Liquid alternatives

Diversification drives Ucits growth

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SPECIAL REPORT/ LIQUID ALTERNATIVES
Diversification drives Ucits growth

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Liquid alternatives 2017

In the 10 years since the global financial crisis erupted, the Ucits hedge fund market has played a key role in reshaping the alternative investment industry – for managers, investors and service providers alike. The liquid alternatives sector continues to enjoy robust growth – in terms of diversification by product, by strategy and by geography; in terms of the broadening of the global investor base, in both the institutional and retail arenas; and in terms of the participation of an ever-expanding and increasingly high-quality universe of managers, allocators and counterparties. At a time when investors are nervous about long-only equity and bond investments – and showing increased demand for alternative investments to act as portfolio and return diversifiers – the prospects look strong for further growth. In this special report, *Philip Moore* assesses the past, present and future for one of the most vibrant areas of the asset management world.

This summer marked the 10th anniversary of a global crisis that is generally regarded to have begun when BNP Paribas suspended trading in three funds - Parvest Dynamic ABS, ABS Euribor and ABS Eonia.

It is convenient to pinpoint the precise moment at which the meltdown of 2007/2008 started. But the announcement by BNP Paribas on 9 August 2007 certainly did not cause the meltdown. It is also questionable whether the suspension of trading in the BNP Paribas products marked the start of the crisis. After all, HSBC had alerted the world to the precarious state of the sub-prime market six months earlier, and during the summer trading in a number of small funds had been frozen.

The funds frozen by BNP Paribas were regulated products domiciled in Luxembourg and France, and the temporary suspension of the calculation of their net asset values as well as subscriptions and redemptions was imposed, according to BNP Paribas, "in strict compliance with regulations". The suspension, as BNP Paribas would explain later, reflected the fact that "with no prices and no trading, there was no market to serve as a reference and thus it was impossible to value the three funds".

Nevertheless, it was the suspension of the BNP Paribas funds on that August day that is commonly seen as the precedent that unleashed a wave of gating and side-pocketing that would give the hedge fund industry a bad name, and drive the most far-reaching process of introspection and change that the industry has ever seen.

Alongside managed accounts, many regarded Ucits in general - and alternative Ucits in particular - as the antidote that would help to restore confidence in the industry. This was principally because of the regulatory oversight, transparency and - above all - the liquidity they promised.

Alternative Ucits had been around since the third Ucits Directive in 2001, which widened the scope of the financial instruments regulated vehicles could hold. Critically, it also allowed for synthetic shorting through cash-settled derivatives.

It was not just the illiquidity of the crisis that alerted institutional as well as retail investors to the benefits of alternative Ucits. The performance of mainstream products during the crisis also led to a rethink of asset allocation models across the investor universe, which in turn underpinned rising demand for alternative products.

The success that alternative Ucits enjoyed post-crisis – and the press coverage they attracted – was mesmerising. By late 2010, a report by Strategic Insight, commissioned by the Association of Luxembourg Fund Industry (ALFI), was reporting that the universe of alternative investment strategies within Ucits was already “bigger and expanding at a faster rate than commonly believed”. By then, according to the same report, assets managed in alternative Ucits were already equal to 10% of the size of the global hedge fund industry.

OVERCOMING EARLY MISGIVINGS

In spite of this striking growth, alternative Ucits were still viewed suspiciously by a large cross-section of market participants, for several reasons. Foremost among these was the belief that the liquidity requirements enshrined in Ucits regulation would mean that it would be impossible to replicate many hedge fund strategies in regulated format, and that even where flagship funds were replicable, they would remain vulnerable to tracking error.

In the formative days of the alternative Ucits movement, misgivings about the restricted range of alternative strategies were largely warranted by supply patterns. “One of the early failures of alternative Ucits in trying to promote themselves as a way of accessing hedge fund strategies in an onshore format was that for many strategies it was impossible,” says Serge Houles, head of investment strategy at the Stockholm-based systematic global macro manager, IPM Informed Portfolio Management. “Even today, investors have to accept that in the case of some strategies, such as credit, replicating offshore products sometimes comes at a cost of significant tracking error.”

Over and above these concerns, the suspicion also remained that from a supply perspective, Ucits would appeal only to second-tier managers struggling to increase AUM. The best managers, it was argued, would regard repackaging their unregulated funds into Ucits wrappers as an unnecessary administrative burden.

These objections have been dispelled in quick order. This is thanks in large measure to the alchemy of financial engineering and the endless capacity of the investment banking community to develop solutions metamorphosing unregulated investment products into Ucits-compliant funds.

ONE OF THE EARLY FAILURES OF ALTERNATIVE UCITS IN TRYING TO PROMOTE THEMSELVES AS A WAY OF ACCESSING HEDGE FUND STRATEGIES IN AN ONSHORE FORMAT WAS THAT FOR MANY STRATEGIES IT WAS IMPOSSIBLE
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Serge Houles,
head of investment strategy, IPM Informed Portfolio Management

This in turn has helped to make the broader Ucits universe a key part of leading prime brokers’ business. “For several years now, probably more than half our pipeline of new funds business has been generated by regulated funds, mostly in Ucits format,” says Andrew Dollery, director at Societe Generale Prime Services in London.

The consequence is that for many managers, Ucits regulation is no longer a bar to innovation. “We don’t see the Ucits regulation as a restraining factor in terms of the risk or leverage you can put into a portfolio,” says Olivier Blin, director and head of cross asset systematic strategies at Unigestion.

The quality of alternative strategies launching in Ucits format, meanwhile, has changed beyond recognition in recent years, according to Sasha Temple Jones, head of Deutsche Bank’s Hedge Fund Capital Group in Europe. “For a number of years, one of the main gripes we have heard from investors was that the supply of high quality alternative Ucits funds did not match that of unregulated products, which meant there were too few good funds to select from,” she says. “Now, a number of well-established hedge fund managers have moved into this space, which is something investors have been demanding for a long time.”

Supported by new launches such as these, and underpinned by a combination of performance and new inflows, the alternative Ucits market has now breached the €400 billion assets under management (AUM) mark, with the sector as a whole projected to post a growth rate of at least 10% in 2017.

This suggests that far from fading with the passage of time, the lessons learned during the liquidity freeze of the global financial crisis remain etched within investors’ collective memory. “Of course many investors are comfortable with unregulated vehicles and managed accounts,” says Dollery. “But the fact that the lessons of the crisis have become so engrained in investors’ psyche is one reason why so many continue to look for the regulatory oversight, liquidity and transparency that alternative Ucits provide.”

Daniele Spada, head of the managed account platform at Lyxor Asset Management in Paris, agrees. “Although some funds have closed down because performance over the last two or three years has not been in line with investors’

expectations, investor interest in the alternative Ucits market continues to grow," he says. "We are seeing more and more managers launching products in Ucits format across a much more diversified range of strategies."

STRATEGY DIVERSIFICATION ACCELERATES

Others share the view that it is the increasingly diversified range of strategies now accessible in Ucits form that has perhaps been the most notable feature of the expansion of the alternative Ucits market over the last five years. "Today, I would say that with the exception of one or two highly illiquid strategies, the alternative Ucits market has become reflective of the hedge fund industry," says Dollery. "In terms of new fund launches, in recent months we've seen everything from CTAs and commodity funds through to liquid credit, multi-manager and emerging market long/short equity funds being offered in Ucits versions."

The broadening of alternative strategies available in Ucits wrappers, says Lyxor's Spada, has been especially welcome for investors against the backdrop of an increasingly uncertain outlook for long-only investors in mainstream asset classes. "Two strategies where we have seen very strong growth are CTA and merger arbitrage," he says. "Demand for genuine diversifiers such as CTAs has been very strong among investors wanting to protect against downside risk or extreme volatility."

He adds: "Another trend that we've seen since the start of this year is that investors have also wanted to maintain exposure to equities, but with less directionality. Event-driven strategies such as merger arbitrage embedding idiosyncratic risk have been an ideal answer to this kind of requirement."

Managers confirm that in the current environment, investor demand for genuine diversification in a transparent and highly liquid format is growing. That has certainly been the experience of Stockholm-based IPM, which was established in 1998 and launched its Systematic Macro strategy under the Ucits format in August 2015, after almost 10 years of live performance in the offshore Cayman fund.

"Business-wise it has been a very good year for IPM, with the uncorrelated return characteristics of the macro strategy something that is clearly sought after in this environment," says Stefan Nydahl, IPM's CEO – noting that total assets have now reached close to $4.5 billion.

Andrew Dollery, director, Societe Generale Prime Services

TODAY, I WOULD SAY THAT WITH THE EXCEPTION OF ONE OR TWO HIGHLY ILLIQUID STRATEGIES, THE ALTERNATIVE UCITS MARKET HAS BECOME REFLECTIVE OF THE HEDGE FUND INDUSTRY
ANDREW DOLLERY, SOCIETE GENERALE PRIME SERVICES

He adds that demand for the Ucits version of the strategy, which is hosted on the Morgan Stanley FundLogic platform, has been especially noteworthy. Assets in the IPM Systematic Macro Ucits fund, he says, have doubled over the last 12 months to around $1.3 billion.

Björn Österberg, IPM's chief investment officer and head of research, says that the solid performance of the macro strategy over the last year has been driven by all of IPM's models save the one focused on developed currencies.

Mattias Jansson, the firm's deputy CIO, adds that over a longer time horizon, the IPM strategy has built a track record of consistently delivering the uncorrelated returns that investors are increasingly demanding. "We have managed to maintain a good return profile with attractive correlation characteristics towards equities and trend-following strategies," he says.

"I think one of the reasons our strategy is performing so well is that our emphasis is on continuously evaluating a large number of different investment ideas rather than being too concerned with what happens to be in vogue at any one time," he adds.

The performance of the strategy speaks for itself, and is described in a recent Kepler report as the stand-out performer in the systematic macro space, returning 6.7% in 2016 and a further 4.9% in the year to mid-August 2017. "What is more, this has been achieved with strong negative correlation to equity markets (-0.6) and no correlation to bond markets (0.0), providing investors with strong diversification," Kepler comments.

As for the strength of demand that IPM has seen for the Ucits version of its flagship strategy, Österberg says that this may be a reflection of the fact that IPM's entire strategy is replicated in the Ucits framework. "Our Ucits product is not an altered version of the unregulated fund," he says. "Unlike some Ucits funds, the tracking error between our flagship fund and the Ucits version is minimal and purely random."

PORTFOLIO STRUCTURING WIDENS RANGE

Diversification across the Ucits landscape has been driven chiefly by portfolio structuring, which has made several previously inaccessible offshore strategies increasingly open to inves-

tors in regulated vehicles. At the most basic level, this has focused on enhancing liquidity. “The golden rule for us is the provision of liquidity, because Ucits regulation calls for dealing NAVs at least on a fortnightly basis, but more often on a weekly or daily basis,” says Dollery.

Innovative structuring, he adds, has progressively eroded barriers which in the early days of the alternative Ucits movement made the market top-heavy with equity long/short products. “In the commodities and fixed income futures area, we have a dozen or so structures that are either already live or being on-boarded now,” Dollery explains. “This is based on issuing a structured financial instrument (SFI) which we hedge with a managed account. The trading advisor trades a portion of its strategy within the managed account, the economic value of which is then transferred through the SFI, which can be marked to market on a daily basis.”

“Another structure that has proved to be very popular is portfolio swaps, not just on equity programmes, which are fairly standard, but also on classic convertible bond programmes, where managers are long the convertible and short the equity,” Dollery adds.

“A number of clients are also trading interest rate swaps and centrally-cleared credit default swaps which facilitate the full replication of a number of liquid credit programmes in Ucits products,” he says.

The costs of using these techniques to repackage unregulated products into Ucits-compliant funds, says Dollery, are manageable. “The costs of a regular equity or bond swap should be equivalent to the financing paid by any hedge fund,” he explains. “Certificates do incur extra costs, but these are relatively modest and are usually linked to AUM. With a reasonable AUM, the cost could be as low as 20bps, which is not prohibitive.”

One notable example of a recent launch which has prized open new opportunities for Ucits investors, says Dollery, is the Andurand Commodities Fund. Recently launched in regulated format, this offers investors access to an asset class which had previously been regarded as largely off-limits under Ucits regulation, and to a strategy with a proven and impressive track record (see box page 8).

Dollery says that there are still some examples of strategies that have been more challenging to replicate in Ucits funds, most obviously in the illiquid assets space. CTAs, he says, still only represent about 4% of the alternative Ucits market, whereas they account for more than 10% of the total hedge fund industry.

“Traditionally there has been a shortage of good CTA and global macro managers in the Ucits space, for a number of reasons,” he says. “The fee element may be one of these, with some managers still reluctant to compromise on the 2+20 fee structure in their flagship products. Another may be the structuring requirements for making these strategies Ucits-compliant.”

Even the CTA space, however, has also seen a notable increase in new launches in recent years, adding to the diversification of the Ucits market. According to a recent Morgan Stanley report, Ucits CTA assets have increased by 57% over the last four years, with the number of funds having more than doubled, underpinned by a proliferation in small and mid-sized CTAs.

Other innovative options are also being explored for wrapping illiquid strategies into regulated products. A variation on the diversification theme, says Temple Jones at Deutsche, is the emergence of multi-strategy products from funds of funds. “A recent trend has been the launch by some funds of funds of Ucits-compliant products where the underlying funds themselves are not necessarily all Ucits,” she says. “A fund of funds with 10 underlying strategies, for example, may contain three or four which don’t fit neatly into a Ucits wrapper, but makes the portfolio more robust and diversified. At the fund of funds level, the product is still a Ucits fund with all the necessary liquidity and regulatory oversight.”

US MANAGERS RESPOND TO UCITS DEMAND

More broadly, however, demand still appears to outstrip supply in the market for regulated onshore alternative strategies away from bread-and-butter equity long-short funds. “The general consensus is that is there is still not enough product available,” says Jueta Kurar, vice president in the Hedge Fund Capital Group at Deutsche Bank. “This is why we are increasingly seeing large, influential investors taking the initiative of approaching managers themselves and asking them to offer Ucits versions of some of their unregulated funds, especially in strategies that are still relatively

Björn Österberg, *CIO, IPM Informed Portfolio Management*

scarce in Ucits format."

It's not just strategy diversification that is in demand in today's alternative Ucits market. Increasingly, managers from outside Europe are responding to a rising requirement among investors for a more geographically-diverse selection of managers. "A clear trend we have seen over the last two years has been the growing interest of US managers in the opportunities that have been opened up by the Ucits market," says Dollery.

Nor has interest in the potential of Ucits in general and alternative regulated products in particular been restricted to US managers. "While we haven't seen as many new fund launches from Asia as we have from the US, there has been a clear increase in the number of enquiries we've had from Asia this year," Dollery adds. "We have had a good half-dozen discussions with Asian managers about portfolio structuring for regulated products."

One example of a new launch in regulated onshore format in 2017, says Dollery, is the Tages Rotella Ucits Fund, the fourth sub-fund of Tages International Funds SICAV, a Ucits-compliant umbrella fund structure domiciled in Luxembourg.

The Chicago and Bellevue-based Rotella Capital, established by Robert Rotella in 1995, has been a pioneer in the development of specialist systematic managed futures programmes, according to Tages. It reports that the Rotella Polaris Programme has been managed since 1991 with the objective of producing consistent absolute returns, minimising monthly drawdowns and maintaining relatively low volatility. The Tages Rotella Ucits Fund, which leverages the Rotella Polaris Programme, launched in July

Andurand makes commodities accessible to Ucits investors

Andurand Capital Management was founded by Pierre Andurand, who co-launched BlueGold Capital in 2007. Under his management, the BlueGold Global Fund achieved returns net of fees in excess of 240% during its four year life.

The former Goldman Sachs oil trader enjoyed similarly striking success with Andurand Capital Management, which was set up in 2013 and had AUM of $1.6 billion at the end of 2016.

The Andurand Commodities Fund, which employs directional and relative value trades predominantly using oil futures, posted returns of 19.7% in 2013, 38.1% in 2014, 4.1% in 2015 and 22.1% in 2016. This year has been less successful, with the fund down in each of the first five months of 2017. Nevertheless, the fact that Ucits regulation has historically appeared to prohibit the sale of Ucits versions of strategies based on physical commodities has been a source of frustration to managers and investors like.

Until recently, it was certainly frustrating to Hakon Haugnes, chief operating officer at Andurand Capital in London. "We had looked at the possibility of launching in onshore format, but until 2015 it had always seemed that it would be impossible for a Ucits to properly replicate a futures fund," he says.

Given that the Andurand Commodities Fund's success has been based on trading oil and energy futures, options and swaps, with no exposure to equities, this appeared to make the replication of the fund in Ucits format a non-starter. "Although we could trade swaps, it was clear that it would be too difficult to replicate all our positions via swaps, so we abandoned the idea," says Haugnes.

The idea of launching a Ucits version of the strategy was brought out of cold storage when a lawyer mentioned to Haugnes that by using a managed account set-up and a certificate issued by an investment bank, Andurand would be able to create a Ucits-compliant version of its commodities fund.

Pierre Andurand, founder and CIO, Andurand Capital Management

Having discussed this solution with Societe Generale, Andurand applied to the Irish regulator and was encouraged by the response. "We explained that as the Ucits fund would be investing in a certificate there would be asset-like limits on its risk exposure, whereas there is theoretically no limit to the margin trading-originated risks taken by investors in the Cayman fund," says Haugnes. "In other words, the risk borne by investors in a security replicating returns linked to the oil price is no different in principle to the risk they would take if they invested in a quoted company equally exposed to the oil market."

This also means that the Ucits version is not an exact replica of the Cayman fund. "We have made it very clear that it is not our aim to track the master fund," says Haugnes. "All we are promising is that the Ucits fund will be exposed to substantially the same investments as the master fund, but diluted. The Ucits will have approximately half the volatility and half the returns."

Haugnes adds that the Andurand Ucits launched at the start of this year is offered to investors on a standalone basis, rather than via a platform. "We considered using a platform but decided against it because we wanted to ensure that we remained in full control of the structure," he explains.

with €25 million of institutional capital.

The same month, Tages announced the launch of another Ucits fund from a US firm, the New York-based global macro hedge fund manager, Atreaus Capital, which was founded in 2012 and now has AUM of more than $1.35 billion. The new Ucits product, also launched with €25 million of institutional capital, offers investors access to Atreaus's expertise in global macro portfolio management focused on the delivery of uncorrelated returns primarily through investment in liquid currency and commodities markets.

Among other US managers, Dollery points to the Washington-based FORT Investment as another example of a group that has targeted Ucits investors. This summer, it announced two new regulated fund launches adding to the breadth of opportunities in the market. These are the FORT Global Ucits Futures Fund, a systematic market neutral fund, and the FORT Global Ucits Trend Fund, a momentum-based strategy.

In the convertible arbitrage space, meanwhile, a recent addition to the Ucits market came with the launch in March of the Quest Convertible Absolute Return fund on the MontLake Ucits platform. This fund is now run by Advent Capital Management, which has recently taken over Quest, and uses a fundamentally and quantitatively-driven strategy that aims to deliver superior, risk-adjusted uncorrelated returns.

MontLake, an independent Ucits platform providing investors with a range of Dublin-domiciled funds, explains that the strategy is based on delivering a "thematic, top-down investment strategy that harnesses the inherently defensive characteristics of convertible securities coupled with their robust upside potential."

Another recent launch by a US manager on the fast-growing MontLake platform, which now hosts 23 funds, is Conquest Capital's STAR Ucits Fund, a systematic absolute return trading strategy, which uses four sub-strategies employing dozens of models to allocated risk dynamically based on the Conquest Risk Aversion Index.

GROWING INSTITUTIONAL INTEREST

In spite of the succession of new launches by European as well as US managers in the regulated space, views are mixed on how successful alternative Ucits have been in gaining traction with institutional investors.

At Lyxor, for example, Spada says that demand has been driven mainly by private clients and distributors. "Institutional investors tend to invest less, but for larger tickets, and require some preparatory work to be done for them about the place of alternative Ucits in their global allocation," he says. Many, he adds, still prefer to access alternative strategies via managed accounts, which provide the liquidity, transparency and control that many of the world's most powerful institutional investors have come to expect.

This corroborates the findings reported by Barclays in its analysis of the hedge fund industry published in February. This notes that in the liquid alternatives space, Ucits have had much greater uptake among European hedge fund investors than '40 Act alternatives have had among investors in the US. "Not only is the preference for Ucits stronger across investor channels, but also it is relatively more consistent than for '40 Act funds," notes Barclays.

The Barclays report adds, however, that "the consistent theme across both regions and products is that the private wealth (particularly private bank and multi-family offices) and intermediary channels have more interest in liquid alternatives and, thus far, institutions have not shown much enthusiasm for allocating to these products".

"For 2017," Barclays continues, "the sentiment across our respondents remained consistent – there is not much interest from institutions for either product and there is considerable interest [in] Ucits among private investors and funds of hedge funds."

Others, however, say that the most significant trend now gathering discernible pace in the market is increased institutional demand for alternative strategies in Ucits wrappers. "Historically, alternative Ucits have been dominated by private banks and retail investors," says Kurar at Deutsche. "While retail investors are still the main driver of demand, the incremental dollar has been coming from institutions. This demand has helped make recent growth in the alternative Ucits space healthier than in the offshore market."

Managers confirm the growth of institutional demand. "The traction we have seen from investors, mainly in Europe but also in Asia, has been very well-balanced," says Tara Skinner,

IPM's London-based director of business development. "In addition to a number of large pension funds which are comfortable with the transparency of the Ucits product, we have seen good demand from insurance companies as well as from asset and wealth managers."

Skinner, who joined IPM from Brevan Howard in 2016, says that this transparency has become a prerequisite for managers promoting regulated alternative strategies to an increasingly demanding institutional investor audience, and that IPM has always been ready to oblige. "We're very happy to have investors desk-side and show them how our model works," she says. "Some are comfortable with seeing regular reports and data, but for others an ongoing dialogue is important, so we ensure that we spend a lot of time engaging with our investors."

Increased institutional demand has been underpinned by regulatory pressures. As Deutsche observed in its 2016 survey, "some institutional investors can benefit from the tax treatment for the onshore European directive in certain jurisdictions. In addition to this, some investors may also be able to avoid regulatory capital charges associated with traditional offshore hedge funds by allocating to onshore Ucits products".

These regulatory pressures and incentives, Deutsche believes, may be one reason why a growing number of institutions are using Ucits to complement or replace traditional offshore hedge fund allocations. "We found that 67% of all respondents that invest in alternative Ucits strategies are making these allocations from their overall hedge fund portfolio as opposed to their long-only portfolios," notes the Deutsche report.

A conspicuous testimony to the continued success of the Ucits movement has been the internationalisation of investor demand. "Ucits has become an international stamp of approval," says IPM's Nydahl. "This is one reason why we have seen increased demand from countries such as Japan, where the Ucits format itself does not lend any advantage on the regulatory side but it is respected as being governed by a clear and transparent set of rules."

INCREASED BARGAINING POWER

Rising institutional participation has led to a redistribution in the balance of bargaining power between managers and investors in the alternative investment space. It has also led to an elevation of the governance standards demanded by institutions allocating to alternative strategies.

Tara Skinner, *director of business development, IPM Informed Portfolio Management*

The increased bargaining power enjoyed by institutional investors in general, and by pension funds in particular, is reflected in the reduced fees they now pay for their exposure to alternatives in Ucits format. According to Deutsche Bank's 2016 survey on alternative Ucits, pension funds pay an average total expense ratio (TER) of 1.1% and an average performance fee of 11.3% for their alternative Ucits investment.

By contrast, more than half of the investors polled by a Deutsche survey on alternative Ucits pay an average performance fee of 15% or less for their typical alternative Ucits investment, while 4% pay no performance fees at all. On average, respondents to the Deutsche survey pay a performance fee of 13.6%, down from 15.4% in 2014.

This is a far cry from the 2+20 fee structures that were more or less standard throughout the hedge fund industry prior to the crisis, and which have been the subject of widespread opprobrium in recent years. "We recognise that fair pricing is key for investors," says Houles at IPM. "Although we have consistently delivered alpha in our strategy, we have revised our pricing structure on a couple of occasions over the last year. First, we reduced our management fee to 1.5%, and then last year we introduced a new threshold arrangement with discounts based on total amount invested. We now offer this structure across all our vehicles."

Nevertheless, some argue that fees are still too high, and that they may be a restraining factor on future growth in the alternative Ucits space. Sara Rejal, global head of liquid diversifying strategies at Willis Towers Watson, says that she is not seeing evidence of an increase in demand for Ucits, although there is also no sign of a decline in the appetite of investors in continental Europe, especially in Italy and Spain.

"What has, however, become more of an issue is the high fees and costs associated with some Ucits hedge funds during a period of weak performance," says Rejal. "These fees and costs mount especially when the funds are hosted on Ucits platforms which can add to total expenses. So we expect to see greater negotiating from institutional investors."

How fruitful this negotiating is likely to be will vary from fund to fund. "In the case of well-established managers running strategies that are capacity-constrained and have been performing consistently well, it will be difficult for investors to negotiate fee cuts," says Kurar at Deutsche. "If managers have capacity and are looking to increase their AUM, discounts will be easier to negotiate, especially for investors allocating larger tickets."

Unsurprisingly, the platforms argue that their fees are reasonable and are declining in line with the broader reduction in fees across the industry. "Fees are an important topic each time we launch a new fund on our alternative Ucits platform," says Spada at Lyxor. "As a general rule we always try to negotiate a fee structure that is reflective of the strategy that investors are accessing. Managing a complex strategy requires a lot of research and technical expertise, so it is unrealistic to expect to charge the same fee for this as you would for a simple long-only strategy. But it is no secret that there has been added pressure on fees across the industry in recent years, and as returns have not always lived up to expectations, it is reasonable to expect that any value created is shared fairly between managers and investors."

PLATFORMS CONTINUE TO GROW

To date, fees have been no constraint on the rapid expansion of platforms that have played a pivotal role in the accelerated growth of the alternative Ucits market. With each passing year, more alternative Ucits platforms appear to have been established. A recent newcomer, for example, is Kepler Liquid Strategies (KLS), an Irish Ucits V platform, which now offers access to the KLS Global Equity Beta Neutral and the KLS Sloane Robinson Emerging Market Strategies.

Prime brokers and alternative investment managers report that there is no sign yet of overcrowding among platforms, given the essential role they play. The service they offer has been indispensable for managers like IPM, which uses Morgan Stanley's FundLogic platform for its Systematic Macro Ucits fund.

"We chose FundLogic because we did not have the operational resources to create, support and distribute our Ucits product," says Houles. "We think the platform has provided excellent value because when we launched we weren't well-known among Ucits investors and the Morgan Stanley branding was very helpful because many investors had already approved the FundLogic platform."

***Stefan Nydahl,** CEO, IPM Informed Portfolio Management*

UCITS HAS BECOME AN INTERNATIONAL STAMP OF APPROVAL. THIS IS ONE REASON WHY WE HAVE SEEN INCREASED DEMAND FROM COUNTRIES SUCH AS JAPAN, WHERE THE UCITS FORMAT ITSELF DOES NOT LEND ANY ADVANTAGE ON THE REGULATORY SIDE BUT IT IS RESPECTED AS BEING GOVERNED BY A CLEAR AND TRANSPARENT SET OF RULES
STEFAN NYDAHL, IPM

At Societe Generale, Dollery agrees that the platforms continue to make an important contribution to the broader development of the alternative Ucits market. "More than half of our clients in the alternative Ucits area choose to launch via a platform rather than on a standalone basis," he says. "And in the case of US managers it is probably closer to 70%. Certainly, any boutique hedge fund manager from outside Europe will gravitate towards a platform which can provide very efficient access to the regulatory cover, operational support and, most important, the distribution capabilities they need to reach investors."

Leading platforms say their emphasis is very much on quality and diversification rather than on quantity. Take the example of Lyxor's alternative Ucits platform, which now has total assets of €2.6 billion and hosts 10 funds. "We recognise that in order to increase the level of assets on the platform innovation is essential," he says. "This is why we are constantly searching for managers with a genuine edge, rather than those that market themselves as alternative strategies but which in reality only have a small alternative component."

This, says Spada, explains why so many funds fail to make it through Lyxor's rigorous due diligence process, which also aims to ensure that funds repackaged into Ucits format are able to deliver the same strategy as their unregulated versions. "The key to success is being able to identify managers that are able to replicate their strategy in Ucits format," he says. "If we can't be sure that the manager will be able to maintain his competitive edge in a regulated fund, we may not go ahead."

Ensuring a Ucits product replicates the strategy and performance of an offshore flagship fund is, however, anything but an exercise in cutting and pasting. "In the case of some of the more liquid strategies, like long/short equity, it is relatively easy to replicate an offshore strategy," says Spada. "It is more challenging in some of the fixed income or global macro strategies, as well as in some of the event-driven strategies where there is usually an element of concentration that is above the threshold authorised by Ucits regulation."

This, says Spada, is where the Lyxor platform

comes into its own. "If there is a hurdle caused by the level of leverage or position concentration in the flagship fund, for example, we have a very good team of analysts and engineers who can develop alternative solutions that are Ucits-compliant," he says.

Spada says that another key way in which Lyxor adds value for its investor clients is through its advisory services. "We don't just sell products," he says. "Over the last two years we have broadened our team of analysts on the long-only as well as the alternative side, which is supporting our fund selection advisory services around the platform and helping investors to integrate alternative strategies into their global fund allocation."

"In other words, we start by discussing their global allocation to equities, fixed income, credit and so on, and then advise on how they can best meet their risk and return objectives by blending traditional and alternative strategies," Spada adds.

While it is clear that platforms play an important role in helping managers to structure and distribute their regulated alternative funds, it is less obvious that investors make any distinction between funds hosted by platforms and those offered on a standalone basis.

"When we ask investors whether they prefer to invest via a platform or directly through the manager, they tend to be agnostic, as long as fund remains competitively priced," says Temple Jones at Deutsche. "However, once they have done their operational due diligence on a platform, fewer resources will be needed for any subsequent investments on the same platform."

FURTHER GROWTH POTENTIAL

In spite of the striking growth in the market for alternative Ucits in recent years, there is still plenty of room for continued expansion. As Dollery says, alternative Ucits still represent less than 5% of the entire global Ucits market, and about 16% of the total hedge fund industry today. "I believe both those ratios will increase over the coming years, as they have in the last five years," he says. "I see continued scope for a relative as well as an absolute increase in alternative Ucits assets."

At IPM, Houles says that demand for hedge fund strategies in Ucits format has held up remarkably well. "In spite of all the criticism we heard last year about the disappointing performance of hedge funds, the key takeaway from the last 12 months has been that the growth in alternative Ucits reflects the continued rise in appetite for alternatives," he says. "Contrary to what was being said last year, this industry is not doomed."

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

WE DON'T JUST SELL PRODUCTS. OVER THE LAST TWO YEARS WE HAVE BROADENED OUR TEAM OF ANALYSTS ON THE LONG-ONLY AS WELL AS THE ALTERNATIVE SIDE, WHICH IS SUPPORTING OUR FUND SELECTION ADVISORY SERVICES AROUND THE PLATFORM AND HELPING INVESTORS TO INTEGRATE ALTERNATIVE STRATEGIES INTO THEIR GLOBAL FUND ALLOCATION

DANIELE SPADA, LYXOR ASSET MANAGEMENT

The main trigger for further growth, he says, will be the fundamental case for investing in alternative investment products, twinned with their performance, rather than structural innovation or regulatory change. Most investor surveys on investor demand for alternative strategies, he adds, clearly show that the most important component of the case for investing in alternatives is diversification.

This appears to be an even more compelling argument among the largest funds. Among respondents to Morgan Stanley Prime Brokerage's *Q2 2017 Investor Survey*, 52% of those with $5 billion or more in hedge funds indicated that diversification was the primary reason for investing in hedge funds, compared with 40% for all investor types.

Among the largest investors, the other main reasons for investing in hedge funds, according to the Morgan Stanley survey, were downside protection (21%) and risk mitigation (17%), with only 7% nominating outperformance as the main motive. Smaller investors are more motivated by the performance properties of hedge funds, but among all respondents the potential for outperformance was identified as the main reason for allocating to hedge funds by just 13% of respondents.

THE RISE AND RISE OF ALTERNATIVE RISK PREMIA

Speak to virtually anyone in the alternative investment management space and they will tell you that the prospects for long-only investment in mainstream asset classes looks bleaker than it has for many years. "The base case of most forecasts for the next five years is that returns for bonds and equities will be flat at best," says Houles.

The downbeat outlook for mainstream asset classes strengthens the argument for what IPM's Nydahl describes as the demise of the old investment paradigm. "When I started in this industry in the late 1990s, and for many years after that, it was divided into strategy buckets," he says. "Today, what is capturing investors' attention is return characteristics rather than the

headline categorisation of individual strategies."

He adds: "For us this is a positive development because one of the most important features of our investment philosophy has always been the lack of explicit momentum in our investment process and hence the low correlation to trend-following strategies."

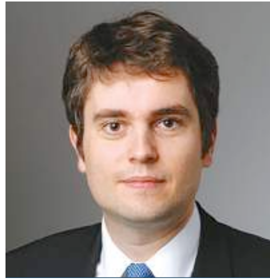
The gloomy prognosis for long-only equity and bond investors, coupled with expectations for increasingly pronounced correlations between the two staples of conventional portfolio construction, has underpinned robust supply and demand dynamics in the market for alternative risk premia strategies over the last 12-24 months.

"Whilst we're not saying that stock and bond markets are going to crash tomorrow, the emerging consensus is that return expectations for investors are lower than they have been at any time since the end of the financial crisis," says Blin at Unigestion. "This is driving increased demand for the diversified uncorrelated returns that alternative risk premia can provide."

Jean-Philippe Royer, CEO of Nomura Alternative Investment Management (NAIM), agrees. "Alternative risk premia is one of the areas that have attracted the most attention from Ucits investors, and we've seen numerous product launches since 2015," he says. "This has been a popular extension of factor-based investing, and was originally driven by the more sophisticated Nordic pension funds, but we are now seeing rising demand from Australia and the US, as well as Europe."

Royer says that for investors attracted by alternative risk premia there are two options available. "Swaps available through banks are one option for outsourcing and delivering the economic return of alternative risk premia," he says. "But they are a less obvious choice for some investors for regulatory reasons or because they need to slice allocations across different mandates, or simply because they are not equipped to handle some of the operational complexities associated with investing via swaps. This is creating opportunities for Ucits manufacturers and managers who can provide a one-size-fits-all product based on either a specific risk or style premium or a combination of alternative risk premia to deliver absolute returns within strict liquidity and transparency guidelines."

NAIM itself, says Royer, has recently developed two risk premia Ucits funds. These are the Equity Volatility Risk Premia (VRP) fund, which sells implied and buys realised volatility, and the Nomura Cross-Asset Momentum (CAM) strategy, which uses trend-following techniques across multiple asset classes including equities, interest rates, currencies, commodities and – more recently – credit.



***Olivier Blin,** director and head of cross asset systematic strategies, Unigestion*

***Jean-Philippe Royer,** CEO, Nomura Alternative Investment Management*

Unigestion, meanwhile, announced the launch of a new alternative risk premia fund in February, complementing its existing range of direct alternative strategies. Although few products have been in existence long enough to give them a meaningful track record, Blin says that alternative risk premia products have already proved their mettle in unsettled markets.

"Although our standalone product is quite new, we have been using alternative risk premia at Unigestion for three years, and in that time they have delivered consistent returns," he says. "In January and June of last year, when equity markets were sharply down, this strategy generated positive returns, highlighting the protection they can provide during downturns."

Risk premia products will be part of a broader mosaic of development across the alternative Ucits space which is likely to be fuelled by the continued search for uncorrelated sources of diversification and product innovation, rather than by any specific regular impetus.

As Dollery at Societe Generale says, some years ago it looked as though the market was being primed for yet another reincarnation of the Ucits regulatory framework in the form of Ucits 6, which may have changed the scope of eligible assets and reviewed the rules on leverage or the value at risk (VAR) approach to risk management. For now, an industry already overburdened with regulation and re-regulation will probably be grateful that the Ucits 6 proposal appears to have been shelved. "Today, the Ucits framework enjoys a good deal of stability and consistency in terms of regulatory thought, which is positive for the future development of the market," says Dollery.

In the meantime, the recipe for success among managers will the delivery of uncorrelated returns. "The good news is that alpha is back," says Houles at IPM. "When the beta tide goes out, those managers unable to generate alpha will be exposed, which will be positive because it should lead to the consolidation that the industry needs."

Sponsor IPM

IPM Informed Portfolio Management (IPM) was founded in 1998 with the purpose of delivering robust investment strategies with a systematic investment process to institutional investors. Today, IPM is primarily recognised for its multi-asset systematic macro strategy, but also for its Smart Beta equity strategy, both building on similar investment principles. IPM has firm-wide assets under management of $7.6bn with $4.4bn in the systematic macro strategy.

IPM's investment strategies are based on economic theory and rely on the belief that market prices fluctuate around the true fundamental value of financial assets. IPM designs novel approaches to model these deviations and then seeks to capture the resulting movement. The investment process is systematic using a broad set of fundamental information as inputs.

Based in Stockholm, IPM has 52 employees of which close to half are involved in research and investments. The company's reach is increasingly global with investors in Europe, Asia, the Middle East and North America.

IPM is registered with the financial regulators in Sweden and the US.

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