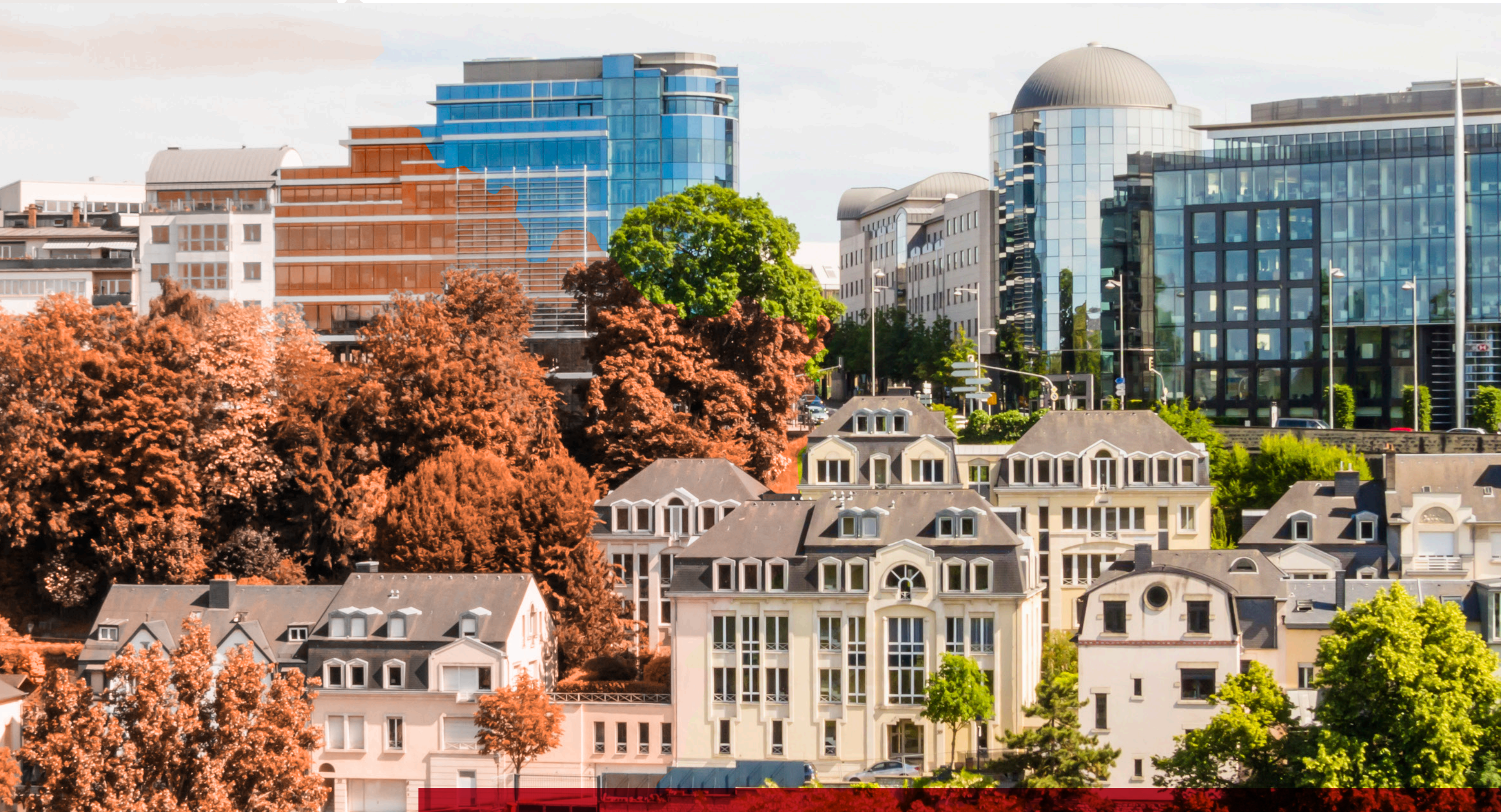
Luxembourg: Maintaining Market Leadership



Fanny Sergent and Michael Delano of PwC Luxembourg, explore how Luxembourg became the fastest growing hedge fund domicile in Europe

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MAINTAINING MARKET LEADERSHIP

FANNY SERGENT AND MICHAEL DELANO OF PWC LUXEMBOURG, EXPLORE HOW LUXEMBOURG BECAME THE FASTEST GROWING HEDGE FUND DOMICILE IN EUROPE

Fanny Sergent is the PwC Luxembourg hedge fund leader and an audit partner specialised in the financial services industry with a focus on asset management including hedge funds.

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With more than 14,000 funds and over $3.7bn of assets under management at the end of 2015, Luxembourg is the second largest investment fund centre in the world, after the United States. Over the past five years, Luxembourg has had the largest growth in its worldwide share of hedge funds, from 6% of the global market in 2011 to 15.6% in June 2015. In addition, 46% of alternative Ucits funds are domiciled in the Grand Duchy. The megatrends described in PwC's publication 'Alternative asset management 2020 – Fast forward to centre stage' will create further opportunities for Luxembourg to strengthen its position in the hedge funds space.

ASSET MANAGEMENT MOVES TO CENTRE STAGE

New source of funding: Regulation will continue to hinder the ability of banks to finance the broader economy – for asset managers this will create significant opportunities to further step into the funding gap.

New asset class/expertise: Asset managers will dominate the capital raising required to support growing urbanisation and cross-border trade; growing asset classes in infrastructure and real estate play into alternatives firms' areas of expertise.

An increasing investor base: Asset managers will be at the centre of efforts by sovereign investors to invest and diversify their huge pools of assets and AIFMs are ideally positioned to partner with them.

Innovative products: As the world's population ages, retirement and healthcare will become critical issues that asset management can solve; capital preservation and alpha generation will be key.

ALTERNATIVES ARE INCREASINGLY MAINSTREAM

The growth of liquid alternatives has been prolific. They are primarily Ucits funds in Europe and mutual funds registered under the Investment Company Act of 1940 in the US, known as '40 Act funds. With greater transparency, a strong regulatory environment, appealing liquidity terms, often lower fees and the ability to access a range of alternative strategies, growth in liquid alternatives is not surprising. By 2020, alternative asset management will become synonymous with 'active asset management' and, increasingly, 'multi-asset class solutions'. Alternatives will become part of the selection of retail products available as investors seek strategies with the prospect of alpha and protection against downside risks.

The recently published AIMA/PwC survey bears this out, with 81% of firms that manage Ucits funds reporting rising assets under management (AuM). In addition, 87% of US managers of liquid alternative funds questioned in the survey say AuM are rising in their strategies. Liquid alternative funds are likely to increase in the future, with half of survey respondents in the UK planning to launch one in 2015-16. Nearly a third of the US firms are planning a liquid alternatives launch.

DISTRIBUTION CHANNELS GAIN IN FOCUS

By 2020, alternatives firms will adopt many ideas and practices from the broader financial services industry and from traditional asset managers. They will develop more sophisticated market strategies; more focused distribution channels and better recognised brands. Most alternative firms will work out exactly which investor channel or channels they want to target and will develop relevant strategies and products. Some will focus more systematically on sovereign investors, pension funds, other sophisticated institutions and private wealth markets. Others will target emerging markets or pursue the potentially huge asset flows through liquid alternative products. A small number of mega-managers in the alternatives space will operate across all major geographies, channels and strategies.

In the wake of new regulation, many firms are developing sophisticated processes to choose investor channels, the markets to target and, consequently, what regulatory regimes they will need to address. Conversely, regulatory changes create opportunities for hedge funds distributing in Europe, the US and Asia.

RESPONDING TO INCREASED REGULATION

The introduction of AIFMD has been a catalyst for firms to reconsider their distribution strategies. More than three quarters of managers surveyed said that they had changed where or how they market non-EU Alternative Investment Funds (AIFs) to EU investors in the wake of AIFMD. In the meantime, a considerable number of managers in charge of non-EU funds marketed in the EU have decided to create their own EU AIFMs or become sub-advisers for EU AIFMs instead of using a non-EU AIFM. AIFMD appears as the next big opportunity for Luxembourg, if the Grand Duchy can replicate the success of Ucits with alternative products. With one third of Ucits assets domiciled in Luxembourg and two-thirds of Ucits registrations worldwide coming from Luxembourg-domiciled funds, the country can easily leverage on its expertise.

The European Council have approved a regulation which creates a new investment vehicle designed to

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channel European investment directly to the real economy. The European Long Term Investment Fund (ELTIF) vehicle sits in between the AIFM and the Ucits rules. This means that, in addition to institutional investors, an ELTIF can be sold to retail investors with certain conditions. An ELTIF must be an EU AIF, must be managed by an EU-authorised AIFM and invest (at least 70% of its capital) in illiquid assets such as shares of non-listed companies, certain loans and infrastructure projects. The ELTIF seeks address the growing need to finance infrastructure projects throughout Europe which is key as we see the increased regulatory constraints on banks leading to a reduction in their capacity to finance the economy.

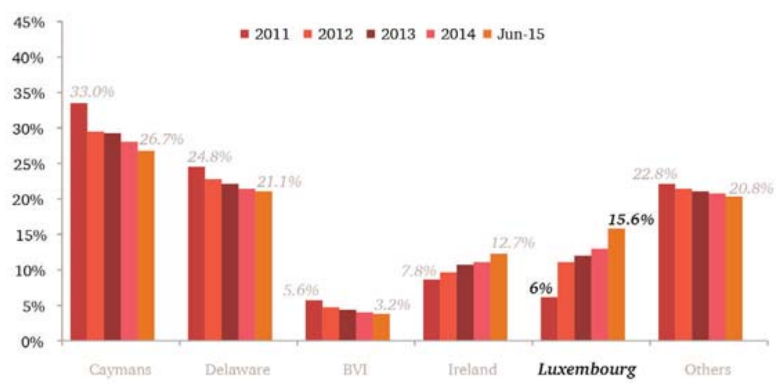
The work on new regulation of the financial markets has also reached the tax sphere; supported by all major countries, the OECD finalised its measures tackling 'Base Erosion and Profit Shifting' (BEPS) practices in late 2015. Countries and the European Commission are now working on related legislation and respectively EU directives. The most visible so far are the steps that enhance transparency and the exchange of information. Here, the common reporting standard and country-by-country reporting of transfer pricing outcomes rules are already coming into force. Luxembourg is fully supporting the BEPS initiative, while also considering the concerns for alternative, as well as mainstream funds. This is particularly important, as BEPS is not a harmonisation of the global taxation systems but rather a collection of coordinated specific measures.

THE RAIF: FAST LANE TO EUROPEAN DISTRIBUTION

AIFMD has introduced the concept of 'unregulated' AIFs benefitting from a European marketing passport through the passport of its authorised AIFM. This passport is available in Luxembourg to either regulated AIFs or unregulated structures under commercial company law managed by an authorised AIFM. In order to better adapt to alternative asset managers' need for tailored structures, the Luxembourg government is about to approve a law creating the Reserved Alternative Investment Fund (RAIF). The RAIF is not subject to regulatory pre-approval, which significantly reduces the time to market. It will be dedicated to well-informed investors and will qualify as an AIF with a passport permitting distribution to well informed investors in any of the EU member states.

The RAIF has already generated a significant amount of interest among assets managers in US and Asia as a way to reach high net worth and institutional investors in Europe. We expect the Raif to further strengthen Luxembourg's position as an attractive domicile for alternative funds. ■

Evolution of the worldwide share of hedge funds by domicile



Source: HFR

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