What are Alternative UCITS and how to invest in them?

The purpose of this paper is to provide some insight in the European Alternative UCITS market. Alternative UCITS are collective investment funds that comply with rather stringent European fund regulation whilst exhibiting an investment management approach that is different from traditional asset management funds. Positive performance in all weather with a good trade off to risk is the aim. Attractive as a separate asset class in a portfolio? Let us try to answer this question in what follows.

UCITS

The idea of managing investment risks by spreading your wealth across multiple assets has been around for a long time. Mutual investment funds offer this diversification by pooling assets of different investors and spreading their capital across multiple investment lines. Mutual funds started attracting a lot of attention during the 1980s leading to the UCITS I regulation, introduced in Europe in 1985.

UCITS regulation, or "Undertakings for Collective Investment in Transferable Securities" is a regulatory framework set up with the objective to harmonize the European fund market and ensure investor protection. Since 1985, there have been different legislation updates and the UCITS mark has become the reference brand name for funds, representing investor protection and professional, regulated fund management.

While originally designed for retail investors, the largest share of investments into UCITS funds is currently coming from institutional investors like pension funds, insurers, private banks and sovereign wealth funds.

Alternative investments

Traditional investment styles use instruments as listed stocks, bonds or cash. Alternative investments in the broad sense include private equity (unlisted equity), hedge funds, real estate and commodities. Alternative investments in the narrow sense are hedge fund investments : investments that use techniques different than linear market access and where fund managers use different strategies to earn active return, or alpha, for their investors. Hedge funds have been very popular with a certain type of institutional investor and with high net worth individuals because they provide diversification to the typical stock/bond portfolio. They are often said to offer an "absolute return" because of their low correlation to traditional equity and fixed income markets.

From the viewpoint of a prudent investor, hedge funds can have some troublesome features though. They often lack in liquidity: where stocks, bonds and cash can mostly be traded in rather deep and liquid markets, it is considerably less easy to transact in complex derivatives. Often hedge funds are less regulated and less transparent. Many institutional and retail investors hence avoid hedge funds or choose to only allocate a limited part of their total portfolio wealth.

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Alternative UCITS funds

The growing demand from investors to diversify their portfolios led to the UCITS III regulation in 2002 and the eligible assets guideline in 2007, both of which expanded the list of assets that UCITS funds can allocate to. Derivatives became an eligible asset allowing UCITS fund managers to leverage positions and/or to short exposures through derivatives. Borrowing as such is only allowed up to 10% and directly shorting the markets is completely forbidden under the UCITS regulation, but derivatives allowed to synthetically replicate such strategies and synthetically create different type of return streams via such instruments. This made it possible for a large amount of hedge fund style strategies to become available to UCITS fund managers and gave birth to a new asset class of alternative UCITS funds.

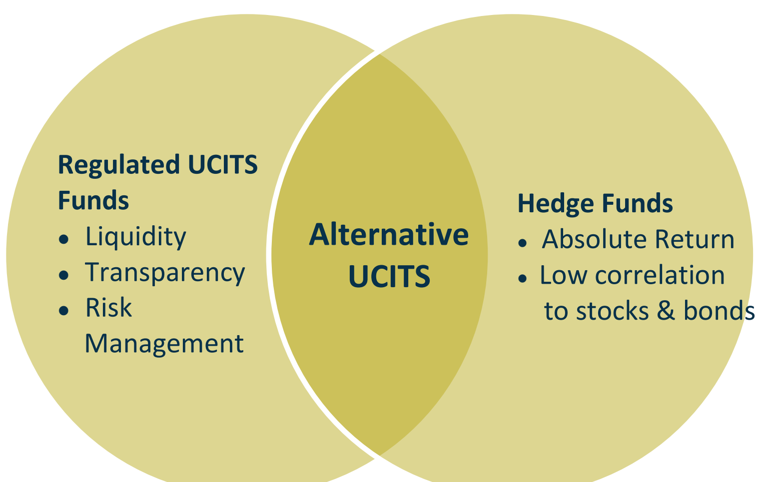
LuxHedge is classifying each Alternative UCITS fund in 5 broad strategy groups and 17 sub-strategy styles. In a next white paper, we will provide further detail and insight into the definition of each of the different segments and how they have evolved over the years.

The greatest UCITS constraint for alternative managers is liquidity. Illiquid strategies cannot be made available under the stringent regulation, these would violate important investor protection mechanisms.

Alternative investment	Available in UCITS format?
Hedge Funds – Liquid strategies	Yes
Hedge Funds – Illiquid strategies	No
Private Equity	No
Real estate	No

While intuitively it may seem that the cost of regulation would hamper the flexibility of the alternative fund manager, recent empirical research by Tuchschmid, N.S., Wallerstein et al. and Busack et al. has shown that UCITS regulation does not hinder the risk-adjusted performance in comparison to orthodox or offshore hedge funds.

Alternative UCITS are thus designed to offer the best of both worlds: a hedge fund like absolute return stream with lower correlation to traditional equity and bond markets in combination with a regulatory framework that imposes liquidity, transparency, regulatory oversight and strict risk management.



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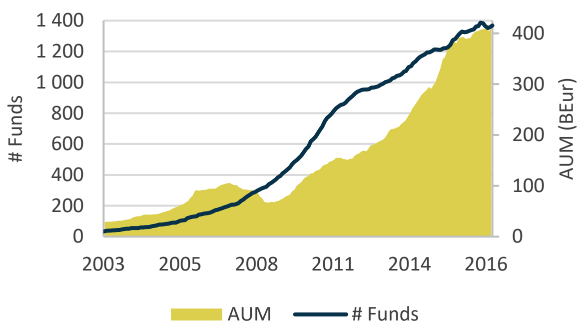
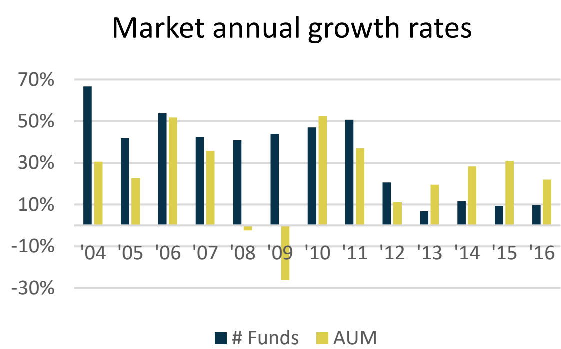
A fast growing Alternative UCITS market

The market for Alternative UCITS has been increasing very rapidly, both in number of funds and in assets under management. Simultaneously, on demand side, there's been a shift in the mindset of investors desiring alternative returns to diversify their portfolios. On supply side, old school hedge fund managers were quick to offer their strategies in the more transparent and regulated UCITS form in order to appeal to traditional investors. Institutional investors often have limitations to invest in illiquid alternative assets. By offering strategies in a UCITS compliant form, hedge fund managers can become part of the larger liquid instrument portfolio.

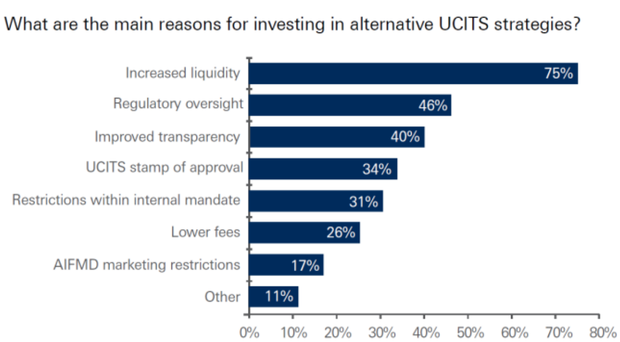
At LuxHedge, we closely monitor the Alternative UCITS market in our large database that is updated every month to reflect new fund launches and liquidations. Below charts illustrate the rapid and continued growth in net number of funds and assets under management. By the end of 2016, the alternative UCITS universe has grown to >1350 funds representing an AUM exceeding 400BEur.



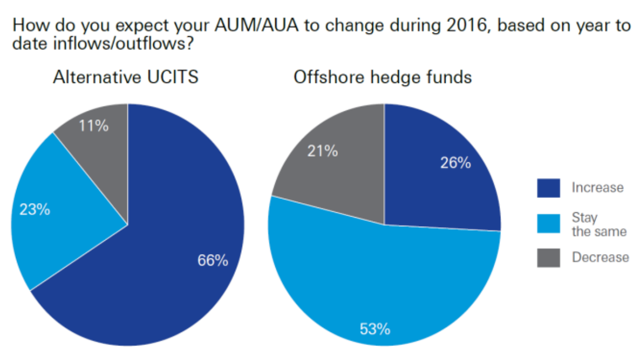


Looking forward, we see still plenty of headroom for sustained growth in the Alternative UCITS space. The total universe of UCITS funds has approximately 8TEur of invested assets, so from an opportunity perspective only 5% of UCITS are currently in alternatives.

In October 2016, Deutsche Bank published a survey confirming that increased liquidity, regulatory oversight and improved transparency are the key reasons why institutional investors allocate to alternative UCITS. Nearly 70% of survey respondents currently already invest in alternative UCITS and a further 5% planned to make their first investment in 2016. Also, two thirds of alternative UCITS investors planned to increase their allocation to such products. Investor demand is clearly still on the rise.



Source: Deutsche bank Alternative UCITS survey, Oct 2016



Source: Deutsche bank Alternative UCITS survey, Oct 2016

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How to invest in Alternative UCITS?

Alternative investments are designed to bring significant benefits to an investment portfolio by diversifying risk away from traditional equity and bond portfolios. Since 2010, Alternative UCITS as a whole have performed solidly under different market circumstances, including the European sovereign debt crisis. Both HFR and LuxHedge publish broad, equally weighted benchmark indices of Alternative UCITS funds that offer a consistent picture of the total market.

	HFRU HFC Composite Index	LuxHedge Global UCITS Index
Annualized Return	2.50%	2.64%
Annualized Volatility	3.25%	3.00%
Sharpe Ratio	0.74	0.85

Risk and return of Alternative UCITS since 2010. Source: hfr.com and luxhedge.com

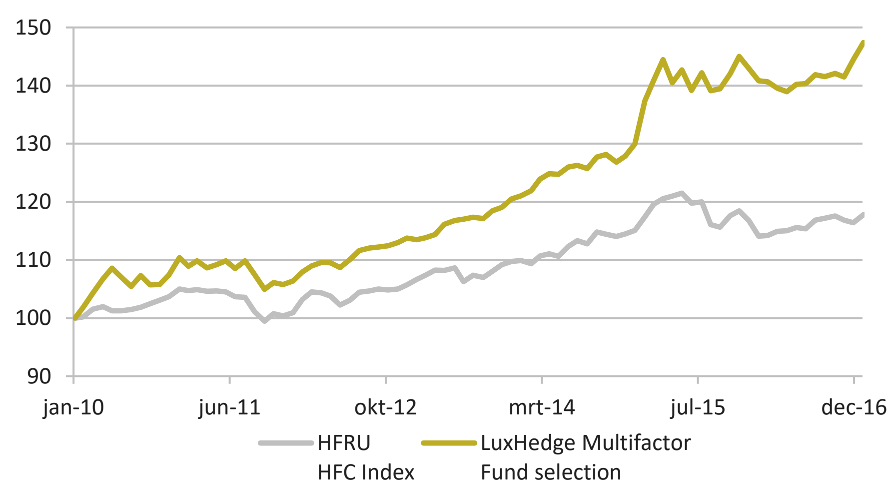
From an investor perspective, there's a clear challenge of how to successfully select the right alternative UCITS funds. It's one thing to realize that an allocation to alternative UCITS is desirable, but deciding which of the >1350 funds to select is a complex task. Moreover, studies suggest that the UCITS universe is characterized by heterogeneity and dispersion both in managerial skill and in investment strategies. This has far reaching implications for fund selection and portfolio construction.

For equity markets, mutual funds and hedge funds, there is a large literature on (multi)factor models to explain returns and find "alpha", i.e. outperformance.

Fama & French (1992)	3 factor model to explain **stock** returns
Carhart (1997)	4 factor model to explain **mutual fund** returns
Fung & Hsieh (2004)	7 factor model to explain **Hedge Fund** returns

Seminal papers with factor models for different asset classes

For Alternative UCITS funds, much of the work to unbundle returns by applying factor models is still to be done. LuxHedge is cooperating with the academics of KU Leuven and Free University of Brussels to apply and develop factor models that can be used to analyze, understand and invest in Alternative UCITS funds. The research project already led to selection models aiming to find outperforming funds and strategies.



LuxHedge multifactor model selecting the top 16 best alternative UCITS funds every quarter. The fund selection

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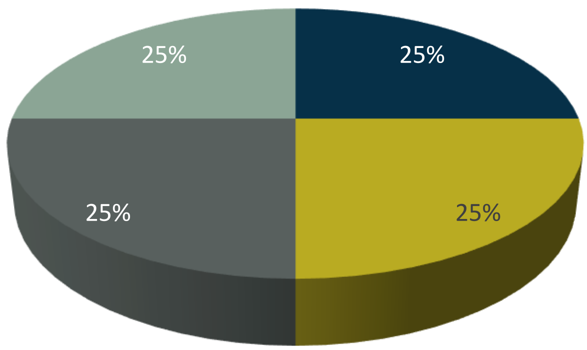
is well diversified across 4 strategy groups and 17 sub-strategies.

Because the spectrum of alternative investment strategies is large, it pays off to further diversify within the Alternative UCITS universe and spread the investment across the broad strategy groups and sub-strategies that LuxHedge has defined.

Diversification across Strategy groups



Equity Hedge & Event Driven
Relative Value
Macro
Opportunistic & Multi Strategy

Applying these techniques, we believe it is currently possible to achieve annual returns of above 5%, doubling the benchmark, while remaining in a framework of low volatility fluctuating around the 5% level.

Conclusion

Alternative UCITS are a unique asset class, combining hedge fund like absolute returns with the stringent regulatory oversight that is embedded in the UCITS framework.

The alternative UCITS universe has been growing at a rapid pace, fueled by investors seeking diversification to their traditional portfolio of stocks and bonds while being very sensitive to protecting their assets and only investing in liquid and transparent instruments with regulatory oversight and strict risk management guaranteed. Currently there are >1,350 Alternative UCITS funds managing a total of >400BEur in AUM. The growth is still strong and all demand and supply side dynamics point in the direction of a continued market expansion in the coming years.

Selecting which Alternative UCITS funds to allocate to is not a straightforward exercise and scientific knowledge on this topic is still being built up. Based on academic research of multifactor risk and return decompositions, models have been developed that seem to be able to successfully detect outperforming funds beating the alternative UCITS reference benchmark.

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