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Alternative UCITS 2018

Market downturn could attract fresh capital

Bank loan UCITS: future growth opportunity

Delivering a Brexit-proof distribution model

Bank loan UCITS could present future growth opportunity

Interview with Philip Lovegrove

The days of managers setting up new long-only large-cap US equity UCITS are largely gone, according to Philip Lovegrove, partner in law firm Matheson's Asset Management Department. "Products are getting more complex and one of the manifestations of this is that for a number of years now, we have been seeing a lot of strategies and instruments that have traditionally belonged in the hedge fund world being brought into the UCITS world," says Lovegrove.

Philip Lovegrove, Partner at Matheson

This assumes the strategy fits the regime, however. Indeed, sometimes the biggest constraint on UCITS can be the 'eligible assets' rules. These rules forbid UCITS from investing in commodities directly or, in many cases, in financial derivatives instruments which provide indirect exposure to commodities.

"If you have a strategy that makes heavy use of commodities or more illiquid assets you may well be constrained when you are looking to obtain exposure via UCITS," says Lovegrove. "People can use certain commodity indices and, to a lesser extent, 'Delta One' securities but there are constraints around the use of both of those."

That is not to suggest that some asset classes, such as bank loans, will not be used in a UCITS fund structure. One of the key aspects of eligibility is the depth of liquidity as pertains to the underlying instrument. As the *Financial Times* reported, the leveraged loan market has become a USD1 trillion asset class.

"At present only a limited sub-set of bank loans will meet the eligibility criteria and even those interpretations may be subject to challenge by regulators.

"We understand there may be concerns that perhaps the UCITS eligible assets rules are set too widely in some areas but there are also views that the rules are not wide enough in other areas. It may be that, as markets evolve, the product range within the UCITS universe could change as well. However, I do think it's appropriate that regulators take a cautious attitude to any such changes and don't tamper too much with the rules because UCITS is such a well-established brand," explains Lovegrove.

Complex instruments, such as Delta One instruments, meet the eligible assets criteria but can be far more difficult to understand, from a risk perspective, than a bank loan.

"I would guess that the regulators framing the original UCITS directive probably didn't have some of the more complex asset-backed securities in mind and modern regulators may share some nervousness around the use of these assets by UCITS. By comparison, we believe that there is a strong argument that bank loans are inherently understandable to a retail investor and may therefore be suited to inclusion in the UCITS world.

"The possibility of some form of review of UCITS eligible assets, maybe as part of "UCITS VI" has been rumoured (and denied!) for some time. If it happens, we may see some tweaking of the rules for determining eligible assets," adds Lovegrove.

Fund managers can opt to use an AIF product if they have concerns over the appropriateness of their strategy in a UCITS format.

"We see a lot of interest in the Irish QIAIF product space for credit strategies, loan origination strategies, real estate and private equity strategies. It is entirely appropriate that these strategies do not work in a UCITS context because of their complexity, liquidity and risk profiles," concludes Lovegrove. ■