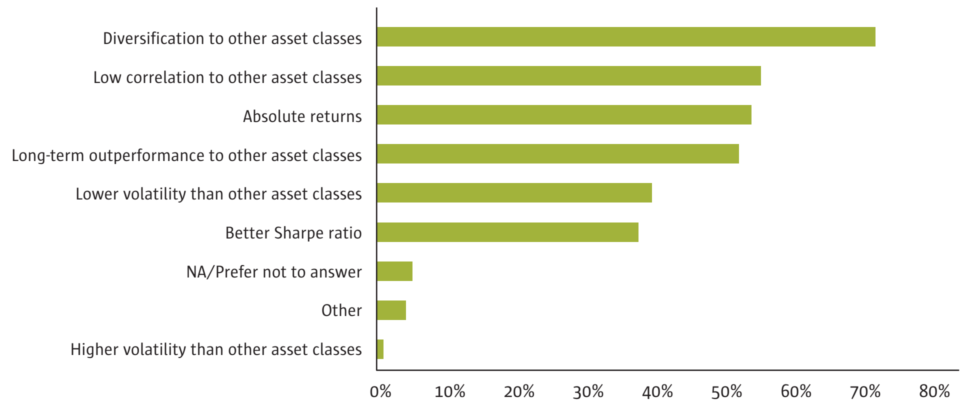
Q&A
With Deutsche Bank's db funds UCITS team

INTERVIEW BY HAMLIN LOVELL CFA, CAIA, FRM and CONTRIBUTING EDITOR

The Global Markets division of Deutsche Bank (DB) has been doing UCITS III almost since the inception of hedge funds using the wrapper in 2001. For DB, UCITS is not just the latest fashionable bandwagon, but a core offering to hedge fund clients that leverages its already successful business in this area. *The Hedge Fund Journal's* Contributing Editor Hamlin Lovell spoke to Manfred Schraepler, head of db funds at Global Markets Structuring, Effie Datson, Product Head of dbSelect and James Orme-Smith, director Global Prime Finance Sales. They discussed how the platform has already gathered over €13 billion of assets under management spread over 60 UCITS funds and expressed strong confidence in increasing assets in UCITS hedge fund strategies going forward. db funds is responsible for developing DB's systematically managed mutual funds investing in a broad range of asset classes and strategies.

Fig.1 What are the main benefits of hedge fund investments?

Source: 2009 Deutsche Bank Alternative Investment Survey



Q: What type of due diligence do you carry out on managers before on-boarding them, and how many of the current UCITS universe would and would not meet your criteria, for what reasons? Do you have any minimum seed ticket size for a new manager?

A: db funds works with managers that have already been on-boarded by DB whether as prime brokerage clients or through our managed account platforms. As we do not actively select managers, we have a process in place, whereby independent consultants review the managers and approve them prior to being on-boarded in our managed account platform for example. There is obviously a range of different commercial criteria that we will apply to decide whether to go ahead with a manager, such as the commercial viability of the project, etc. but within the bank key people are supporting this initiative.

Q: What are your criteria for selecting service providers for the platform? Can you discuss each of: custodian, any sub-custodians, administrator, auditors, lawyers, technology providers, choice of domicile?

A: We opted to set up our funds in Luxembourg, which is a traditional location for UCITS funds in Europe. According to recent data, Luxembourg UCITS funds are one of the most widely sold funds in the world. The list of our service providers is set out in the prospectus of the funds. For custody, transfer agency and administration we appointed RBC Dexia Investor Services. As the servicing of our funds tends to be more demanding than traditional mutual funds, RBC Dexia set up a dedicated team for db funds. Ernst & Young are our auditors and KPMG is responsible for tax certification in Germany. Specialist data service providers such as KNEIP in Luxembourg assist with requirements to publish NAVS in various countries and media. Our UCITS advisers are Linklaters in Luxembourg.

Q: What is the look through, all inclusive, total expense ratio, and how does this compare with non-UCITs managed account platforms, and traditional fund structures? Is your business model to take a cut from investors, from managers, or both?

A: We believe that UCITS can be a huge opportunity for alternative managers and investors and that the managers' aim should be to bring the costs of their UCITS in line with their relevant offshore strategy and investor expectations. Investors in db funds can always transparently see each element of the expense ratio, to the basis point, and make their own comparison with traditional offshore funds, where some expenses may perhaps be less transparent.

Q: Are UCITS doomed to be the Cinderella sisters of hedge funds, with diluted returns and negative tracking error?

A: It all depends how they are structured. There are examples of UCITS funds that are underperforming, albeit while offering far better liquidity and transparency. At DB, hedge fund managers have access to the most advanced ways of implementing their strategy in a UCITS fund to minimise tracking error. We have managed account platforms, as well as a very sophisticated prime brokerage platform. With CTA and macro managers, for example, our managed account platforms provide various types of UCITS structuring capabilities that most of the other providers do not offer. For example, db funds works very closely with the dbSelect team led by Hans Feder. dbSelect is a unique and extremely efficient set-up that currently allows futures/options managers to operate their strategies in a UCITS compliant format. We also have very successful initiatives in UCITS with our db X-markets platform, run by Stéphane Farouze, and our Global Prime Finance business.

Q: Does the platform offer investors the benefits of exchange memberships?

A: The strategies implemented by our UCITS funds benefit from DB's wide range of exchange memberships. The savings achieved by utilizing DB's infrastructure are passed on to the funds' investors.

Q: Is all cash essentially subject to DB credit risk? By trading in DB's name do managers get keener prices for swaps owing to the higher counterparty quality?

A: Where there is an exposure to DB via an OTC derivative, we either reset the transaction regularly to ensure that we stay within the UCITS requirements or we collateralise it with UCITS compliant securities. As you know, the UCITS rules would only allow up to 10% exposure per counterparty. For deposits, the rules allow for up to 20% of cash being deposited with a single counterparty bearing in mind that any form of risk needs to be aggregated and cannot exceed 20% per counterparty.

Q: How do you safeguard against any cross contamination risks on the platform?

A: Every fund is completely segregated legally, as well as operationally, from DB and from any other fund on the platform. All cash collateral posted by DB is held in a segregated third-party custodian account.

Q: Can the platform offer investors the chance to obtain notionally leveraged exposure to less cash intensive strategies,

by dialling up to a higher risk target as they might with a managed account? How do the costs of this compare with the costs of borrowing from a prime broker to lever an investment in a fund structure?

A: Our funds are perfectly well integrated with our managed account platforms or our prime brokerage set-up and hence benefit from any leveraged exposures they allow, provided it is done within UCITS. Note however that the rules are about to change in respect of leverage/global exposure of UCITS. The Committee of European Securities Regulators (CESR) has published, for consultation, guidelines on risk measurement and the calculation of global exposure and counterparty risk for UCITS that will likely be adopted by July 2010. CESR has emphasised that the calculation of the global exposure represents only one element of the UCITS' overall risk management process. In that context, CESR proposes detailed methodologies to be followed by UCITS when they use the commitment or the Value at Risk (VaR) approach. CESR sets out amongst others, the methodology for the computation of the global exposure when using Relative and Absolute VaR with a set of quantitative and qualitative requirements to be respected; and additional safeguards, which UCITS should put in place when calculating the global exposure with the VaR approach. CESR also defines a set of high-level principles relating to assets used as collateral to reduce counterparty risk and cover rules for transactions in financial derivative instruments. We will monitor very carefully the outcome of this consultation and ensure that we implement them as soon as possible, where necessary. Currently, we operate with more rigorous risk management standards and sophisticated tools than required by the regulator as these were already in place for the platforms we leverage to implement UCITS strategies (managed accounts, prime brokerage).

Q: How onerous is it for funds to comply with the UCITS risk reporting requirements?

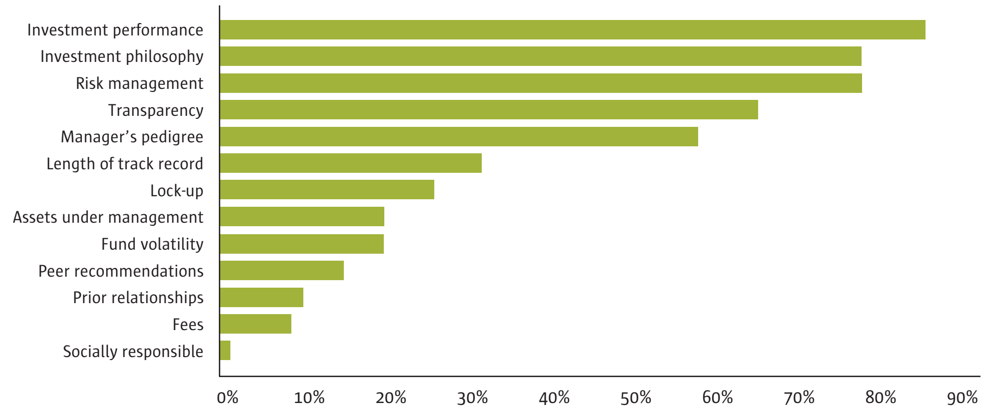
A: The UCITS rules demand a high degree of monitoring, reporting and disclosure. UCITS fund managers need to work with good partners all the way through the value chain: fund administrators and custodians, a prime broker, managed account providers, and others, to ensure all these requirements are met successfully.

Q: How many currency share classes can investors choose from? Can currency hedges be put at risk by large moves in the currency pairs?

A: DB has the ability to offer investors share classes in almost any currency including non-deliverable forwards. In practice investor demand has been concentrated in the euro, Swiss franc, sterling and the dollar. Even in Asia and Latin America, the dollar is often the most popular unit, but it is relatively straightforward to create new currency share classes in response to investor demand. For strategies on the dbSelect Platform, we have the ability to deliver FX exposures that are reset daily, which also can greatly reduce the intra-month performance-related tracking error of traditional hedging. Leveraging DB's market-leading position in foreign exchange is a significant plus for our investors.

Fig.2 What FIVE factors are most important when assessing a HF manager?

Source: 2009 Deutsche Bank Alternative Investment Survey



Q: Will you be offering other types of structured products, such as Shariah-compliant or capital guaranteed ones, on the platform?

A: The current interest rates environment has reduced investor interest in capital guaranteed products, but they could easily be done if demand revived. DB has been a pioneering force in Shariah-compliant investing and could structure many UCITS to be Shariah-compliant.

Q: Will the platform be able to accommodate UCITS IV as well as UCITS III?

A: When UCITS IV arrives in 2011, we will certainly implement the relevant measures, particularly with respect to cross border fund registrations.

Q: How far will the platform acquiesce in the use of swaps and derivatives designed to circumvent the spirit, if not the letter, of UCITS rules?

A: While we believe that the UCITS regulatory framework is very well-suited for liquid hedge fund strategies, we are extremely conservative when implementing our funds and we do this in conjunction with our legal advisers and the Luxembourg and Irish regulators.

Q: A number of leading fund of funds, including Liongate, Stenham and UBP, have complained that the UCITS universe is not yet diverse enough to run a pure UCITS fund of funds. Would you agree and how fast will this change?

A: The initiative that consists of combining UCITS with hedge fund strategies is still in its infancy, so we would be sympathetic to that view, although the team around Pascal Botteron from DB's Hedge Fund Group have managed to set up a very comprehensive UCITS portfolio where most strategies are included and represented by household names in the industry.

Note that a UCITS fund of funds only has to keep a minimum of 70% in actual UCITS funds. There is some freedom to allocate up to 30% to funds that are similar in their characteristics to UCITS, but need not be UCITS compliant. In any event, our pipeline for UCITS launches is very strong.

Q: What is your forecast for UCITS market growth?

A: It is difficult to provide numbers, but there is a lot of appetite from a variety of investors for the type of funds that are launching and every launch attracts significant interest. There are several things driving this. Investors are keen to access the liquidity, transparency and regulatory supervision provided by UCITS but within a strategy provided by a hedge fund manager. Essentially, investors want the best of both worlds. So if projections are right, this could be a market that could grow to €150-200 billion in 5-10 years.

Q: How much transparency do investors get, with what time lag, and how far can this be tailored to suit managers who are more sensitive about position data? For instance, can you provide real time risk aggregation to identify factor exposures?

A: The UCITS regulations require full portfolio transparency every six months. More frequent transparency can be offered, but is subject to the manager's consent and practicalities. DB itself obviously has full real time transparency, as do our Luxembourg custodian, fund administrator and regulators. We are able to provide in certain cases a complete risk report on a daily basis.

Q: How do you propose to raise assets? Do you have captive distribution channels or are other parts of DB operating in an open architecture framework? Would you help managers raise assets in line with the traditional third party marketer model whereby the introducer receives a cut of fees in perpetuity?

A: DB does have an impressive sales organisation that has phenomenal reach, both in terms of investors and regions. As UCITS is a popular investment vehicle in Europe, Asia and Latin America, we leverage our global network to distribute these products. UCITS funds are marketed in a similar manner to offshore funds in that they may allow the payment of rebates to distributors or allow the allocation of institutional investors in non-rebate paying share classes.

The funds that are on our platform are certainly available to our institutional/sophisticated investors and we can help managers to commercialise their UCITS fund in various markets.

Q: From the demand side, which countries are you already selling into and which are you developing distribution capabilities for?

A: The rules theoretically make Europe one market, but in practice local barriers to entry remain. These include requirements for notarised translations in Spain, for example, and, more importantly, tax reporting requirements in other countries. While the cross-border registrations work relatively efficiently, we expect UCITS IV to help simplify and render these processes more cost efficient. Traditional asset managers have been navigating these mazes since the first versions of UCITS in 1985. Hedge fund managers may find that re-inventing these wheels is not worthwhile and therefore prefer to partner with DB, which has already done much of the groundwork.

db funds is very strong in its native Germany as well as in Austria, Spain, Italy, France and Switzerland. It has some capability in Portugal and a good presence in Scandinavia and the UK. Outside the EU there is no regulatory imperative to buy UCITS, but the predictable and transparent structure makes it increasingly popular anyway. In Asia, we find sizeable interest in Korea, Singapore and Taiwan. We recently had a first China based investor investing over $60 million in one of our UCITS funds. In Latin America, Chilean and Peruvian pension funds are keen UCITS allocators.

Many US tax exempt entities, such as endowments, which traditionally prefer offshore funds, are now looking closely at UCITS as an alternative structure. We are very excited by the prospect of allowing our investors access to hedge fund strategies in a UCITS format.

Q: From the supply side, what are the main manager concerns about launching a UCITS?

A: Cannibalisation is undoubtedly their main concern. Why offer a cheaper and more liquid vehicle when you may have abundant capital locked up and paying high fees? Two counter-arguments are the sheer size of the potential UCITS market, and the possibility of attracting a new investor base to diversify business risk. The active equity mandates market is worth $50 trillion a year compared with total hedge fund assets of $1.5 trillion – and equity is, of course, just one asset class that can be wrapped in a UCITS. UCITS allows managers to diversify their investor base by attracting investor inflows that are not allowed to invest in offshore funds. Clearly where transparency or diversification or liquidity is a sensitive issue, then some managers might decide against using UCITS, but the potential growth still looks huge.

Q: What differentiates you from other UCITS platforms and other managed account platforms in general? Note that plenty of non-UCITs platforms are able to offer weekly or bi-weekly liquidity anyway. What is the split between bi-weekly liquidity, weekly and daily on the platform?

A: DB offers daily liquidity on 95% of its funds on the platform and switches between many of these funds can be made seamlessly without awaiting settlement. In any case, settlement typically takes three days. The benefits of managed accounts, in terms of transparency, liquidity, control and counterparty risk mitigation do overlap with those of UCITS. But they are also different and if structured appropriately, complement each other very well. And finally, with db funds, DB offers a very powerful platform enabling hedge fund managers to reach new investors. **THFJ**

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