ALTERNATIVE UCITS: GOING FROM STRENGTH TO STRENGTH

Much the fastest-growing section of the hedge fund industry, the Alternative UCITS phenomenon shows no signs of abating. In this Expert Opinion, Daniele Spada, Head of Managed Account Platform at Lyxor Asset Management, explains how the transparency, security and performance offered by Alternative UCITS make it a favorite among investors and why this trend is set to continue.

STRONG APPETITE FOR ALTERNATIVE UCITS STRATEGIES

Alternative UCITS funds have been very popular with European investors over the past year, with €70bn of net new assets in 2015 according to Morningstar (+30% vs. 2014). Despite the decline in global hedge fund capital in the first quarter of about €13bn*, Alternative UCITS in Europe have experienced strong inflows that went somewhat unnoticed. Alternative UCITS is actually the only asset class experiencing inflows in Europe this year, with €3.6bn in March, bringing the cumulated figure to €7.7bn in the first quarter**.

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 €20bn and fixed income & credit funds saw outflows near €13bn in the first quarter**. 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.

At Lyxor, we think the current trend on Alternative UCITS is set to continue and we estimate that the Alternative UCITS industry should grow at a 20-30% rate for the next two to three years.

There are some good reasons for this. Investors need strategies to diversify their portfolios, and this has led them to look to hedge funds. But they want hedge funds in a regulated, transparent format, which is what UCITS strategies are able to provide. What’s more, UCITS is tried and tested: the regulation has been in place for several decades; UCITS V is about to be launched, so it is in an advanced state and is trusted by investors. In the space of a few years, UCITS has become a powerful brand, exerting the appeal of transparency and simplicity of use on investors.

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Alternative UCITS Experience Strongest Inflows In Europe in Q1-16

As of 31/03/2016
Source: Morningstar, Lyxor AM

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* Source: Hedge Fund Research
** Source: Morningstar, based on the universe of funds available for sale in Europe.
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We have seen particularly good appetite for UCITS hedge funds from private banks over the past 12 months. Many private banks have avoided the alternatives space for years, but are now coming back quite strongly into UCITS hedge funds, for the sake of diversification as well as of simplicity – two features that have also drawn other institutional investors.

**MARKET TURBULENCE LEADS INVESTORS TO LOOK TO LIQUID, NON-DIRECTIONAL ALTERNATIVES**

Alternative UCITS managers have shown a good ability to mitigate volatility, which is a crucial need for large institutional investors in the current market context.

Besides continued interest for multi-strategy UCITS funds, the first half of 2016 has witnessed significant inflows into market-neutral long-short equity strategies, and secondly into managed futures or CTA funds. Both of these have very little market directionality, and so are excellent risk mitigators and diversification tools.

Faced with a volatile environment, investors have been very keen to hedge a portion of their portfolios – it is important to bear in mind that in the second quarter of last year there was a huge jump in bond yields in Europe, especially in German Bunds, of the kind we had not seen for several decades. Then, equities became volatile later in the year, so investors have been looking to diversify their portfolios but with liquid vehicles. Other alternative investments, including private equity and real estate, are available, but these are highly illiquid. Alternative UCITS provide excellent liquidity, with more and more funds offering daily subscriptions and redemptions.

**ALTERNATIVE UCITS, CLEARLY A POPULAR BRAND TODAY**

The sheer popularity of Alternative UCITS strategies has taken many people by surprise, and is something of a paradox.

Initially designed to give more transparency and security to the funds industry, the UCITS regulation in fact imposes stringent requirements that should act as constraints on hedge fund strategies – such as limitation on leverage, liquidity schedule, and exposure to fixed income. It also completely prohibits any investments in commodities. These constraints are why some hedge fund strategies, such as event-driven and global macro, are poorly represented in the UCITS space. Some event-driven strategies, for example, invest in assets with very poor liquidity, so it is not possible to design a strategy that meets UCITS liquidity requirements. Yet, UCITS hedge funds are gaining in popularity, while the AIFM regulation, which was specifically designed for alternatives, has met with limited demand from investors since it was launched a couple of years ago. This is testament to the sheer power of the UCITS brand, as the UCITS format has already been approved by investors’ boards of directors and risk departments. The greater liquidity of UCITS may be another factor – investors want to be able to redeem at short notice in the current climate. Everyone has been looking for liquidity since 2008, and UCITS provides just that.

It can take investors time to get used to a new format, and the demand at present is for UCITS strategies. But while AIFM is not taking off at the moment, it may do so within a few years.

**UCITS HEDGE FUNDS WITH LONG-TERM RETURN POTENTIAL AS WELL**

If they just looked at hedge fund indices, investors might think that hedge funds have performed poorly as a whole in recent times. There has been significant dispersion in hedge fund returns over the past year indeed. While the average hedge fund return was close to zero in 2015, some funds however rose by over 20%. This clearly shows that investing in the right strategy and the right fund is key. This potential for strong returns coupled with the ability to mitigate market volatility,

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helps explain why demand for alternative strategies has been so constant, even though the performance of hedge fund indices has been rather disappointing. It is clearly important for investors to work with the right partner to help them find the best managers: fund selection is a key aspect of successful investing in hedge funds.

While one is not systematically better than the other, UCITS strategies and offshore hedge funds can perform differently depending on the market environment. To put things in a simple way, when the market is bullish, UCITS funds tend to lag because traditional hedge funds can invest in illiquid assets, enabling them to capture the illiquidity premium. But when the market is falling, and there is no longer an illiquidity premium to exploit, UCITS can outperform offshore strategies as illiquid assets can experience falls in value. For instance, loans are an illiquid asset class and cannot be implemented in UCITS strategies, and they can suffer drawdowns when the market falls. Similarly, some high yield strategies, which typically underperform amid economic headwinds, cannot be fully implemented in UCITS strategies.

ALTERNATIVE UCITS PUT PRESSURE ON THE FEE STRUCTURE

Fees are also a big issue for investors at present, against a backdrop of poor returns from traditional asset classes and bond yields close to zero. Overall, both management fees and performance fees have been falling over the past couple of years, and this trend has accelerated recently. As the cheapest format to access alternative investments, UCITS hold an undeniable appeal for investors looking for uncorrelated sources of performance. This focus on fees and total expense ratio also explains the premise behind, and popularity of, new products such as multi-manager UCITS funds.

MEETING THE NEEDS OF OUR CLIENTS: LYXOR’S UCITS STRATEGY

Lyxor’s Alternative UCITS platform has reached the $2bn mark last year. Given strong investor appetite, Alternative UCITS will keep a central role in Lyxor business development strategy.

We have been seeing considerable demand from our investors for less directional strategies such as market-neutral long-short equity and global macro, so our teams have been very active in monitoring the universe and meeting hedge funds involved in these areas to assess the possibility of launching their funds in a UCITS format.

We always strive to meet demand from our investors and expect to launch four funds over 2016 – including two in the coming months – to help our clients diversify their portfolios. As ever, we are being highly selective, and will avoid areas not currently in demand. Such areas include event-driven, which has suffered significant drawdowns over the past couple of years and in any case is difficult to implement in the UCITS format. We are also avoiding strategies with a lot of market directionality, such as long-short equity with a long bias. We prefer to look at strategies with limited exposure to the market in the current climate.

It is clearly important for investors to work with the right partner to help them find the best managers: fund selection is a key aspect of successful investing in hedge funds.
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