A guide to Alternative UCITS

HSBC Securities Services
Introduction

UCITS and increasingly AIFs (Alternative Investment Funds) have become bedrocks of the European Union’s (EU) fund management industry. Very few fund structures have come anywhere close to replicating or challenging the engrained hegemony and global distribution footprint of UCITS. In this context, hedge funds – once loosely regulated private investment vehicles – are swallowing up the UCITS compliance costs as they sense excellent commercial and distribution opportunities to cultivate sizeable assets in daunting capital raising conditions.
UCITS: The Story so far…

UCITS (Undertakings for Collective Investment in Transferable Securities) is a mutual fund wrapper that emerged in the mid-1980s, and which is readily available to retail investors globally. Due to this retail investor audience, UCITS products are generally considered vanilla in nature operating with embedded investment restrictions and subject to robust regulatory oversight and scrutiny. The brand has evolved dramatically since it was first conceived with five different iterations of UCITS being pushed through by EU policymakers over the preceding three decades. A sixth version of UCITS has long been rumoured to be in the works.

It was the passage of UCITS III in 2003, which was perhaps the most instrumental and formative in the brand’s evolution. UCITS III’s Product Directive expanded the type and range of instruments which these funds could hold.1 While this change did not affect UCITS’ strict underlying liquidity criteria or risk management provisions, it provided managers with expanded scope to use ETDs (exchange traded derivatives) and OTC (over the counter) derivative instruments for purposes beyond just risk mitigation and hedging, but rather in their investment processes as well.

“UCITS categorically prohibits physical short-selling, but the availability of ETDs and OTCs meant managers could use financial instruments such as Contracts for Difference (CFDs) to replicate short exposures synthetically, thereby opening up opportunities for hedge funds to launch UCITS products. So-called “alternative” UCITS, previously referred to as “Newcits” truly took off around 2009 as investors asked probing questions about the risks of conventional hedge funds following the financial crisis, and looked on approvingly at this robust, regulated fund structure,” said Paul Ellis, global head of regulatory product development at HSBC Securities Services.

“Alternative UCITS truly took off around 2009.”

Paul Ellis

There were initial misgivings that hedge funds would be unable to operate and perform capably within the UCITS liquidity constraints, but financial engineering and product innovation have proven the early detractors incorrect.2 “Since then, alternative UCITS have proliferated, and their growth shows no sign of slowing. When hedge funds first started launching UCITS, there were critics suggesting that the talent pool of alternative UCITS was insignificant compared to traditional offshore structures. I would emphatically say this is no longer the case,” said Ellis.

Not all alternative asset managers, however, may want or be able to operate within the constraints of UCITS, and instead prefer to comply with the AIFMD (Alternative Investment Fund Managers Directive). AIFMD is a post-financial crisis regulation introduced in July 2014 impacting hedge funds, private equity, real estate, infrastructure and nearly any asset manager that was marketing non-UCITS in the EU. Whereas UCITS’ history is firmly steeped in the retail market, AIFMD-compliant managers typically target the institutional and high net worth individuals’ (HNWI) market. AIFs are therefore subject to marginally fewer regulatory and operational restrictions, with far greater flexibility around what they can invest in.

2. HFM Week – Liquid Alternatives: Diversification drives Growth
Growing Brands: Asset Growth in Alternative UCITS and AIFs

Cash has consistently flooded into alternative UCITS and AIFs in recent times. In totality, UCITS manages approximately 9.71 trillion Euros on behalf of investors not just inside the EU, but across Asia-Pacific (APAC) and Latin America. Of this sum total, alternative UCITS run over 450 billion euros, having grown 16% since the beginning of 2017. It was also reported that more than 248 new alternative UCITS came to market in 2017 alone. Strategy-wise, the most popular alternative UCITS is fixed income arbitrage, which saw its AUM (Assets under Management) grow by 14.7%, followed by global macro (13.9%), multi-strategy (12.9%) and long/short equity (4.9%).

Meanwhile, AIFMs manage 5.94 trillion Euros, according to the European Fund and Asset Management Association (EFAMA), and saw net sales of 201.6 billion Euros year-to-date (YTD) to November 2017, compared to 187 billion Euros for the entirety of 2016. Within this, hedge funds are a sizeable subset. After a positive 2017 both in terms of capital inflows and performance, hedge funds’ AUM stands at $3.21 trillion globally, the highest ever, indicative of its resilience. Within this sum total, $657 billion or 20% of AUM is managed inside Europe, of which the UK is the dominant market. It is important to note here that past performance is not a reliable indicator of future results.

The Performance Case for Alternatives

Alternative assets – whether they are being sold under UCITS or AIFMD banners – offer end clients a number of benefits. Principal to any credible, risk-adjusted portfolio is diversification beyond traditional asset classes, namely stocks and bonds. Alternatives offer this diversification because they tend to be fairly uncorrelated to broader market trends and indices. As such, alternatives can provide investors with downside risk protection, hedges against rampant inflation, and access to niche or underexplored trading opportunities normally unavailable through ordinary mutual funds.

Aggregate performance, however, has been chequered at alternative UCITS mainly because of the difficult market backdrop – fuelled by low interest rates and Central Banks’ Quantitative Easing (QE) policies – which have made it a challenging environment for active portfolio managers to deliver absolute returns. Despite these tough conditions, the average performance at alternative UCITS has been solid with returns of 2.27% in, 2017.

After several years of subpar returns, partial green shoots are starting to appear in the hedge fund industry’s performance. Data provider Hedge Fund Research said the average manager had delivered returns of 8.7% in 2017 in what is a major turnaround for the sector following a disappointing 2016. Client concerns about hedge fund returns have not wholly retreated, but more than half of investors either had a positive or neutral view on the asset class, and a third expected performance to improve over the following 12 months. However, it is important to note that past performance is not a reliable indicator of future results.

“Underperformance in alternative UCITS relative to other hedge fund structures may be a result of tracking error at the UCITS product.”

Tom Kehoe. Global Head of Research at the Alternative Investment Management Association (AIMA)

The performance drag at alternative UCITS when benchmarked against other asset classes is attributable to the heightened regulations and investment restrictions, which these products are subject to. “Underperformance in alternative UCITS relative to other hedge fund structures may be a result of tracking error at the UCITS product,” explained Tom Kehoe, global head of research at the Alternative Investment Management Association (AIMA), the global hedge fund trade body. However, a number of alternative UCITS strategies do not suffer performance drag, making the investment rationale for such products highly desirable.

3. EFAMA – EFAMA Investment Fund Industry Fact Sheet
4. Luxhedge – (January 15, 2018) Another year of double digit asset growth for alternative UCITS
5. Luxhedge – (January 15, 2018) Another Year of double digit asset growth for alternative UCITS
6. Institutional Asset Manager – July 20, 2017 - Alternative UCITS market sees 10 per cent asset growth and 120+ new fund launches since beginning of 2017, says LuxHedge
7. EFAMA – EFAMA Investment Fund Industry Fact Sheet
9. Prequin – June 2017 – Hedge Funds in Europe
10. LuxHedge – (January 15, 2018) Another Year of double digit asset growth for alternative UCITS
11. Hedge Fund Research (January 19, 2018) Investor inflows accelerate as hedge fund capital eclipses milestone
The Distribution Advantages of Alternative UCITS

Despite the superior returns of AIFs versus alternative UCITS, there does appear to be an increasing investor bias towards the latter. EU investors are more familiar with UCITS products whereas AIFs are still a fairly nascent fund structure. Europe is of course the second largest distribution market after the US, making it a logical starting step for managers launching alternative UCITS.

While US retail investors remain wedded to conventional “40 Act” fund products and show little inclination to purchase UCITS, US hedge fund managers are increasingly spotting the EU distribution benefits that can be enjoyed by launching UCITS. The return of relative stability and growth to the Eurozone versus the ongoing political risk in the US has been an impetus for US managers to embrace UCITS more readily. The challenging capital raising conditions at liquid alternative products in the US may also have prompted managers to reconsider European UCITS as a tool to attract retail money and further diversify their investor base beyond institutions.

“Our major investor markets for UCITS products are predominantly in Europe and Asia.”

Alex Lasagna

The prolonged existence of UCITS has given it an unrivalled retail distribution footprint in markets outside of the EU. Even in core APAC markets such as Hong Kong, Singapore and Taiwan where localised fund passporting initiatives are slowly winning mandates, UCITS still accounts for around 60% of all funds sold, making the region a very attractive capital raising destination for hedge funds hungry for assets.

“Our major investor markets for UCITS products are predominantly in Europe and Asia,” said Alex Lasagna, group chief operating officer (COO) at Algebris, an asset manager which runs a number of alternative UCITS products. Algebris has enjoyed considerable success in asset raising for its alternative UCITS’ range over recent years growing its AUM base by approximately 40% in the ten months leading to October 2017.

UCITS provides an excellent tool for hedge funds to escape investor concentration risk and diversify into new and exciting markets and geographies. The retail distribution reach of alternative UCITS is pivotal, said Lasagna. “The chief reason behind the success of alternative UCITS is that the UCITS brand gives us access to global distributors and their vast investor networks. Distributors have a number of selection criteria, and AIFs tend to find it harder to get onto their platforms. This is because distributors give a premium to fund managers which are regulated under UCITS and have excellent liquidity terms,” said Lasagna.

The brand’s accessibility has also helped augment investor interest. “The minimum investment into an alternative UCITS is much lower than an AIF. For example, AIFs in Luxembourg often have a minimum 125,000 Euros subscription threshold, which puts them out of reach for a lot of investors. I estimate around 70% of our investor base is from our distributor networks, and the rest is institutional,” said Lasagna.

Alternative UCITS also have a sizeable institutional book of businesses, which has in part been driven by the longevity of the brand. Institutions have a long experience of investing into tried and tested UCITS managers, and have accumulated in-depth understanding and knowledge about its fund structure and nuances. UCITS’ durability and familiarity makes it more straightforward for conservative-minded allocators like pension schemes and insurers to convince investment committees, risk boards or trustees about the merits of alternative UCITS, at least when compared to AIFs, which have existed for much less time. “UCITS – similar to the “40 Act” Funds in the US – are a more recognised wrapper, and as such a product that more investors are familiar with,” said Kehoe.

Interestingly, a growing number of alternative UCITS providers are looking to lose the “alternative” moniker. “We need to be careful when talking about ourselves as being alternative UCITS. Nowadays, we try to avoid referencing the words ‘alternative’ or ‘hedge fund’ when we are with distributors as it subjects us to a due diligence by the hedge fund team. Instead, when we talk to distributors and institutional investors, we refer to ourselves as active or UCITS. The term ‘alternative UCITS’ is going out of fashion,” said Lasagna.

14. HFM Week – Liquid Alternatives: Diversification drives Growth
16. Asia Asset Management – February 2016 – Cross-border Funds Sale in Asia
The Regulatory Benefits

UCITS is subject to regulatory oversight, which sets the standard for fund wrappers worldwide. These protections have helped cement its growth and reputation among investors, who associate the fund structure with safety and excellent regulatory supervision. But what are the key regulatory selling points of alternative UCITS?

UCITS is fully onshore, whereas some AIFMD compliant managers may operate offshore funds. For example, a UK AIFM may indeed run a Cayman Islands or British Virgin Islands (BVI)-based fund. Some European regulators are hostile to offshore products making it difficult for institutions in those jurisdictions to justify such investments. “Some institutional investors simply view offshore fund products as being a non-starter. Running an onshore UCITS – in our experience – has made the entire due diligence process far simpler,” explained Lasagna. Kehoe concurred that onshore UCITS products resonated among particular investors.

UCITS regulations subject managers to leverage and concentration limits whereby no more than 10% of a funds’ assets can be invested in the securities of a single issuer. The rules also impose restrictions on UCITS’ counterparty exposures with managers prohibited from having in excess of 5% of their assets exposed to an OTC derivative counterparty, or 10% if the latter is a credit institution. Again, this helps satisfy investors’ counterparty risk concerns and risk management criteria.

Central to UCITS’ popularity is its liquidity. Hedge funds using UCITS wrappers will only invest in liquid instruments as the rules oblige managers to offer a minimum of fortnightly liquidity to end clients looking to redeem capital. The highly generous liquidity provisions enabled under UCITS is a selling point, said Lasagna. This means UCITS must subscribe to rigorous investment restrictions, and are prohibited from having exposures to certain financial instruments, such as loans or commodities, which cannot always be quickly offloaded into the market, particularly when conditions are volatile.

Regulators have been very focused on UCITS’ liquidity and deviations by managers from the underlying principles are not tolerated. Kehoe acknowledged some hedge funds were putting more esoteric although not necessarily illiquid products into UCITS wrappers. “We have seen a growing number of managers move beyond equities into CTA (Commodity Trading Advisor) type products, merger arbitrage through to liquid credit, multi-manager and emerging market long/short equity funds within the confines of UCITS,” he said.

“Alternative UCITS’ underlying assets are liquid in nature and can be disposed of with minimum disruption allowing for redemptions to be realised on a daily basis.” Paul Heffernan

UCITS and AIFMD do impose similar checks and balances designed to protect investors with the most prominent being the appointment of a depositary. A depositary is usually a banking entity. The depositary is appointed to ensure that all assets under Custody belonging to UCITS and AIFMs are safe-kept appropriately. Other key functions of the depositary include verifying cash-flows going in and out of the funds, and overseeing managers’ compliance with some of the key regulations and their investment mandates.

UCITS V and AIFMD rules arose as a direct consequence of the failure of Lehman Bros, whereby assets and client collateral which was supposed to have been held by the now bankrupt investment bank had actually been re-hypothecated elsewhere. This safekeeping role does carry with it significant fiduciary liability, as AIFMD and UCITS elevate depositary responsibilities to recompense clients entirely if assets go missing or are stolen. In this sense, UCITS is more dogmatic than AIFMD in its application and interpretation of depositary liability provisions as it does not allow for such liability to be discharged to a sub-custodian provider.

An investor buying an alternative UCITS or AIF benefits from this consumer protection mechanism which has been a very compelling selling point for both brands in what is a highly risk-adverse capital allocation environment.

18. ALFI
20. ALFI
The Big Challenge to Alternative UCITS

The future for alternative UCITS and AIFs is positive, but there are likely to be bumps or challenges along the way. The most obvious and immediate risk to UK and EU fund managers is Brexit. The UK’s departure from the EU is going to force asset managers to adapt to a new regulatory and political environment in a coherent and sensible manner, which does not imperil investors. The UK is the jurisdiction of choice for asset management in the EU, with total assets (of IA members) standing at £6.9 trillion21, of which £2.6 trillion is managed on behalf of overseas investors, and half of this is derived from non-UK European clients.22

Irrespective, the UK’s departure from the Single Market could result in managers in both the UK and EU being forced to increase their presence in each other’s markets if they are to keep investor distribution channels open. Lasagna, for example, said Algebris has opened an office in Luxembourg in order to mitigate the risk of Brexit. “Those UK UCITS or AIFMs who do not want to invest in additional bricks and mortar may look to fall back on National Private Placement Regimes (NPPR) or consider reverse solicitation, although neither is wholly secure or permanent. NPPR is likely to run out in the next few years, while reverse solicitation introduces risks as regulators may interpret some activities as being marketing even if it was not intended to be by the manager,” said Ellis.

Brexit is a highly complicated process, and new risks are already emerging even in the early stages of the negotiations. Rows concerning delegation have already flared up between the UK and EU, as it is very plausible that the set-up – whereby an entity domiciled in the EU outsources the running of portfolio and risk management to a third country manager – could face scrutiny. EU backpedalling on delegation would have serious consequences for a large segment of the market.

21. Investment Association (September 14, 2017) UK Cements its position as global asset management hub
22. Investment Association (September 14, 2017) UK Cements its position as global asset management hub
An IA survey, for example, said around £900 billion was “managed on behalf of fund ranges in Dublin and Luxembourg, which delegate their fund management activity to the UK.”

But what exactly is happening? The European Commission recently published a proposed amendment to the ESA Regulation recommending the European Securities and Market Authority (ESMA) enjoy a greater role in the authorisation procedures of delegation arrangements. ALFI (Association of the Luxembourg Fund Industry), the Luxembourg funds’ industry association, warned this proposal could introduce costs and delays to authorisation processes involving delegation. Any regulatory initiative which has the potential to undermine delegation would have very serious consequences on UCITS and AIFMs in third countries, which are reliant on this model. It could also lead to retaliatory regulatory actions by third countries against UCITS and AIFMs impairing the global attractiveness of both brands.

Brexit is not the only challenge which UCITS have to contend with. A number of managers have been bracing themselves for compliance with the Markets in Financial Instruments Directive II (MiFID II) which became EU-wide law on January 3, 2018. MiFID II imposes a number of demands on investment managers advising UCITS, particularly when the UCITS is being distributed through MiFID entities.

“The costs and effort involved with MiFID II compliance is significant, and it has prompted some hedge fund managers with MiFID licenses to convert into AIFMs so as to avoid the rules. The benefits of transitioning into an AIFMD structure, however, may prove to be short-lived as ESMA is going to conduct a review on the AIFMD passport and its progress in 2018. While the outcome of ESMA’s assessment is unknown, there is speculation that the regulator will look to eliminate some of the arbitrages that exist between AIFMD and MiFID II,” said Ellis.

25. ALFI – October 2017 – Commission Proposals could adversely impact investors, fund and the European financial market, says ALFI
26. Skadden – January 2016 – MiFID II expected to have a significant impact on investment managers
What the Future Holds

Alternative UCITS are set to play an increasingly important role in managers’ diversification strategies as they seek to attract money beyond just institutional investors and increasingly target retail allocators. The distribution benefits of alternative UCITS, its strong regulatory banner and highly-regarded brand give it an edge in soliciting money from conservative investors – both institutional and retail – while enjoying a far superior geographical footprint than many other fund brands.

Perhaps the biggest challenge for alternative UCITS – moving forward – will be the ability of UK managers to organise and optimise their businesses ahead of Brexit. The uncertainty around Brexit has not made the process straightforward so far for asset managers. It is imperative managers engage with experienced service providers like HSBC Securities Services to assist them with any Brexit-related transitions that may happen between now and 2019, or 2021.