Debate about hedge funds' use of Ucits continues

Hedge funds are continuing to look at Ucits products as attractive. However, there are pitfalls to putting any strategy into the framework. In a forum sponsored by Alceda Fund Management, Bank of America Merrill Lynch and KB Associates, fund managers explain why it is imperative to understand the rules and constraints

Panel participants

Alceda Fund Management
Michael Sanders, chief executive officer

Bank of America Merrill Lynch
Eric Personne, managing director and head of EMEA equity structuring and fund solutions

KB Associates
Claire Cawley, executive director

Salus Alpha
Günther Schneider, head of global business development

HEDGE FUNDS REVIEW: Why should a hedge fund manager be looking at a Ucits structure? What advantages will it give them?

Michael Sanders, Alceda Fund Management: There are two main reasons why a hedge fund manager should go with Ucits. First, there are certain requirements from institutional investors, particularly in the European markets. This is very important. The financial crisis and the Madoff affair in 2008 are two of the reasons why a lot of institutional investors are looking for a well-regulated product, and that is Ucits.

The second point is you can easily sell or use a Ucits fund for global distribution. It is quite easy to set up a Ucits fund in Luxembourg or Ireland, then sell it to Asian markets or distribute it in the Middle East or even Latin or South America.

If a hedge fund strategy fits into the Ucits requirements – and that is one of the most important things – then I'm pretty sure the manager should go for Ucits.

Claire Cawley, KB Associates: There is a significant appetite for launching Ucits funds and it is driven by investor demand. After the financial crisis in 2008, investors are looking for products that offer a regulated solution, a certain amount of comfort and that look like a safe house. You also find a lot of US managers looking towards Ucits to gain access to a large number of markets.

There is also uncertainty throughout the industry with respect to the alternative investment fund managers (AIFM) directive, and this is pushing managers towards saying there is a solution here that we may be able to use. We should be able to market it easily so let's look at it and see if it is an appropriate solution for us.

Eric Personne, Bank of America Merrill Lynch: About two years ago, Ucits would have not necessarily have registered great interest. Since then, hedge fund managers have done their homework. Also, the AIFM directive coming into place incentivised them to think about the impact of regulatory change. So it is fair to say that serious managers understand the value of Ucits now.

There is an even more basic reason why hedge funds are interested in Ucits. You have the offshore world and you have the regulated world for investment. Alternatives are alternative because they are not mainstream. But, if you believe alternative strategies deliver real added value – alternative investors claim it is added value, and I believe it is – there is no reason why this product should not reach the largest possible audience.

Günther Schneider, Salus Alpha: We were one of the first [hedge funds to move into Ucits]. The company started a Ucits-compliant multi-strategy hedge fund in 2003, which was a very new development and a challenge. Since then, there has been growing interest from institutional investors, from semi-institutional investors and even more retail-type investors.

The reasons for this are that it is a standardised package, it has safe assets and you have very defined liquidity – and that has always been missing in the offshore world.

As Ucits, being regulated is a great thing. But we should not forget the first and most important thing: an asset manager has to deliver performance and protection of its investor's money.

If you believe that an asset manager or a hedge fund manager can deliver that, then the second question is which vehicle can they package it in? Let's get our priorities right.

I am a true and strong believer in Ucits but the good asset managers will go into Ucits and the others, even with non-Ucits or Ucits, won't have a chance.

Claire Cawley: There is a significant amount of convergence between the alternative world and the traditional Ucits world. If you are looking at alternative Ucits, alternative managers are not necessarily running them.

Convergence, to some extent, is very beneficial because it stops this barrier between the Cayman hedge fund world and the European Ucits world. There is room for all kinds of products that give returns to investors and allow them to diversify. By using the Ucits products, you can get your product out to more people and that can only be a good thing.

Michael Sanders: Because of Ucits you can easily target every small investor group. It is not only institutional or qualified investors that can invest in them. That is another very important point: you can market it to retail clients as well. The alternative hedge funds really get some mainstream exposure.

Günther Schneider: According to our experience, there is little difference between markets. Typically, in German-speaking markets, we do see large institutional investors looking for Ucits. They love regulation and the authorities love it. It is a little bit different in the UK or in Asian markets, for example, where they also have active distribution of funds.

Eric Personne: The fact is that Ucits is a fairly new segment. We are talking about something that wasn't really talked about two or three years ago and I expect we will have to wait a little while for this market to become really mature. It is progressing fast, however. Journalists are writing about it and market participants are scrutinising whether it is happening or not happening. It is happening, but it's not going to reach its full potential in one year.

We should be looking at a five- to 10-year horizon because this market is progressing in parallel to something that is fundamental – the fact that asset managers are being challenged anyway by the exchange-traded funds (ETFs) market. More than ever they have to prove they are delivering value and it is all about performance first and what investors really need, from a product delivery perspective, second. Having a big beta component and being long only is not necessarily what investors fundamentally need. We are just learning that now, so we are adding an additional building block for people to manage money.

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> **Claire Cawley, KB Associates**

Günther Schneider: Let me be contradictory because I don't think it is a new thing. Maybe the package is new but, as you said, the investors – whether they are institutional or retail – did not expect asset managers to just follow an index and be long only. They always expected them to take care of their money. Now, with the new instruments we have, there is a toolset ready within the regulated space. People have become more demanding: 'Now you have the tools, why don't you deliver the results I expect?' So maybe the packaging is new but the challenge for the industry is what it has always been.

Eric Personne: Look at all the other questions that gravitate around Ucits. For example, are they too expensive? Yes, in absolute terms, if you compare them to long-only beta, they are certainly more expensive. But what investors should be assessing is whether they deliver value. If it is expensive but it delivers exactly what it says, then the price is of secondary importance.

Then there is risk. When some observers suggest that complex equals risky – which is not the case – this gives a false impression. Today, you can sell a long-only emerging markets fund to traditional retail investors in France but not be comfortable selling a fully diversified market-neutral fund. That doesn't make any sense and yet that is where we are.

Claire Cawley: Investors looking for safety have driven the growth in Ucits hedge funds. It does seem to have come out of the crisis. Managers see an opportunity: will the strategy fit into a Ucits? If it fits and we can manage the returns and all of the risk requirements, then we should go ahead.

Michael Sanders: There is a really strong network in Germany in terms of institutional investors – insurance companies, pension schemes, and so on. What happened there was that, in 2003–2004, these investors opened up their minds to investing in alternatives. After the financial crisis in 2008, they were scared of investing in those less-regulated offshore structures. They are really looking for a well-regulated product so they can invest into alternative strategies.

Günther Schneider: Fees and pricing – we have to compare things that are alike. If I compare an offshore non-transparent vehicle to a regulated, liquid and safe instrument, there must be a different price structure. If you look at the details, I am not sure which would be the more expensive, even if you look at manager fees in the offshore world.

We should make sure we compare things that deliver the same results within one group and then look at price structure. Having set standards, safety of assets and liquidity, then net of fees is what people look at and is what we have to deliver.

HEDGE FUNDS REVIEW: Do you think investors understand that, if you have transparency and the liquidity, it is a payoff and you are going to have to pay for that in the structure?

Günther Schneider: I have had so many conversations about this. It was not about pricing structures. It was not even about structuring the product. It was about results, about protecting their assets, it was about managing the drawdown. That is what people actually care about. If markets ease, then we have the discussion about it being 10 basis points more or less. Yes, they are fully aware of the price and the cost of an instrument that is able to deliver performance.

Michael Sanders: That is exactly the same feedback we get from the managers that join our platform. There are no discussions about the fee structure, absolutely not.

Eric Personne: I sometimes get a few questions about the fee structures, usually when people are telling us it is expensive. But I ask them, 'what are you comparing the price with?' If you are comparing with an ETF, then we are not selling the same product here.

Günther Schneider: I agree. But the due-diligence process of a pension fund is definitely different to the selection process of, let's say, the grandmother in France. But on days like we had in August, the reactions to the market are not that different. They ask us first, 'did we do our job?' and 'did we lose money?' Then they worry about structuring, fees, and so on. Yes, in a certain way, they are different. But, at the end of the day, they react very much alike and do not want to lose money. They want to sleep well at night.

Claire Cawley: That comes down to the fundamentals of the Ucits directive in terms of the safekeeping of assets, risk diversification and liquidity.

You have to have, at the bare minimum, bi-monthly liquidity or, at the top end, daily liquidity. These are the fundamentals: are the assets safe, are they diversified and do you have risk procedures in place to manage all the risk? When it comes down to the bad days, people are looking for security.

"If you operate in the traditional asset management world, it is more fragmented, far more complex. The rules are totally different"

Eric Personne, Bank of America Merrill Lynch

HEDGE FUNDS REVIEW: Ucits have a great brand name. Is there a danger investors may not bother with due diligence? Or are investors just as careful when they are buying into a Ucits product as they would be putting money into an offshore hedge fund?

Claire Cawley: I would think they would – or they should – be just as careful. Due diligence is fundamental when you are making any investment. Certainly from the institutional investor's perspective, the due-diligence process has to be as thorough as it is for any type of investment.

Michael Sanders: Absolutely. Ucits does make the due-diligence process much easier from a legal point of a view because they can just tick the box and say the structure is approved by a European regulator and it is fine – only in regard to the legal structure, not in terms of the investment.

If an institutional investor wants to check the legal structure of a Cayman fund or British Virgin Islands fund, it is not that easy. A Ucits fund is approved by a European Union regulator in terms of investment guidelines, risk management, and so on. They have to do the regular due-diligence process on the fund.

HEDGE FUNDS REVIEW: Is using a platform one way of helping managers market and distribute the Ucits fund?

Eric Personne: One of the ways a platform can bring value is definitely in the setting up of a fund. From a legal standpoint, it is not really hard to team up with a lawyer and build the prospectus. The complexity is more operational if you want to do it right.

A platform does it in a scalable manner, so that can really help you. For example, a US manager that does not know the European environment well could go on a platform and say, 'you are going to do it because you have done it before'. Certainly, they could do it themselves but the platform makes the process faster and easier for them. That is one of the values of a platform.

If a platform is considering hiring a new manager, there is no guarantee he/she can properly run a Ucits fund. Experience is key and therefore the platform self censors in this respect.

Michael Sanders: That is a very interesting point. If the set-up consists of just two guys and Bloomberg, from our point of view, we would never add them to our platform because we do our own due diligence on the managers. We are focused on mid-sized or growing managers, supporting them with every service they need to launch their fund. For all those mid-sized managers, the best way to go is with a platform because everything is in place – all of the agreements, distribution agreements, and so on. They can focus on their core competence of asset management.

Günther Schneider: I completely understand the value of a platform to a fund manager but I would expect an asset manager that runs a Ucits product to understand 100% what they are doing, and in enough detail so they could do it themselves. If the platform provides better distribution and maybe seeding, I totally agree [it is a good option]. But let's say basket swap versus index swap, which has severe consequences on the range of eligible assets – even if the manager is in the US or offshore – he should definitely understand in detail what is necessary before starting to run a Ucits product, and then benefit from better distribution from a platform.

Michael Sanders: We need to educate the managers about Ucits, yes. The service provided by a platform is more substantial. If a manager decides to go their own way and set up their own operation, they need to build some sort of operation. From my point of view, that really is the most important service we provide: the substance. Yes, we need to educate the manager and ensure they know what Ucits is and the requirements in terms of investment management.

Eric Personne: Operational set-up is extremely important, I agree. Nevertheless, as far as our platform is concerned, we actually focus on distribution and helping funds gain access to a market segment they don't necessarily know well.

Claire Cawley: Our experience of managers launching Ucits is that they already have a lot of that information. If they have internal operations and they know they don't need to rely on a platform, then they go it on their own for the purpose of flexibility, choice of service providers and being able to manage costs on their own.

In terms of operations, while a platform does offer a certain amount of support, it has been a learning curve for the managers that have gone out on their own. There has been an investment in time and energy.

Günther Schneider: You mention distribution. Did it change? Yes, it did certainly change. If you mention Ucits in the introduction, you get people who would not even listen before to talk about alternative investment strategies.

Coming back to the daily work, no it hasn't changed that much. It is still hard work, it is still legwork, and it is talking to more people than anybody else. So the basics didn't change that much. It is just that you can give a different set-up, which is not that much easier just because it is Ucits.

Eric Personne: If you operate in the traditional asset management world, it is more fragmented, far more complex. The rules are totally different. It is not enough to speak solely to the due-diligence groups when they are not the primary decision-maker.

Michael Sanders: We had a lot of meetings and discussions with US managers. In the end, it is a question of distribution and sales network, absolutely.

Eric Personne: I had managers coming to me and asking, 'can you raise a billion euros in six months because I have seen you can raise a lot of assets in Ucits?' You have to explain to them that is not the way it is going to work. You don't build the business model on that. It could take three years. You have to educate them.

You could have another approach and say, 'of course you are going to raise a billion', but you may well disappoint them quickly.

What you have to do, if you are a platform and your mission is to distribute, is to demonstrate to the hedge fund manager that you really know what you are talking about, that you understand who is going to buy, who is not going to buy, the time it is going to take and the work the managers will have to do.

Two years ago it was totally unclear. Now what is possible and what is not possible is starting to be clearer for distributors and hedge funds.

Michael Sanders: You can compare platforms in other regards as well – for example, independence and experience. The mid-sized or growing managers are looking for a really independent platform because they want to choose their own custodian bank, for example, or choose their own prime broker. An independent platform offers more than an insurance-owned or bank-owned platform.

Claire Cawley: That is a very important point in terms of whether you have some choice of service providers or are tied to a particular prime broker.

If they are using a platform, they are very focused on what they can get in terms of distribution, but they are paying for it. They also want to get the platform to make their life easier. They don't want to have to make major changes to their own operational infrastructure if they are using a platform. Having access to the providers they want to use is fundamental for a lot of managers. If it becomes a problem, that is where you find many managers going it alone.

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Michael Sanders, Alceda Fund Management

Günther Schneider: It is exactly as you say. If you have an asset manager who says, 'okay I want to become rich quickly and I need this billion to survive, and then everything is fine', that is definitely not the kind of asset manager we would have, not in Ucits, not in offshore, not ever.

We decided to have our own distribution network. We have an office in Hong Kong, one in Singapore and one in Scandinavia. Yes it is hard work but we know our

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investors. I have a local manager in Singapore who knows his counterparty. Especially in times like these, that is helpful. We know the decision-makers so we can communicate face-to-face. That is very helpful for us in managing their money.

Michael Sanders: That is the same way we like to go with our managers. On the one hand, we like to provide them with sales and distribution in the markets we are active in – like Europe and we are opening up an office in Singapore – but, on the other hand, if the manager has his own sales network or distribution network, we can do it together. We can do it both ways.

Claire Cawley: Do you find you have managers coming onto your platform that already have a sales or distribution network? What are they really gaining? Is it extra contacts in those markets?

Michael Sanders: Yes. To give an example: we recently launched a Russian long/short equity fund. It is a New York-based manager with a strong distribution network in the Spanish and Italian markets. Our network is stronger in the German market. It fits very well. We focus on distribution in Germany, Switzerland and Austria, and they focus on southern Europe.

Eric Personne: After two years, we looked at who had been raising assets – the managers or us. We realised that, for €100 million of assets in a fund, we had raised between €80–85 million and they raised nearly €15–20 million. It was interesting because it was proof we were bringing value.

Claire Cawley: Ultimately, those of our clients that have made a success of raising assets in Ucits funds have been those managers that have put people on the ground and devoted significant time, energy

and money to developing distribution contacts. There is no two ways about it. That is what you have to do in order to get assets raised.

We find that, when managers come to us, they might have been speaking to a platform and decided to go it on their own.

HEDGE FUNDS REVIEW: Looking at the key investor information document (Kiid), is that something you think is going to be beneficial or do you think it is something that is going to be more of a problem for managers and possibly even for investors?
Claire Cawley: It might be a problem getting it done. Ultimately, the Kiid was brought in because the simplified prospectus wasn't simple or easy for people to understand. Some were not four pages long but significantly longer. It had not achieved its original purpose, so the Kiid is good in that it is supposed to be a short piece – two pages – and people can compare it.

Now people are trying to write them, it is proving very difficult to get complex investment strategies into a few phrases.

There are going to be many teething problems. Ultimately, it is a good thing for the industry because it is a shorter document and makes the high-level analysis easier at the beginning. These are the key pieces of information I need to know. You don't have to rifle through a prospectus to page 55 to find out the fee levels.

Eric Personne: The concept is good, it is an additional tool. What is important is the way you sell products to people – the dynamic between the adviser and the investor. The Kiid can help but it is not going to be the end of the story, it is just the beginning.

HEDGE FUNDS REVIEW: If the EU decides to differentiate between retail Ucits and a Ucits product aimed at more sophisticated investors, do you think that would be a positive or negative development?
Eric Personne: I don't think it is fair to say that what is complex is risky and what is risky is complex. We have to navigate through this debate.

Claire Cawley: The concern is where you draw a line in the sand. If you are assessing it on complexity, how do you actually say what is complex? If you are assessing it on risk, how are you measuring that risk?

There is a framework within the Ucits regulation for managing risks. There are procedures managers have to comply with. You know there are set limits: if you have a simple Ucits, you have to monitor your leverage and your exposure.

There were already some systems in place and some changes with Ucits IV in terms of appointing individuals responsible for risk and widening the scope of the risk management process to include all types of risks, including operational and liquidity.

Revisiting the Ucits concept in terms of sophisticated or non-sophisticated funds, or complex and non-complex funds, that is a long way down the track.

Eric Personne: Substance prevails over form. Within the framework we already have, some funds may well try to push it to the very limits. If substance prevails over form, as a regulator, you will be in the position to say, 'yes that technically works, but I am telling you no'. They do that and everyone is more protected as a result.

Claire Cawley: I agree. If you are technically in the Ucits limits, but the spirit of what you are doing is not appropriate, the regulators will say, 'we don't think this is appropriate and we are not going to approve it'.

Günther Schneider: What makes me optimistic is that, in the past – Ucits I, Ucits III and now Ucits IV – regulators have done a great job. It enables the industry to provide something that has not been there before.

The consultation processes have been very professional in the past and created results. That is why I believe it will remain the same.

Eric Personne: What is important is not to convey to investors the idea that there is no risk whatsoever. An example is the debate around the depositary in the AIFM directive. We know when this debate started – it began as an immediate reaction to the financial troubles. Now custodians will have to guarantee everything. This will mean the price that custodians charge will increase.

Günther Schneider: The process of moving this way and then the other is due to political reasons. In a plain vanilla, long-only equity product, there might be a lot more risk than any complex total return model-driven fund. That is where we, as an industry, have to make it clear that risk is a drawdown, not managing your assets in a proper way. That is the way risk should be discussed, in a more focused way. Then we discuss the wrapping.

Michael Sanders: What makes me very optimistic is the requirements of institutional investors, they are really looking for those alternatives. I am convinced the regulators and European Commissioners will take care of those needs and will create some sort of Ucits V where there are some alternative investments. We are not concerned about this.

Claire Cawley: Our experience of dealing with the Irish regulator is that the risk department is happy to engage. As a manager, you want to talk to the regulator as soon as possible to explain what you are doing, explain about the risk in the portfolio. The regulators are open to talking about that. They will speak to you and you can explain to them what it is you are doing.

HEDGE FUNDS REVIEW: Do you think the introduction of the AIFM directive is going to make Ucits redundant or will it open the market to more and different kinds of products?
Eric Personne: The Ucits market is not going to disappear tomorrow and therefore hedge funds wrapped in Ucits will continue and grow. The fact that you have more sophisticated investors keen to invest into hedge funds means they will continue to exist as well. If they have the choice between Cayman or other places and more regulated but fully flexible wrappers, I would anticipate they are going to move towards specialised investment funds (SIFs), qualifying investor funds (QIFs) and the equivalent. That is what I would do and that is what I am hearing. I don't think it is putting Ucits in danger, I believe there are great opportunities for these vehicles.

HEDGE FUNDS REVIEW: Looking at new markets for Ucits funds, is there a big pool of investors in Europe that can be tapped? What are the other areas managers can look at to sell these products?
Michael Sanders: We have the experience, particularly in the Asian markets like Hong Kong, Singapore and Taiwan. There really is a big demand for Ucits. In 2010, more than 40% of all net inflows into Luxembourg-based Ucits were coming from Asia. Asian investors are looking for this structure. This is one of the most important markets for the future.

Claire Cawley: Certainly some of our clients have said they are using the Ucits product to distribute not just in Europe and Asia but also in South America. There is a lot of demand for the Ucits product there.

Michael Sanders: Something like 50% of all mutual funds are Ucits funds that are sold in Bahrain, and it is the same in Dubai. They are looking for quality brands with regard to the structure and that can found in Ucits.

Günther Schneider: It is a great success for Europe to have Ucits as a brand. However, it is definitely not limited to Europe. At the same time, there are definitely a lot of market participants within Europe that have not yet looked at alternative Ucits funds, and that is where we have to spend time to educate people and hopefully raise assets.

HEDGE FUNDS REVIEW: Do you think emerging managers from regions like South America and Asia will want to put their products into Ucits wrappers?
Claire Cawley: We have seen some growth in this area and some interest from managers from South America and some from Asia. They are looking not just at the Ucits product, but also the QIF in Ireland and the SIF in Luxembourg – at regulated products. So there is definitely an interest from emerging managers in terms of launching their products with a European wrapper.

Michael Sanders: For instance, in Hong Kong, the Association of the Luxembourg Fund Industry opened an office in October just to have some representation in that market. We have joined a couple of conferences in Hong Kong and Singapore and a lot of managers were talking about Ucits. There is quite a lot of interest.

HEDGE FUNDS REVIEW: Five to 10 years in the future, do you expect to see more convergence? Will hedge funds or alternatives dominate? What will be the place of Ucits funds?
Claire Cawley: The convergence will continue unless there is major regulatory change. Ucits will always be a strong brand and it will be stronger in five to 10 years than it is now.

Eric Personne: Alternatives will continue being alternative even in 10 years' time. We haven't mentioned the word capacity, but the market has a capacity issue. You can't run each strategy with unlimited size, so it will grow fast but fundamental long-only products will continue to exist and Ucits will grow.

Michael Sanders: The demand on alternatives will steadily grow, particularly with demand from institutional investors, like insurance companies and pension schemes, because there is no alternative on a long view. I'm convinced that Ucits will continue to grow.

Günther Schneider: I am 100% convinced that the investment environment is not going to become easier, so we will see more volatility and more challenges there. We will see demand for all the instruments the alternative investment management industry delivers and, if they are Ucits, they are even better. So a clear 'yes' for Ucits and a clear 'yes' for alternative investment managers.

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