Alternative UCITS: More to come

With projections for the universe to exceed USD550 billion in assets by 2022, the growing popularity of alternative UCITS strategies is clear. As they gain appeal as a complement to traditional long-only fixed income strategies, close attention is required to separate novel approaches with limited lifespans from the stalwart performers that can consistently generate alpha.

PUBLISHED
September 2018

READ TIME
10 mins

AUTHOR
Gianni Mangini
Senior Product Development Manager

Alternatives to core fixed income

Regulation gave birth to what is commonly referred to as 'alternative UCITS' (Alt UCITS). As surprising as it sounds in a post-global financial crisis (GFC) era where regulation has boomed, it was the 2002 UCITS III directive and the 2007 Eligible Assets directive that extended and clarified the types and use of eligible assets, allowing for the use of long and short derivative positions.

Alt UCITS – also known as liquid alternatives and UCITS hedge funds – are generally understood to be collective investment funds that can utilise derivatives as part of their investment policy and implement strategies akin to those of hedge funds.

Aside from this broad description, the industry is lacking an agreed, detailed definition of exactly which products make it into the Alt UCITS category. The result? Varying estimates when trying to assess the size of the market. The diversity found within the space in terms of investment objectives and strategies means one neat definition is unrealistic, and a handful of funds will always be deemed by some as not 'alternative enough' to be included.

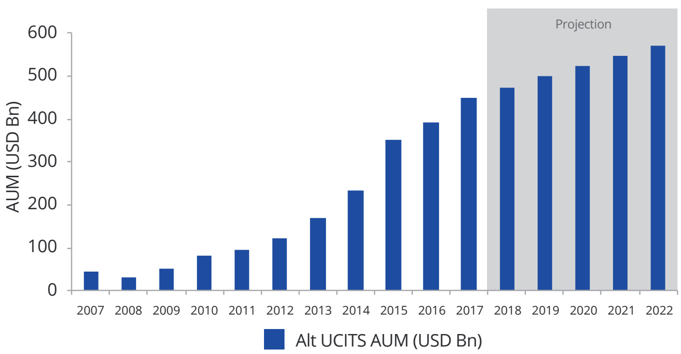
To avoid adding to the confusion, we have based our research on the UCITS strategies found in the Morningstar 'Alternative' categories. While recognising the imperfect nature of these categories, any results derived should be broadly in line with the classifications of other providers.

Rising popularity

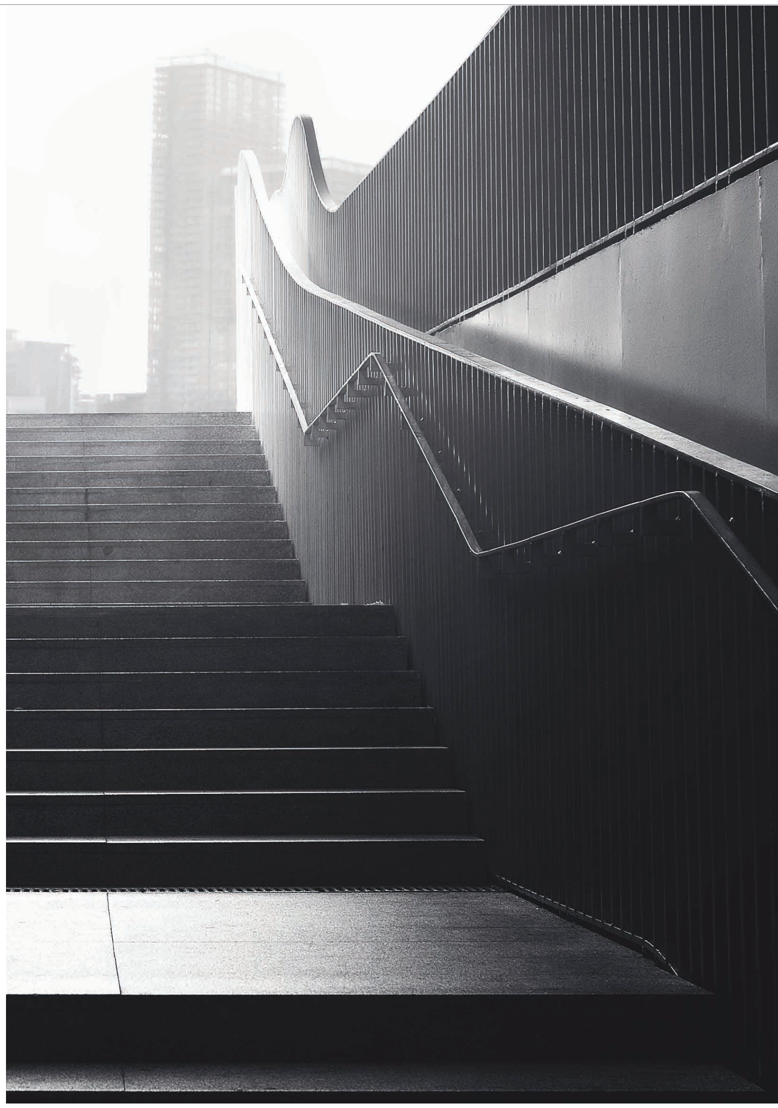
We believe the Alts UCITS universe is guaranteed to grow. Funds in this space represented more than USD400 billion in assets as at the end of 2017, up from USD50 billion pre the GFC according to Morningstar.

However, they currently represent only 7% of total assets invested in UCITS. If the industry grows its market share between 2017-2022 at the same pace as seen during 2015-2017 (which were more stable years than the prior ones), Alt UCITS would exceed USD550 billion in assets (see chart 1). Hence, we anticipate Alt UCITS to enjoy a strong growth trajectory over the next few years.

CHART 1: ALT UCITS' STRONG GROWTH TRAJECTORY



Source: Morningstar. BlueBay calculation. As at end 2017



Right fit, right time

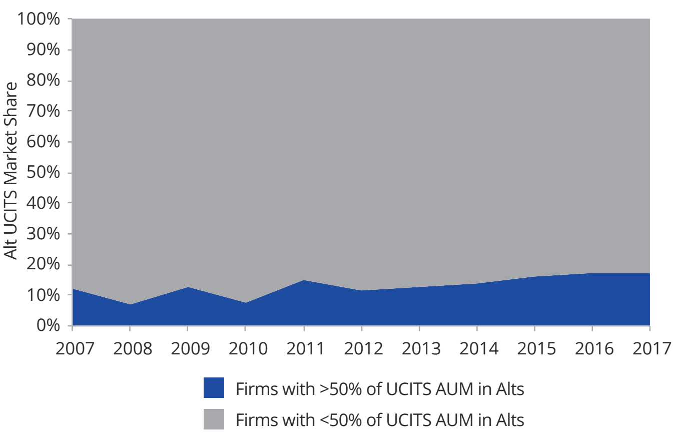
While, in our view, the make-or-break success factor for achieving this growth is performance relative to traditional funds, there are several other factors from an investor (demand) and manager (supply) standpoint that constitute strong tailwinds for the universe.

The types of investors and managers interested in Alt UCITS supports the universe's growth trajectory. For example, Alt UCITS seem to be increasingly appealing to traditional buyers looking to complement or replace their long-only fixed income exposures, where their stabilising role in diversified portfolios is threatened by rising rates. Similarly, with equity markets at all-time highs, Alt UCITS offer equity investors the potential for diversification and capital preservation.

On the supply side, the growth in passive investing is, somewhat paradoxically, encouraging growth in Alt UCITS. The popularity of model-driven and free-float allocation weightings creates opportunities for managers to generate alpha as i) markets may be more exposed to technical dislocations and (ii) bottom-up research is more likely to add value in a world where higher rates prompt higher dispersion between securities.

When looking at managers by the percentage of assets within their UCITS offering that is invested in Alt UCITS (see chart 2), the market is dominated by firms with less than 50% of their fund range in Alt UCITS. This suggests that traditional managers are the main actors in the Alt UCITS space.

CHART 2: ALT UCITS AUM BREAKDOWN BY TRADITIONAL AND ALTERNATIVE MANAGERS



Source: Morningstar. BlueBay calculation. As at end 2017

However, this data does not reflect the blurring of lines between traditional and alternative managers, as some long-only firms have hired specialised teams with hedge fund experience or operate with a multi-boutique approach, where affiliates have a similar set-up to autonomous hedge funds while benefiting from the backing of a wider group. Not to mention independent hedge funds launching Alt UCITS version of their flagship strategies on fund platforms belonging to traditional managers.

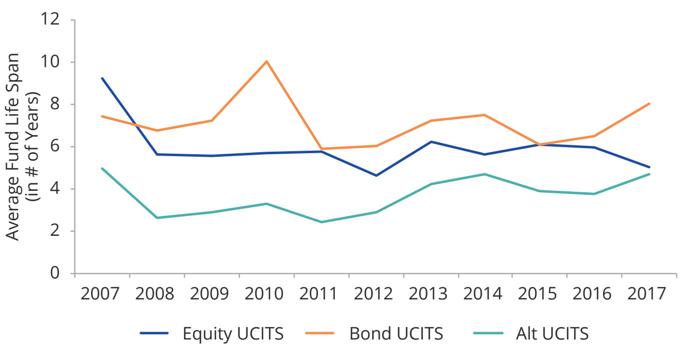
Dedicated alternative managers are also present and contribute to the growth of the universe. The share of firms with more than 50% of their UCITS assets in alternative funds has increased from 12% to 17% in the last 10 years, suggesting growing success for some specialised actors and independent third-party platforms.

Quantity over quality?

While the increased competition among managers is undeniable, the improvement in quality is debatable. The convergence in managers active in the Alt UCITS space has increased competition, which should theoretically benefit investors as they can access a wider range of strategies and gain in bargaining power to drive costs down. But the diversity in investment approaches within the universe makes it difficult to compare one strategy to another and requires investors to spend more time and resources not only to identify the strategy that best matches their objectives, but also to understand the risks involved and assess how the strategy might perform under various market conditions.

As Alt UCITS are supposed to rely on alpha rather than beta to generate performance, assessing manager skill and the opportunity set are of upmost importance. This is particularly important for Alt UCITS, as illustrated by the average life span (ie from inception to liquidation) of funds in this space. Alt UCITS which have been liquidated were on average shut down after four years. This has improved from the lows of 2.5 years in 2011, but is still less than that of traditional equity or bond funds, which were liquidated on average six and seven years after inception respectively since 2007 (see chart 3).

CHART 3: FUND LIFE SPANS



Source: Morningstar. BlueBay calculation. As at end 2017

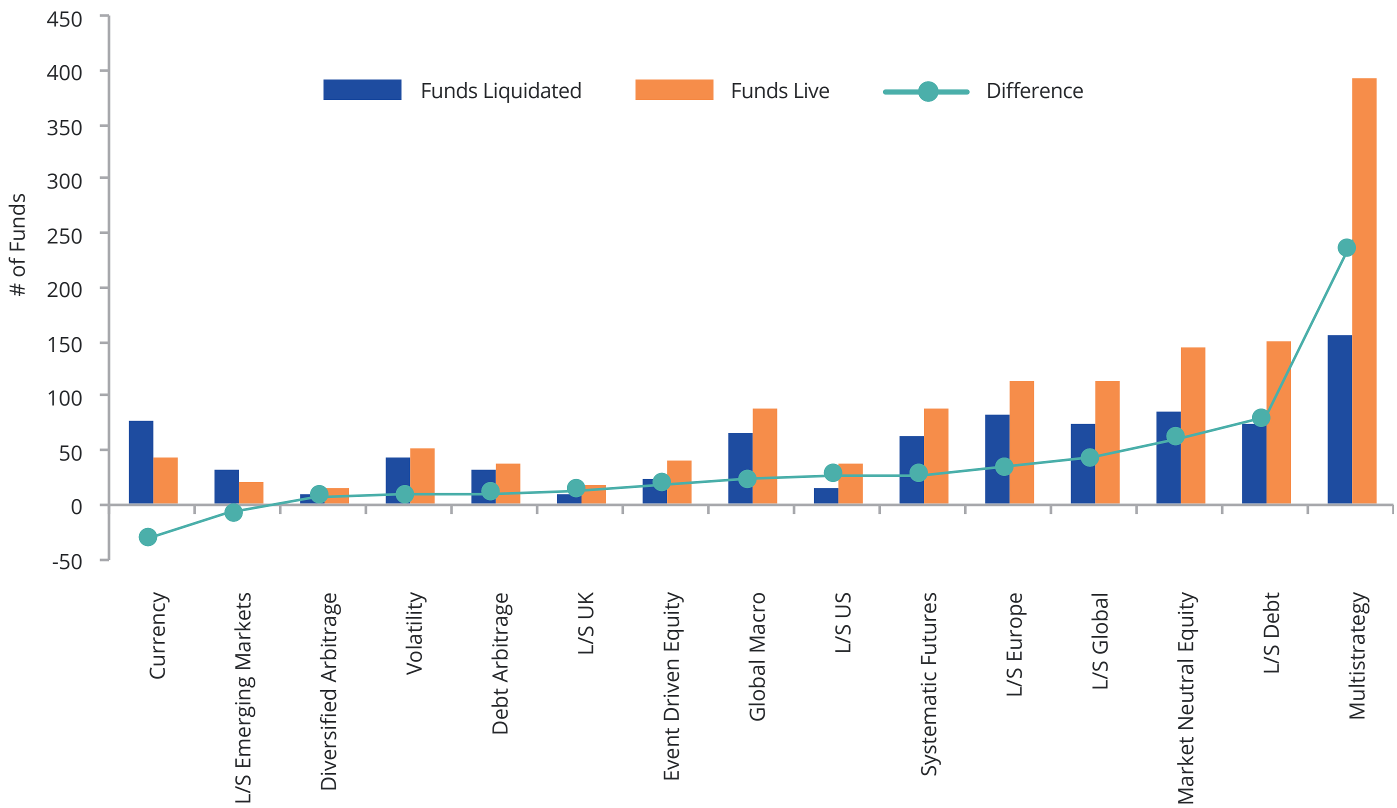
Not all Alt UCITS are equal

Looking at the various buckets within the universe reveals that some strategies have been more successful than others. This could be due to the UCITS framework representing too much of a constraint on managers, because generating consistent alpha in certain strategies is challenging, or a combination of the two depending on the strategy. The concentration of flows could also partly explain why some funds are liquidated due to a lack of commercial success, as demand tends to be polarised with flagship funds representing a large proportion of total assets, similar to the 'winner takes all' situation found in traditional UCITS.

When putting fund size aside and only looking at the number of funds per Alt UCITS category, strategy types such as currency and long/short emerging market equities are in negative territory, with more funds liquidated than still currently running. Others, such as volatility are almost flat with live funds just ahead of liquidated funds. This scenario could potentially lead to the disappearance of certain strategy types, as was the case of enhanced money market funds following the GFC. Global macro and systematic futures, which are more popular in terms of number of funds, have also seen their share of liquidations.

Conversely, closures offer opportunities for new entrants to shine if they manage to deliver attractive risk-adjusted returns where others have failed. Product innovation in Alt UCITS has front-run existing categories, partially explaining the bloated multi-strategy bucket, which includes a wide range of otherwise uncategorised strategies. As managers incorporate new tools to their approach and strive to develop innovative solutions to the changing market environment and investor needs, Alts UCITS is where novelty, with its benefits and risks, is likely to persist. This should keep investors as well as regulators on their toes.

CHART 4: LIQUIDATED VERSUS LIVE FUNDS BY ALT UCITS STRATEGY



Source: Morningstar. BlueBay calculation. As at end 2017

DISCLAIMER

BlueBay
Asset Management