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The opportunities and challenges of convergence

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SPECIAL REPORT/LIQUID ALTERNATIVES

EDITORIAL/SUBSCRIPTIONS

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The opportunities and challenges of convergence

The growth in liquid alternative investment products – through alternative UCITS in Europe, and also through the '40 Act alternative mutual fund market in the US – has been one of the most significant developments in the asset management industry on both sides of the Atlantic in recent years.

Liquid alts have helped to break down long-standing boundaries between traditional and hedge fund products – enabling new types of investors to access alternative investment strategies, providing alternative investment managers with new and fast-growing distribution channels in both the retail and institutional investor arenas, and creating new business opportunities for third-party asset management platforms and service providers in other key areas.

Especially in the alternative UCITS space, the opportunities for further expansion remain high – with the range of investment strategies available through liquid regulated funds continuing to expand, and with new types of managers and investors arriving to swell the overall universe of participants.

But the global convergence trend that liquid alts have helped to accelerate also brings challenges as well as opportunities – in terms of product control, in terms of regulatory oversight, in terms of potential liquidity risks and in terms of investor protection.

In this special report, Philip Moore looks at the growth of liquid alternatives and at the key opportunities and challenges that are arising from a dynamic that is changing the face of the mainstream and alternative investment landscape.

Nick Evans, *editor, Hedge Fund Intelligence*

THE RANGE OF INVESTMENT STRATEGIES AVAILABLE THROUGH LIQUID REGULATED FUNDS IS CONTINUING TO EXPAND, WITH NEW TYPES OF MANAGERS AND INVESTORS ARRIVING TO SWELL THE UNIVERSE OF PARTICIPANTS

The mainstream route for alternative investing

"The creatures outside looked from pig to man, and from man to pig, and from pig to man again; but already it was impossible to say which was which."
George Orwell, Animal Farm, 1945

Ten or 15 years ago, the strategic, regulatory and cultural demarcation lines between hedge funds and traditional products were still clearly visible and well-understood.

The progressive erosion of those boundaries in recent years is probably irreversible. In a report published in 2013, SEI commented that "it is no overstatement to say that the move toward alternative investing has been among the farthest-reaching developments in institutional investing over the last quarter century."

As an exhaustive 2012 survey conducted by KPMG and AIMA pointed out, the institutional drift towards alternative investment strategies had begun well in advance of the 2008 crisis. By then, assets under management (AUM) in the global hedge fund industry had already reached $2 trillion.

True, high net worth individuals were still the leading investors in hedge funds. But as the KPMG/AIMA survey observed, the period of growth leading up to the upheavals of 2008 were marked by increased participation by institutional investors, with pension funds and university endowments attracted by hedge funds' uncorrelated returns and low volatility.

2008 was therefore a watershed year for hedge funds not because it marked a sudden epiphany among institutional players about the investment properties of hedge funds. Indeed, in its 2012 survey, KPMG/AIMA reported that new inflows into hedge funds from the European Union had held steady, while those from Switzerland had declined, with the bulk of fresh money coming from North America, Asia-Pacific and the Middle East.

Equally or perhaps more significant than the increase in institutional demand for hedge funds post 2008 was the change in the governance and culture of the alternative investment management industry that accompanied it.

Deep-pocketed pension funds, in particular, signalled that while they were committed to increasing their allocations to alternatives, they were no longer prepared to stomach the illiquidity, opacity and lack of accountability that characterised swathes of the hedge fund universe. And an increasing number indicated just as emphatically that they were no longer prepared to accept all of the above for a 2+20 fee structure they regarded as being unwarranted and anachronistic.

Some would eventually attest to their disenchantment by withdrawing entirely from the hedge fund market, frustrated by high fees and impatient with modest performance. CalPERS in the US and the Dutch pension scheme for healthcare workers, PFZW, are among the best-documented examples of institutions that have pulled back from hedge funds.

Others, however, wanted to have their cake and eat it, putting the hedge fund industry on notice that they still expected reasonable, uncorrelated risk-adjusted returns in a liquid and transparent format. For good measure, they also wanted this at reduced fees.

Some hedge fund managers dug their heels in, seeing no reason why they should abandon long-standing practices that had served them so well in raising capital throughout the 1990s and early 2000s.

An increasingly large cross-section of funds, however, recognised that if they wanted to attract new inflows of capital, and the fees that went with them, they would need to overhaul time-honoured business practices and culture. The consequence, as KPMG/AIMA noted in

2012, was that the term 'institutionalisation' no longer referred exclusively to the influx of new institutional capital into hedge funds. It also referred to "the continued evolution and advancement of hedge funds' infrastructure and operational processes with respect to transparency, compliance and due diligence."

Specifically, this meant either repackaging existing unregulated offshore funds into regulated onshore vehicles that met these new standards, or launching entirely new products that conformed to investors' evolving demands and preferences for liquidity and enhanced governance practices.

THE GROWTH OF RETAIL DEMAND FOR ALTERNATIVES

In a parallel development, the winds of change were also sweeping across the retail-targeted or traditional investment management industry. Again, it is sometimes mistakenly assumed that it was the crisis of 2008 that opened retail investors' eyes to the benefits of strategies that freed them from the long-only constraints that denied them access to protection in falling or volatile markets.

In Europe, the process of weaning retail investors away from a diet of long-only products had started to gather momentum several years before the 2008 meltdown, with the amendment in 2003 of the ponderously-named Directive on Undertakings for Collective Investment in Transferable Securities (UCITS). Originally adopted in 1985, UCITS 1 allowed for the sale of mutual funds to any investor in the European Union (EU) under a harmonised regulatory regime.

One of the principal shortcomings of the funds sold under the first UCITS directive, however, was that they were too heavily regulated. When equity markets plunged, first after the puncturing of the dotcom bubble and again after 9/11, this regulation was exposed as well-intentioned but ridiculously counterproductive, leaving retail investors trapped within a world populated exclusively by long-only products.

Those wanting to express a negative view on equities had nowhere to go other than cash or bonds. This may have worked in the past, but in the 2008 crisis the notion that bonds and equities could be depended upon to provide conveniently uncorrelated returns was exposed as a dangerous myth.

It was not until 2003 that the masonry of the long-only edifice entrapping retail investors started to crumble, with the passage of the UCITS 3 Directive (there was, mysteriously, no UCITS 2). This was a combination of a management directive, introducing tighter risk management and capitalisation requirements, and a product directive, which expanded the range of investments eligible for UCITS to hold. This stopped short of giving the green light to short selling. But because it allowed for the use of derivatives such as contracts for difference (CFDs), it enabled funds to achieve the same economic effect as short positioning.

Critically, it also enshrined the principle of liquidity, requiring that the underlying assets of UCITS are able to support redemptions on at least a fortnightly basis. In practice, however, the vast majority of UCITS funds offer daily liquidity.

Nevertheless, a concern in the early years of the UCITS market was that the limitations on the use of derivatives, concentration limits and liquidity requirements would inevitably lead to a high level of tracking error between alternative UCITS and the unregulated flagship strategies they aimed to replicate.

Managers insist that away from highly illiquid strategies, tracking error has been progressively minimised and in some cases eliminated altogether, which has clearly encouraged a rising number of investors to migrate onshore. So too has the administrative simplicity of UCITS.

"For high net worth individuals, it is so much easier to transact in the UCITS market," says Donald Pepper, managing director of alternatives and institutional at Old Mutual Global Investors. "Rather than having to fill in forms and wait until the end of the month to put in a redemption notice, you just send instructions to your wealth manager or private banker. Ease of dealing has been a very important factor in the growth of the market."

Galvanising demand for these alternative products on either side of the North Atlantic has been the recognition of the limitation of the traditional 60/40 model, constructed

around a 60% allocation to equities and the balance to bonds. The problem with this model, as a report from PIMCO explains, is that risk is driven almost entirely by the equity component because of its higher volatility. "While this can lead to strong performance during equity bull markets, as has been the case in the US since 2009, it can also leave portfolios exposed to severe drawdowns," PIMCO cautions.

Specifically, according to the PIMCO analysis, in the 1980s and 1990s a traditional 60/40 asset allocation generated an average annualised return of 13.7% over rolling five-year periods. After 2000, that average shrank to 5.9%.

None of this need mean that the bell is tolling for unregulated offshore strategies. "It's clear that in the equity long/short space the best way to engage investors in Europe is now through the UCITS market because they are liquid and should have limited tracking error," says Serge Houles, head of client portfolio management at the Stockholm-based systematic manager, IPM.

"But I think there will still be demand for Cayman vehicles. Offshore products will remain relevant for US investors, while equity strategies that are too concentrated or leveraged won't fit into the UCITS format."

Others agree that even in the equity space, there are several reasons why there is still plenty of room in the market for unregulated strategies that are not constrained by daily or weekly liquidity rules. Pepper points to M&A arbitrage as one example of an equity-based strategy where quarterly liquidity remains a more appropriate structure for managers entering into longer payoff trades.

THE FASTEST-GROWING SECTION OF THE HEDGE FUND INDUSTRY

Nevertheless, it is the confluence of all these powerful trends that has given rise to the rapid growth in the market for alternative investment funds on either side of the Atlantic. Although these are sometimes clustered together under the umbrella of "liquid alternatives", in Europe they generally still go under the acronym of alternative UCITS.

The name may be ponderous, but demand from investors is anything but. In 2015, according to Morningstar's numbers, they channelled €70 billion of new assets into alternative UCITS, a 30% increase over 2014's total, leading Lyxor to describe them in a recent update as "much the fastest-growing section of the hedge fund industry".

Andrew Dollery, *director, Societe Generale Prime Services*

While some say this demand continues to outpace supply of alternative assets, managers are clearly rising to the challenge of providing new product. "UCITS is a continuing theme that at Societe Generale we see as core to the strategy of any alternative asset manager of scale," says Andrew Dollery, director at SG Prime Services. "In Europe, at least half of the new funds in our pipeline today are alternative UCITS as opposed to offshore products."

"I see two main reasons why the alternatives UCITS market will continue to grow over the next few years," says Daniele Spada, Paris-based head of the Lyxor managed account platform. "The first is that the regulatory environment is leading more and more investors to look at UCITS, since the AIFM regulation designed for hedge funds has not been very successful." Published in 2011, the AIFM Directive is a comprehensive regulatory and supervisory framework for non-UCITS alternative investment funds marketed in the EU.

"Second," says Spada, "with political and economic uncertainty likely to remain high, we don't think anyone can expect to generate high single digit or double digit performance from long-only equity strategies. We believe investors will increasingly turn their attention to strategies which allow them to maintain an exposure to the market but with less directionality and a stronger attention to risk management. This is what is delivered by most strategies in the alternatives UCITS space."

WITH POLITICAL AND ECONOMIC UNCERTAINTY LIKELY TO REMAIN HIGH, WE DON'T THINK ANYONE CAN EXPECT TO GENERATE HIGH SINGLE DIGIT OR DOUBLE DIGIT PERFORMANCE FROM LONG-ONLY EQUITY STRATEGIES
DANIELE SPADA, LYXOR ASSET MANAGEMENT

GROWTH IN THE US LIQUID ALTS SPACE

In the US, the more expressively-named liquid alternatives are structured under the confines of the 1940 Investment Act, making them the only practical option for retail investors looking for access to hedge fund-style strategies.
As a recent note published by Allen & Overy explains, "US retail investors generally do not qualify to invest in traditional hedge funds or

private equity funds due to the high net worth requirements and steep minimum investment amounts, and therefore must look to 1940 Act Funds, which do not typically require net worth or similar minimums. 1940 Act Funds also do not require subscription documents, which makes the investing process more streamlined than traditional hedge or private equity funds."

As with UCITS, liquidity is (by definition) a key feature of the liquid alternatives market, with alternative mutual funds required to ensure that at least 85% of their exposure is to liquid assets. As with the UCITS market, this has given rise among some investors to concerns that the performance potential of liquid alternatives may be compromised. A paper published in July 2015 by K2 Advisors – *Liquid Alternatives: Dispelling the Myths* – rejects this suggestion.

"Our empirical examination of the actual performance and composition of liquid alternative funds and their traditional hedge fund counterparts illustrates the illiquidity premium may be overstated, and in fact very little is lost in terms of investment performance on the part of liquid alternatives," notes the K2 report. In its sample, which K2 recognises is "somewhat limited", liquid alternatives outperformed traditional hedge funds over a one, three and five year period by margins of 217, 104 and 303 basis points respectively.

As PIMCO puts it, the growth of liquid alternatives has acted as a democratising force for investors. It is, however, by no means purely a retail market, as Mark Mannion, head of relationship management for BNY Mellon's Alternative Investment Services business in EMEA, points out.

"Funds of funds used to be the access point of choice for pension funds and other institutional investors expanding into alternatives," he says. "But growing concerns about the high costs and relative illiquidity of funds of funds have fuelled a rise in institutional demand for alternative UCITS and other liquid alternative products such as managed accounts."

The net result, says TeHsing Niu, who is responsible for liquid alternatives business development at BNY Mellon, is that aggregate assets under management in the US and Europe now exceed $1 trillion.

Mark Aldoroty, *head of Pershing Prime Services*

"In the last 12 months alone, we have seen more than 500 alternative UCITS and '40 Act funds being launched in Europe and the US," she says. "The liquid alternatives market now covers a multitude of investment strategies with drastically different investment objectives, risk-return characteristics and performance records."

That may be. But as Mannion says, the common thread that draws together demand from heavyweight institutions as well as retail investors is their pursuit of uncorrelated returns in a liquid, transparent and relatively low-cost format.

THE PROS AND CONS OF CONVERGENCE

With further growth in the market for liquid alternatives on either side of the Atlantic will come an acceleration in convergence between hedge funds and traditional, regulated investment products.

For some industry participants, this need not make much of a difference to their day-to-day business. "If you think of it from a prime broking perspective, a hedge fund is a mutual fund by another name," says one market participant. "The two are legally different, and are governed by different regulations. But they both trade. They both need execution, clearing and custody services. And they both use leverage in some shape or form, although '40 Act Funds have stricter rules about how much leverage they can use."

That is true enough. But for the firms and individuals used to managing unregulated and regulated funds on a daily basis, the changes that are being brought about by the convergence between the two are far-reaching. "Traditional long-only investment managers already possess the infrastructure and distribution channels," says Mark Aldoroty, head of Pershing Prime Services. "When launching an alternative strategy, their challenge is expanding their portfolio management to include a levered and/or short component."

This echoes a point that McKinsey made in a 2012 report entitled *The Mainstreaming of Alternative Investments*, which identified the seismic changes that the convergence dynamic would bring to the global asset management industry.

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"This is a massive opportunity," said McKinsey. "But to capture it, traditional asset managers will need to embark on a major shift in their operating focus, away from the relative return investment framework and well-defined boundaries (such as style boxes, or long-only products), toward managing investments to an absolute return target or objective. In addition, they will need to address shortcomings in risk management and reporting and sales capabilities, and resolve the organisational conflicts that will likely arise from the integration of traditional and alternative work cultures."

Firms with a long standing presence in the traditional side of the asset management industry reject any suggestion that their long-only heritage may make them ill-equipped to compete against hedge funds. "There is no evidence to support this argument," says Old Mutual's Pepper. "At Old Mutual, we run a UK mid and small-cap equity fund which has never had a negative year in its 13-year history. Its average net exposure over the last five years has been around 3%, so it has effectively been run as a market-neutral strategy, but it was up 14% last year. In some years, more of its alpha has been generated by the short side of the book than by the long side."

The so-called traditional investment management industry on either side of the Atlantic is certainly serious about further penetrating the market for hedge fund-style products. Take the example of a firm like Jupiter, which in July announced the appointment of Magnus Spence, former chief executive and managing partner of Dalton Strategic, as its new head of investments for alternatives. "This is an asset class which is highly sought after and important for the future development of our investment proposition," said Jupiter at time.

For hedge funds relaunching unregulated products in the regulated format required to reach a broader retail and institutional investor base, the opportunities and challenges are no less extensive. "Hedge funds understand leverage and shorting," says Aldoroty. "Their challenges centre around leverage within the '40 Act construct and developing distribution channels."

Hedge funds stepping into the liquid alternatives space to target a different investor audience face other complications. Foremost among these is the prohibition on fees in the market for '40 Act Funds, which potentially raises the issue of cannibalisation of the investor base. After all, it's hard to see how managers charging existing investors 2+20 can justify offering the same product with the same returns for 100bp. This is why in many cases managers have chosen to act as sub-advisors on multi-manager platforms.

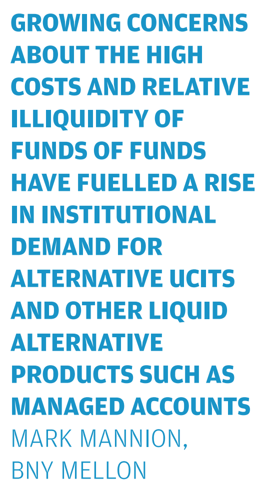
AN EXPANDING INVESTOR BASE

Although there are some important differences between liquid alternatives and UCITS – or, more specifically, alternative UCITS – the two products are similar in that they provide investors with a low entry point to the strategies that were previously the preserve principally of high net worth individuals and family offices.

It is institutional demand for UCITS, however, that is seen by most managers in the market as the key to raising assets, and demand is clearly gathering significant traction. "UCITS are now attracting serious institutional money, and it's not uncommon to see tickets of €20-€50 million going into UCITS strategies from pension funds and insurance companies these days," says Dollery at Societe Generale.

Insurance companies are also stepping up their participation in alternative UCITS, in part because of the regulatory imperatives of Solvency II. "We see Solvency II as a very good opportunity for us," says Lyxor's Spada. "The liquidity of alternative UCITS makes them an ideal investment for insurance companies, and we have the necessary technology to help them build well-diversified and transparent portfolios and optimise their capital requirements in conformity with Solvency II."

Individual managers confirm that the volumes of new money flowing into UCITS are formidable. Take the example of a manager like the Nordic systematic specialist, Informed Portfolio Management (IPM), which was founded in 1998 and had AUM of some $5.6 billion in June 2016. IPM launched a UCITS version of its systematic global macro flagship strategy last year on Morgan Stanley's FundLogic platform with assets of $50 million. "Since then, its as-



GROWING CONCERNS ABOUT THE HIGH COSTS AND RELATIVE ILLIQUIDITY OF FUNDS OF FUNDS HAVE FUELLED A RISE IN INSTITUTIONAL DEMAND FOR ALTERNATIVE UCITS AND OTHER LIQUID ALTERNATIVE PRODUCTS SUCH AS MANAGED ACCOUNTS
MARK MANNION, BNY MELLON

sets have risen to $650 million, so by whatever measure you look at it, it has been a great success," says IPM's Stockholm-based CEO, Stefan Nydahl.

Demand for the IPM UCITS has come from a reassuringly diverse range of investors. "Prior to 2008, demand for alternative UCITS was concentrated largely among private banks in the UK and Switzerland," says Tara Skinner, head of UK and US Sales at IPM. "Over the last five years, we have seen a broadening of demand, and in some strategies UCITS are now becoming the investment of choice for institutions in Europe."

Investor demand for alternative UCITS has not weakened in spite of the iffy recent performance of much of the absolute return sector. Quite the reverse. As Lyxor observed in an update published in July, alternative UCITS is the only asset class which has seen inflows this year, with €3.6 billion in March alone bringing the total for the first quarter to €7.7 billion.

"This strong appetite for alternative UCITS is in stark contrast with the outflows experienced by traditional asset classes, as equity mutual funds experienced outflows of €20 billion and fixed income and credit funds saw outflows near €13 billion in the first quarter," added the Lyxor review. "Money market and diversified funds have been hit as well. This is fully in line with what we have been hearing in our discussions with our clients; investors are clearly interested in UCITS hedge funds at present."

Much of this demand is coming from investors that are moving away from unregulated products, either because of misgivings about transparency and costs or, in some instances, because of regulatory pressure in their home markets.

"We've been seeing very strong demand from high net worth individuals and the private banks that advise them, as well as from wealth managers and institutions throughout Europe," says Pepper at Old Mutual. "Demand has been particularly strong from some of the big European countries where regulators are increasingly ill-disposed towards funds from offshore jurisdictions such as the Cayman Islands."

This growth in demand, says Pepper, is a long term phenomenon that is unlikely to be derailed by the disappointing recent performance of absolute return strategies. "I don't see a short term period in which alternatives are down by 3% as having the capacity to throw demand off-kilter," he adds.

Tara Skinner, *head of UK and US Sales, Informed Portfolio Management (IPM)*

This argument appears to be supported by the empirical research into the long term risk-adjusted returns of liquid alternative mutual funds (AMFs) undertaken by Craig Lewis, Madison S. Wigginton Professor of Finance at the Owen Graduate School of Management at Vanderbilt University.

This includes the reassuring finding that "the diversifying nature of AMFs expands the "efficient frontier" available to investors. This enables investors to construct portfolios that either reduce the level of risk for a given level of return, or increase returns at the same level of risk, or both. That is, investors could possibly add 1-2% per year in expected return without taking more risk, or allowing them to meaningfully reduce risk without reducing expected return."

Sarah Alfandari, head of sales and partner of Longchamp Asset Management, says that investors are lowering their expectations about the performance of alternative UCITS. "Rather than look at hedge fund UCITS as separate asset classes, they are now looking at them as a bond diversifier, which is probably a more realistic approach," she says. "In other words, instead of looking for annual risk-adjusted returns in the high single digits, they are expecting returns in the 4% to 6% range."

RATHER THAN LOOK AT HEDGE FUND UCITS AS SEPARATE ASSET CLASSES, THEY ARE NOW LOOKING AT THEM AS A BOND DIVERSIFIER, WHICH IS PROBABLY A MORE REALISTIC APPROACH
SARAH ALFANDARI, LONGCHAMP ASSET MANAGEMENT

This, say others, probably explains why demand may be weakening for traditional long/short equity products in favour of those offering more in the way of risk mitigation. "For several years we've had an equity bull market which has driven demand for equity long/short and long-biased products," says Societe Generale's Dollery. "The volatility we've seen this year has made investors rather more cautious, which is why there has been rising demand for CTAs and global macro strategies relative to some of the higher beta equity funds."

RISING INSTITUTIONAL DEMAND IN THE US

A similar trend of rising institutional demand is unfolding in the US, where the speed with

which the market for liquid alternatives has grown in recent years has encouraged a series of bullish projections about its potential over the coming five to 10 years.

Cerulli Associates, for one, has forecast that by 2023 liquid alternatives will account for 14% of total mutual fund industry assets. PwC, meanwhile, has calculated that demand for liquid alternatives will rise from $260 billion at the end of 2013 to around $664 billion by 2020.

Much of the growth in demand for liquid alternatives may come from heavyweight institutions that have recently announced plans to reallocate some of their assets to alternatives, most notably among investors in the $24.2 trillion US retirement system. Several US pension systems have already set up managed accounts as a cost-effective way of accessing liquid alternative strategies.

"One of the themes we've been seeing over the last two years has been an increase in institutional demand for dedicated managed accounts through our HedgeMark subsidiary," says Declan Denehan, liquid alternatives business head at BNY Mellon. HedgeMark, which was founded in 2009 and became a BNY Mellon subsidiary in 2014, specialises in supporting institutional clients in the development and operation of their own private hedge fund dedicated managed account (DMA) platforms.

One of the main attractions for managers using this private structure, says Denehan, is that it allows them to charge performance fees which are prohibited under most circumstances in the '40 Act market. Investors, meanwhile, are attracted by the visibility and liquidity offered by the platform mechanism, as well as by the fees which Denehan says are flexible and transparent.

Little wonder, against this backdrop, that Denehan believes there will be substantial interest from US institutional investors, led by pension funds, for this type of structure. His confidence is supported by a survey of institutional investors published in June 2016 in a paper by BNY Mellon and FT Remark entitled *Split Decisions: Institutional Investment in Alternative Assets*. 43% of respondents to this survey indicated that they are currently invested in hedge funds via managed accounts, while a further 13% are considering doing so.

Stefan Nydahl,
CEO, Informed Portfolio Management (IPM)

Within the US retirement system market, perhaps the most exciting area in terms of demand for liquid alternatives is in the defined contribution (DC) space. "A growing number of DC sponsors in the US are looking to increase their use of alternative strategies in a liquid and transparent format," says Denehan. Convergence between the hedge fund and regulated mutual fund sectors is accelerating this process, although distribution remains a challenge.

As Pershing explains in a recent report on DC plans' increased demand for liquid alternatives, "there are two elements that should be considered to make an alternative offering attractive to a DC plan. First, plan advisors need to examine what reasonably converts from the hedge fund space to the DC plan space. The strategy needs to feel like a daily liquid product, and not everything will prove to be transferable. Originally, the first transferred strategies were in the futures and CTA space where there was already liquidity."

"Second," adds the Pershing note, "the DC plan itself wants to know how to get greater access to hedge funds. DC platforms are evolving to accommodate less frequent liquidity events, so as hedge funds begin to understand what products work within the space, alignment will increase, driving more liquid alternatives into DC plans."

THIRD-PARTY PLATFORMS: SPOILT FOR CHOICE?

A notable by-product of the breathless expansion of alternative UCITS over the last five years has been the proliferation of third-party platforms and their rapid AUM growth. "Third-party platforms are generally umbrella fund structures established by investment managers or promoters, including distributors, which allow other previously unaffiliated (sub-) investment managers to essentially "plug and play" by joining the platform with their own separately managed sub-fund," explains a note published by the law firm, Dechert.

The Dechert piece goes into considerable detail about the principle advantages and drawbacks of the platforms. Foremost among their benefits for managers are the cost savings they

can offer, twinned with access to platforms' capital bases. Platforms can also accelerate the launch of new funds, provide know-how on the launch process and take responsibility for time-consuming compliance and governance requirements.

Perhaps their most important advantage, however, is the established distribution network and potential for capital introduction that the leading platforms can offer.

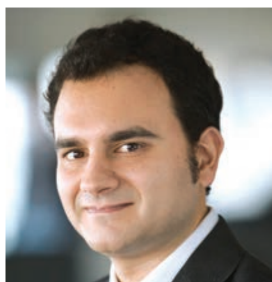
The platforms come, however, with a handful of notable strings attached. One of these is their costs. As Dechert cautions, "with fees calculated on an AUM basis, platforms may be prohibitively expensive once a certain size is achieved". The Dechert note adds that for start-ups the costs incurred during the on-boarding process can easily equal those of a new launch.

Many managers that have recently undertaken the platform selection process confirm that distribution capabilities were at or near the top of their priority list. "Because the client base for our Cayman strategy had always been mainly large institutions, we had had very little contact with the UCITS investor base when we decided to launch our flagship strategy in UCITS format last year," says Houles at IPM in Stockholm. "So it was critical that as well as providing all the necessary reporting and passport support, the platform could distribute the strategy as broadly as possible."

Houles, who led IPM's platform selection project last year, adds that IPM chose Morgan Stanley's FundLogic platform for several reasons. While he recognises that all of the leading platforms have good distribution capabilities, he says that FundLogic's proactive interaction with the investor base gives it an edge over its competitors.

"One of the things that Morgan Stanley did very well was enter into a dialogue with a number of early-bird investors, which we didn't feel other platforms did as well," says Houles. "Getting UCITS investors to commit to the strategy early was key for us because we wanted to grow the fund to a decent size as rapidly as possible."

"We also liked the Morgan Stanley model because rather than setting out to on-board as many funds as it can, it is highly selective about the strategies on its platform," he adds. "Rather than focus purely on asset growth, the platform aims to attract the best in breed for each strategy, which we thought was an important feature of its branding among investors."



Daniele Spada, *head of managed account platform, Lyxor Asset Management*

Spada at Lyxor's managed accounts platform, which has total AUM of $8 billion, of which $2 billion is accounted for by eight alternative UCITS, explains that the platform is much more than a distribution hub. "We have an investment banking approach," he explains, "which means we have an open architecture set-up which provides much more than basic infrastructure."

"We have built our managed account platform around a series of additional services that are highly valued by our investors," he adds. "For example, as of today, the platform has a team of 30 analysts, 20 of whom exclusively cover hedge fund strategies, while the other 10 follow the long-only world. This means that our research and selection capabilities are such that we can advise investors on how to build a diversified allocation beyond the funds that we have on our own platform."

Spada adds that the length of the Lyxor platform's track record means that it is well-positioned to fulfil another key role, which is to support managers that are launching UCITS versions of unregulated strategies. "Because we've been in this market since 1998, we have built up very strong expertise in structuring funds," he says. "This means we can help hedge fund managers to convert and adapt an existing strategy into a UCITS fund. Because we are not restricted to any individual strategy, we can do this across all funds that meet the UCITS requirements on leverage and liquidity, be it equity long/short, event-driven, credit, CTA or whatever."

None of the leading platforms have aimed to specialise in any individual strategy. That, managers say, would probably be self-defeating, given their objective of providing investors with access to a well-diversified range of strategies. The result is that the inventory of products offered by the largest platforms tend to mirror the broader structure of the alternative UCITS universe, which means that their strategy range is inevitably weighted towards equity-based funds.

In the case of the Bank of America Merrill Lynch platform, which is the largest in the alternatives UCITS space, seven of its funds are equity long/short strategies, while two each are long-only, event driven and multi-strategy. The other strategies represented on the platform are commodity arbitrage, dynamic asset allocation, enhanced volatility premium, global macro and CTA.

The spread of strategies on the BAML platform is also well-diversified geographically, with 12 named as global strategies, with three focused on Europe, two on the US and two on Asia.

The second largest platform is the Schroders GAIA offering which had AUM at the end of June of $4.8bn. By August, Schroders had nine funds on its two GAIA platforms, eight of which are managed by external hedge fund managers and one internally.

Among investment bank platforms, one of the fastest growing is Morgan Stanley's FundLogic Multi-Asset Alternatives Platform, which was set up in 2010 and saw over $1 billion added to the programme in the last two years, according to Federico Foglietta, executive director at Morgan Stanley. He says that at the end of July 2016 platform AUM stood at $2.6 billion. "Our investor base has expanded in breadth and we now have a more diversified reach than we did a year ago," says Foglietta.

Foglietta adds that demand from this widening investor base is for diversification away from higher beta strategies. "Whilst there still aren't that many products to meet investor appetite for discretionary macro, we do see a lot of demand in that space," he says. "In terms of flows for FundLogic, we see significant interest from investors in CTA, market neutral and credit long/short strategies. More generally, any low beta strategy which can provide diversification and yield generates interest."

Another of the fastest growing of the platforms is the Goldman Sachs offering, which has been active in the alternative UCITS space since 2011. The platform now hosts five alternative UCITS funds with AUM of about $1 billion, with the emphasis firmly on quality and geographical diversification rather than quantity.

"Investors buy funds primarily because they like the manager and/or strategy, and they are often agnostic about the platform," says Neha Jain, executive director at Goldman Sachs in London. "We view the platform as a partnership with our hedge fund clients and hence give the manager control over the brand and growth of the fund, while generating direct, strong relationships between the manager and underlying investors."

Federico Foglietta, *executive director, Morgan Stanley*

The four third-party alternative UCITS on the Goldman Sachs platform are LBN China Opportunity, Maverick Fundamental Quant, MSK Equity and Select Equity Long/Short. The fifth alternative UCITS strategy on the platform is an internal, rules-based, algorithmic equity risk premia fund.

Jain agrees that two of the requisites for success for a third-party UCITS platform are diversification of their strategies twinned with robust and far-reaching distribution capabilities, both of which will be fundamental to the continued growth of the Goldman Sachs platform. "There is a well-acknowledged shortage of supply across all alternative UCITS, especially in strategies other than long/short equity," she says. "We're in an exciting growth phase in our business, and the industry as a whole, and we are looking to expand our offering and add high calibre managers and diverse strategies."

As to the platform's distribution strategy, Jain says that Goldman Sachs has opted for a very bespoke and targeted approach which she believes differentiates it from its competitors. "Engaging sales people across the firm who sell other alternative products and have strong existing client relationships maximises access and impact," she says. "It also eliminates the need to fill our shelves with products, allowing us to be very selective about the number and type of managers that we choose to partner with."

EXPLOITING GEOGRAPHICAL DISTRIBUTION NICHES

While the platforms do not specialise from a strategy perspective, some of the more recent entrants have aimed to build their franchise around highly concentrated geographical distribution. One example is Longchamp Asset Management (Longchamp AM), which was founded in 2013 by David Armstrong, previously managing director at Morgan Stanley,

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where he was global head of the funds and fund-linked business which developed the FundLogic UCITS platform. Aside from offering asset management and advisory services, Longchamp AM operates in the distribution of absolute return UCITS to investors in the French-speaking markets of Europe.

"Of the 18 funds on the FundLogic platform, many are managed by US-based asset management firms," says Alfandari at Longchamp AM. "An increasing number of these managers feel less comfortable with having marketing teams dedicated or partially dedicated to developing relationships in Europe."

In the case of France, says Alfandari, insurance companies make up a large portion of the investor market for alternative UCITS. Those insurers, she adds, have in the past often guaranteed policyholders annual returns of 3% or 4%, which used to look modest, but in this era of low or negative rates are becoming increasingly elusive in fixed income markets. "Insurance companies in France are chasing returns, which is one reason why they are becoming so active in the alternatives space," says Alfandari.

Hence Longchamp's other business line of providing distribution as well as outsourced investor relations for some FundLogic funds which represent a well-diversified cross-section of UCITS strategies. "Some of these managers still travel to Europe a few times a year to meet investors, but feel that it makes sense to be represented by an outsourced IR team with a permanent local presence," says Alfandari, who was in charge of marketing and communications for FundLogic before co-founding Longchamp AM.

Another example of a platform that has trailed its sights on distribution of alternative UCITS to a specific European investor base is the Hamburg-based alternative investment company, Aquila Capital.

In March, it appointed the much-travelled Manfred Schraepler to head up its liquid private markets business. In July, Aquila named Alpha Centauri as the first manager to be added to its Associated Manager Group Platform. The Alpha Centauri alternative beta strategy, which will be offered in a UCITS format, feeds into the

Neha Jain,
executive director, Goldman Sachs

strength of investor demand for market neutral strategies by offering access to alternative risk premia across equities, fixed income, interest rates and FX.

"My objective is to on-board good managers with strategies that can be co-branded by Aquila and distributed across our core region," says Schraepler. Although he includes Italy and Central Europe among the regions that make up Aquila's target market (it has recently opened an office in Prague), Schraepler is especially enthusiastic about the potential for the investor base in the German-speaking countries.

"I was very impressed with the inflows that we saw in the alternative UCITS space between 2013 and 2015," says Schraepler, who was previously at Deutsche Bank, IKOS and, most recently, Bank of America Merrill Lynch's Fund Solutions Group. "There was massive interest from wealth management clients and other institutions throughout Europe, but especially from Germany, where investors were starting to allocate big tickets to alternative UCITS. The largest I was concerned with was a €150 million ticket from a German pension fund to an alternative UCITS strategy."

The increasing popularity of liquid and transparent absolute return strategies among institutional investors in Germany gives Schraepler confidence that the Aquila platform can grow its share of an already crowded market. "We have identified 600 to 800 active investors in this space across Europe, including pension funds, insurance companies and family offices, which are increasing their allocations to alternative UCITS," he says.

The challenge, Schraepler adds, is to attract top quality managers to the platform. "We know we're playing catch-up," he says. "But we believe that the combination of our selection expertise and investor demand will allow us to identify one or two managers per year. Some of the larger funds are running into capacity constraints and we believe this is creating room for newcomers."

Schraepler insists that in the search for new managers, the emphasis needs to be on quality rather than quantity. Others echo this view. Spada says that it typically takes between three and six months of due diligence before a strategy

can be admitted to the Lyxor managed account platform, and that plenty of poorly performing funds have been axed from the platform over the years. "The business model does not consist of saying yes to everybody," he says.

It is not just the platforms themselves that have much of their time taken up by the due diligence process. "Intuitively, you would assume that there is less work associated with buying a regulated UCITS fund via a platform than there is when you buy an offshore hedge fund," says Dirk Wieringa, alternative investments advisor at Credit Suisse in Zurich. "But we find there is actually more work involved, because there is one more party involved in the sense that you need to do extensive due diligence on the manager, the fund and the platform."

"Where the leverage factor starts to work for the investor is that when you feel comfortable with the platform you don't have to do the work again," he adds. "Approving funds for due diligence purposes then becomes easier and faster."

Beyond helping existing strategies to launch products in UCITS format, third-party platforms can play a key role in supporting new fund launches. Dollery says that Societe Generale's prime broking unit supports new launches in a number of ways. "Through our capital introduction team we are helping managers connect with investors across a number of jurisdictions," he says. "And because Societe Generale hosts UCITS funds we can either help managers launch their own products via our platform or offer them consultancy to find external platforms."

SGSS's Irish UCITS platform, Gateway, was launched in the summer of 2015, providing access to an investment fund structure, Gateway UCITS Funds Plc. As SGSS explained at the time of the launch, "with significantly lower start-up and running costs, asset managers can benefit from a model which is more cost efficient than establishing a standalone fund. The funds also benefit from an infrastructure that offers additional services provided by Gateway such as audit and company secretary functions."

The competitive pressures among the platforms should be positive for investors because simple supply/demand dynamics ought to be driving down fees. "When the alternative UCITS space was still in its nascent stages five or six years ago, the bank platforms were generally able to charge relatively high fees," says Dollery. "The sheer choice available these days probably means we are reaching the point where there has been a normalisation of hosting fees, which are now within a much tighter range."

Dirk Wieringa, *alternative investments advisor, Credit Suisse*

BRIGHT, NEW SHINY OBJECTS?

Fundamental to the proposition offered by alternative UCITS in Europe and liquid alternatives in the US is their ability to use derivatives for investment purposes. This means that although UCITS products may not be able to replicate Cayman-based strategies precisely, they can come very close, thanks to the alchemy of synthetic prime broking, which many bankers say is the fastest growing area of the prime brokerage business today.

"In the case of an equity long/short, market-neutral or convertible bond arbitrage strategy, for example, we would set up a synthetic prime brokerage relationship with an ISDA agreement where we hold the underlying equities or convertible bond in swap format allowing the manager to access the leverage or long/short exposure he needs," says Societe Generale's Dollery.

"In the case of CTAs or macro funds, most of what they do is naturally eligible for UCITS because it involves trading futures, options and FX," he adds. "The tricky part is commodities, which UCITS are prohibited from holding in physical form. In that case, the UCITS would typically hold a certificate issued by a bank referencing an underlying managed account in which the commodities are traded."

While the use of derivatives to structure hedge fund-style products for the retail market has opened up a new range of opportunities to private investors, it has also made regulators uneasy – especially in the US.

The SEC's jitters about derivatives and leverage are consistent with some of the concerns that the US regulator and other observers have expressed about the turbocharged growth in liquid alternatives over the last six years.

These have centred around the belief that in their pursuit of fresh inflows in an uncertain

environment for mainstream assets, standards of investor protection that have been the centrepiece of mutual fund regulation for over 75 years may have been compromised. “I am concerned that we are starting to see some cracks in the foundation of this framework that we should all be thinking about,” said SEC commissioner Kara Stein in a speech to the Brookings Institute last year.

One manifestation of this is the use of derivatives by registered funds, which Stein described as having “skyrocketed” in recent years, resulting in almost 30 no-action letters having been issued by the SEC on the topic of leverage generated by derivatives. Stein added that the SEC had heard reports of funds using swaps and futures to achieve notional exposure of up to 10 times their net asset value. “I think that most would agree that this type of leverage runs counter to the leverage restrictions required by Section 18 of the Investment Company Act,” said Stein. She also quoted an official at the SEC who had described alternative mutual funds as “bright, shiny objects that are also very sharp and fraught with risk.”

Denehan at BNY Mellon recognises that regulators face a delicate balancing act between allowing managers the flexibility they need to generate positive uncorrelated returns on the one hand and safeguarding less sophisticated investors on the other. Equally, however, he says that the industry needs to play its role in ensuring that investors are able to make fully-informed allocation decisions.

“Regulators are certainly looking at the use of derivatives and at imposing some additional risk management constraints on registered investment companies,” he says. “But the industry’s responsibility to explain what these products aim to achieve is paramount.”

The same is true in Europe, where leverage levels from one alternative UCITS strategy to another can be very different. “Leverage rules can be determined by a fund’s limits, but they can also be based on the VAR [value at risk] methodology, where you could have leverage as high as 200% of notional exposure,” says Wieringa at CSAM. “It is essential that investors understand the difference between the two.”

Market participants say that the pity of

REGULATORS ARE CERTAINLY LOOKING AT THE USE OF DERIVATIVES AND AT IMPOSING SOME ADDITIONAL RISK MANAGEMENT CONSTRAINTS ON REGISTERED INVESTMENT COMPANIES
DECLAN DENEHAN, BNY MELLON

any possible heavy-handedness in regulation is that the majority of managers of liquid alternative products adhere to the spirit as well as the letter of the Act. They add that most use derivatives as wholly legitimate risk management tools, rather than as instruments of reckless speculation.

In Europe, too, there are concerns that over-zealously wrapping retail investors in cotton wool can create misunderstandings about the risks embedded in alternatives. “I laugh every time I read an article – sometimes in very sound publications – warning about risky alternative funds,” says Old Mutual’s Pepper. “If you have an account at a private bank you have to sign forms certifying that you’re a high risk investor if you want to buy a market-neutral strategy which has about a third of the volatility of common equities.”

Some recent evidence certainly implies that alternative investment funds have done a creditable job of mitigating rather than inflating risk. According to Craig Lewis’s empirical study on alternative mutual funds published in March, there is a “widely held misconception that AMFs use derivatives to take on significant risk in the search for outsized returns.”

This study reports that “all of the alternative fund asset classes we examine have risk levels that are significantly less than standard equity benchmarks like the S&P500. The relatively low volatility levels suggest instead that derivatives are being used to expand the investment opportunity set in a conservative manner that has been unproblematic.”

All the more reason for the industry to be concerned about a proposed SEC change in regulation issued in December 2015. According to the Financial Stability Oversight Council (FSOC), this aims to “limit the amount of leverage that registered investment companies (RICs) such as mutual funds and ETFs may obtain through derivatives transactions, strengthen their asset segregation requirements, and require derivatives risk management programs for certain funds”.

The Lewis study suggests – none too subtly – that the authorities should think twice before introducing any new legislation that reduces the investment freedoms and flexibility of

alternative investment products. Insisting that AMFs do not expose investors to undue risks, this advises that "policymakers engaged in rulemaking concerning the use of derivatives may want to use this study as input for their considerations."

DEFINING THE LIQUID ALTERNATIVES UNIVERSE

Maybe the liquid alternatives market in the US has to a degree been a victim of its own success. Its rapid growth has given rise to a highly diverse range of investment strategies, which has in turn created some controversy and confusion over the definition of alternatives. This, say market participants, is one area where the US market for liquid alternatives differs notably from Europe's alternatives UCITS space.

"Because UCITS come with far stricter limits on concentration and the use of leverage, investors have a very clear understanding of what they are buying in the UCITS space," says Mannion at BNY Mellon. "The US has far greater flexibility in the way funds can be structured, which is one reason why in the US you often see highly complex multi-manager structures with several managers within a single regulated fund," he says. "This is popular with investors because it provides exposure to a blending of strategies and returns within a single product."

Perhaps. But the regulator in the US is becoming increasingly uncomfortable with the way a growing number of alternative mutual fund managers have used (and perhaps abused) the 1940 Funds Act to reach retail investors. "In some ways, it appears that registered funds have slowly drifted towards a more flexible and permissive disclosure regime," said SEC commissioner Stein last year. "This drift increasingly places the onus on the retail investor to figure out whether a fund is right for him or her. And the retail investor, who generally tends to be less sophisticated in financial matters, might not even understand what he or she needs to know to make that decision."

This dilemma is aggravated by the fact that the liquid alternatives asset class is a relatively new option for retail investors. "Few liquid alternative funds have more than a five-year track record," notes a recent report published by Goldman Sachs Asset Management (GSAM). "Thus, they have generally experienced only one prevailing market environment – a bull equity market coinciding with a period of steadily declining interest rates. For this reason, we believe it can be difficult to know what to expect from these funds as market conditions change over the longer term."

The report adds: "We believe investors considering alternative mutual funds, also known as liquid alternatives, face a quandary: the number of offerings has grown rapidly, but useful information about these strategies is lacking. Many investors are trying to assess liquid alternatives using traditional mutual fund evaluation methods, when we believe these investments do not fall neatly into traditional mutual fund strategy classifications."

The numbers speak for themselves. At the end of April 2016, according to Morningstar data, there were 673 liquid alternative funds across 17 sub-strategies. Of these, more than a fifth (150) were categorised as multi-alternative, a larger share than the long/short equity strategies (140) that are generally regarded as the staple of the alternative fund universe. These were followed by non-traditional bonds (109 funds), managed futures (56), market-neutral (51), trading-leveraged equity (47), option writing (33), bear market (27), long/short credit (21) and multi-currency (16), with a hotchpotch of others making up the balance.

To make life easier for investors faced with this bewildering array of strategies, few of which have a track record stretching back more than five years, GSAM has created what it calls the LAI MAPS, which look at liquid alternatives through a "hedge fund lens".

This narrowed the universe of truly liquid hedge fund-like products from 637 to 333, sub-divided into five strategies more immediately familiar to hedge fund investors – equity long/short (103 funds), tactical trading/macro (84), multi-strategy (75), event driven (39) and relative value (32).

"We believe a categorisation framework which mirrors what has been adopted by the hedge fund industry may help investors construct more diversified portfolios and set

more realistic risk and return expectations for their LAI allocations," GSAM explains. "By paring down the LAI universe into hedge fund-like peer groups, we believe the returns of LAI mutual fund peer groups and the hedge fund indices could be more comparable."

THE CONUNDRUM OVER PERFORMANCE FEES

Confusion over definitions and categorisations apart, there may be other pitfalls awaiting less experienced investors expecting hedge fund-like risk-adjusted uncorrelated returns in the liquid alternatives space. Some argue, for example, that the fee structure in the market has the potential to act as a drag on performance by failing to provide the sort of incentives that hedge fund managers are given through 2+20 fee arrangements. Managers in the liquid alternatives space in the US are generally prohibited from charging performance fees, except in the case of limited offerings of funds of hedge funds or funds of private equity funds to so-called sophisticated investors.

The prohibition of performance fees in the '40 Funds Act is one reason why a manager like Old Mutual has chosen not to enter the liquid alternatives market. "We have looked at the US, but the problem there is the risk of negative selection bias because you're not allowed to charge a performance fee," says Pepper at Old Mutual. "We don't see the value in using up our time and capacity to generate alpha without being paid for it. That only makes sense if you have a very scalable strategy."

More broadly, Pepper says that the absence of the performance fee incentive in the US liquid alternatives market can magnify tracking error between flagship strategies and their regulated equivalents. "A number of funds of funds in the US have put together dumbed down '40 Act versions of flagship strategies often generating much less alpha," he says. "Investors in these funds need to be aware that they may be buying something very different from the flagship product."

In its report on "dispelling the myths" about liquid alternatives, K2 Advisors dismisses the suggestion that the best managers are deterred by the absence of incentives comparable to those they may be accustomed to in the private space. "We believe this is inaccurate," says K2. "Information from Morningstar supports this assessment, showing that such established hedge funds as Wellington Management, AQR Capital Management, Coe Capital Management, Chilton Investment Company, Loomis Sayles, Jennison Associates, Chatham Asset Management, Graham Capital Management and York Registered Holdings all participate in liquid alternative fund structures. Sub-advising managers may be attracted to liquid alternative mutual funds because of a desire to diversify their investor base and to obtain a stream of inflows from the retail market."

The growth of the liquid alternatives market has also attracted the attention of overseas managers, as has the potential of the broader US asset management industry. As Allen & Overy says in its introduction to a recent update on the 1940 Act Fund, "any manager seeking additional streams of AUM must consider the depth and breadth of the US retail market, which is estimated to have more than $33 trillion in investible assets." Of this total, notes the Allen & Overy briefing, 1940 Act Funds hold over $18 trillion, with more than 40% of US households owning interests in at least one 1940 Act Fund. To put the size of the 1940 Act Fund market into a global perspective, it is equivalent to more than 50% of the worldwide market.

THE GROWING US RETIREMENT MARKET

The US mutual fund market is likely to become considerably more attractive to the investment management industry over the foreseeable future. In her speech to the Brookings Institute last June, SEC commissioner Kara M. Stein said that over the next 35 years, the share of the US population aged 65 or over is projected to increase from 15% to 22%, which means there will be close to 85 million Americans with a retirement to fund by 2050.

"That's a big shift," she said, adding that it also coincides with what former SEC chairman Arthur Levitt has described as "an era of self-reliance" for American retirees, as it does for pensioners throughout the developed world.

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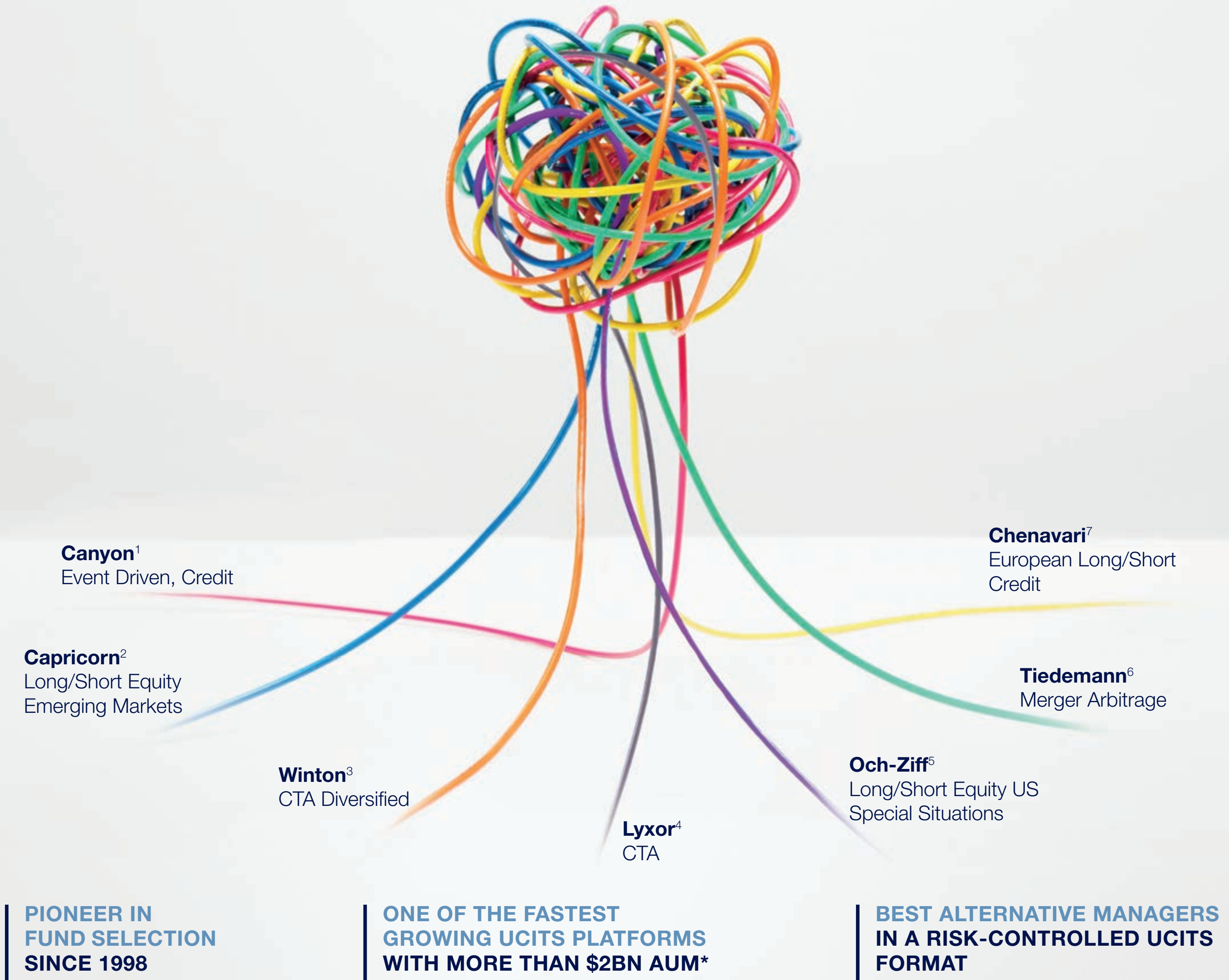

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"For much of the last century," said Stein, "people have thought of retirement as a 'three-legged stool' – social security, a pension, and personal savings. However, for many families, at least one leg of the stool has disappeared – the pension. And the two other legs have become a bit more wobbly."

The result, Stein added, is that Americans expect more and more of their retirement income to come from personal investments. "Most Americans will make such investments through mutual funds and ETFs [exchange-traded funds]," she said.

Small wonder, then, that this market holds considerable appeal for non-US management groups. According to a guide to market access to the US for regulated fund managers published by the Investment Company Institute (ICI) in October 2013, overseas fund managers have enjoyed reasonable success in accessing US investors via Regulated Investment Companies (RICs).

"As of June 2013, $2,153.17 billion of the total value of US open-end investment company assets, which represents 15.8% of open-end assets, were managed by foreign-owned investment advisers or their affiliates," this advises. "These figures compare with approximately $897.69 billion, or 12.6%, as of June 2000. For closed-end RIC assets, approximately $63.5 billion, which represents 23.2% of closed-end RIC assets, are managed by foreign-owned investment advisers as of June 2013. These figures compare with approximately $22.48 billion, or 16.19%, as of June 2000."

"More specifically, European-owned managers represent the largest segment of foreign-owned managers of RICs," adds the ICI report. "As of June 2013, $1,616.17 billion of the total value of US open-end RIC assets, which represents 11.9% of open-end RIC assets, were managed by European-owned investment advisers or their affiliates. In comparison, as of June 2000, European-owned management companies managed $716.78 billion, or 10.06%, of open-end RIC assets. For closed-end RICs, European-owned investment advisers or their affiliates managed $49.3 billion, or 18% of closed-end RIC assets, as of June 2013, compared to $16.46 billion, or 11.85%, in June 2000. These statistics indicate that foreign-owned management companies, and especially European-owned companies, are readily accessing the US regulated fund market."

Mark Mannion, *head of relationship management for EMEA, alternative investment services, BNY Mellon*

ASSET-RAISING CHALLENGES IN THE US

The principal challenge for European managers with their eyes on the US liquid alternatives market remains distribution. "How successful managers have been in selling liquid alternatives to US investors has often depended on the access they have had to distribution channels," says Mannion at BNY Mellon.

Mannion explains that historically, European alternative managers have accessed US investors via private placement, which requires larger hedge funds to register with the SEC and make various regulatory filings. More recently, he says that European managers have been exploring a range of other options. One is via acquisition, which has been the favoured route into the US market for some managers.

A second has been via the establishment of their own mutual funds under the terms of the 1940 Act, which imposes the same regulatory standards on all managers, irrespective of whether they are managed by local or overseas firms. According to the ICI guide on access to the US regulated market, "although the investor protection requirements of the 1940 Act are strict, there are several areas that are not subject to detailed regulation in the United States in contrast to many other countries. The 1940 Act does not impose high capital, residency, or US place of business requirements, and the absence of requirements in these areas contributes to the ease of access foreign firms have to the United States. The initial seed capital for a new fund that is required under the 1940 Act is only $100,000, and the 1940 Act does not require RICs to have directors or managers who are residents or citizens of the United States. A RIC also can be administered outside of the United States. As a result, it is easy for a foreign firm to establish RICs in the United States."

Straightforward, perhaps. But not necessarily cost-effective. "The US market is eye-wateringly competitive," says Mannion. "Although the

pools of money that managers can access are vast, you need to achieve a highly competitive total expense ratio to be attractive because there are so many players within the distribution chain – in addition to the distributor, there is the fund promoter and the sub-advisor. Funds in the US require more costly operating systems than their UCITS equivalents, together with added corporate governance."

The costs associated with distribution in the US means that granular distribution analysis is becoming increasingly important for managers. "Through our Albridge Solutions and Analytics subsidiary we have been seeing more hedge funds and traditional managers asking for more detailed analysis on where their product is being distributed," says BNY Mellon's Niu. "This gives them a much better understanding of the areas their sales staff should be focused on in their dialogue with RIAs."

A third option for European managers attracted by the potential of the US, says Mannion, is to access the market in a sub-advisory capacity on an existing fund platform. This is the route that has been selected by IPM, for example, which last September added its systematic macro strategy to Blackstone's $1.4 billion Alternative Multi-manager fund.

"We've been gaining traction rapidly in the US, where investors have a very good understanding of systematic macro strategies," says IPM's Nydahl. "Today, the US accounts for about 35% of our total AUM, compared with close to zero a few years ago, and given that the US accounts for more than 50% of global hedge fund assets, I see no reason why this share should not increase further. In the case of '40 Act funds, given the quite different regulatory framework, we feel more comfortable operating in a sub-advisory role to a manager like Blackstone with proven experience of distributing '40 Act products."

Approaching the US market will require careful cost-benefit analysis, as Mannion advised in a recent paper entitled *Split Decisions: Institutional Investment in Alternative Assets*, published by BNY Mellon and FT Remark in June 2016. "While the asset-raising opportunity is sizable, players must remember that management fees are lower than typical alternative products and a fund's expense ratio must stay competitive," this advised.

THE ALTERNATIVE SPACE IN EUROPE IS STILL SIMILARLY DOMINATED BY SOME VERY LARGE FUNDS
ANDREW DOLLERY, SOCIETE GENERALE

This, added to the regulated nature of '40 Act products, means that strategies are likely to differ from flagship funds or UCITS products. "Lastly," Mannion's note advised, "operational demands can be hefty, including daily valuations, new interfaces with US service providers, and time-zone differences."

The economics of distribution in the US have also made the market for liquid alternatives a notoriously difficult nut even for local newcomers to crack. "If you can establish a three year track record and you have access to the right platforms and distribution channels, you can attract significant assets in the US market," says Mannion. Without a demonstrable track record, he adds, entering the US market can be prohibitively expensive.

In the meantime, the market for liquid alternative products on either side of the Atlantic remains dominated by a small group of the largest managers. "Analysis we did recently showed that something like 70% of the US CTA mutual fund market remains dominated by about five funds," says Societe Generale's Dollery. "The alternative space in Europe is still similarly dominated by some very large funds."

Others agree. "We would consider critical mass in the liquid alternatives space to be $200 million and over," says Niu at BNY Mellon. At or below that rather modest minimum, the survival rate of many of the new managers breaking into the market may be limited. "While I expect AUM growth to be strong, I also think we will see some headlines about a lot of the smaller funds closing if they are unable to achieve the scale they need," says Denehan at BNY Mellon.

A BROADER RANGE OF ALTERNATIVE UCITS STRATEGIES

During the initial phase of the market for alternative UCITS and liquid alternatives, one of the most frequently expressed concerns about its growth prospects was that it would restrict investors to the most liquid strategies, denying them access to some alternative products that ought to play a key role in constructing a well-diversified portfolio.

As a Regulatory Brief published by PwC in

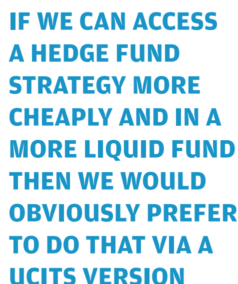
2014 explains, "launching liquid alts is not as simple as repackaging existing private fund strategies into a mutual fund". Restrictions on the use of derivatives and short selling, twinned with strict liquidity requirements, means that a number of familiar alternative strategies and asset classes are not feasible within a mutual fund structure, adds PwC. "Not surprisingly, the primary strategies currently employed in liquid alts tends to be global macro, long/short equity and managed futures, while private equity, venture capital, timberland, infrastructure and merger arbitrage are not viable options."

The relatively narrow range of strategies available to investors in the early days of the alternative UCITS movement meant that some of the larger institutions involved in the market needed to flex their own muscles in order to persuade managers to broaden their repertoire. Take the example of Credit Suisse Asset Management (CSAM), which now has some $11 billion invested in offshore funds and alternative UCITS.

CSAM's Wieringa says that CSAM has been investing in alternative UCITS since 2009, launching its first multi-UCITS fund of funds in August 2010 and adding a second, slightly more dynamically managed strategy the following year. "We now have over $1 billion in those two funds, in addition to other client funds invested directly in UCITS products."

"If we can access a hedge fund strategy more cheaply and in a more liquid fund then we would obviously prefer to do that via a UCITS version," says Wieringa. "Our buying power both in Europe and the US has meant that we have been able to persuade a number of managers to launch UCITS versions of their strategies. This was important for us back in 2010 when there was a limited range of UCITS funds available to us, but there is now a much wider selection in the market."

While investors and third-party platforms say they would like to see a broader supply of new funds in strategies other than long/short equity, the consensus is that the range of products available to UCITS investors is now more diversified than it has ever been, and that it is becoming more so by the day.



IF WE CAN ACCESS A HEDGE FUND STRATEGY MORE CHEAPLY AND IN A MORE LIQUID FUND THEN WE WOULD OBVIOUSLY PREFER TO DO THAT VIA A UCITS VERSION
DIRK WIERINGA, CREDIT SUISSE

At Societe Generale, for example, Dollery says that he is encouraged by the diversification of new launches he has seen in the UCITS market over the last 12 months. "We've seen everything from convertible bonds to CTA and global macro, so there has been a healthy variety in the range of strategies being offered in UCITS format," he says. "Aside from illiquid or highly concentrated strategies such as activism, most strategies are now adequately represented in the UCITS space."

Dollery echoes a number of other market participants when he says that one of the most active areas for new fund launches this year is the quant space. He points to the example of a strategy like the Tiber CTA, a short term systematic trading fund, which has launched recently via the Mortlake platform.

According to ML Capital, "Tiber Capital's Diversified Program trades 25 global futures markets using 18 algorithms and aims to meet different investors' risk and return requirements. The Program trades with varying time frames (intraday to medium term, with an average holding period of 4.5 days) and strategies (momentum, volatility breakout, pattern recognition, mean reversion and tactical trend). Returns are independent of the movement of financial markets and show low or negative correlation to other asset classes."

Quant strategies have also been increasingly popular in the US liquid alternatives market over the last 12 months. "The winning strategies this year have been managed futures, and the most striking success story in the US market has been AQR, which has raised a tremendous amount of money over the last 12 months," says BNY Mellon's Niu. AQR's Managed Futures Strategy had net assets of some $13.25 billion at mid-year.

THE RISE AND RISE OF RISK PREMIA

The market for smart beta, factor-based or risk premia products has been one of those to attract the most attention among managers and investors in the UCITS space.

"The rise of alternative beta is one of the strongest trends we're seeing among new UCITS launches this year," says Dollery at

Conviction is paramount

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Find more information about our approach at ipm.se or contact us at info@ipm.se.

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IPM Informed Portfolio Management was founded in 1998 with the purpose of delivering robust investment strategies with a systematic investment process to institutional investors. Today, IPM is primarily recognized for its multi-asset systematic macro strategy, but also for its Smart Beta equity strategy, both building on similar investment principles.

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IPM
INFORMED PORTFOLIO MANAGEMENT

Societe Generale. “To some extent this represents the infiltration into Europe of a very successful US theme where investors have been attracted by products with a low fee in the 50bp to 100bp range. We think this will continue to be a feature of the UCITS market, where managers will focus on offering systematic, simpler and lower volatility versions of their flagship products.”

At Old Mutual, Pepper agrees. “We think the development of risk premia products offering market neutral exposure to various investment themes will be very interesting for the alternative UCITS market,” he says. “Because 70% or 80% of the returns can be explained by systematic exposure to these themes rather than granular single stock picking, you can pile these products high and sell them cheap. They can also be wrapped in ’40 Act funds without performance fees.”

This reflects a more general trend across an industry where containing or reducing fees are becoming paramount for investors. “I think investors are prepared to accept more modest returns of 3% or 4% in this environment, but they’re not prepared to pay hedge fund-style fees to generate those returns,” says Wieringa at CSAM. “This is why risk premia strategies with flat fees of 100bp or less have done so well.”

As low cost, uncorrelated and highly liquid funds, risk premia-based strategies and UCITS look like a match made in heaven. The same cannot be said for some other strategies which continue to be unsuitable for inclusion within funds requiring weekly liquidity, still less for those promising daily liquidity. “The red line for us is always around the issue of liquidity, because this is where the most obvious mismatch lies between UCITS and their underlying investments,” says Societe Generale’s Dollery. “We would never look at a fund that trades a highly illiquid strategy.”

Others agree. At Credit Suisse, Wieringa describes liquidity risk as being “front and centre” of investors’ misgivings about the risks associated with the rapid expansion of the alternatives UCITS space. “It is absolutely essential that the UCITS brand does not become tarnished by any liquidity mismatch,” he says.

Donald Pepper, *managing director of alternatives and institutional, Old Mutual Global Investors*

THE IMPORTANCE OF QUALITY CONTROL

The consensus among all market participants is that it is critical that the industry as a whole remains vigilant against any loosening of the high standards that have been set in the alternative UCITS space.

“As investors seek more complex products, we think that one of the challenges will be continuing to ensure that the liquidity profile of underlying products is in line with UCITS regulations,” says Jain at Goldman Sachs. “It is essential that asset managers and platforms are thoughtful about their fund launches, and therefore about protecting the UCITS reputation and brand.”

The obvious way to prevent this happening, say market participants, is to ensure that investors have an absolutely clear understanding of the product they are buying. That is usually straightforward enough in the case of an equity long/short strategy, but can be considerably less so in the world of debt or credit.

As Dollery at Societe Generale says, this is because credit is a good example of an asset class that can lend itself to liquid as well as illiquid strategies. “Credit can mean a number of different things to different people,” he says. “It can mean trading cash instruments, which in the case of high yield bonds can be tricky for strategies offering daily liquidity. Alternatively, it can mean centrally-cleared derivatives such as credit default swaps (CDS), which have brought credit into the alternative UCITS fold because they are more liquid. We recently launched a UCITS product which is called a credit fund but it won’t be trading cash bonds. It will focus purely on centrally-cleared CDS.”

It is easy to see why higher yielding fixed income should be becoming increasingly appealing to investors. According to an update published in July by Schroders, some 36% of global government debt now trades at a negative yield, while 77% yields below 1%. As Schroders says, “unless you believe in a significant deflationary bust, owning these securities makes little sense.”

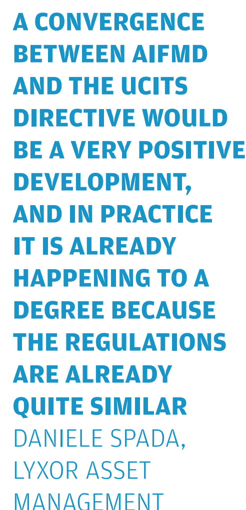
Little wonder, against that backdrop, that alternative credit products have become

increasingly popular among investors engaged in an increasingly challenging hunt for yield. "One of the strategies we think is going to attract a lot of attention over the next few years is loans and debt, although they don't often fit into liquid alternatives because of the illiquidity of the underlying assets," says Mannion at BNY Mellon.

In the US in particular, this unnerves regulators which are uneasy about the potential for managers attempting to shoehorn strategies such as bank loans into alternative mutual funds which are only allowed to hold up to 15% of their assets in illiquid securities. In her speech to the Brookings Institute last June, SEC commissioner Kara M. Stein was explicit about the regulator's unease about the inclusion of illiquid strategies in products which are – by definition – intended to be liquid. Since late 2009, she said, assets in bank loan mutual funds and ETFs had increased by almost 400%.

"Yet, many of the underlying loans in these funds may take over a month to actually settle," she said. "If it takes over a month to settle, it is reasonable to wonder how the fund could possibly meet the seven day redemption requirement in the Investment Company Act in times of market stress."

Stein added that the portfolios of some bank loan funds contained collateralised loan obligations (CLOs). Others were almost entirely made up of illiquid bank loans. "How is this happening?" she asked, rhetorically. "Funds have relied on an interpretation that allows them, for example, to base the 15% standard on when a contract price is struck to sell the underlying bank loan and not on when actual settlement of the loan occurs, which is when the fund would actually receive cash and transfer ownership of the loan. "Unfortunately, I am not sure that retail investors have received the memo that interpretations of liquidity rules have changed beneath their feet for certain funds. Not only that, retail investors may not even receive disclosure about risks related to this extended settlement period. Over time, this 15% liquidity standard has arguably become more of a compliance exercise than a true restriction."



Commissioner Stein's concerns echo those of the Financial Stability Oversight Council (FSOC), which calls in its most recent annual review for "robust liquidity management practices" for mutual funds. This would involve the "establishment of clear regulatory guidelines addressing limits on the ability of mutual funds to hold assets with very limited liquidity." Among other initiatives to tighten up protection for retail investors, the FSOC is also calling for "enhanced reporting and disclosures by mutual funds of their liquidity profiles and liquidity risk management practices."

The SEC has already suggested some measures aimed at addressing the liquidity conundrum. In September 2015, it issued proposed rules for mutual funds and ETFs designed to enhance liquidity risk management by funds, provide new disclosures regarding fund liquidity, and allow funds to adopt swing pricing to pass on transaction costs to entering and exiting investors.

As with the SEC's concerns about derivatives, a number of industry participants believe misgivings about liquidity may be overegged. In its recent report on "dispelling the myths" associated with the liquid alternatives market, K2 Advisors comments that in 15 event-driven funds that it monitors, "roughly 58% of the portfolios' holdings could be fully liquidated within one to five days, 62% within five to 10 days, and 67% within 20 days. For the 27 global macro funds we monitor, roughly 95% of the portfolios' holdings could be fully liquidated within one to five days, 96% within five to 10 days, and 97% within 20 days (all as at January 2015)."

K2's conclusion is that "some trading strategies are less liquid by nature, such as certain specialist credit funds, but in general our analysis suggests these represent the minority. As such the supposed advantage of illiquidity may in practice be very limited."

UCITS REGULATION: ENOUGH IS ENOUGH?

Whether or not Europe could also see regulatory pressure to tighten standards in its equivalent of the liquid alternatives market is open to question. Most appear to think

this is unlikely and unnecessary. "It's true that the financial services industry is highly creative and innovative," says Spada at Lyxor, who is not worried about abuses being allowed to creep into the UCITS market. "But the rules on alternative UCITS are very tight and clear, and managers offering complex and less liquid strategies can do so via the AIFMD instead."

Following a series of amendments to the original UCITS Directive, managers and their service providers could be forgiven for complaining of regulatory and acronym fatigue. The good news, they say, is that the most recent reincarnation of the regulatory framework has been relatively painless. UCITS V, which was published in August 2014 and transposed into national law in March 2016, amended a handful of issues relating to manager remuneration, the depository function and administrative sanctions, none of which caused much friction in the investment management industry.

"UCITS V was not too disruptive, and the decision not to impose any hard cap in the manager remuneration provisions was sensible," says Dollery at Societe Generale. "As for the new guidelines on depositories, because a prime broker is seldom appointed as a sub-custodian for a UCITS fund the increased depository liability is unlikely to have much of an impact on our business."

So successful have UCITS become that they are now regarded around the world as offering the highest level of investor protection. "UCITS have achieved a gold standard which funds authorised under AIFMD would very much like to enjoy," says Mannion at BNY Mellon. "AIFs still haven't enjoyed the levels of success that were forecast back in 2014. Even though they are a highly regulated product there still appears to be an investor preference for alternative UCITS because of the standards they have set with regard to governance and liquidity."

Although there has been some speculation about continued convergence between UCITS and AIFs, Mannion and others point out that as they are intended for professional rather than retail buyers, AIFs will remain governed by considerably more flexible guidelines. "Many of the loans and debt strategies, as well as anything with a private equity or retail feel, will still end up in AIFs rather than UCITS," says Mannion.

Serge Houles,
head of client portfolio management, Informed Portfolio Management (IPM)

That may be. But a number of market participants are vocal about the desirability of combining AIF and UCITS regulation. "I wish and hope that the European regulator would look at merging AIFMD and UCITS to create a single global passporting system," says Houles at IPM. "The existing dual system is complicated for managers and investors to navigate, and given the traction of UCITS-compliant versus AIMFD-passported funds, in such a scenario UCITS might be the sole regime going forward."

Others agree. "A convergence between AIFMD and the UCITS directive would be a very positive development, and in practice it is already happening to a degree because the regulations are already quite similar," says Spada.

As Spada points out, Lyxor is well-positioned to comment on the difference in investor preference for the two because it offers alternatives UCITS as well as AIFMD products on its platform. Today, he says, Lyxor has eight strategies on its alternative UCITS platform and four on its Luxembourg-based AIFM platform. But he adds that while Lyxor is actively looking to add to the repertoire of alternative UCITS it offers investors, it has no plans at present to extend its AIFMD offerings. "This is because 90% of the requests we receive are for alternative UCITS," he says.

One of the principal differences between AIFs and UCITS is that while the AIFMD governs the fund management company, UCITS focuses on governing the fund itself, which industry participants say is a much more sensible approach for investors.

"Don't quote me on this," says one. "But I can't help thinking that regulation of the asset management industry is shaped more in the interests of the regulators themselves than on behalf of the investors it is supposed to protect."

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** Equivalent to €114.5bn - Assets under management and advisory as of end of June 2016*

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