

PwC Luxembourg podcast – To the point

Episode 2: Trends in cross-border fund distribution

The distribution of cross border investment funds continues to grow at a phenomenal pace. Today the UCITS brand is recognised as the only truly globally distributed investment fund product, 75% of such cross border funds being Luxembourg domiciled.

There are many reasons contributing to the success of UCITS distribution globally including: the stability and regulatory regime of UCITS, the levels of consumer protection, the flexibility and adaptability of the fund and the perceived “neutrality” of the Luxembourg based funds.

This article examines some of the recent trends surrounding UCITS distribution, the challenges that may arise and the strategies that promoters need to consider to achieve successful distribution.

Trends – current and future

Today, the clear trend is that more UCITS are being sold into more jurisdictions by an increasing number of fund promoters than ever before. An increasing number of organisations that have or are establishing a UCITS fund range are doing so with a clearly defined global distribution strategy. Only a few years ago there was but a mere handful of UCITS promoters who distributed their product on a global basis – effectively outside 3 or 4 core European jurisdictions.

Today, the global marketplace for UCITS funds is significantly more competitive and crowded. In addition there is a strong trend to implement a distribution strategy using global “flagship” platforms, as many promoters see a significant competitive and commercial advantage in maximising the distribution of a single umbrella platform. Local product ranges still exist, and in some jurisdictions remain essential due to local investor preferences or tax requirements, but the trends is to reduce product replication to the maximum extent possible.

Although challenges exist using single flagship funds, the potential economies of scale that can be extracted are significant and ultimately the profits and returns to shareholders that can be obtained.

So just how much more competitive is the global fund distribution space? Well – in 2000, approximately 2,900 funds, (some 70% of them being Luxembourg domiciled), were registered for public distribution in more than 50 countries, representing some 20,000 separate registrations. In 2007 almost 6,000 funds are sold cross border, with total registrations are expected to be 50,000 by year end - representing a 60% growth in the over the past 2 years – and more than 100% growth over the past 5 years.

Currently some 26 fund promoters were distributing UCITS into more than 20 countries, more than four times the number doing so back in 2001. 10 years ago there were just three UCITS promoters with such coverage. Presently more than 65 fund promoters are distributing their UCITS platforms into more than 10 countries. Back in 2001 only 15 were doing so.

The distribution footprint of UCITS continues to rapidly expand because more jurisdictions and their local investors now accept UCITS as providing a stable, high quality, well regulated investment product with significant levels of investor protection. Since 2000 the average number of countries of UCITS distribution by the top 50 fund promoters has grown from 12 to 20 countries – a 70% increase. The recent trend of more promoters launching and distributing more UCITS in more jurisdictions is likely continue for at least the next 2 – 3 years, especially with the impetus from moving fully to UCITS III.

UCITS distribution is now focused predominately on three key regions – Europe, South America and Asia. Demonstrating the importance of UCITS distribution outside of the EU, the later two regions, together with Switzerland, now contribute more than 40% of total UCITS net sales and growing faster than EU sales

Within Asia UCITS market penetration has been extremely successful, although limited to Hong Kong, Singapore and Taiwan where UCITS account for more than 70% of the total market for authorised funds due to a lack any regulatory and/or tax barriers to entry and strong market and regulator acceptance of UCITS.

In sharp contrast China, Korea, Japan, India, Malaysia and Australia have not been successful for the UCITS distribution to date for a variety of regulatory, tax and cultural reasons. Nevertheless, given the size of these domestic markets, (especially compared to Hong Kong and Singapore), they remain significant opportunities for the future.

Turning to Europe, the previous array of national tax and regulatory barriers that restricted the effective operation of an EU single market for UCITS have been significantly eliminated or reduced over the past few years and this has certainly contributed to the significant growth of UCITS cross border distribution within the EU.

Moreover, the elimination of these national obstacles, especially discriminatory tax rules, is assisting in the continued slow decline of local investor preferences for national funds. Such trends are helping to drive the increased use of “neutral”, (Luxembourg and Dublin), global flagship funds.

Due to the above trends there is increasing demand to consider and implement fund rationalisation programs. This issue, more than any other, should be the primary focus of any future legislative changes to the UCITS Directive as it would deliver real and significant benefits and savings to the industry.

Although much maligned, the CESR notification guidelines announced in 2006 have been implemented by a number of countries already with the reminder to follow during 2007. The impact of these guidelines are already being felt and once fully implemented the UCITS EU registration process will be more transparent and delays shortened, especially due to self-certification of fund documentation and national regulators committed to streamlining their review process.

In terms of target countries, Germany, France, the Netherlands, Italy, Spain and Switzerland still remain the core of most UCITS European distribution strategies. However, there is an increasing trend to adopt “regional” approaches. For example, often when the German market is targeted, Austria and Switzerland is also included. The Scandinavian countries tend to be targeted as a group, Spain and Portugal, as are France, Belgium and the Netherlands. These groupings are being driven by market synergies and the opportunity to extract economies of scale throughout the distribution and sales processes.

Notwithstanding its maturity and the level of competition there is increased attention on the UK market by Luxembourg UCITS since the UK tax rules were changed in

2004. In contrast, UCITS promoters continue to approach the Eastern European region with caution due to concerns about general market immaturity, a lack of available distribution channels and potential sales on offer. The result is that UCITS penetration into this sub-region is still disappointing low when compared to the rest of Europe.

There is growing interest in the Middle East as a fourth distribution region. At present a mere handful of UCITS are marketed into this region evidencing concern about the degree of market maturity, the optimum distribution strategy for this region and the potential AUM available for open ended investment funds.

Challenges & strategies

The key challenge going forward is to ensure that the past success of cross border UCITS distribution continued into the future. What obstacles or challenges exist now or are on the horizon that may threaten the global dominance of the UCITS brand.

Within Europe, the drive towards a UCITS single market is not yet over and whilst a significant journey has been completed further work needs to be done to ensure the total elimination of all tax and regulatory discrimination. Moreover, there is a strong desire to extract further economies of scale through pooling and to eliminate the main obstacle to effective fund rationalisation - the lack of a harmonised regulatory and tax regime to facilitate the process in a cost effective manner. Threats exist from other investment products although this has always been the case. What UCITS needs is an up to date framework that supports effective competition.

We must carefully evaluate what are the most appropriate outcomes before commencing a journey down the path to UCITS IV. The foundation of the success of UCITS distribution is its acceptance as a stable investment product with high levels of consumer protection. Would UCITS IV blur the divide between the current UCITS product and alternative products – is that already occurring? Would UCITS IV result in the potential loss of traditional UCITS investors around the globe that prefer the existing permitted investment restrictions? How would non-EU regulators respond to UCITS IV and what, if any, input would or should they have into the design of a UCITS IV Directive?

Turning to challenges associated with globalised UCITS distribution – implementing such a strategy means that global risk management, compliance and product development processes that are appropriate to support the product range across need to be determined and effectively implemented. Although the trend is towards maximising the distribution of flagship platforms for scalability, cost control, governance etc., the downside risk is that the global fund becomes subject to an ever increasing array of local regulatory, tax and market practices that tend to restrict the ability to provide local tailored investment solutions for all investors.

Outside of the EU UCITS are subject to the non-harmonised tax and regulatory framework of each host country of distribution. These and market practices can change regularly and as the distribution footprint of your fund platform widens so does the risk to the product should these aspects not be monitored, centrally managed and coordinated.

Moreover, a critical challenge for a UCITS distribution strategy is to determine the extent of the distribution of a global flagship product and in which circumstances may it be appropriate to restrict distribution and implement a different strategy. For example, in some circumstances, depending on the specific market and/or target investors, it may be appropriate or indeed necessary to only distribute a local fund range or to market both the global UCITS and a tailored local product. Potentially, a separate UCITS platform (or some specific sub-funds of the global fund), distributed in a few selective territories may be an appropriate strategy to shield the global platform from local regulatory restrictions more severe than those under UCITS III.

The overriding distribution challenge is to balance the commercial benefits of moving towards a globalised UCITS model against the structures to appropriately support such a strategy and impact of local requirements.

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