



# Fluttering away?

'Newcits' funds give offshore hedge fund managers an opportunity to attract European investors wary of the offshore environment, but this wariness is receding. **Nicholas Pratt** asks whether the newcits craze could soon be a thing of the past and not a fund for the future

A recently released report by Strategic Insight and commissioned by the Association of the Luxembourg Funds Industry (Alfi) has predicted a bright future for so-called new alternative Ucits (or 'newcits') funds. The report, entitled *Alternative and Hedge Fund Ucits in the Next Decade*, points out that these funds account for more than €114bn across more than a thousand products and attracted €25bn of net flows during 2010, as of the end of September.

This represents a 70% increase on returns in 2009 and already this year new alternative Ucits funds have captured €6bn of

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investment capital. Flows are expected to increase over time, says the report, but the industry is anticipating a ramp up in 2011 as fund selectors and institutional investors gain comfort with the new products and their managers and complete an extended process of due diligence.

The report then extrapolates the current statistics to propose that, if alternative strategies can increase their share of total Ucits flows from 15% to 25% by the end of the decade, and if overall Ucits flows increase by 5%, then it would bring more than €600bn of net flows to hedge and other

absolute return fund managers within regulated vehicles.

The report is basing much of this future growth on the belief that the fundamentals supporting alternative Ucits growth remain solid. "Investment flexibilities within a well-defined and evolved regulatory framework, persistent demand for absolute return solutions and profound changes in the hedge fund industry and its regulation are driving expansion over the long term," says the report.

#### **Positive projections**

Luxembourg would be one of the main beneficiaries of a growth in the alternative Ucits market as it currently accounts for almost half of all assets and flows from these funds so it is not surprising that the report's future projections are welcomed by Alfi. "These predictions reflect the interest that we are seeing from sophisticated investors for adequately regulated and supervised products, as well as hedge fund managers who were looking to start Ucits funds as a reaction to the uncertainties surrounding the draft AIFM Directive."

But these predictions run the risk of overstating the case for alternative Ucits funds, particularly when this demand appears to be driven by two negative trends – the unpopularity of unregulated offshore domiciles and the uncertainty around the AIFM Directive, both of which appear to be subsiding.

The demise of the offshore hedge fund industry has been greatly exaggerated. Reports earlier this year suggested that business in the Caymans and other Caribbean domiciles was about to wither on the vine as a result of new regulation and investor sentiment. It was anticipated that fund promoters would be gathering their investment vehicles into a hastily packed suitcase and setting sail for the regulated waters (or land, even) of mainland Europe.

This speculation was understandable to a degree. The gap that used to exist between offshore and onshore domiciles has been levelled in recent years. For example, the flexibility around fund types and structures as well as the streamlined process

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for establishing new funds, is something that has been adopted by onshore jurisdictions. Plus the onshore domiciles have the added bonus of a reputation for greater regulatory oversight.

But the negative connotations that developed around the offshore domiciles were largely based on a perception, says Dan Mannix, head of sales at London-based hedge fund RWC Partners, which has several funds domiciled in the Caymans. "So many hedge funds did not return capital within the expectations they set and this has created a reputational issue – and hedge funds are linked to the offshore world. But the perception does not really equal reality," says Mannix,

For his part, Mannix says that his firm is very happy with the Caymans as an offshore domicile for its funds. "Our investors, which are mainly institutional, have been focused on the liquidity of the portfolio, the returns and the reporting. As long as this criteria is met, investors are not too concerned with where the funds are domiciled."

Mannix is also unsure whether the number of funds being redomiciled from offshore to onshore jurisdictions is really as high as current speculation suggests. "It is still quite a complex undertaking to redomicile a fund and I think it is more likely that managers will set up new onshore funds to run alongside their offshore funds."

This view is supported by Matthew Feargrieve, a partner in the investment services team at law firm Appleby. "We are not seeing any migration from the Caymans or other Caribbean jurisdictions. It is very expensive to move funds from one jurisdiction to another. It takes time and requires the agreement of all investors. Instead we are seeing managers expanding their funds to include EU-domiciled alternative funds to run alongside their existing Caribbean-based funds so there are two markets developing."

#### **Benign influence**

Feargrieve also suggests that the great angst among offshore fund providers generated by the uncertainty of the AIFM directive has now dissipated. For many of the last 18

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months the offshore market was expecting to have to introduce EU-equivalent regulation if it was to be able to access any European investors. Then Timothy Geithner entered the debate, accused the EU of starting a trade war and threatened to pull all US funds out of Europe. "The US has effectively saved the day and market access has prevailed," says Feargrieve. "The directive will be more benign than first thought."

The directive's third-country provision will allow private placements to continue until 2018 and from 2015 domiciles such as the Caymans will be able to apply for a passport enabling it to sell to European investors. Consequently this has reduced the demand for redomiciling, says Nigel Strachan, chairman of the Jersey Funds Association. "It would be unusual to move to an onshore jurisdiction as a result of the AIFM Directive and to gain a passport just for those two years between 2013 and 2015."

"The idea that offshore jurisdictions have to desperately do something to stop hedge funds migrating onshore is simply not true. There is a discerning investor base in the hedge fund world, both institutional and high net worth, and they realise that they can continue to invest as usual through private placement or through an AIFM passport as of 2015. They also realise that the low cost and high flexibility of the offshore world remains attractive. There is no real demand to move onshore."

### Working in tandem

The most likely scenario suggested by Mannix, Feargrieve and others is that hedge fund promoters will launch a number of EU-based Ucits funds to run alongside its offshore portfolio rather than replace it. "Much has been made of the fact that a hedge fund the size of Brevin Howard has launched a Luxembourg-based Ucits fund, but it is still keeping all of its Cayman funds," says Feargrieve. And then there is the example of BlueCrest, which recently announced it would be closing its Luxembourg-based Bluetrend Ucits fund because it was unable to replicate the performance of the offshore Bluetrend fund, despite raising more than \$630m (€475m).

Speculation has been rife over what other reasons may lie behind BlueCrest's decision, with some suggesting that the level of

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investor interest and level of returns were not as high as anticipated and not high enough to outweigh the cost of operating in Europe rather than the Caymans. Others have suggested that there are fundamental problems in trying to fit hedge fund strategies within the Ucits structure. Whatever the truth is, it should be enough to raise some concern over the continued growth of alternative Ucits funds.

In Luxembourg, however, the industry remains confident about the continued growth of newcits funds and the regulatory uncertainty that is leading hedge fund managers to Luxembourg to set up their alternative Ucits funds. "The fact that we have a final text for the AIFM Directive certainly helps, but there are still 97 level two measures that need to be decided on," says Charles Muller, deputy director-general of Alfi. "So we have a political compromise but now we need to get down to the nitty gritty and that means that some uncertainty remains."

### Long-term potential

Muller also accepts that most hedge fund managers will run two different funds – one for the European market and one for the offshore market – and that this will continue until they are certain that the AIFM passport is a viable option. "I still think it will be difficult for hedge fund managers outside Europe to sell funds into Europe in the first phase of the passport and it is only when these difficulties no longer remain that they may look to merge the two funds. Even when the AIFM Directive becomes more certain and the passport issues are resolved, it does not cover retail investors and if hedge funds want to attract any retail investors, they will have to use the Ucits brand. So I concur with the report and I foresee long-term potential growth for the alternative Ucits funds."

Muller does not refer to these funds as newcits for the reason that a fund is either Ucits or it is not and to rename them as either newcits or even new alternative Ucits leads some investors to consider these investment vehicles as more risky than a conventional fund, even though this may not be the case. But perhaps Muller is simply aware of the fact that any brand containing the word 'new' tends not to last too long. ■