Spotlight on UCITS

Amin Rajan and RBC Dexia's survey reveals benefits and challenges

The European Union's UCITS framework has been in operation for over 20 years. A new survey highlights its success, despite large scale net withdrawals due to the current market turmoil.

Titled *'Global Fund Distribution – Bridging New Frontiers'*, the survey was carried out by CREATE-Research and commissioned by RBC Dexia Investor Services.

It involved 110 fund companies domiciled in 23 countries, with total FuM of €15,746bn. They offered a detailed appraisal of the impact of the UCITS framework on their industry, focussing on areas like systemic inefficiencies and new alliances.

A WIN-WIN FOR INVESTORS AND THEIR MANAGERS

The survey shows that the benefits enjoyed by investors can be viewed in three groups.

The first and most important one focuses on choice, comfort and access. Clients have been able to have a greater choice from a range of investment strategies from trusted brands renowned for full transparency in all their activities, backed by good risk and compliance systems. They have also been able to access all-weather portfolios as well as customised solutions. Of course, at the individual level, more choice does not mean better. Choice is bringing a new generation of clients into the marketplace, intensifying competition and focusing fund managers' minds on what matters most to their clients.

There is little doubt that there is over-capacity in global fund management and rising competition is seen as a problem. This trend will be reinforced under UCITS IV, which will accelerate competition and fund mergers.

The second cluster of benefits revolves around service quality. As the client base expands fund managers are increasingly segmenting their clients into different classes with clear service propositions for each. This is a new phenomenon outside private banking. Under it, the 'baseline' standard is being improved with more accurate and timely reports, regular communication, and better response time to clients' queries. Clients are offered other value added services too – frequent valuation, investment reviews, and bespoke solutions.

> "OF COURSE, AT THE INDIVIDUAL LEVEL, MORE CHOICE DOES NOT MEAN BETTER"

The third group revolves around returns and fees. Currently, around one in three fund managers believes that UCITS has delivered good returns within a value-for-money fee structure. The current market turbulence has undoubtedly influenced their judgment on this score. But, almost half of managers believe that things will improve, when the markets recover.

They believe that using UCITS as a platform for global expansion will not be worthwhile unless the fund industry delivers decent returns above cash benchmarks at charges that demonstrate a clear alignment of interest between managers and their clients. Indeed, in the longer term, it is not enough to provide better choice on the back of sound business basics alone.

UCITS has delivered a number of mutually reinforcing benefits for fund managers within four clearly discernible structures.

The first group revolves around innovation and product development. Their pace has accelerated as fund managers have sought to meet the needs of clients in diverse geographical, regulatory, fiscal and cultural settings. As a result, managers' ability to attract, retain, motivate and deploy talent has improved. New products are few and far between. Most of the innovation has been targeted at customising existing products.

Secondly, there is enhanced expertise to engage in cross-border business. The top management capability for globalising the business is distinctly superior now, compared 2000. There is better understanding of how funds are changing, where the emerging opportunities are, how to capitalise on them and how to forge alliances, where necessary. The ability to identify, develop and nurture cross-border alliances has been a major spin-off from UCITS.

The third group revolves around the client base. As managers have gone cross-border, their client base has expanded and become more varied. Since there are restrictions on the investment strategies under UCITS, fund managers have been able to take standardised products and customise them at the periphery. This has disproportionately expanded their revenue base compared to costs; delivering cost effective growth and improved net margins.

The fourth cluster focuses on operating leverage. In the 1990s, the majority of fund managers in Europe and the US suffered from a major impediment when scaling up their business: costs rose faster than revenue.

This reflected numerous inefficiencies, such as complex products with no clear value proposition, legacy systems in the back office with little integration potential, guaranteed bonuses for key executives and star managers irrespective of performance, and inadequate management to cope with business growth.

These problems have not gone away, but the growing internationalisation of fund business under UCITS is sharpening the focus on expertise, meritocracy, costs and accountability.

But progress has been hampered by the following:

- Rules under UCITS III have held back fund managers who have seen an explosive growth in their long/short strategy.
- Skill shortages and limitations on the prevailing IT infrastructure at the service provider end in Luxembourg and Dublin.
- The clouded outlook in the financial markets is forcing attention on the existing revenue streams and their sustainability.

Fund managers feel they must stick to basics and not get sidetracked into international projects. But fund managers have embraced UCITS as a vehicle for penetrating new markets. Over the next three years growth in UCITS assets will average at 25% in Europe, and 30% in Asia and Latin America.

NEW ALLIANCES

UCITS has started the long overdue process of driving out the systemic inefficiencies that had thrived behind regulatory barriers.

In this competitive environment new alliances are emerging. Players in the are focusing on their core competencies. As a result, they are replacing the old model of vertical integration within a firm one that involves horizontal integration between firms. Non-core activities are outsourced to distributors and administrators. New alliances are emerging across national boundaries and will evolve.

Concerns over third party administrators relaxing the rules on the management company passport are exaggerated. An infrastructure has emerged in Luxembourg and Dublin that is capable of handling clients' business in any jurisdiction.

Third party administrators are delivering better value by offering new functionalities that promote product innovation in manufacturing and seamless integration in distribution. These alliances are amplifying the craft focus in manufacturing, mass customisation in distribution, and service standardisation in administration.

Tony Johnson, global head of sales and relationship management, says: "This is becoming a critical area and we have boosted distribution support capabilities via our Funds Hub platform – connecting distributors and manufacturers, providing data in settlement and custody activity and employing extremely robust management information systems." TFB

AMIN'S ADVICE

Tips for CEOs, CIOs and COOs:

1. UCITS OFFER A MORE COST EFFECTIVE ROUTE TO GLOBALISATION OF YOUR BUSINESS: you don't need physical presence on the ground

2. UCITS IV WILL RESHAPE THE FUND INDUSTRY: systemic inefficiencies will not be tolerated

3. UCITS WILL BE INCREASINGLY JUDGED ON THE BASIS OF RETURNS AND FEES: sound business basics are necessary but not sufficient

4. THE FUND VALUE CHAIN WILL CONTINUE TO FRAGMENT : core capabilities will differentiate winners from losers

5. MANUFACTURING AND DISTRIBUTION CONTINUE TO DECOUPLE: third party administrators are the agents of integration

6. THE ABILITY TO FORM ALLIANCES WILL BE A DIFFERENTIATOR

CASE STUDY: OF A LARGE GERMAN FUND MANAGER

The market volatility sparked by the credit crunch has forced clients to withdraw their funds from UCITS and non-UCITS products. Before, returns and net inflows were healthy. We expect these trends resume once the crisis is over.

UCITS has offered clients far more investment transparency than ever before. It also offers clients access to a range of investment options delivered within a proper risk-controlled framework of the sort that didn't exist ten years previously. It has offered clients customised solutions to their pre- and post-retirement needs.

The main benefits of UCITS lie in the improved conduct of investment business and its governance and physical infrastructure. There have also been some gains on the cost side.

However, there have been consequences. UCITS has promoted a huge wave of new products, and most are copycats. Few funds have the critical mass to generate significant economies of scale.

That is why it is important to implement UCITS IV, especially the provision on the merger of funds and the creation of master feeder funds.

*Global Funds Distribution - Bridging New Frontiers, is free from: www.create-research.co.uk and www.rbcdexia.com