Tentative signs of convergence between traditional and alternative investment managers have been around for some time. Lately, they have been apparent for all to see. A new vehicle, dubbed ‘hedge fund lite’ has emerged — and is being sponsored as a Undertakings for Collective Investments in Transferable Securities (UCITS) product by firms from both ends of the industry spectrum. At the same time, a small number of hedge fund managers have started turning their hands to long-only investment. Convergence is fast becoming reality.

‘The old labels are starting to look a bit worn,’ says Richard Ernesti, Global Head of Client and Sales Management for Investors at Citi’s Global Transaction Services. ‘Increasingly, firms will be viewed not as long-only or alternative but as alpha or beta managers, depending on whether they generate absolute or relative return. While beta products such as exchange-traded funds are becoming increasingly popular, people will pay a premium for genuine alpha.’

Several factors have combined to accelerate the convergence process in the alpha space. Traditional managers that have lost inflows to their competitors in the alternatives market are having to rethink their role after the disaster that was 2008. Even some well managed funds that beat their index benchmark by several percentage points in 2008 lost money and failed to endear themselves to their investors.

‘An absolute return capability is a useful weapon in the armoury for long-only managers that have lost inflows to alternative managers in the past,’ says Mr Ernesti. More and more multi-manager funds are investing in absolute return products for their alpha and ETFs for their beta. Relative return products are being squeezed.

The divide between long-only and hedge fund managers is becoming increasingly blurred as convergent approaches emerge in the UCITS space. More than ever, investment managers need an administrator with expertise in both areas.
The UCITS III regime, with its more relaxed approach to the use of derivatives and leverage, has provided long-only investment managers with a platform on which to spice up their strategies. A recent survey by Bank of America Merrill Lynch found that 76 per cent of institutional managers were planning to use derivatives in their mainstream funds. Many are already using Over-the-Counter (OTC) instruments while hedge fund-style performance fees are also making an appearance. Absolute return (or ‘hedge fund lite’) funds are proliferating.

On the other side of the fence, hedge funds are being pressed by their investors to deliver more transparency. In the wake of the Madoff affair, well regulated, European-domiciled funds have suddenly become hugely attractive. ‘We are seeing a lot of enquiries from Cayman-domiciled groups looking to re-domicile in Europe and convert to UCITS,’ says Catherine Brady, EMEA Head of Fund Services, Global Transaction Services, Citi. ‘They are not looking for in-country registrations to go retail: they just want the UCITS label,’ she says.

Several hedge fund groups have already taken the UCITS III route. One of the earliest was Marshall Wace, which launched an open-ended UCITS version of its Amsterdam-listed hedge fund, MW Tops, in November 2007. Also in 2007, Insight Investments, the asset management arm of HBOS which spans both the absolute and relative return markets, replicated a range of Cayman-domiciled absolute return funds under UCITS III. Since then, the likes of GLG Partners, Odey Asset Management and Brevan Howard have all followed suit.

While more liberal than previous regimes, UCITS III still imposes certain limitations on asset eligibility and leverage, which reduce its applicability to some hedge fund strategies. Nonetheless, Aquila Capital, a German investment manager, broke new ground earlier this year by launching what is believed to be the first managed futures fund to comply with the UCITS rules. With a minimum investment of just EUR1,000, the fund was partly targeted at the retail investor market. The ability to diversify the investor base is clearly a major stimulus for many of these fund launches.

There is one cloud on the horizon. It is the ability to apply Value at Risk (VaR) budgeting measures in so-called ‘sophisticated’ funds that has allowed many hedge fund managers to work their way around the UCITS restrictions. However, the Committee of European Securities Regulators (CESR) is currently reviewing the two risk measurement methodologies permitted in the UCITS regime — VaR and the commitment approach. If VaR were to go, it would hamper a number of strategies.

Limited convergence is also taking place in the opposite direction. Hedge fund firms, such as Thames River Capital, have bolstered their range with the addition of long-only funds. Marshall Wace has taken a team with long-only management experience and is contemplating following suit.

The All Seasons Fund, managed by IKANO Fund Management in Luxembourg, highlights the increasing convergence between the traditional long-only approach and the hedge fund marketplace. Launched over three years ago, the multi-manager fund recently moved from a strategic to a ‘dynamic asset allocation’ approach. Says Henk van Eldik, IKANO Fund Management’s Head of Fund Distribution: ‘We realised that just trying to generate alpha was not enough. In most funds, asset allocation is not reviewed often enough. We were looking
at the top of the pyramid for the 1 per cent of alpha rather than the bottom where 90 per cent of returns are realised.

'We start from a cash base with a long list of investment ideas,' he says. 'Rather than diversify across all asset classes, we boil our ideas down to a short-list, identifying those areas where there is a good reason to invest at that time. We then decide where there is value from an active manager or whether we should go passive, then we invest'. The fund is currently heavily concentrated in Japanese smallcap shares, and corporate and high yield bonds.

Mr van Eldik notes a number of trends in the marketplace. Increasingly, he says, bank-owned investment managers are expanding into alternatives such as real estate and private equity to complete their product offering. 'The problem is that they lack competence in managing lots of different asset classes. Others, with good records, are taking the opportunities offered by UCITS III to seek additional returns with 130/30 funds. But you need to be a good market timer as well as a stock picker,' he adds.

With the increasing use of derivatives and the spread of absolute return products, it is vital that firms have an administrator with a depth of experience in the administration of both long-only and alternative funds, says Catherine Brady: 'There is no one platform that will process the full spectrum of instruments. The challenge is to streamline the information into common data warehouses and deliver it to the client in a standardised fashion as part of a consolidated view.'

As a leading hedge fund administrator, Citi has developed solutions to cope with a broad diversity of portfolios, styles and instruments. 'We have leveraged our global footprint to develop centres of excellence that give us the capability to manage big volumes quickly and effectively,' says Ms Brady: 'One example is in the area of pricing where we have centralised teams in the US, India and Europe, who can ‘follow-the-sun’ and meet the toughest reporting deadlines. Another is the provision of customised and ‘off-the-peg’, modular solutions from across the front-, middle- and back-offices. An area in which Citi is practically unrivalled.

Will the convergence process continue? UCITS III has given both sides of the investment management industry a highly flexible tool with which to promote advanced strategies. The hedge fund industry is responding to the pressure to launch regulated, European-domiciled funds, while at the same time taking the opportunity to broaden its customer base. Traditional long-only managers are responding to old-fashioned competitive pressures and increasingly tackling the hedge funds in the alpha space. The asset management industry is changing – and quickly. That change looks irreversible.

Clearly, investment managers must partner with their providers like never before to implement resilient business models that can withstand the tests of the future.