

## Widening channels: Five Key Factors to Setting up Alternative UCITS Funds

**Luxembourg/Dublin/London, 11 May 2011**—Burgeoning interest from hedge fund managers in developing or replicating alternative investment strategies within UCITS products has put these funds in the spotlight. Alternative UCITS are not new, nor do they operate under a separate regulatory environment, they are funds wrapped in traditional UCITS structures -- but there are five key factors to consider for a successful alternative UCITS fund.

1. **Pick your strategy** - RBC Dexia's analysis shows that hedge funds strategies representing 90% of all Cayman invested assets can be replicated within the UCITS format. During the first half of 2010, the company analysed the requirements of the UCITS structure, including the types of instruments requiring counterparty risk management, with Cayman hedge fund strategies. Only a small minority of hedge fund strategies are so esoteric that they cannot be replicated under UCITS.
2. **Location, location, location** – Selecting the right domicile for an alternative fund depends on the investor segment being targeted and the preferred infrastructure. Both the Qualifying Investor Fund (QIF) in Dublin and Luxembourg's Specialised Investment Fund (SIF) benefit from well-informed investors and private placement distribution, while pan-European UCITS funds focus on retail investor protection and have more restrictions on investment and borrowing restrictions.
3. **Think liquidity** – UCITS funds come with greater liquidity requirements than traditional hedge funds. While this can be assessed and navigated when setting up a fund, it is crucial that it is stress-tested for scenarios under which markets seize up, as they did following the Lehman default. On paper, a UCITS fund can have bi-monthly liquidity. In reality, many investors expect daily liquidity. All UCITS actors - investors, custodians, hedge fund managers, fund promoters - should carry out assessments to ensure that funds respect their liquidity ratios.
4. **Remember operational risk** – Funds that apply a hedge fund strategy in UCITS vehicle do so by changing the model from physical to synthetic prime brokerage and the instruments from short and long holdings in stocks and bonds to Contracts for Difference (CFDs) and Equity Swaps. Leverage, concentration, and counterparty risk need to be addressed, together with OTC derivatives processing and collateral management.
5. **Tracking error** – There are many issues to consider with regard to tracking error for UCITS replications of offshore hedge fund, including whether liquidity requirements will create performance drag, the level of error acceptable to investors and the extent to which the selected strategy will affect performance. Investors may accept greater tracking errors for high performing funds but equally economic conditions will strongly affect performance.

“As the popularity of alternative strategies deployed within UCITS structures continues to grow, it is crucial that every group with an alternative UCITS product is conscious of the requirements for liquidity, risk management and reporting and can demonstrate its ability manage these in a comprehensive manner with the right people and technology,” said Olivier Laurent, Director, Alternative Investments Product Management, Global Fund Products, RBC Dexia Investor Services. “The administrator plays an important role and can work in partnership with funds to ensure this occurs.”

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