more than 40 per cent,” says Dreaneen.

Dispersion is at its widest point in quite a long time, which makes for a better environment for stock pickers and active managers. The number of active managers outperforming their benchmarks is 62 per cent, according to Dreaneen (https://www.ft.com/content/150bfb14-a848-11e7-93c5-648314d2c72c), considerably higher than previous years when that figure was as low as 10 to 20 per cent.

Generally speaking, correlation between UCITS funds and offshore counterparts has been getting closer. According to Ed Morse, Sales and Marketing Director at Tages Capital, a leading alternative investment specialist, for highly liquid strategies there is no real reason why a UCITS fund should not perform, with a very close correlation, to its offshore counterpart.

“UCITS tend to be daily or weekly liquidity, whereas most offshore funds are monthly liquidity or longer. That means offshore funds can invest in less liquid stocks, for example, which may add extra alpha, relative to a UCITS fund. Broadly speaking, correlations are very close for liquid strategies such as equity long/short and CTAs,” says Morse.
Last year, there was a clamour for global macro funds. The difficulty with these funds, though, is the requirement to disclose leverage numbers in the UCITS KIID. Often, global macro funds end up using enormous amounts of leverage, which makes the regulators nervous; the last thing they want is a major blow-up that could jeopardise the UCITS brand.

“Macro can be hard because of the levels of gross leverage often employed,” continues O’Bryan. “There are a handful of Credit long/short funds in the UCITS space; I would say that both areas are under-represented at present. There are a lot of equity long/short funds these days, as well as CTAs. I do think the macro space is one that investors want to see (develop further) and we expect to see some launches soon.”

In Reutter’s view, choice is always good for investors. He argues that the best funds always stand out, ultimately, regardless of the strategy.

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By bringing together people, capital and ideas, Goldman Sachs produces solutions and results for our clients. Our Fund Solutions team within the securities division helps clients access both unique internal cross asset content and a select group of external alternative asset managers.
Goldman Sachs Fund Solutions is a bespoke solutions-oriented fund investments platform that was launched in 2004 within the Securities Division. The platform, at large, provides investors with access to unique internal strategies via regulated funds (UCITS and AIFMD-compliant funds), unregulated funds, as well as managed accounts. In addition, it offers investors access to carefully selected external alternative fund managers; referred to specifically as the Third Party Managed (UCITS) Platform.

Laura Elliott is an Executive Director at Goldman Sachs and oversees manager selection on the UCITS platform. Commenting on the importance of the alternative UCITS space, she says: "We see the UCITS platform as allowing our investors to access two of our key product types within the bank; hedge fund strategies through our strong external relationships and Goldman Sachs developed alternative risk premia products."

Hedge funds have always been a key part of Goldman Sachs's business, in terms of building relationships and supporting managers' trading and execution needs, and providing access to securities (long and short), market research, etc. As managers increasingly look to diversify their investor base, regulated fund structures are being more seriously considered.

If one factors in that there is also growing interest in alternative risk premia (ARP) strategies, many of which are offered in a regulated wrapper, one can start to get a sense for why alternative UCITS funds are viewed favourably by Goldman Sachs.

There are currently seven managers and eight funds on the Third Party Managed Platform.

The platform currently has two alternative risk premia products managed by Aberdeen Asset Management, a selection of equity long/short strategies focusing on the US, on China, and on global markets, a managed futures strategy operated by the well-known US manager Campbell & Co, as well as a systematic macro fund operated by ADG.

"We are seeing demand for different types of products," says Elliott. "Initially, the majority of interest from UCITS investors came for equity long/short and CTAs, which made sense given that these strategies can often fit within a UCITS wrapper, but as the market place has developed, investors are looking for diversification in their portfolios and therefore branching out to other strategies."

"That prompted more launches in global macro and credit for example, and more recently alternative risk premia. This was already an important space for our securities division and it has meant we can now offer many of these strategies in a regulated fund format.

"Not only can we launch funds with risk premia that is not managed (i.e. passive), we can also work with asset managers to provide combined solutions, where they selectively pick our risk premia products and manage them on an active basis."

A good example of this is Aberdeen, who are managing a portfolio of risk factors in two versions (one enhanced) of their multi-strategy fund on the platform.

"This first managed risk premia product was added onto our platform in November 2016 and we are excited about the opportunities in this space," explains Ben O'Bryan, Executive Director and Head of Fund Solutions, Goldman Sachs.

He notes that much of the demand
for UCITS products has been driven by regulatory change. Certainly, with MiFID II coming into effect in January 2018, the bar has been raised for manufacturers and distributors of all financial products. Given that UCITS funds are well-established, highly regulated funds in their own right, O’Bryan sees them as becoming a more logical choice for many clients, moving forward.

The longest track on the platform dates back to December 2011 when the team onboarded Select Equity Long/Short UCITS, a US equity long/short fund which currently has USD120.7 million in AUM.

Some of the big European managers have become more adept at running their own stable of UCITS funds – both Marshall Wace and Winton Capital now offer a number of internally hosted UCITS to the market. However, for those managers outside of Europe without the infrastructure or expertise to operate in European regulated markets, they often need platform solutions as a way to tap into European investors.

Goldman Sachs provides a turnkey solution for managers. The platform works closely with investors to understand what they are looking for in terms of strategy type and calibre of manager.

“Everything we do is investor-driven. We are a solutions business. We don’t push out what we think is the best manager,” states Elliott.

O’Bryan also points out that having added managers from Asia and the US on to the platform, some have limited experience in setting up funds within the European regulatory framework and may not have European distribution scale. “We want managers to be able to focus on managing the investment strategy. All of the service providers are in place and the manager simply gets added to our existing infrastructure.”

This makes for quicker time to market and it takes away all the heavy lifting involved in the launch process.

One important consideration for managers is that they may end up with lots of smaller allocations in the UCITS fund compared to what they are used to in their offshore fund; certainly in the early stages of the fund, as it builds a track record.

As such, knowing that network of investors and having the resources to contact them is actually quite a heavy responsibility, “It’s not to be underestimated,” says Elliott.

O’Bryan concludes: “We have regional sales teams who are experts in each market. We provide them with the right information and analysis needed to facilitate the conversation between the manager and the investor.”
be forgiven for getting carried away and ploughing into this highly regulated space without due thought and consideration. Attracting institutional dollars is top of mind, alongside performance, for any ambitious manager. There are, however, no guarantees that having a UCITS fund will act like a magnet to investors. Platforms are extremely diligent as to who they partner with. There has to be high conviction that any new fund brought to market succeeds in growing AUM as quickly as possible; the Two Sigma fund referred to earlier by Dreaneen is a good example.

“As a platform provider we have a responsibility not to shoehorn strategies into UCITS,” comments Laura Elliot, Vice President at Goldman Sachs, overseeing manager selection on the UCITS platform. “As much as investors are looking for innovative strategies, we won’t put them on the platform if they don’t fit in the UCITS framework. For example, you have to be sure that the products you provide meet the liquidity and transparency constraints.”

Knowing what investors want is critical. Kenneth Sim, Head of Sales, ML Capital, which operates the MontLake UCITS platform, says: “We actively seek out managers to bridge the gap for investors. Even though we don’t ourselves seed, the network of seed investors we work with could decide to allocate to a new manager on MontLake if the solution we can provide them is correct.”

A UCITS fund that remains in the EUR20-30 million for too long is unlikely to succeed. When ML Capital actively selects a manager to go out and raise money for, the decision falls squarely on its shoulders.

“We make a qualitative choice based on research we would have done within our investor network to understand what they are looking for, to help us determine what the AUM growth potential of a new fund could be,” says Cyril Delamare, CEO of ML Capital. He offers the following advice to those thinking about launching UCITS:

“Understand the market and price your fund in a way that will appeal to investors. Be cognisant that in the early days there should be a seed price for the fund, then a growth price for the fund, and finally a maturity price for the fund. If you can figure out what those three pricing points are, then you will have a successful distribution strategy; provided your strategy performs.”

Elliot says that AUM growth tends to be exponential over time: “It can be a slow process, lots of small ticket allocations to begin with due in part to many investors holding ratio constraints and as the track record builds over time it starts to attract the attention of the larger investors who are likely to make larger ticket allocations.”

Another point to consider, at the pre-launch phase, is whether to launch a completely new product, making no reference to one’s existing offshore hedge fund, or whether to launch a UCITS that will closely – if not completely – mirror the offshore strategy. “The best successes I’ve seen are where you have a high quality/brand name manager offering a UCITS fund pari passu to their offshore fund,” opines Dreaneen.

Ultimately, there is no point taking out 50 per cent of the book in order to fit it into a UCITS fund.

“Generally speaking, most successful UCITS launches incorporate all or substantially all of the flagship strategy; it can be a slower process to raise assets for a new or partially replicated strategy as investors will want to see a track record develop,” says O’Brien.

There is an allure to having a UCITS fund. If the strategy can be properly managed within UCITS restrictions, and if it addresses a lacuna in the investor marketplace, managers can enjoy huge success, not just in Europe but globally (ex-US). Having a UCITS fund certainly adds an institutional seal of approval to one’s hedge fund business.

“We are definitely seeing more eagerness and interest from larger hedge fund managers...
The value of a well-crafted distribution strategy

Interview with Kenneth Sim

Getting distribution right is crucial when launching UCITS funds. The last thing a manager wants is to struggle to grow their AUM. Not only does it look bad in the eyes of prospective investors, an inadequate marketing effort can quickly become a costly and frustrating exercise.

ML Capital has a two-fold approach to distribution, namely Passive and Active, which focuses on the manager and the investor respectively. ML Capital ensures the highest possible service quality for all fund structures on its MontLake UCITS platform so that the investor has the best possible investment experience.

Passive distribution is offered to all fund manager and focuses on market accessibility and visibility, ranging from the regulatory requirements of passporting to specific investor needs, such as tax reporting, platform accessibility and much more. Active distribution, on the other hand, is only offered to a small handful of fund managers.

“A lot of managers we work with already have their own distribution networks and sales teams, or do not meet our clients’ needs. In that situation, we simply provide infrastructure support on the platform,” explains Kenneth Sim, Head of Sales, ML Capital.

“Often, we invite managers with distribution needs to join MontLake because we specifically want their strategy to be part of our exclusive distribution mandate. The key is to ensure that our commitment is based on the demand for their investment strategy in the marketplace. Simply put, the priority for each sub-fund is to raise the most assets possible. To achieve this, we will only consider complementary, not competing, strategies.”

The goal is to always match investor demand with manager supply.

“We take the time to listen to our clients and focus our efforts on finding suitable investment solutions for their portfolios,” adds Sim.

The firm has seven active sales people dedicated to selling funds on the platform. They come from a range of different cultural backgrounds across Europe, are all multi-lingual and have experience raising capital in Europe. ML Capital’s core sales regions include the UK, Ireland, French-speaking parts of Europe (Geneva, Paris, Benelux), German-speaking parts of Europe (Zurich, Austria and Germany) and Italy.

ML Capital’s sales team has an ongoing dialogue with investors across Europe to determine the issues they face today, from a UCITS investment perspective. Where do they feel there is a lack of manager supply? What are the issues they are facing in their investment portfolios? With correlations rising in the market, how do you find managers and strategies that can help diversify some of the risks away in an investor’s portfolio?

“On the one hand we have seen demand from German allocators for higher volatility managers who look to maximise their alternatives exposure. However, in Switzerland and the UK demand remains strong for lower volatility products. The common thread is a desire for these returns and risk exposures to be taken independent of broader equity and fixed income market movements, coupled with an ability to protect or even perform in varying bear markets,” says Sim.

Whilst it’s important to know the investor, one also has to understand the market from a fund investment infrastructure perspective. If a fund is not correctly plumbed into each market, from a tax reporting and compliance perspective, or from a fund distribution platform perspective, it will face difficulties.

“Oftentimes, UCITS funds (on distribution platforms) fail to raise capital because the manager doesn’t receive the ongoing support to really engage with investors actively by doing roadshows, exchanging information and keeping the clients updated, all of which will make that distribution channel a success,” concludes Sim.
(with respect to having a UCITS vehicle) than we were say four or five years ago. They understand the brand better; and they understand the calibre of investors. As the UCITS brand has strengthened, a lot of the larger managers are more willing to consider it.

“Having a turnkey solution that we can provide, where we do all the heavy lifting, is an attractive proposition to many managers,” says Elliot.

It is partly due to the support offered by platforms such as Goldman Sachs, Lyxor and ML Capital that US managers are showing greater willingness to move into this regulated area of the market.

This is evident by the recent addition of Connecticut-based hedge fund manager, Conatus Capital Management, to the Schroder GAIA platform back in May this year. The Schroder GAIA Conatus Equity fund, an equity long/short strategy, launched on June 7th 2017, and is managed by David Stemerman, co-founder of Conatus. This is the first foray into UCITS since Conatus was established in 2008.

ML Capital’s Delamare is adamant that the US remains a huge potential market from which further UCITS funds could be launched by managers.

“That said, you have to educate US fund managers on how to manage UCITS funds and to understand the cultural differences, such as moving from quarterly or monthly liquidity to daily or weekly liquidity; that is quite a big hurdle to overcome still.

“Still, we are seeing more and more interest from US managers who see UCITS as a diversifier away from their existing client base. They might have already launched ‘40 Act mutual funds and so have gotten used to managing more liquid portfolios, and are thinking of taking a second step by launching a UCITS vehicle.

“There is tremendous opportunity in the US and I think over the next few years we will see a segmentation of managers and strategies, with more boutique and specialist fund managers coming to market i.e. sector-specific managers,” comments Delamare.

Platforms are able to take a lot of the burden away, in terms of regulation and compliance, or at least help with the set-up (if a manager wants a standalone fund). For that reason, Reutter believes it is “not as daunting

“It was a great year in the industry for emerging market long/short funds. Several of the top 20 best performing hedge funds are either EM, China or India long short funds, several of which were up more than 40 per cent.”

Andrew Dreaneen, Schroders

as perhaps it might appear at first glance if managers partner with the right people”.

“We’ve already seen a good number of US blue-chip names launch, as well as smaller boutique names, so there’s definitely a good track record of managers having success. But there have been failures as well. Maybe they didn’t give the UCITS fund the attention it needed, maybe the manager was unlucky in terms of market conditions. I anticipate that US managers who want to have a footprint in Europe, should and most likely will, consider launching a UCITS. But it doesn’t come without its risks,” warns Reutter.

Many US managers have jumped on the ‘40 Act bandwagon and a lot of assets have been raised, but there’s a big difference between ‘40 Act funds and UCITS funds; UCITS funds can charge a performance fee, which ‘40 Act fund cannot. So from a profitability perspective, UCITS is significantly more attractive.

“I think the US equity/long short strategy, as a category, still has plenty more room for new funds. There’s always room for good quality US equity-focused products. One of the problems is there are many US equity long/short managers who are capacity constrained. They have significant assets from large US institutions, which creates a bit of a conundrum,” observes Morse.

He says that in 2018, Tages Capital hopes to launch at least three more UCITS funds on its platform.

“We are and will continue to be opportunist. If we find interesting fund strategies that we think make sense for our clients we will seek to add them to the platform to widen the choice for our investors,” concludes Morse.