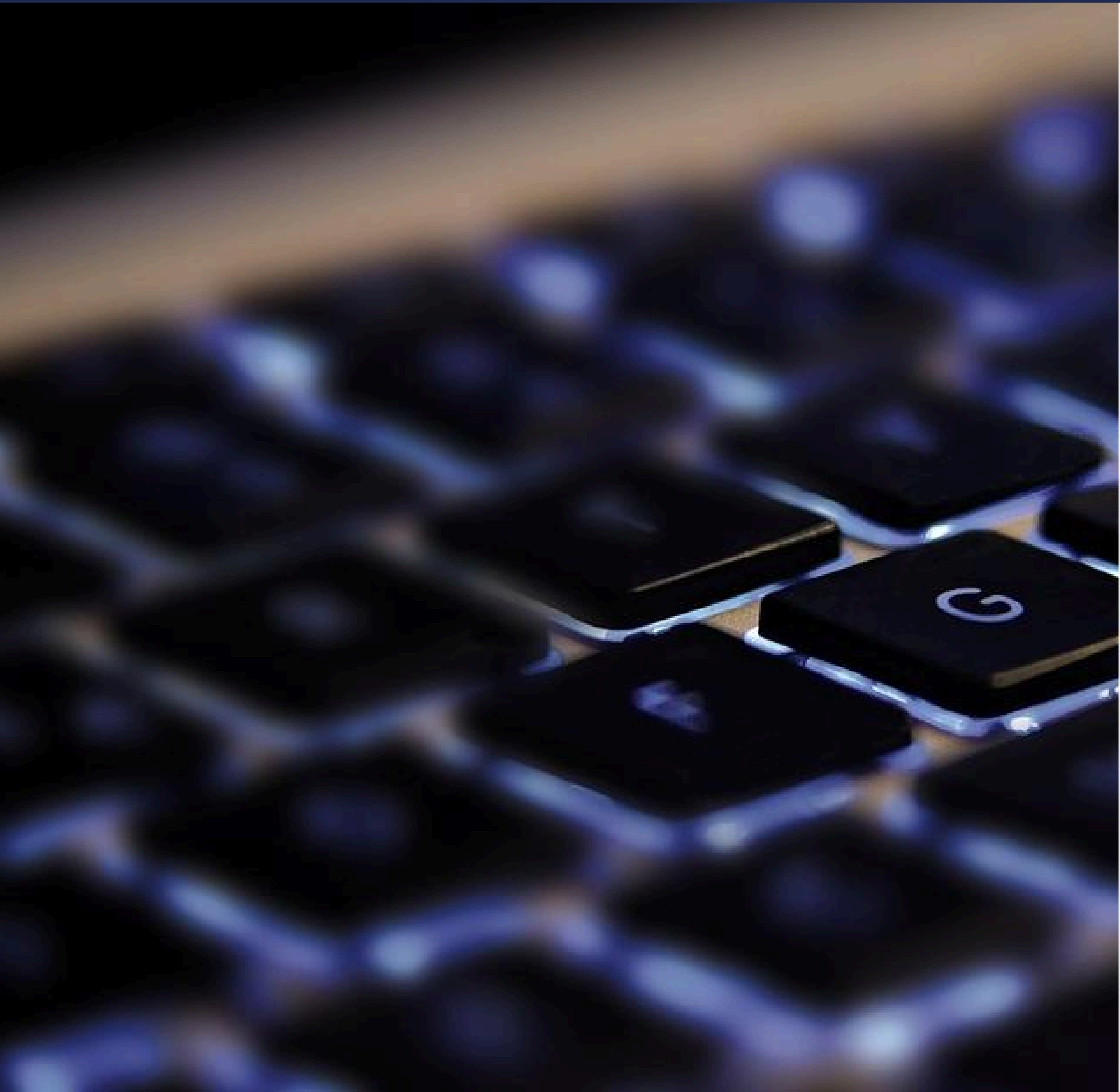
AIMA Journal Edition 109

Includes articles about:

- Sustainable investing
- Brexit and free movement
- Philanthropy
- Artificial intelligence
- APAC industry developments
- Senior managers' regime

...and more



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New year, fresh start

By Jack Inglis, CEO, AIMA

Jack Inglis, CEO, AIMA

Last year was undoubtedly an eventful year globally – both politically and in the financial markets. Potential reviews of the regulatory frameworks in the US and UK/Europe, as well as ongoing developments across Asia-Pacific, present opportunities for us to engage and help to shape policy in 2017.

This could be a watershed moment for our sector and financial services more generally. Whether it is the UK's decision to leave the EU, the US elections or changing regulatory environment across European and Asian markets, AIMA continues to be actively engaged with policymakers and regulators. As always, we will work closely with our members in constructing the industry's position across these and other discussions. Our membership already is extremely active, with around 1,500 individuals contributing to over 125 working groups and committees worldwide.

This year will see further investments in our research, our online and media presence, in our investor education programme and in our events. I was in Hong Kong earlier in January for our flagship Asia-Pacific conference, the AIMA APAC Annual Forum. We will host over 200 events this year, with our longest-running regulatory event, the AIMA Global Policy & Regulatory Forum, being held in Paris in April.

More sound practice guides and DDQs will be published in 2017. The forthcoming pipeline includes guides to MiFiD 2/MiFIR, market abuse prevention, liquidity risk management and selecting and assessing fund administrators. Our research team will produce further papers to improve understanding of hedge fund management and alternative credit.

In 2017, the Alternative Credit Council (ACC), an affiliate of AIMA, will intensify efforts through events, advocacy and media engagement across the private debt space. The ACC, which was founded in 2014, now represents around 80 managers of private credit funds. We estimate that these firms' combined AuM is roughly 50% of the global industry.

We will also continue to engage closely with politicians in the UK. Earlier in January, the All-Party Parliamentary Group on Alternatives, which AIMA is providing the secretariat for, was formally established. A series of educational events and other initiatives are planned, all with the objective of improving understanding of our sector in Westminster.

Finally, I do hope you like the new AIMA website, which we launched on January 25th. I look forward to updating you about our work globally throughout the year and wish you a prosperous 2017.

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AIMA

The news behind the headlines: Five things we learned in 2016

By Michelle Noyes, COO, AIMA

Growth. Partnership. Meeting market demand.

After all the blaring headlines, breathless commentary and political volatility, the real story about hedge funds in 2016 is now coming into view.

As the dust settles on a turbulent and challenging year, the global alternative investment industry finishes larger, stronger and better equipped to meet the needs of its diverse investor base. As we look ahead to the rest of 2017, here are our key take-aways for last year.

1. The industry did grow (again)

It was a turbulent start to 2016 and the year has not passed without its challenges – some of which have played out in the public eye. A small group of notable pension funds divested from hedge funds. The big events of the year wrong-footed even some of our sharpest minds. But by the end of the year, the headlines were these – a very small net outflow, a modest decline in the number of funds, and performance gains more than outweighing the withdrawals. By year-end, the industry had grown by about 3% overall and reached a new high of about $3.3 trillion according to Preqin.

Let's look at some of those numbers in more detail. Around $67bn net was withdrawn - 2% of total assets at the start of the year. Liquidations of individual fund products outpaced fund launches by just 1%. Public and private sector pension funds now account for 41% of institutional capital invested in hedge funds – virtually identical to last year, according to Preqin. Indeed, there was a small net increase in the number of institutional investors allocating $1bn or more to hedge funds this year, from 227 last year to 238 today.

Among billion-dollar investors, the average allocation to hedge funds is now 16.8% of total assets, up from 15.9%, while for investors with smaller allocations, it reached 14.8%, up from 14.3% last year. In terms of performance, the "average" fund produced gains of 7.4% (equal-weighted), according to Preqin, while about two-thirds of all funds were in positive territory.

2. Alignment of interest has never been closer

Investor loyalty this year was helped by increasing levels of transparency and growing alignment with managers. Disclosure of data has increased substantially since the financial crisis. Investors are given greater access to portfolio managers and other front-office staff. The IR function has grown and become ever more important and sophisticated.

"Skin-in-the-game" and the high watermark are as popular as ever. But many fund managers are clearly going much further. Investors and managers now talk frequently about the forming of partnerships. Fees have continued to come down – management fees are now

typically in the 1.4%-1.6% range. But as our 'In Concert' survey showed, some fund managers are also introducing hurdle rates, sliding fee scales and, in a few cases, clawbacks, often in return for longer lock-ups.

3. The impact of Trump and Brexit is uncertain

Brexit and the US elections were major political events that caused upheaval on financial markets and clearly provided short-term opportunities for many managers. Yet the long-term impact remains uncertain. We will be following closely the policy positions in the US that begin to emerge once the Trump administration is in place. With Brexit, the key issues for the industry, both in the UK and internationally, will involve access to investor capital and human capital. At the time of writing, we are finalising our joint position on Brexit with the Managed Funds Association (MFA), which will inform our engagement with British and EU policymakers and regulators in 2017.

4. Tech transforming hedge funds

2016 was notable for the prominence of FinTech. While we are still in the early innings, a survey we conducted earlier this year with KPMG and the MFA found that 94 percent of hedge fund managers believe that technology will have an impact on competition over the next 5 years. Much of the industry's investment in technology is going to improve compliance, efficiencies and controls, and investor relations but managers are also looking to disruptive technology in the form of artificial intelligence, predictive analytics and automated trading. Interest in applications of block chain is still quite nascent. As hedge funds start to rely more heavily on technology across their front, middle and back office, many managers are becoming increasingly concerned about data risk. Cyber security is a top level agenda item and will attract significant investment.

5. Alternatives increasingly filling a void

During 2016, alternative investment managers continued to fill voids left by banks. Fund managers are lending to businesses and financing social investment projects. Investor appetite in such investing was strong and credit strategies performed well. Managers are also providing vital liquidity to markets - as our report with State Street, 'Let's Talk Liquidity,' found, nearly half of respondents felt decreased market liquidity was a permanent shift, while three-fifths felt market liquidity had affected their investment management strategy. Amid increasing numbers of alternative investment managers playing a market-making role, the industry is providing a solution to this long-term challenge.

Conclusion

As we look ahead, a number of predictions seem safe to make. The global alternative investment industry again will see winners and losers. Investor education will become ever more necessary as trustees and fiduciaries increase scrutiny of hedge fund allocations. The need for the industry to engage constructively with policymakers and regulators in the US and UK following this year's election shocks will be even more vital. And as alternatives continue to be features of the investment mainstream and play a vital role in economic growth, we are confident that 2017 will produce even more success stories for this diverse group.

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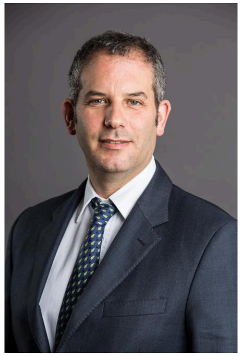
Mobilising the industry for a positive environmental impact

By Adam Sweidan, CIO at Aurum Funds Limited



Adam Sweidan, CIO at Aurum Funds Limited

Introduction

For the majority of hedge fund businesses, environmental issues remain at the periphery of business management and investment strategies. However, institutional investors are increasingly thinking about what sustainable investment means and how they should be capturing this when they assess fund managers. Whilst developing environmentally sustainable investment strategies presents significant complexity, with very few hedge fund managers pursuing this approach, environmental impacts can be addressed at a business level by all hedge funds as part of their Environmental, Social and Corporate Governance (ESG).

The 'E' in ESG

The Directors of Aurum Fund Management Ltd. ("Aurum") had lengthy discussions over two years ago about how to begin to address the 'E' in ESG and this kick-started a process that took us much deeper into considering what the reality of environmental impact looks like and what our actions could set out to achieve.

Like most businesses we looked at consumption we could measure; energy, paper and water use. We then set out to look at what we could reduce and then what schemes were available to 'offset' this consumption.

What does offsetting do?

The notion of 'offsetting' is an interesting one. The term is now in common usage and one dictionary definition tells us the verb means to 'Counteract (something) by having an equal and opposite force or effect'. It is important to question the accuracy of this definition when applied to the use of environmental offsetting in the business world. To answer this we need to understand what environmental impact actually looks like. To go beyond litres of water and tonnes of CO2 emissions to the impact on landscapes around the world.

Environmental impact is not a discrete set of independent factors that can be individually 'offset', or a portfolio of assets that can be perfectly 'hedged'. Our natural environment is a complex web of inter-dependencies that we are currently unable to map accurately. We are in the foothills of understanding how ecosystems work and being able to model how these systems change as conditions change. This tells us that 'offsetting' is a misnomer and is mitigation at best.

The complexity of environmental impact

Before coming up with potential solutions, we need to properly understand the problem. What is the impact that our global activity is having on the natural systems that support our lives? A good place to start is by looking at some high level data on species populations that helps us measure the state of the world's biological diversity.

The Living Planet Index1 is produced through a joint venture between the Zoological Society of London (ZSL) and WWF and is a core part of the biennial 'Living Planet Report' by WWF. The report just published in October shows that for vertebrate species, populations declined by 58% between 1970 and 2012 (the previous report in 2014 showed a decline of 52 % between 1970 and 2010). This is a statistic that should cause us all to pause and think.

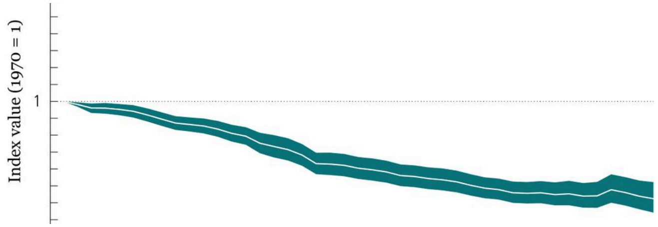
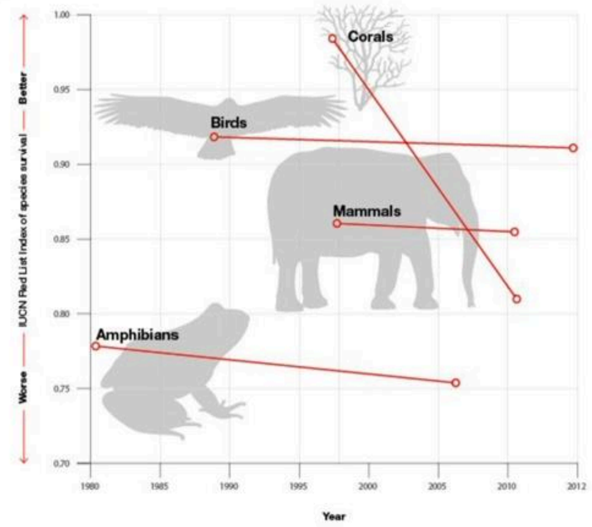


Figure 2: The Global Living Planet Index shows a decline of 58 per cent (range: 48 to 66 per cent) between 1970 and 2012. Trend in population abundance for 14,152 populations of 3,706 species monitored across the globe between 1970 and 2012. The white line shows the index values and the shaded areas represent the 95 per cent confidence limits surrounding the trend (WWF/ZSL, 2016).

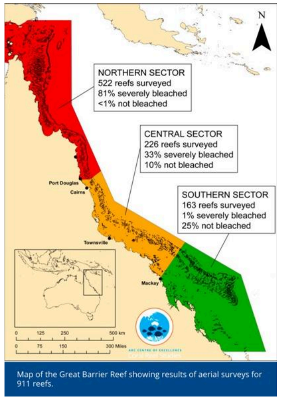
ZSL and WWF Living Planet Index: population trend for vertebrate species from terrestrial, freshwater and marine habitats

Rather than looking at individual species we can also look at higher classes of species using data from the International Union for the Conservation of Nature, (IUCN) Red-List Index (RLI). This index was created to track trends in extinction risk of different taxonomic groups and as the graph shows, for the four groups for which there is sufficient data, Corals have suffered the most extreme decline, whilst Amphibians are the most endangered group.



IUCN Red List Index: An RLI of 1.0 equates to all species qualifying as ''Least Concern', whilst an RLI of 0 equates to all species having gone 'Extinct'.

One of the drivers of rapid coral decline has been warming ocean temperatures as a result of Climate Change, with the latest El Nino causing widespread coral bleaching. A study published by the ARC Centre of Excellence for Coral Reef Studies, at James Cook University, Australia, published in April this year showed the extent of coral bleaching on the Great Barrier Reef. As the map shows, in the northern sector of the reef, 81% of reefs were severely bleached, with less than 1% untouched.



ARC Centre of Excellence for Coral Reef Studies, James Cook University, Queensland, Australia: Map of the Great Barrier Reef showing results of aerial surveys for 911 reefs

All this data tells us that ecosystems and global biodiversity have been in serious decline for the past 50 years and more. We are now having to consider how the impacts of climate change will further complicate the outlook for our natural systems.

Our natural systems have evolved over many thousands of years and the process of evolution constantly balances the diversity of species within an ecosystem and the resilience of the ecosystem. As we reduce biodiversity we reduce the capacity of ecosystems to adapt to changing conditions or shocks to the system and we know that climate change is bringing about change across the globe. In this context the importance of biodiversity is even greater.

So how should businesses approach the complexity of mitigating their environmental footprints? These footprints are not just carbon emissions, although these are an important constituent. They include all the components that go into computers and mobile phones as well as buildings and office furniture. This takes us into a web of supply chains that stretches across the world, with the ends of many supply chains in developing countries, where the rate of environmental change is the greatest.

Single dimension solutions do not answer multi-dimensional problems

Using a carbon 'offsetting' approach is a step in the right direction, but it is a one- dimensional solution to a multi-dimensional problem.

Having understood this, what does a multi-dimensional approach to environmental mitigation look like? Aurum started with carbon emissions and carbon offsets, but soon started to look beyond this. The goal was to have a broader and more positive environmental impact reflecting the complexity of our footprint.

Regenerating Ecosystems; a multi-dimensional approach

Aurum partnered with conservation organisation, Synchronicity Earth and with their help devised a 'Regeneration' approach to this problem. Synchronicity Earth works with a broad range of local and mutli-national Non-Governmental Organisations (NGOs) that are undertaking conservation work in developing countries in collaboration with local communities. Their Regeneration partners set out to regenerate landscapes using the range of species native to an area with the long term aim of re-establishing biodiversity and species abundance. This also results in carbon sequestration, improved freshwater catchments and reduced soil erosion.

Aurum's 'Regeneration' initiative is a two-year funding partnership with Hutan, an NGO partner of Synchronicity Earth. It was established in 1998 to restore highly degraded and fragmented forest patches in Sabah, Malaysian Borneo. This part of Borneo has already lost 80% of its forests to palm oil plantations. The forests that remain are vulnerable to further degradation, leaving wildlife isolated in 'islands' of forest where small populations are often not viable over the long term.

Hutan has been rehabilitating wildlife habitat and forest corridors with local staff since 2003 by planting a broad range of species of native, fast-growing tree species in areas where regeneration does not naturally occur. These forest corridors aim to provide shelter, food and connectivity for orangutans and many other animal species, as well as restoring carbon stocks and reconnecting ecosystems. This means that regenerating key areas of connecting forest can amplify the impact by re-connecting ecosystems that are sustainable over the long term.

Hutan team members monitoring tree regrowth

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Benefits for people and the environment

What we have also learned is that the funding Aurum is able to provide to Hutan also supports livelihoods, gender equality and education. The team replanting and nurturing seedlings are local paid staff, who are now predominantly female. They have become firm supporters of the regeneration project and their role in the project has changed the status of these women in their community. At the end of 2015 we heard that a local young woman had left the project. What we initially thought of as a set-back turned out to be one of the best demonstrations of impact to date. This young woman had gone to University to learn more about environmental science, having been inspired by the work she had done as part of the project team.

Aurum is not alone in this approach

Other businesses in the hedge fund industry are now using this approach. Recently Albourne hosted a conference in Singapore and mindful of the environmental impact of participants travelling long distances, they decided to support a Regeneration project, restoring mangroves in Thailand, also partnering with Synchronicity Earth.

Another London based hedge fund is funding a Regeneration project in Ecuador, which will support a forest reserve in an area of rich biodiversity and begin reforestation to link the reserve to nearby protected areas.

The capacity of the sector to both understand the problem and be an important part of the solution is enormous and the data in the 'Living Planet Report' published by WWF in October reminds us how urgent the need is for action.

Can the hedge fund industry have a new, positive environmental impact?

The hedge fund industry understands complexity and risk. A sector strength is analysis of data and seeking to understand the impact of trends and system changes. By extending this approach to how businesses approach environmental impact, the sector could be a genuinely positive force for change.

Funding regeneration of ecosystems can produce long term, sustainable and measurable positive environmental impacts. If done with local people the benefits are as multi-dimensional as the impacts we are attempting to mitigate. This approach has fundamentally changed the way many of the team at Aurum think about the environment and interest in the project continues to grow.

Conclusion

If our actions to mitigate environmental impact do not bring about behaviour change and a positive change in the biodiversity and landscapes around us, our actions are of little consequence. I would encourage other businesses to engage more deeply with what environmental impact looks like and set out to have a measurable and positive impact on the enviornment by using muti-dimensional approaches such as Regenerating ecosystems.

References:en

1. Living Planet Index
2. The Living Planet Report
3. Food and Agriculture Organisation of the United Nations, 'The State of World Fisheries and Aquaculture 2016'

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Asset Managers: Should your Head of Legal be included within the approaching Senior Managers Regime?

By Emma Sutcliffe, Partner, and Lilian Small, Of Counsel, Simmons & Simmons LLP

The focus of the Financial Conduct Authority ("FCA") on corporate governance, structural reform and investor transparency within the asset management sector continues to pose a significant regulatory burden on the industry. As part of those regulatory developments, the extension of the Senior Managers & Certification Regime ("SM&CR") to the asset management sector is now becoming more pressing as indications from the FCA suggest that the SM&CR will be rolled out across the industry from 2018.

One critical issue is whether the SM&CR should include the head of the legal department as a Senior Manager. This is an issue which has prompted widespread debate within the regulated industry and prompted the FCA's Discussion Paper 16/4 titled "Overall Responsibility and the Legal Function" (the "Discussion Paper").

The reaction of our asset management clients to the issues in the Discussion Paper significantly varied across the industry and appears to be impacted by a number of factors, including: whether the legal function is viewed as advisory or as a control function; the size of a firm's legal function; whether the head of the legal department is a member of the board or other decision making committees; the geographical footprint of the firm, including where decision making is centralised (particularly where a firm is headquartered outside the UK); whether the head of legal also performs another Senior Manager role; and the structural complexity of the firm.

AIMA itself has submitted a response to the Discussion Paper as a result of canvassing views from its members. Additionally, Simmons & Simmons has submitted a response to the Discussion Paper on behalf of its clients which includes banks, asset managers and other financial services firms. Simmons & Simmons' response captures the varied feedback received from clients across the financial services industry, and ranges from those who favour the inclusion of the head of legal within the regime to those who believe it would be inappropriate to regulate an advisory function.

As might be expected, there was a large degree of similarity in the views of AIMA members and the wider regulated community. However, as a general trend, for some of the larger asset managers where the role of the General Counsel or head of the legal department is regarded as integrated with the business and not just seen as advisory, and where the head of legal works closely with, say, the head of compliance, there was more acceptance that the role should be included within the SM&CR subject to certain reassurances, carve outs and qualifications. We summarise the Simmons & Simmons response to the Discussion Paper below.

The head of the legal department should not be included within SM&CR

A number of firms strongly consider that the head of the legal department should not be, and was not intended to be, included within the SM&CR. In summary, these firms consider that:

- the statutory definition of a "business area, activity or management function"[1]

should not include the legal department; this was made clear in the Parliamentary debate preceding the statute's creation and subsequently in its definition;
- the role of the legal department is to provide legal advice; it is an evolution of bringing external legal advisors in-house to deliver a dedicated and specialised legal service; the FCA clearly cannot intend to regulate external legal advisors so it is unclear why they would seek to regulate the same role brought in-house;
- while there is recognition of the FCA's objective to create a 'no gaps' approach, the purpose of the SM&CR is to deliver individual accountability of senior management who are performing high risk external or internal facing business functions; as such there is no 'gap to plug' by including the legal department within the SM&CR;
- it is not possible or practical to separate (as the FCA suggests it is) the advisory role of the legal department with the management of that role; the two are in reality entirely connected; and
- the proposed inclusion within the SM&CR would put the head of the legal department in unmanageable positions of conflict; he or she would not have control over demonstrating the reasonable steps he or she had taken (COCON 2.2, SC1) if he or she could not waive privilege over the advice given by the legal department (which would be owned by the firm, as the client); he or she would have competing obligations between his or her duty as a lawyer and his or her obligations under SC4 (COCON 2.2.4); the independence of his or her advice would be, or would be perceived to be, affected; he or she may face a variety of conflicts as a result of being dual regulated.

The head of the legal department should be included within SM&CR

However, a number of firms do not, in principle, take issue with the inclusion of the head of the legal department within the SM&CR. This was particularly the case where the head of the legal department performs another Senior Manager role, where the legal department performs what they consider to be a 'control function' or works closely with other control functions (e.g. compliance), or frequently in smaller or less structurally complex firms. In summary, they consider that:

- while hopefully unlikely, it is possible that a failure in the management of the legal department could lead or contribute to significant failings by the firm; alongside the role of giving legal advice, those firms consider that managing the legal department is part of the role as head of that legal department. In many cases, the General Counsel will be the appropriate person to do this;
- there is, at least hypothetically, a distinction between 'management' (and the need to ensure there are 'no gaps' in management) and the giving of legal advice; nonetheless they would welcome clearer guidance on the practical challenges as to how the FCA intends to distinguish between the two; and

- while there remain concerns about the protection of privileged communications, the independence (and perceived independence) of the legal department, handling conflicts where they arise, these firms considered it may be possible to manage these issues with appropriate guidance and published clarification from the FCA.

As part of the Simmons & Simmons response we included some case scenarios to draw out some of the potential issues around including the head of legal within the SM&CR and invited the FCA to answer questions on how these scenarios would be handled.

Conclusion

Notwithstanding the broad spectrum of views expressed by the firms we consulted, almost all remained concerned that issues surrounding legal privilege, its protection and the ability of the head of the legal department (or indeed other Senior Managers) to demonstrate they had taken reasonable steps (especially in an investigation/enforcement action) where they were not the owner of the legal privilege, has not been adequately addressed by the FCA. There is overwhelming consensus amongst regulated firms and industry bodies that the FCA should provide detailed guidance following a formal consultation process. In particular, Simmons & Simmons proposed that the FCA should:

- clearly define what amounts to "management";
- consider carefully the impact on legal privilege, the risk of erosion of LLP, and what reasonable steps a Senior Manager would need to take to demonstrate that his or her duty of responsibility had been performed in circumstances where he or she cannot waive privilege over LPP communications;
- consider how the head of legal would manage any conflicts between his or her professional obligations and his or her duty to the regulator; and
- explain how it would approach enforcement action against the head of the legal department given the conflicts and issues surrounding LPP.

In light of the wide and varied response from across the regulated industry to this Discussion Paper and the impending introduction of the SM&CR to the asset management community, we await with interest the FCA's response to these submissions.

Footnotes:

[1] Section 59ZA of the Financial Services and Markets Act 2000

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This document is for general guidance only. It does not contain definitive advice.

Defining the role of philanthropy in the hedge fund sector

By Tony Cowell, Head of Alternative Investments at KPMG (Cayman Islands), and Co-Chair of the Editorial Committee for the Cayman Alternative Investment Summit (CAIS)

Tony Cowell, Head of Alternative Investments, KPMG (Cayman Islands), and Co-Chair of the Editorial Committee for the Cayman Alternative Investment Summit (CAIS)

The job description for the typical hedge fund manager used to be pretty simple—generate alpha.

Investors derived value from hedge funds for their ability to provide diversification and outperformance. This is still true today, with many managers now expanding beyond the "alpha" umbrella to also talk about things like "risk management" and "capital protection."

However, with the industry now representing more than $3 trillion in assets under management and key figures playing prominent roles in global markets and monetary policy, I think it's time to add a new job requirement—"acting socially responsible."

In recent years, publicly traded companies have had to grapple with simultaneous demands to generate returns for shareholders while also practicing corporate social responsibility. Now, there is increased pressure on the hedge fund industry to do the same—generating returns for investors while also embracing its role as a leading source of philanthropic capital.

Of course, many investors are already doing just that. A significant number of veteran hedge fund managers have established their own foundations, launched conferences, or supported charitable causes. For example, Paul Tudor Jones founded the Robin Hood Foundation in 1988 to help fight poverty in New York City. Since then the organization has pumped nearly $2 billion into local poverty-focused programs, and its board of directors now includes several luminaries of the hedge fund industry.

Hedge funds are also an important contributor to various large-scale initiatives, like the United Nation's Sustainable Development Goals and climate agreements, which require the mobilization of a full spectrum of financial resources.

The importance of these efforts can't be overstated, but there's more work still to be done.

At the Cayman Alternative Investment Summit (CAIS), an annual conference that gathers thought leaders from across the alternative investment industry, one of the most popular panels is on philanthropy. Chaired every year by Lord Michael Hastings, Global Head of Corporate Citizenship at KPMG, the panel aims to inspire delegates to be responsible individuals and to support philanthropic efforts both locally and internationally.

The recurring theme shared at these panels, which in past years has featured leading philanthropic figures such as Sir Richard Branson and Kerry Kennedy, is that more needs to be done to bridge the gap between the financial world and the charitable world. The solutions vary widely—impact investing, ESG investing, mission investing, charitable donations, and more. But the fact remains that non-profits and other humanitarian organizations are starved for capital, while hedge fund managers represent one of the most prominent potential sources of capital. The two need to find a way to come together.

Here I outline three suggestions to help push the industry, and the world along with it, forward.

1. Embrace a hands-on approach.

There's a reasonable temptation for a hedge fund manager to sign a six- or seven-figure check once a year and be done with it. After all, they have billion-dollar portfolios to manage, and likely don't have the time to properly vet which charitable causes are the most in need and where their capital will have the most impact.

Fund managers are wired to think through every investment decision, looking for any potential advantage that might signal which direction a security might move. However, the philanthropic world just doesn't work that way. There's no unified global database for charitable causes, with standardized details on the potential return on investment for each donation. Although some managers have privately built sophisticated systems and dashboards that can measure impact, these systems still can't speak to each other or leverage the power of big data.

That's why it's important for hedge fund managers to take their philanthropic activity more seriously, and get involved in the decision-making process of which causes to support and how. Hedge funds can also play a major role in pushing charities and other non-profit organizations to focus more on the impact of each dollar, an area where financial and investment expertise can be particularly helpful. It may be worth a regular phone call or in-person meeting to make sure all parties are aligned on the mission and how best to execute and allocate capital. For an even more hands-on approach, hedge fund managers should consider sitting on the boards of the charities they want to be involved with.

Hedge fund managers are traditionally advocates of active management. They should embrace this philosophy in all their endeavors, especially charitable ones.

2. Partner with philanthropic organizations.

Still, no matter how much time an investor spends vetting potential philanthropic opportunities, they're unlikely to have as good of an understanding about a particular cause as the individuals who work in the non-profit space every day. That's why many managers are now turning to strategic partnerships—with other investors, public and private foundations, universities, financial institutions and business leaders—to maximize the impact of their philanthropic activity.

For example, a consortium of high-profile investors, along with long-time charitable advocates like Bill Gates and Jeff Bezos, recently announced a $1 billion venture fund that will invest in clean energy technology. Other firms are showing their commitment to social responsibility by joining trade associations or signing pledges dedicated to responsible investing, such as the United Nations' Principles for Responsible Investment, which requires all signees to adopt six voluntary principles, including incorporating ESG into their investment analysis and decision-making.

Research has shown that these types of partnerships greatly expand the reach of things like impact investing and philanthropic capital. Much like how an institutional investor makes a big upfront investment in a newly launched fund as a sign of confidence, hedge fund managers can use their wealth to "seed" philanthropic initiatives and help convince other parties to come on board. Another advantage of these partnerships is that they bring together people from diverse backgrounds and areas of expertise, which means the charitable initiative is more likely to reach a wider audience and thus be more successful.

3. Share success stories.

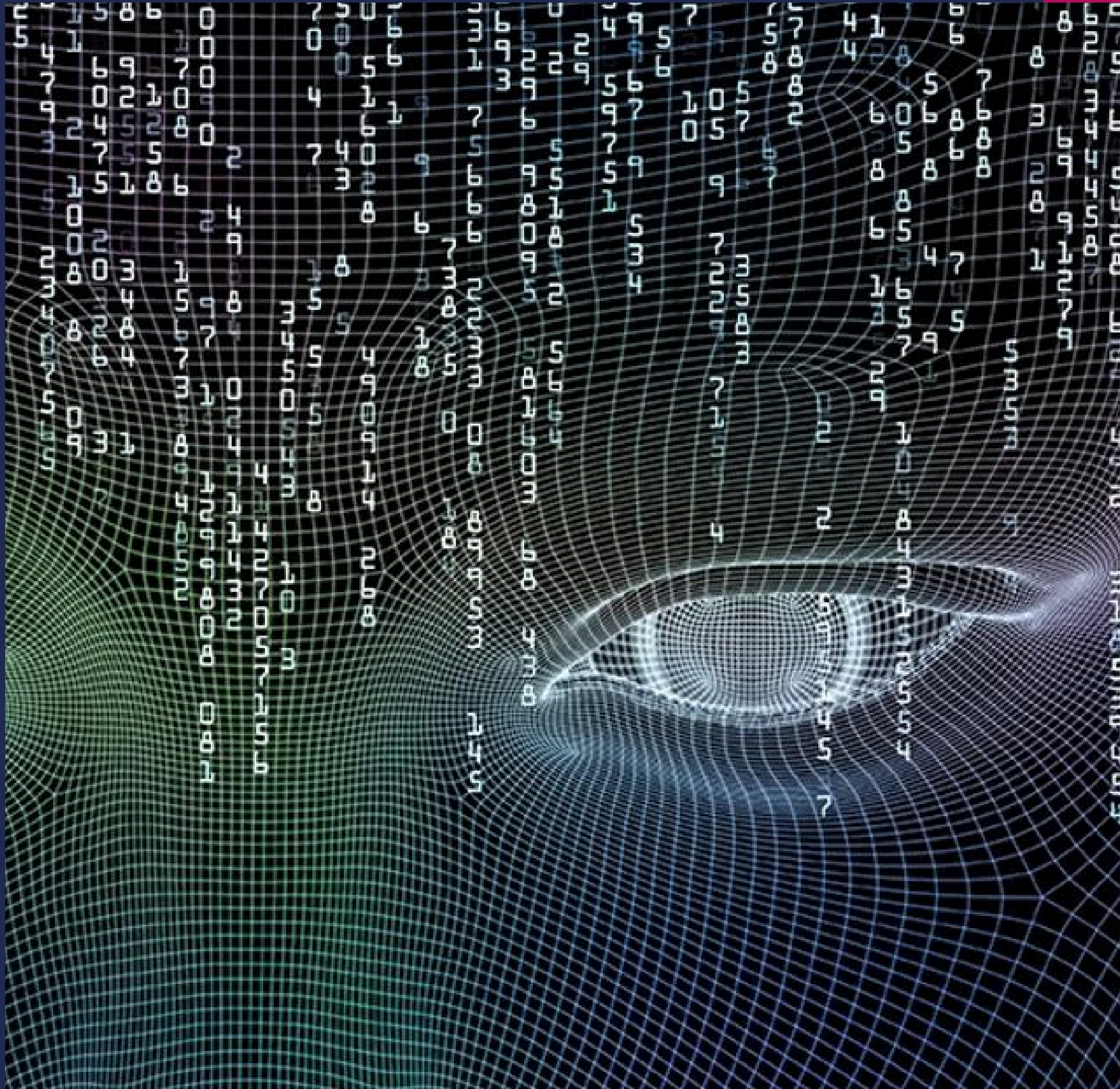
Hedge fund managers, still to this day, have a reputation for wanting to stay in the shadows. There's also a perception that if they talk about their philanthropic activities, they won't be taken seriously because the general public may just view it as an example of them trying to "save face."

While this is an understandable concern, the reputation of the hedge fund industry won't improve unless its leaders are more forthcoming. Investors shouldn't have to hide their charitable efforts—they should shout them to the world. Hedge fund managers, as stewards of capital, are some of the brightest and most well-respected minds in the world. They should take the lead in raising awareness for a particular cause, and encourage others to contribute in the process.

Philanthropy isn't like the rest of the investment world where there's always the threat of a competitor jumping on an idea and reducing the return potential. In fact, it's just the opposite. Philanthropy is most effective when it's an all-in effort, with contributions coming from all over rather than just one source. There's no competition for who can donate the most money or make the biggest difference—it has to be a collaborative effort. It's time the hedge fund industry as a whole embraces its potential as a champion of social causes, and helps lead the fight to build a socially responsible world.

Tony Cowell will give the opening address at CAIS 2017, scheduled for February 15-17 in the Cayman Islands. Lord Michael Hastings will moderate the last panel of the event, titled: "The Birth of Stars: An Explosion of Philanthropy." For more information, please visit www.caymansummit.com. AIMA is proud to support CAIS 2017.

AIMA



The rise of machine learning

By Dr Anthony Ledford, Chief Scientist, Man AHL

Dr. Anthony Ledford, Chief Scientist at MAN AHL

Quantitative or systematic investing has evolved rapidly in recent years, particularly as the opportunities provided by artificial intelligence and Machine Learning transition from the laboratory through into client portfolios. At Man AHL ('AHL') Machine Learning is a core area of research effort both within AHL and at the Oxford-Man Institute, our unique collaboration with the University of Oxford.

So what is Machine Learning? Machine Learning is a catch-all name for a range of applied practical algorithms that aim to identify repeatable patterns and relationships within observed data, and importantly without having to be told explicitly what kind of patterns and relationships to look for – the algorithms work that out for themselves. This is what distinguishes Machine Learning from more traditional data analysis techniques. Such algorithms arise in computer science, information engineering, statistics and various mathematical disciplines, so Machine Learning is best thought of as a hybrid discipline. Just as there have been Machine Learning breakthroughs in many other areas of applied science and business, it is also having a positive impact on quantitative investment.

"Machine Learning… can identify repeatable patterns in data, without having to be told what patterns to look for"

Commentary on Machine Learning has recently hit new volumes, but Machine Learning is not a new subject. Indeed, it was in 1957 that Frank Rosenblatt invented the Perceptron – a machine that could learn to classify images – and today's rapid developments in Machine Learning are built on three separate and long running revolutions:

Computing power – this has broadly doubled every two years since the 1970s (Moore's Law);
Data generation, storage and retrieval – it's estimated that 90% of the data in existence today were created in the last 2 years, whilst in 1981 a Gb of storage cost $300,000 today the price is below $0.10[1];
Methodology – practical techniques from statistics, computer science, mathematics and engineering have matured and amalgamated into powerful new algorithms.

In recent months we have seen Google's Machine Learning AlphaGo system beat South Korean Lee Sedol, one of the world's most decorated Go players, by 4 games to 1. The game of Go is reported to have more possible board configurations than there are atoms in the universe. Given this, some commentators have asked whether the same computational fire-power[2] can be recalibrated to tackle the "game" of investment. The reality is unlikely to be straightforward. Go has total observability and fixed clear rules, but with investment the "rules of the game" are more nebulous and are prone to change over time e.g. through regulatory, economic or demographic influence.

We think that an investment world of unbridled artificial intelligence with people rendered redundant is some way off. We do, however, think that machines will continue to enable investors to benefit from areas that the human brain struggles to reach. Homo sapiens individuals have strong pattern recognition ability over small homogeneous datasets but they struggle as the information set becomes larger and more varied. This is undoubtedly the case for financial information, which is not only burgeoning in size – AHL alone receives around 1.5bn data ticks every day – but is also very diverse, consisting of the obvious numbers and text, but also more unusual information sources. For example, in the case of energy and crop markets, important information may be found in meteorological diagrams and weather

Image recognition using Deep Learning techniques, illustrating the potential of Machine Learning algorithms to recognise structure in complicated data sets. The algorithm was trained using an extremely large dataset of images. Left image: original picture, Centre: outline marked by human, Right: outline as determined by Machine Learning algorithm. A Machine Learning researcher in Man AHL worked on this project when previously employed as a Postdoctoral Research Fellow at the University of Oxford.

Machine Learning applied within quantitative finance offers a coherent, versatile and practical way of combining numerous and varied weak information sources into investment systems that have greater signalling power than any individual source. Such systems capture insights that both human intelligence and less sophisticated systematic models may miss.

The data modelling challenges remain formidable, however, not least because financial datasets are vastly more noisy than those typical of the applications where Machine Learning has scored its greatest goals.

The Oxford-Man Institute (OMI) – with its focus on Machine Learning applied to quantitative investment – is at the forefront of academic Machine Learning research and is ideally placed, through its co-location with AHL's research laboratory and the Department of Engineering Science's Machine Learning Research Group, to collaborate with AHL's research teams. The OMI also makes broad academic contributions across a range of disciplines, and solutions in one domain can resonate strongly in quantitative finance and investment. One such example is the Galaxy Zoo Supernovae project[3] which presents online volunteers with astronomical images and asks them to classify what they see. Answers from the vast ensemble of volunteers are aggregated using Bayesian Machine Learning to determine which images contain supernovae. Collaboration between the OMI and AHL enabled the methodology for solving this astronomy problem to be applied to the task of extracting predictive signals from broker recommendations. Both applications involve classification decisions based on groups of potentially conflicting evidence where the abilities of the individual astronomers or analysts have to be learned and coherently combined. We expect to find similar examples where methodology is transferable across disciplines as our research efforts in Machine Learning increase and progress.

AHL has been researching Machine Learning techniques for around five years, and trading Machine Learning components within its multi-strategy client programmes since early 2014. The practical usefulness we have obtained with these systems echoes the considerable experience of Professor Stephen Roberts (OMI Director, Royal Academy of Engineering / Man Group Research Chair in Machine Learning) and his 30-strong research group in other practical high-impact cases, e.g. in-flight monitoring of aerospace systems. The University's Engineering Science Department – of which the OMI is formally part – has a broad portfolio of real world Machine Learning projects underway, including self-driving cars[4] and computer vision[5]. In all these cases, there are clear implications for getting it wrong.

The Galaxy Zoo and image recognition examples are just two instances where AHL has been able to migrate applied Machine Learning research from academia and non-finance areas into its systematic investment research. The potential for Machine Learning to be used in AHL's client programmes is vast, and we believe we are just starting-out on this journey. Through the partnership with Professor Roberts, his team at the OMI, and the wider expertise within the Department of Engineering, AHL is in a position to access cutting-edge research in the field, and intends to build-out its palette of machine learning across all of its investment vehicles.

Find out more:

AHL Explains – Machine Learning, www.ahl.com/insights/machine-learning

Footnotes:

[1]https://www.ibm.com/developerworks/co... http://notebooks.com/2011/03/09/hard-dri...

[2]The deep learning approach used in AlphaGo contains a modern-day extension of artificial neural networks, which can in-turn be traced back to Rosenblatt's seminal work.

[3]See https://www.galaxyzoo.org/

[4]Robot Car: http://mrg.robots.ox.ac.uk/application/r...

[5]Vision Group: http://www.robots.ox.ac.uk/~tvg/

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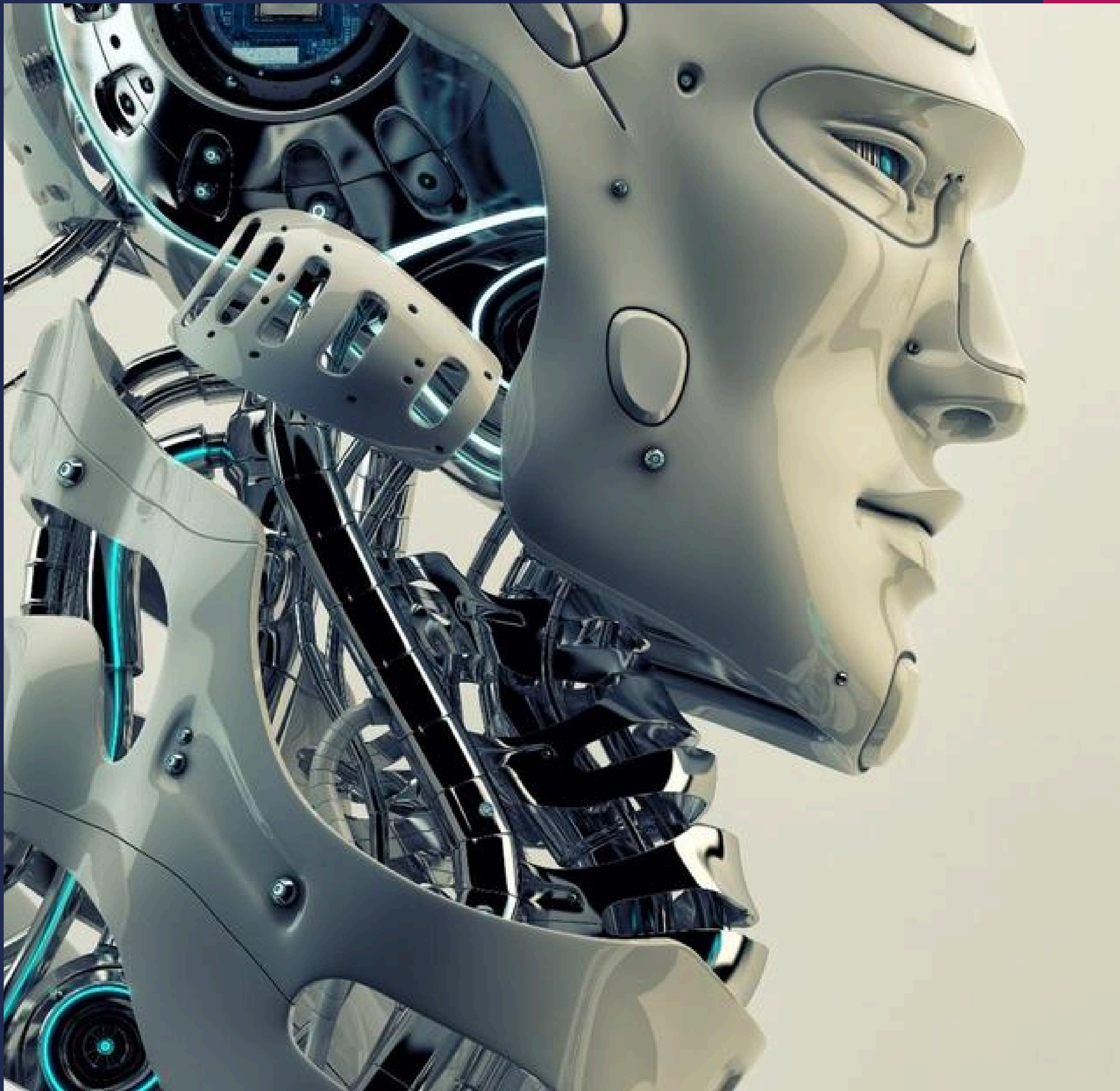

Fund Operations of the Future

By KB Venkataramanan, Chief Information Officer, and David A.A. Ross, Global Head of Marketing, Viteos Fund Services LLC

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Technology is driving a digital transformation across investment management. In the future, operating a fund across borders without friction or delays; offering multiple services at low cost; and providing new services at a moment's notice will be the price of entry. Middle and back office operations will see significant advances in speed and automation. Settlement and cash management will occur instantly, governed by rules guided by cognitive intelligence engines to instantly manage no fee, cross border payments in public ledgers that offer unprecedented transparency without compromising traditional notions of privacy, effectively eliminating today's burdensome reconciliation process. A common framework for compliance functions will become one of the earliest entrants, forming the basis of the most ubiquitous services in the years to come. While to date most compliance services have related to the macro economics of one specific country, there will be a gradual shift to a more homogeneous framework as countries reach consensus on what constitutes risk that should be monitored.

If this sounds like science fiction, it's time to face reality. While this new breed of operational efficiency is still nascent, most of it is here today and adoption will soon be widespread.

The Sharing Economy, Digital Convergence and Open Standards

Today, most fund management systems are monolithic proprietary entities created and supported by a single vendor, typically running on owned or leased infrastructure. Customizing software is a complex, ongoing process requiring significant investments in resources.

Over the next few years, monolithic solutions will begin to look like dinosaurs. Newer applications will be small—designed to do one thing better than any similar application.

Today, integrating applications from different sources is complex and costly.

In the future, software will be designed with standardized open protocols that allow it to accept data from many sources in many formats.

Progressive managers will pick and choose from a variety of "single purpose" applications which work together seamlessly.

These applications will be built using a common industry-standard connection and able to interact with data in a variety of formats, including Swift, XML and new formats yet to be determined.

Two of the most sought after of the new breed of service applications will be identity management and KYC to provide identity assurance in a virtual world.

Artificial intelligence will become a cornerstone of services as providers seek to process any routine quickly and cheaply while also recognizing evolving rules and incorporating those changes without programming delays.

Startups and Funding Climate

According to Forbes, more than $1 Billion has been invested in Blockchain based startups since 2008. Ethereum, T0, Enigma, Kraken, Digital tangible trust, Liquid and Accelerator are all attracting funding for new ideas based on cryptocurrency and blockchain technologies.

Security, Privacy and KYC

The current industry focus on reconciliation will disappear with the rise of public multi-entity distributed ledgers such as Blockchain, which don't require reconciliation and offer nearly complete anonymity.

As firms pass data more freely, the potential for malware and identity theft increases significantly. This threat has given rise to new forms of cybersecurity tools that use cognitive learning, AI and natural language to quickly identify abnormal activity without relying on old-style pattern recognition. Darktrace and DeepArmor are two of this new breed.

Most of today's privacy regulations are driven by individual governments with different regulations for sharing information, causing difficulty in abiding by KYC regulations, forcing compromises on business processes and introducing friction that impedes data velocity.

As a common business platform achieves critical mass, many of these differences will disappear in favor of uniform data sharing rules, similar to the way the adoption of the Euro led to common rules that enabled the free flow of goods.

Strong KYC applications will be one of the first prerequisites for digital transformation. Since most processing will actually be done in the cloud, the location of the systems will become less and less relevant except where it relates to government regulation of data storage.

The Impact of Distributed Ledgers and Smart Contracts on Reconciliation

Many firms outsourced reconciliation and NAV processes to offshore facilities or sub-contractors to save money and to take advantage of "follow the sun" reconciliation.

Blockchain is a sharable, public ledger that validates every cryptocurrency transaction that has ever occurred chronologically in a near instantaneous reconciliation.

Smart contracts are digital protocols to enforce or verify contract terms or performance, making many clauses self-executing or self-enforcing and giving ISDA master agreements the potential to reconcile themselves. Mundane tasks that were historically handled by banks and lawyers can be executed faster, more transparently and less expensively.

However, security, performance and programming languages are current issues with Blockchain and smart contracts. As chains grow ever longer, calculating smart contract values in real time may cause performance issues.

Improving performance is the concept behind startups such as Blockstream Liquid, which moves transactions off the primary chain to improve performance.

Since smart contract platforms run across multiple physical systems, errors and bugs are quickly visible but not quick to fix, another potential issue. Security holes become easier to exploit, as seen in the spectacular attack on the distributed autonomous organization widely known as the DAO.

The Rise of Cryptocurrency

Cryptocurrency may make currency trading both anachronistic and superfluous. Bitcoin, Ethereum Ether, and Codius Ripple are the most well-known of the cryptocurrency cadre, but there are more than 700 cryptocurrencies in existence. In addition to those three, cryptocurrencies with market caps over $20 million include Litecoin, Monero, Ethereum Classic, Steem, Dash, NEM, MaidSafeCoin, Factom, Lisk, DogeCoin, Dixiedao and Nxt, according to Coinmarketcap.

Artificial Intelligence and Cognitive Robotics

Today, middle-and front office systems run on a series of configured or hard coded rules adapted to fit the fund's daily operations. Any rule changes must be made using the same technique.

Soon, an AI engine will monitor transactions, watching for alternatives that might have provided a better outcome or instances when a human overrides the default action. It will suggest adding or changing its own rules to improve outcomes or more closely align with actions taken by humans. After human approval, the AI engine will modify the rules on its own without the need to wait for IT to make changes.

Public Cloud and SaaS

IT infrastructure typically costs about the same whether on premise or in the cloud, but the SaaS model adds the ability to scale infrastructure and computing power to match increases or decreases in trading volume, allowing funds to pay only for the capacity they use in a specific period.

Contrast that with the current on premise model, where funds must invest in sufficient IT capacity to manage their highest trading volumes. Most of this capacity sits unused between peak loads, making the capital investment in infrastructure higher than necessary.

The cloud also provides an unmatched degree of security. Most cloud providers have taken the time to get SSAE16 Soc I and II certified, ensuring that their processes and procedures meet rigorous standards, and providing physical and biometric security such as CCTV or live guards.

In-Memory Databases

Traditional relational databases are inflexible, slow to process, difficult to modify and do not lend themselves to data mining or rapid simulations.

Rather than store data persistently in predefined layouts, in-memory databases keep all the data in memory, eliminating the constant input/output to hard drives that slows down relational processing. In-memory databases do not require fixed file layouts since they can create structures on the fly as needed, making them ideal for simulations and data mining.

An in-memory database can accept large volumes of data in both structured and unstructured formats, combining disparate data easily to search for patterns or trends. Using an in-memory database with a big data analytics engine enables companies to use large volumes of data in a variety of different formats at an extremely high velocity to generate predictions and insights that would be impossible with traditional reporting tools.

Because an in-memory database uses a great deal of memory while processing, it is an ideal solution for the cloud where companies pay for the infrastructure they consume rather than owning capacity in anticipation of peak loads.

In addition, as more governments dictate where citizens' data can be stored, in-memory data bases become even more valuable. When data is needed for real time processing, the in-memory database can request it and use it for analysis. When the analysis is finished, the data is automatically purged from memory, eliminating any regulatory concern about where the data resides.

The Future is Here

The concurrent rise of these complementary technologies is creating massive changes in fund management. While some of these predictions may sound futuristic, many of them are here now. All will be "business as usual" within the next three to five years. Fund managers will need to move quickly to adopt these new digital business models as soon as they become commercially viable or be swept away by the competition.

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"Hard times come to hedge funds" ...again?

By Cédric Kohler, Head of Advisory, Fundana

Cédric Kohler, Head of Advisory at Fundana

In 1970, a Carol Loomis article in Fortune, titled 'Hard times come to hedge funds', predicted the end of hedge funds. Almost 50 years later, some critics of the industry may think this title could not be more appropriate given today's environment.

Recent press articles are again predicting the end of the hedge fund industry, with reasons including allegedly geriatric returns over the last two years, 2016 seeing the largest outflows since 2009, or potentially one of the worst years on record in terms of fund closures. Is the industry at the beginning of its decline or is it, on the contrary, consolidating to become stronger? An overview of a few key trends helps us answer this 3 trillion-dollar question.

Performance erosion

Whether in absolute terms or in alpha terms, the industry's current performance is far below its best years. While investors have been used to 8% to 10% of alpha in the past, they have had to adjust to 4% to 5% in recent years. Of course, markets have become more efficient over time and as David Harding from Winton says, "alpha is what you get paid for making markets efficient". Additionally, too many smart guys (since 1996, Hedge Fund Research recorded a net increase of 7,565 funds) chasing the same opportunities has contributed to this decline. The combination of a low growth environment and zero interest rate levels has also made the market very narrow (think 'FANG' stocks and fewer arbitrage opportunities). Further, managers' information edge has also declined with much easier access to information.

As a result, it is clearly harder to find alpha - and when you find it, it's much lower - but there is still some. Note that 5% of alpha per year for a decade still yields a 40% cumulative return, and typically, this return comes with a much lower volatility than equity indices.

The rise of the quants

With more than $1 trillion in assets under management (AuM) across quantitatively-managed hedge funds, mutual funds and smart beta products, these strategies have drastically changed the investment landscape. Note that this is 5% of the overall asset management industry, double what it was in 2012. Over the last few years the amount of data creation has exploded, reaching 2.5 quintillion bytes every day. The combination of this data with quantitative tools has enabled the proliferation of factor investing and the birth of the quantamental strategy. A traditional stock picker who ignores his exposure to factors, such as momentum, is a sure candidate for bottom-quartile returns. Conversely, quants can now model a company's earnings stream alone, get customers' online activity data and all of this without meeting any CEOs or CFOs and calculated much faster than any fundamental analyst could.

Inefficiencies disappear quickly and the time horizon for traditional hedge fund managers has been compressed. However, strategies which do not rely on historical data have not been impacted as much. For instance, distressed investing where managers take a company through a restructuring process in the courts, will be harder for quants to handle: you actually have to go to the court.

AuM: Less is more

With $3 trillion in AuM and about 8,500 funds, the hedge fund industry is at its all-time high. However, as of October 2016, $50 billion of outflows were recorded year-to-date, the largest amount since 2009. 530 funds had closed year-to-date by then, on pace to be the record year for hedge fund closures.

What can we expect going forward? As in many industries, the largest hedge funds dominate and 10% of the managers control 90% of the AuM worldwide. Since 2009 the largest players have grown even bigger. Consequently, performance suffered and investors' patience seems to have reached its limit. Half of the $50 billion redemptions were in funds with more than $5 billion in AuM. Many legendary managers have decided to quit.

At the other end of the spectrum, 50% of the managers have less than $100 million in AuM. A challenging investing environment, paired with an increased regulatory burden, is shortening most of these funds' life spans. Many prefer to call it a day.

Thus, while it is indeed likely that the industry will see fewer managers going forward, the overall industry AuM could continue to grow. Current average hedge fund allocations are typically between 0% and 10%, which is still much lower than pre-crisis. In addition, given the low expectations for other asset classes, hedge funds have plenty of room to grow just like they did back in 2002 after the equity market collapse.

Manager lifecycles: Going, going, gone!

Hedge fund managers, like many companies, have their own lifecycle. From start-ups with young and hungry entrepreneurs, those with the best returns emerge to become confirmed managers. The latter manage enough AuM to make a decent living and yet are not so big as to make the portfolio or the team unmanageable. In short: it's the sweet spot. The best ones, and perhaps the greediest, morph further into the large stage. Many of these funds thought they could maximize performance and assets at the same time. For many, this large stage is also their last. Going, going, gone!

While this manager lifecycle has been known to hedge fund allocators for a long time, what has changed since the crisis is the speed of that cycle. Said differently, a fund life span has shortened significantly and is closer to 5-7 years than the previous 10+ years. The markets are so volatile since the crisis that many funds with good and consistent returns over a three-year window will see their AuM explode once they reach the magical billion-dollar mark. The only exceptions are those managers with the self-discipline to close their funds to new investments. This AuM growth will at best dilute returns and at worst kill the fund. Deploying such large amounts in such short periods of time is extremely difficult either because of liquidity or simply because of the enormous work needed to find new opportunities.

Thus, successful hedge fund investing going forward requires higher monitoring and turnover than we typically had pre-crisis.

Towards a better industry

The industry is indeed changing for the better. Yes, alpha has eroded but it is still there and the best investment talents still have great incentives to join hedge funds. Yes, the rise of quants has impacted several hedge fund strategies and managers need to adapt to it. However, strategies with less data available will thrive. Yes, there will probably be fewer managers in the next decade, however, this is not necessarily a bad thing and those who remain will operate closer to the sweet spot stage. Yes, the manager life span is shorter, but this only means that portfolio turnover must be higher, not that hedge fund investing is pointless.

And perhaps most important, the opportunity set ahead of us seems exceptional. Simply put, hedge fund performance has been impacted by almost two years of risk reduction in the multi-PM hedge fund platforms. That flow has now reversed and platforms are aggressively building risk again. Typically, hedge funds do well during such periods and these cycles usually last several years.

As Mark Twain once quipped, “rumors of my death are greatly exaggerated”. The same applies to the comments of many of the hedge fund industry's critics. And we all know what happened to the industry after that Fortune article in 1970…

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What's new in the Asian asset management industry?

By Stuart Martin, Partner, Kylee Zhu, Associate, and Claire Bentley, Associate, Dechert LLP

Claire Bentley, Associate at Dechert

Stuart Martin, Partner at Dechert

Kylee Zhu, Associate at Dechert

Dechert's financial services team recently presented a seminar in London, during which panellists provided insights into "What's New in Asia". Topics included: the growing opportunities for foreign asset managers seeking to attract Asian investors; recent changes in the way funds can be offered into Asia; and developments in Mainland China to stem capital outflows while encouraging inflows. Some key takeaways from the panel discussion, which focused on recent updates in Mainland China, Hong Kong and Singapore, are summarised below.

Attracting Asian investors

Investor preferences

Asia continues to provide a growing source of capital for fund managers generally, with many Asian investors seeking to increase their exposure to a wide range of alternative investment classes and strategies in an attempt to diversify their portfolios and obtain higher returns. While Asian investors have traditionally favoured locally focused funds and many continue to view Asia as offering better investment opportunities than elsewhere, there seems to be a heightened appreciation – particularly among investors in China, Japan and South Korea – of the benefits afforded by a globally diversified portfolio. In a similar vein, although some Asian investors prefer to invest in "brand name" funds or management teams with whom they have an existing relationship, there has been an increasing willingness to consider first-time funds and smaller/mid-market managers where investors anticipate favourable opportunities.

In terms of strategy, while there has been sustained interest in growth funds, there has been increased interest from Asian investors in venture, infrastructure and mid-market buyout

funds in recent years, and there is also a growing interest in credit-based strategies.

The Asian investor base

Alongside other typical types of fund investors in Asia, one key trend in recent years has been the emergence of Asian insurance companies (in particular from Mainland China and Taiwan) increasing their allocations to alternative investments following the easing of certain regulatory restrictions applicable to investments in offshore funds. Accepting such insurance companies as investors presents various challenges, which include: (i) compliance by the fund with the relevant regulatory requirements; (ii) local regulatory and exchange control approvals to be obtained by the insurance company prior to investing offshore; (iii) regulatory restrictions on the percentage of capital that may be allocated to alternative investments; and (iv) ongoing reporting requirements to which the manager may become subject. Nonetheless, this trend could prove to be a significant development given the large potential source of capital that this group represents.

As experienced in Europe and the United States, family offices in Asia are becoming increasingly sophisticated – seeking to invest into more deals directly, either alone or as part of a platform of multi-family offices, with some even exploring setting up their own funds with the aim of eventually managing third party capital.

Fund structures

It is common for private funds (e.g., hedge, private equity, venture capital) managed by Hong Kong-based and Singapore-based managers to be structured as Cayman Islands-domiciled funds – the structure with which Asian investors are most familiar. Singapore-domiciled funds or investment holding companies are also sometimes used, but this structure is typically driven by tax reasons (i.e., to take advantage of Singapore's wide network of double taxation treaties in respect of a fund's downstream investments). UCITS remain popular in Hong Kong, but the large majority of funds that are authorised by the Hong Kong Securities and Futures Commission (SFC) for retail distribution are structured as Luxembourg-domiciled and Irish-domiciled UCITS. Luxembourg, UK and Irish fund vehicles are also becoming more familiar to Asian investors in the private credit funds space, as these typically offer tax-efficient structures for credit strategies.

Nevertheless, a growing number of funds are being structured as Hong Kong-domiciled unit trusts, due to the eligibility requirement under the Mainland-Hong Kong Mutual Fund Recognition Scheme (Scheme) that SFC authorised funds seeking to be offered into Mainland China pursuant to the Scheme must be domiciled in Hong Kong. Currently, under Hong Kong law, open-ended funds may be established only as Hong Kong unit trusts, as the Companies Ordinance[1] has restrictions on capital reduction and distributions. In Singapore, the Companies Act[2] has similar restrictions, which do not allow a locally domiciled fund to be structured as an open-ended fund company.

Significant developments

Recent developments in Hong Kong, however, may make Hong Kong a more attractive investment fund jurisdiction in the future. The Securities and Futures (Amendment) Ordinance 2016 (Amendment Ordinance) – which proposes to provide a legal framework for the incorporation and registration of open-ended fund companies – was gazetted on 10 June 2016. The commencement date of the Amendment Ordinance has not yet been announced and the SFC is likely to issue more detailed operational guidelines in due course.

In March 2016, the Singapore government announced the proposed introduction of a Singapore variable capital company. However, further details in relation to this development have yet to be issued. These developments may be important, since Mainland Chinese regulations for cross-border initiatives tend to require a locally domiciled entity as an eligibility requirement (including under the Scheme and the Renminbi Qualified Institutional Investor (RQFII) program).

Offering funds into Asia

Generally, there are two main ways to offer funds into Asia: (1) registration of the fund with the local regulator for retail distribution; and (2) use of local private placement regimes.

Retail distribution channels

In Asia, there are a number of initiatives that facilitate the cross-border offering of funds in other participating jurisdictions. For example, the Scheme (as discussed above) allows funds to be offered between Hong Kong and Mainland China on a bilateral basis. Further, on 2 December 2016, the Hong Kong SFC and the Swiss Financial Market Supervisory Authority signed a Memorandum of Understanding on Switzerland-Hong Kong Mutual Recognition of Funds and Asset Managers. This will allow eligible Swiss and Hong Kong public funds to be distributed in each other’s market through a streamlined vetting process.

From a multiple cross-border perspective, the ASEAN Collective Investment Scheme Framework is an initiative that permits funds authorised in one participating jurisdiction to be offered in another, via a simplified registration process. Currently, Singapore, Malaysia and Thailand are participants in this initiative. Another multiple cross-border initiative is the proposed Asia Region Funds Passport, which is expected to be implemented at a later date.

Local private placement regimes
Local private placement rules and parameters must be observed and legal advice from local counsel should be sought if a local private placement regime is to be utilised.

Establishing a local presence

Even if a fund is offered on a private placement basis, certain jurisdictions may have regulatory requirements in relation to the offering of foreign funds into such jurisdictions (e.g., the intermediary offering a foreign fund may need to be suitably licensed/registered to be able to carry out any marketing activity onshore). In particular, in Hong Kong and Singapore, the local regulators (the SFC and the Monetary Authority of Singapore, respectively) require an entity to be appropriately licensed before it may carry out (or hold itself out as carrying out) regulated activity in that jurisdiction (this includes the activity of "dealing in securities" – e.g., marketing funds).

In Mainland China, it is currently permissible for a Wholly Foreign Owned Enterprise to be established with "asset management" or "investment management" specified in its licence (an Asset Management WFOE). Prior to conducting any onshore private fund management business, such an Asset Management WFOE must also register with the Asset Management Association of China.

It is important to note, however, that any funds

offered to the general public will nevertheless require authorization by the relevant regulator for retail distribution.

Regulating RMB outflows and inflows

Chinese regulatory restrictions on offshore investment

It has been difficult historically for offshore managers to raise money from Chinese investors, due to the hurdles posed by various domestic PRC regulatory approvals as well as currency exchange control regulations. However, as discussed below, a gradual liberalisation of the rules over the past decade has opened up new channels for Chinese investors wishing to invest offshore.

The Qualified Domestic Institutional Investor (QDII) regime introduced in 2006 allows eligible Chinese financial institutions to invest capital from domestic investors offshore into approved investments, subject to the QDII obtaining approval from the Chinese Securities Regulatory Commission (CSRC) and a quota from the State Administration of Foreign Exchange (SAFE). However, this regime is primarily limited to the offshore secondary market, and is therefore limited in scope.

In 2012, a relaxation of the regulations governing Chinese insurance companies resulted in such companies being able to invest in a wider range of offshore products (including real estate, private equity and hedge funds). The same year, the Qualified Domestic Limited Partnership (QDLP) scheme was launched, enabling offshore managers to establish onshore feeder funds in certain pilot cities in China in order to pool capital from domestic Chinese investors for investment into approved offshore asset classes (including hedge and private equity funds) not otherwise permissible under the QDII regime.

A new Qualified Domestic Individual Investor program (QDII-2) was proposed to be introduced, which would allow wealthy Chinese individuals to directly invest in offshore markets. However, following the Chinese stock market rout in 2015 and the general slowdown in the Chinese economic growth rate, QDII-2 appears to have been put on hold; quota allocations under both the QDII and QDLP schemes have been largely suspended, as the Chinese government focuses on controlling capital outflows and reviving the domestic economy.

Expansion of new access routes into Asian investments

In contrast to the Chinese government's efforts to stem the outflow of funds from Mainland China, it has been actively encouraging the inflow of funds from foreign investment. In particular, there have been increased efforts to further internationalise the RMB by relaxing the regulations applicable to existing investment access routes and introducing new initiatives to encourage foreign investment into the Chinese markets.

The two traditional routes for foreign investment into Chinese securities and bonds are the Qualified Foreign Institutional Investor (QFII) regime and the RQFII regime. Changes to significantly relax both the QFII and RQFII regimes were announced in February and September, respectively, 2016. For example, the introduction of the concept of a "basic quota" will now allow QFIIs and RQFIIs to apply for an investment quota within this basic quota without requiring SAFE approval (i.e., only a filing with SAFE will be required).

The Shanghai-Hong Kong Stock Connect launched in November 2014 has been supplemented by the Shenzhen-Hong Kong Stock Connect, which commenced trading on 5 December 2016. Most recently, it has been reported that a Shanghai-London stock connect program is underway.

Another scheme that came into effect in 2016 is the China Interbank Bond Market (CIBM), which offers certain eligible foreign institutional investors an additional direct access route into the Chinese bond market, which is currently the third-largest in the world. Prior to the CIBM, foreign institutional investors could invest directly in the Chinese bond market only via either a QFII or RQFII licence. Eligible foreign institutional investors may now directly invest in the CIBM without being subject to any quota restrictions.

Looking ahead

The past year has seen a number of significant developments in Asia. In the coming year, the availability of more locally domiciled fund vehicles (e.g., the Hong Kong open-ended fund company, the Singapore variable capital company) will be a much anticipated development. Asset managers focused on attracting Asian investors or considering investing into Asia may wish to monitor how the Chinese government continues to seek to strike a balance between managing outflows (in particular, whether quota allocations under the QDII and QDLP regimes will be resumed) and encouraging inflows (e.g., relaxing the rules for QFII and RQFII, extending cross-border stock connects, and extending mutual fund recognition schemes to other jurisdictions).

Footnotes

[1] Companies Ordinance (Cap. 622, Laws of Hong Kong).

[2] Companies Act (Chapter 50).

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Investing in African private funds

By Mayank Gupta, Partner, and Solomon Olukoya, Trainee Solicitor, K&L Gates

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Introduction

Investors have been looking at the emerging markets, including those in Africa in particular, as an important piece to their investment strategy in a time where the established Western markets have not been producing expected returns.

The Private Equity (“PE”) industry has been expanding rapidly in places such as Asia, Latin America, and Sub-Saharan Africa. PE deals in Africa used to be in large infrastructure projects that attempted to solve the needs of everyday people in sectors such as electricity and clean water. Subsequently, there has been a diversification in the sectors that PE deals target.

The obvious benefits of investing in Africa — an increasing middle class and an abundance of natural materials — are very well known and have been for many years.[1] The risks that have been a barrier to investment in Africa for many years — political instability and conflict — are reducing with each passing year. There is now less conflict in Africa than in any time since the “decolonization” of the continent. However, as the old risks subside, African PE faces new challenges — some unique to the continent and some mirrored by other emerging markets.

This note looks at the appeal for funds investing in Africa, the risks associated with such investment, regional differences in PE, and the outlook for the medium- and long-term future.

Appeal

PE in Africa plays attracts a diverse investor base: the industry was pioneered by development finance institutions that looked into large infrastructure projects to help develop specific industries in Africa.[2] Now, the local and international investor base includes pension funds, sovereign wealth funds, foundations, and endowments.

Africa’s appeal to private funds is multi-faceted: Infrastructure needs investment across the continent, and the growing middle class means there is an increase in the demand for consumer goods. Fund managers have cited the increasingly mature role that Africa now plays in the global economy coupled with the ease of doing business with other fund managers across multiple countries as factors that make Africa attractive.[3]

Energy, infrastructure and telecommunications are the sectors that most funds have targeted recently.[4] These sectors are vital in the development of modern economies. Statistics on the access to electricity in Sub-Saharan Africa show that there is dramatic underdevelopment in this sector. The 48 countries in Sub-Saharan Africa generate approximately the same amount of power as Spain.[5] PE firms filled in this demand for capital. For example, Blackstone Group completed a hydroelectric dam project in Uganda in 2015.[6]

Risks

The risks for private funds investing in Africa can be split into two groups: (1) risks for investing in Africa generally; and (2) specific risks within the African PE industry. Conflict and corruption remain risks that may affect any business operating in Africa. Although conflict is now at its lowest level in 50 years, it still exists and disturbs nations, governments, and service provisions, thus making it harder to operate in African countries. Corruption has long been highlighted as one of the key problems hindering development in Africa, and poses special risks for PE investors that may be subject to the Bribery Act or the Foreign Corrupt Practices Act.

The PE industry faces specific issues dealing with the size of business that PE firms want to take over and the typical methods of improving the business. Although large PE firms typically prefer to purchase businesses that are valued at over US$100 million, targets of that size are generally scarce in Africa.[7] The statistics show that most deals in the PE industry in 2015 were for less than US$10 million. These smaller types of deals that are available dim the appeal of Africa, to some extent, for some of the larger funds. Nonetheless, despite that challenge , the PE industry closed on a record US$4.3 billion of fundraising for African investments in 2015.

The standard PE model of buying a company, loading it with debt, and selling the company after five years of expanding the business and improving its profits is not always successful in Africa. First, the local owners may not recognize the need for private equity and be unwilling to relinquish control of their companies. Furthermore, international funds need local knowledge from fund managers in order to identify the key improvements that can be made to make the companies more profitable.[8]

For fund managers, investing in Africa requires a much more hands-on approach than typical Western PE, as it can be difficult to exit via a listing due to immature stock markets. In 2014, 31 PE firms in Africa reported exits, and this figure dropped slightly to a total of 28 in 2015.

Regional disparities

PE in Africa has been growing, but Africa is an extremely diverse continent and there are marked differences between regions. Thirteen of the AVCA Index funds are focused primarily on South Africa, which evidences South Africa’s continued preeminence in African PE, despite

Nigeria’s economic growth in recent years and the fact that Nigeria is the largest economy in Africa.

Since the oil price drop in mid-2014, Nigeria’s economy has been struggling. It is currently in recession, with third-quarter 2016 results showing that the economy shrank 2.24% as compared to the same three months in 2015.[9] It is too early to predict the effect that this will have on private funds that focus on Nigeria. Considering that Nigeria is the biggest economy in Africa, and that 25% of the PE deals between 2010 and 2015[10] were in Nigeria, the recession is a concern for the future of PE investment in that country and for western Africa more generally.

Although Nigeria and South Africa dominate the headline figures for African PE, East Africa posted the strongest returns in comparison to the public markets in those countries between 2007 and 2015.[11]

Looking forward

PE firms active in Africa are looking to diversify from infrastructure, increasingly in competition with development financial institutions seeking new industries and asset classes in which to invest in the future growth of the continent. The new sectors that are interesting PE fund managers in Africa include financial services, education, and healthcare. These areas will continue to be targeted by PE investment in the foreseeable future.

Only 7% of the working population in Africa currently invests in a pension, and with the growing middle class, this figure will only increase. As more African countries develop more sophisticated pension programs, more African pension providers will have capital to invest. This extra capital coupled with continued interest from overseas will help grow PE in Africa.

Fund managers are aware that valuations have tended to be inflated in recent years. As a result of the fall in commodity prices, the growth projections across Africa have been dialed back, which will bring down the prices of overvalued businesses and keep less serious investors away from the African market.[12]

Conclusion

Despite downward trends in emerging markets, Africa’s long-term growth outlook provides attractive investment opportunities for emerging markets PE firms. PE in Africa has diversified from its traditional development infrastructure starting point to more consumer-focused sectors in order to cater to the growing middle-class population. The risks associated with PE in Africa — smaller deals and nontraditional methods of growing the business — means that PE firms must be nimble and equipped with local knowledge to tap into the continent’s potential. Africa is not a homogenous place, and there are regional differences in the successes of PE. Looking ahead to future African pension funds will be vital to the continued growth of PE in Africa in the financial services, education, and healthcare

Footnotes

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[3] Into Africa: the rise of private equity, Freshfields Bruckhaus Deringer, 2014 page 1

[4] AVCA Annual African Private Equity Data Tracker, 2015

[5] CNN, Why are 600 million Africans still without power, 2016 edition.cnn.com/2016/04/01/africa/africa...

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[7] The Economist, A sub-Saharan scramble, accessed on 1 December 2016, http://www.economist.com/news/business/2...

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[11] EY and AVCA, How private equity investors create value , 2015

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'Brexit' and the free movement of people

By James Perrott, Senior Counsel, Macfarlanes LLP

James Perrott, Senior Counsel at Macfarlanes

The result of the European Union (EU) Referendum is clearly going to have widespread economic and political implications for the UK and beyond. It has also led to concern among some of the nearly 3m European Economic Area (EEA) and Swiss nationals who are currently resident in the UK about their continuing and future ability to live, work and study in the UK.

Current Situation

As a number of commentators have already said, it is important not to panic. Although Article 50 of the Treaty of Lisbon gives a two year deadline for countries to leave the EU, this deadline is only activated once a country gives notice of its intention to leave. It is important to note that EEA / Swiss nationals will be able to continue to exercise their right of free movement and come to live, work and study in the UK up to the point that the UK leaves the EU.

Another important consideration is that nearly 2m British citizens live abroad in other EEA countries, mostly in Spain, France and Ireland, and Switzerland. It is therefore unlikely that any negotiated exit would result in EEA / Swiss nationals who are already in the UK being required to leave as this would likely result in any British citizen currently living in an EEA country or Switzerland potentially being required to return to the UK. The Prime Minister, Theresa May, has said repeatedly that she wants to protect the status of EEA / Swiss nationals already living in the UK. However, she has also made it clear that this will not be possible if British citizens' rights in EEA Member States / Switzerland are not protected in return.

It is therefore important to note that there are steps that EEA / Swiss nationals who are currently in the UK and are concerned about their status can take to consolidate their position in the UK.

Potential Options

As the law currently stands, in order for EEA / Swiss nationals to legally reside in the UK long term, they must be exercising an EU Treaty Right in the UK. They may apply for a Registration Certificate as evidence of this.

Once an EEA / Swiss national has been exercising an EU Treaty Right in the UK continuously for 5 years, they may be deemed to hold Permanent Residence and may apply for a document certifying Permanent Residence. If they do so, they should not have to submit any further immigration applications once the UK leaves the EU.

In order to be deemed to be exercising an EU Treaty Right in the UK, the EEA / Swiss national must fall into one of the following categories:

a. job seeker;
b. worker;
c. self-employed person;
d. student; or
e. self-sufficient person.

When applying for a Registration Certificate / document certifying Permanent Residence, the EEA / Swiss national must submit certain documentation to evidence that they were exercising a particular EU Treaty Right throughout the period claimed.

1. Apply for a Registration Certificate

Although it is not currently a requirement for an EEA / Swiss national who is in the UK to hold a Registration Certificate, some do apply for one as it evidences that they are currently exercising an EU Treaty Right in the UK.

There are two main reasons why obtaining a Registration Certificate is likely to be of benefit to EEA / Swiss nationals looking to remain in the UK long term:

It will mean that the EEA / Swiss national is on the Home Office's system. Consequently, when the UK does leave the EU, it should be relatively straightforward for any EEA / Swiss national looking to remain in the UK to obtain any new immigration status that they are required to possess going forward. It is also possible that possession of a Registration Certificate may, at least for an initial period, be sufficient to evidence an individual's permission to remain in the UK post-Brexit.

As part of the Registration Certificate application, the individual is required to confirm the date they first started exercising an EU Treaty Right in the UK, which should assist with any future application for a document certifying Permanent Residence. In addition, if the UK decides to instigate a “cut off” date after which any EEA / Swiss national arriving in the UK will not automatically qualify to remain in the UK post-Brexit, the fact that, as a result of the Registration Certificate application, the Home Office has confirmation of the date that the EEA / Swiss national first entered the UK should protect the EEA / Swiss national's position.

2. Apply for a document certifying permanent residence

EEA / Swiss nationals who have been exercising an EU Treaty right in the UK continuously for at least the last 5 years may have a right of Permanent Residence in the UK. In order to satisfy the Permanent Residence requirements, the EEA / Swiss national must have resided in the UK for a continuous period of 5 years. This means that the individual must not have been absent from the UK for more than six months in any of the 12 month periods which make up the 5 year qualifying period for permanent residency.

In addition, the EEA / Swiss national must provide evidence that they have been exercising an EU Treaty right throughout this period. For example, if the EEA / Swiss national has been in employment, they should provide a letter from their employer(s) confirming their period(s) of employment, their payslips and bank statements covering the relevant period and / or their P60 End of Year Certificates. For periods of self-employment, they must demonstrate that they have been registered as self-employed with HMRC and provide evidence that they have paid UK tax as a self-employed person for the relevant period(s). If the EEA / Swiss national has been studying, they must provide a letter from their school / college / university confirming their dates of study, together with evidence that they possessed comprehensive sickness insurance for the relevant period(s). Those who are in the UK on the basis of self-sufficiency must also provide evidence of their finances and comprehensive sickness insurance for the relevant period(s).

3. Apply for British nationality

Since November 2015, in order for an EEA / Swiss national to apply for British nationality, they must be able to demonstrate that they have been living in the UK for at least 5 years, that they hold a document certifying Permanent Residence and that they have held the right to Permanent Residence for at least 12 months. It is important to note that the residence requirements for British nationality are stricter than those for Permanent Residence. In order to satisfy the residence requirements for British nationality, the EEA / Swiss national must not have been outside the UK for more than a total of 450 days in the last 5 years and 90 days in the 12 months before they submit their British nationality application. Applications may still be approved if an individual exceeds these limits, provided they can show that the excess absences were due to an extenuating factor, such as a job which requires extensive international travel, and it is clear that the EEA national has established their home in the UK.

Applicants must also demonstrate that they meet certain requirements in relation to their ability to communicate in English and pass the Life in the UK test.

It is important to note that we have seen a number of examples recently of EEA / Swiss nationals who were unaware that they are also British citizens. EEA / Swiss nationals who were born in the UK may be British by birth depending on the date of their birth and the status of their parents at the time of their birth.

Current Challenges

It is often the case that EEA / Swiss nationals who are currently, or have been, exercising EU Treaty Rights as students or self-sufficient persons do / did not hold comprehensive sickness insurance during the relevant period. This is normally because they were not aware of this requirement. Unfortunately, any period spent in the UK as a student or a self-sufficient person where the EEA / Swiss national does not hold comprehensive sickness insurance cannot count towards the five year qualifying period for Permanent Residence. Furthermore, this may break the continuous five year qualifying period for Permanent Residence.

It is also important to note that, if there are any breaks in employment and the EEA / Swiss national wishes to claim that they were exercising an EU Treaty Right as a jobseeker during that break, they can normally only claim this for a maximum period of six months. If they were out of work for more than six months, they would normally have to demonstrate that they were exercising an EU

Treaty Right as a self-sufficient person during this time.

Consequently, it is possible for an EEA / Swiss national to have lived in the UK significantly beyond 5 years and still not qualify for a document certifying permanent residence due to there being a period when they were not deemed to be exercising an EU Treaty Right.

Conclusion

Before the UK voted to leave the EU, the majority of EEA / Swiss nationals thought they had an unlimited right to live and work in the UK and were unaware that, technically, they were required to be exercising an EU Treaty Right. However, as more and more EEA / Swiss nationals are looking to consolidate their status in the UK by submitting applications for Registration Certificates and, more importantly, for Permanent Residence, they are finding that they do not meet the relevant requirements by, for example, having significant breaks in employment or being self-sufficient in the UK without having comprehensive sickness insurance. Although it is unlikely that the UK Government will look to remove EEA / Swiss nationals who are not exercising treaty rights in the UK at this stage, it is important that, before the UK formally leaves the EU, EEA / Swiss nationals ensure that they are exercising an EU Treaty Right, and obtain evidence confirming this, to give them the best chance of remaining in the UK post-Brexit.

Looking to the future, it is, of course, difficult to predict the UK immigration law changes that will be implemented once the UK leaves the EU. There will still be a need for wealthy and skilled migrants to safeguard the continuing growth of the UK economy. In addition, in order to maintain its "open for business" stance, the UK will have to continue to allow international businesses to transfer skilled staff from their overseas offices and local UK companies to hire overseas workers to fill roles which require skills which are not present in the resident labour market.

It seems likely that some form of limited free movement or special arrangement that will allow EEA / Swiss citizens to come to live and work in the UK, and vice versa, will form part of any future trade deal negotiated with the EU.

However, in the meantime, EEA / Swiss nationals wishing to remain in the UK in the long term are best advised to familiarise themselves with each of the categories which amount to exercising an EU Treaty Right in the UK to ensure that they continue to have the right to remain in the UK until it formally withdraws from the EU.

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Brave new world of price discovery - Adopters win, adaptors will need to catch up

By Vuk Magdelinic, Co-Founder and CEO, Overbond

Vuk Magdelinic, co-Founder and CEO at Overbond

One of the most exciting and dynamic shifts in the financial world is the way that new financial technologies — ‘fintech’ — have penetrated various sectors within the market. The finance world is undergoing a dramatic shift experienced in other established industries (like publishing) that are built on information as opposed to concrete goods. Over the past decade, fintech innovation has influenced a range of sectors within the financial industry: payment technologies, wealth advisory companies, peer-to-peer lending, and consumer financing (to name a few). All these sectors have experienced substantial positive development due to technological innovation.

In the similar fashion, the capital markets sector - although largely untapped - is a fertile ground for fintech providers to add value and to spur the types of innovation seen in other segments of finance. Tellingly, as KPMG noted last year, capital markets can only remain immune from fintech innovation for so long. “A perfect storm of conditions is brewing that makes financial technology the right solution for the right conditions at the right time,” they write. “And that time is now.”

The bond market - as the largest part of the capital markets - can benefit greatly from fintech innovation due to its structural conditions and recent market developments. The bond market is returning to a state of sustained growth, but struggling to meet the demand of investors, especially outside the cadre of institutional investors. 2016 has seen a sizable increase in U.S. bond supply: according to Bloomberg, 2016 had seen a 9.5 per cent increase by the end of August, surpassing $1 trillion in total new supply in September. While bond supply is rising, however, yields still remain low: over the course of 2016, yields have fallen consistently and only at the end of the year have we seen the indicators that yields will rise in the near future. And at the same time, liquidity in the secondary markets is down: in October 2015, large U.S. banks reported negative corporate bond inventories for the first time in history. Some Wall Street banks now hold a view that low market liquidity has become a norm for corporate bond markets.

Emerging fintech innovations promise to deliver solutions to many of the structural problems that exist in the market architecture for primary bond origination. Price discovery, for instance, is a vital aspect of market functionality that is fundamentally inefficient due to market fragmentation and a lack of suitable communication tools.

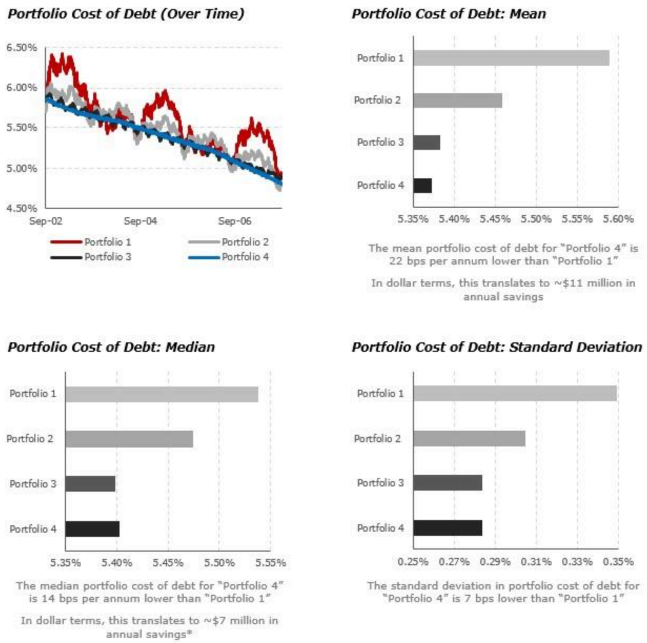
Because the market is functioning OTC (over-the-counter) and is fragmented - information flows slowly and unequally. Due to relative bargaining power and access to information, larger investors and dealers develop an inherent advantage in the marketplace. While this system works well enough for large institutional participants, it has the effect of exacerbating imbalances, whereby many investors — including those in emerging markets - are disadvantaged not only in terms of their opportunities to participate in primary bond issuances, but in their ability to navigate the process in such a way that allows for accurate price discovery. In effect, an unintended byproduct of a growing OTC bond market is that it has also grown to be filled with challenges and obstacles that raise costs and inhibit equal access for all investors.

The corporate bond origination process, largely done manually and only minimally updated over the last fifty years, is an impediment to the efficiency of price discovery and diversification of the entire bond market — two of the biggest challenges that the market faces for long-term sustainable growth. Even in an increasingly transparent, information-focused financial environment, the bond market remains opaque; what information is readily available is often fragmented and spread thin between different players in the marketplace. Investing power is thus thrust into a state of imbalance: smaller investors do not have neither the time nor the resources to accurately engage in price discovery and determine transaction costs — which, for smaller investors and smaller transactions, can be up to twenty times higher than for their larger counterparts. Increased costs, and the increased difficulty of accurate price discovery, enable only the largest institutional investors to meaningfully participate in the primary bond market. This, in effect, keeps the market from diversifying in a way that would promote sustainable growth. It also contributes to a lack of connectivity between dealers, investors, and issuers who in the bond market (as opposed to equity markets) have no centralized infrastructure through which to buy and sell and thus lack the kind of robust data and analytic tools to streamline price discovery. It is possible to solve many of the problems inherent in price discovery at the point of bond origination, however. By using technology to increase transparency, connectivity, and the flow of information, fintech platforms can solve both problems: first, they can serve as a centralized system through which dealers, issuers, and investors can interact and connect; secondly, by increasing transparency and connectivity, fintech platforms can drastically improve the accuracy and efficiency of price discovery, information flows, and deal execution, thus improving some of the major obstacles to efficient bond origination.

Interestingly, as our own fixed income research shows, if major obstacles related to the current nature of bond origination are overcome through fintech innovation, substantial benefits to issuers, investors, and dealers are possible. The ability to issue debt more frequently is hampered primarily by the costly and manually intensive bond issuance processes that all market participants have relied on for decades. A less manually intensive, more transparent, and connected issuance process would allow dealers to reduce deal related transaction costs while streamlining price discovery for all market participants. As a result, issuers would be capable of accessing the market on a more frequent basis and for smaller notional amounts – allowing for opportunistic issuances. Based on our fixed income research, the ability to issue more frequently and in smaller notional amounts would drive down the cost of funding for issuers while reducing interest coupon volatility (Exhibits 2, 3, 4, and 5). Conversely, with more frequent issues, both large and small investors would have more opportunities to participate in the bond issuance process, potentially driving more equality in new issue participation.

Summary of Debt Issuance Strategies

	Portfolio 1	Portfolio 2	Portfolio 3	Portfolio 4
Issuance Tenor	10 year	10 year	10 year	10 year
Strategy Horizon	10 year (rolling)	10 year (rolling)	10 year (rolling)	10 year (rolling)
Data Start Date	2002-09-30	2002-09-30	2002-09-30	2002-09-30
Data End Date	2016-09-28	2016-09-28	2016-09-28	2016-09-28
Credit Rating	BBB Generic	BBB Generic	BBB Generic	BBB Generic
Currency	USD	USD	USD	USD
Annual Issuance Size	$1,000,000,000	$1,000,000,000	$1,000,000,000	$1,000,000,000
Issuance Frequency (p.a.)	0.5	1	4	12
Size Per Issuance	$2,000,000,000	$1,000,000,000	$250,000,000	$83,333,333



Source: Overbond Corporate Cost of Funding Research Report

The capabilities of fintech have proven to be a valuable asset to other financial sectors, improving efficiency, lowering costs, and increasing the breadth and diversity of the user base. The bond market, as it exists now, is in need of modern solutions and processes. Technological solutions are the optimal way to solve the most pressing problems in capital markets: a lack of centralized connectivity, the difficulty of price discovery amidst a volatile economic climate and the challenge of diversifying the investor base. With fintech innovation the bond market can bring itself towards a more efficient, centralized and diverse future.

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The Securities Financing Transaction Regulation (SFTR) – What you need to consider

By Ben Challice, COO, Pirum Systems

Ben Challice, COO at Pirum Systems

Introduction

As part of the policies identified by the Financial Stability Board (FSB) to increase transparency across Securities Financing Transactions (SFTs), the EU introduced the Securities Finance Transaction Regulation (SFTR) which came into effect on 12th January 2016.

The regulation includes a number of new rules for market participants, including a requirement to report all SFTs to a registered Trade Repository (TR) on a T+1 basis which will begin in April 2018. The SFTS in scope include repos, margin lending transactions (including those under a Prime Brokerage agreement) stock loans, buy/sell backs and commodity loans.

The SFTR reporting obligations apply to any counterparty to an SFT that is established in the EU (including their branches, wherever they are located) or any counterparty established outside the EU transacting SFTs through an EU branch.

Where the SFT counterparty is a UCITS fund or AIF, the reporting obligation applies to its management company instead of the fund itself. The scope therefore doesn't directly cover the AIFM but they will be expected to report on behalf on their underlying principal. However, if AIFMs utilise a non-EU fund structure, then reporting will not apply regardless of the location of establishment of the fund manager inside or outside of the EU.

The main exclusion from reporting is for transactions with EU member central banks, other Union public bodies managing public debt or the Bank for International Settlements.

Regulation Overview

Counterparties have to report details of the 'conclusion, modification and termination' of any SFT to a registered trade repository on a T+1 basis, and similar to EMIR, SFTR reporting will be dual-sided. This means that the 'collateral giver' and 'collateral taker' (using ESMA's proposed terminology) will be required to separately report their version of the transaction.

For example, Alternative Investment Funds (AIFs) that are in scope of the SFTR would also have to report their side of the margin loans received from their Prime Broker(s) at the fund level. An AIF trading bilateral repo with a bank would similarly require both sides to report a matching transaction to a Trade Repository including cancellations, amendments and rolls. In addition to the reporting of the SFTs, counterparties also have to report the associated collateral to the trade repository on either T+1 or Settlement date dependent on the method of collateralisation used.

The SFTR mandates the use of unique trade identifiers (UTI) so that each SFT has its own identifier, thereby enabling the regulators to pair together the separate transaction reports from both sides of the transaction. Participants must also use Legal Entity Identifiers (LEIs) to identify their counterparts along with a number of other parties involved in the SFT (e.g. Agent Lenders, CSDs, CCPs). A separate UTI and LEI is required for each fund engaging in an SFT which means the Prime Broker and the Alternative Investment Fund who takes delivery of these securities will have to report each UTI and LEI also.

The regulation also requires the reporting of both the collateral that is available for re-use as well as the collateral that has been re-used, where it is distinguishable from other assets. Where cash collateral is involved, the re-investment details must also be reported. Market participants will need to consider how they intend complying with these reporting requirements, as data on re-use eligibility and actual re-use may not be easily available or available at all in some situations.

Challenges

The data ESMA is requesting includes the portfolio of assets used by the PB as collateral for any margin loans and the loan to value ratios used in their calculations. Not only are the AIFs entirely reliant on timely feeds from the PB, but often this data is only stored on the PBs systems and not replicated in the systems of the AIFs in a way they could then easily report. Furthermore, the proposed reporting of lifecycle events, creating frequent updates and modifications between trade and settlement, is also a concern for AIFs; even if they receive this data, they are unlikely to capture it.

Furthermore, there are some reportable data elements (e.g. legal agreement traded under, notice period for recall of term transaction) which market participants are not currently storing in a structured format in their existing trade booking systems. Such data elements may only be recorded in contractual documentation and therefore may not be easily accessible for direct / timely automated transaction reporting. Analysis will be required to identify any required data fields which are not easily accessible and consideration will then need to be given as to how this information will be made available to the transaction reporting process. Although the SFTR is a 'two sided requirement' there will actually be a great deal of one side reporting for the Prime Brokers who are in scope and the AIFMs who fall out of scope due to their jurisdiction. The PBs will however be reliant on the AIFs providing them with LEI information for example even if they are not obliged to obtain it for their own reporting.

ESMA in their second consultation paper have now amended the requirement to allow reporting of collateral to be provided on settlement date (rather than T+1) however it still has to be linked back to the original SFTs using the LEI of the counterparty with whom the collateral was exchanged and the master agreement under which it was agreed. Although they have amended their requirements, providing this information on settlement date would still present significant challenges to the industry.

Reporting approach

Whilst the concept of transaction reporting doesn't seem to be too complicated, once you delve into the detail, the sheer number of fields required to report the on-loan data, collateral data, margin and collateral re-use in conjunction with minimal tolerances applied to the matching fields reveals the complexity. This is likely to lead to incorrect or missing data being reported with no chance that it will ever be reconciled or matched at the repositories. By way of example. for loan and collateral data for repos, ESMA require 70+ fields, if you include margin and re use data the total number of fields increases to 90+

One advantage the securities finance market has over other market practices is the process of contract comparison, or transaction reconciliation on a real time basis throughout the day. If you already have matched positions on each side of the trade before you report, you are effectively replicating what the TRs will be looking to do when they receive the data. However, in the Security Finance value chain, Alternative Investment Funds do not widely utilise this kind of service currently.

In addition to reporting, storing the data for SFTs transactions is a concern also. ESMA mandates that loan records have to be kept for a minimum of five years and this aspect of data storage only adds to the cost of the regulatory exercise.

A key consideration for any firm in their initial assessment is to assess whether to build or buy. If you build, minor improvements to existing systems, or increasing the levels of manual work won't be sustainable in the long term when you look at the multi-regime reporting framework spanning the globe. Deciding to buy doesn't remove the pain entirely as you will have to contribute internal resources to evaluate requirements and ensure compliance. However, it does utilise expertise for system integrations, leverage existing infrastructure connectivity and, more often than not, save on cost.

The decision to leverage technology vendors is becoming more prevalent as many firms are assessing their delegated reporting responsibilities post EMIR and the upcoming MiFIR implementations and now have to make the decision if they want to offer this service for SFTR, especially on the sell to buy side.

Conclusion

Some firms have not yet started their analysis of SFTR due focus on other regulation, the implementation deadlines appearing far away (April 2018 for AIFMs) and the details not yet being completely finalised. We have seen from the two ESMA consultation papers, however, that the main points are now largely defined. SFTR poses a significant challenge to the industry with far reaching operational implications, therefore, the earlier the regulation is addressed, the more efficient and well informed decisions your organisation can make. Regulatory compliance is key to financial reputation, the right technology can give firms a competitive advantage going forward and adherence to best practice will ensure that a fund remains attractive to investors and is best placed to raise capital in the future.

Finally, if firms do opt to use a solution provider then it is important that the vendor doesn't just solely report the transactions but will offer value add services such as reconciliation of reports, enhanced visibility of reporting lifecycle, data validation and offer data enrichment. Implementing SFTR from a technology perspective will require significant effort, so firms need to start preparing for this now as transaction reporting is here to stay.

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Shifting Risk Management Priorities

By Ken Owens, Partner, and Sean Herlihy, Director, PwC

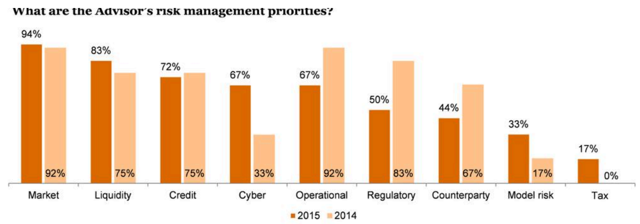
Ken Owens, Partner at PwC

While risk management remains a primary area of focus for Hedge Funds Advisors, priorities have shifted over the past year. Favorable credit conditions with low default rates, strong market prices and a changing regulator landscape are just some of the reasons firms might be turning their attention to other looming formidable risks.

PwC's Asset Management practice is delighted to publish the results of our European Alternative Asset Management Benchmarking study. This study was designed to gather, analyse, and share information about key industry trends and metrics. The study covered

Sean Herlihy, Director at PwC

19 European focused alternative asset management firms representing $427 billion of assets under management across various product types and strategies. The study replicated a similar study performed in the US where participant advisors provided data covering industry practices related to their organizational structure, boards and governance, products and strategies, operations, service providers, regulatory, valuation, financial reporting and of particular interest, Risk Management Priorities.

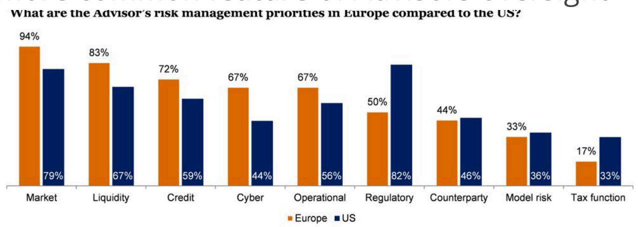


In order to comply with enhanced governance and regulatory requirements, alternative advisors are focusing on risk more than ever before. 59% of participating advisors say they have a dedicated risk management function. The remaining 41% of the participant pool indicate that the greater part of their risk personnel sit in the front office. In total 44% of participants have created a dedicated role equivalent to Chief Risk Officer. This demonstrates how integrated risk management needs to be within the investment process.

When it comes to risk priorities, market risk continued to top the list of priorities for Advisors, hardly surprising given Hedge Fund performance over the past year and the continued outflows from the sector. Interestingly we noted increased concern around tax possibly coming from the increased uncertainly around the possible outcome of the OECD's work on base erosion and profit shifting (BEPS). Liquidity and credit risk have remained broadly static year on year, what is slightly more of a surprise is shifting priorities around cyber, regulatory and operational risk.

We can quite clearly see that one of the significantly increased areas of concern is cyber risk. 67% of Advisors cite cyber risk as a priority for 2015, this risk has more than doubled when compared with last year. Based on PwC’s Asset Management 2020 report, technology will become paramount and mission critical in five years, while cyber risk will increasingly become one of the key risks for the industry. We can already see the impact of this on the ground with both fund advisors and fund boards looking to ensure that they are ready for ‘when’, not ‘if’, the cyber-attack happens. Regulators are also waking up to the issue with a number of European regulators, such as the Central Bank of Ireland, recently issuing circulars citing the growing threat to the industry. While we believe the industry is becoming more aware of the risks and better able to manage the threat we feel that it will continue to stay near the top of the list of risk management priorities for the foreseeable future.

One of the more dramatic shifts is regulator risk. Falling from third on the list of risk management priorities in 2014 to sixth on the list for 2015, a drop of 23%. In Europe AIFMD was a huge challenge for the industry, with the regulation now well established and advisors having found their solutions, regulation is for the moment at least, falling back down the list of priorities. We would think however that this will be short lived as the ever increasing regulatory burden will begin to bring the risks of non-compliance back up the agenda. Interestingly regulatory concerns have stayed high on the agenda for US firms reflecting US regulators continued focus on the alternatives sector. Looking to other elements of our benchmarking we can see 43% of managers surveyed, either already operate or are planning to launch a liquid version of their existing alternative product. In this context we would expect regulatory concerns to come back to the fore. In parallel to this we have seen a notable fall in counterparty risk as a concern, which is perhaps an indication that element of regulation such as ESMA’s work on the European Market Infrastructure Regulation (EMIR) is restoring some confidence. Perhaps as an indication of how views are developing in the space we have seen a rise in advisors setting up committees tasked specifically with regulatory oversight. While still only present in a minority of participating advisors (26%), we expect to see such committees become a more common feature of Advisors oversight



As an interesting aside we have seen a marked increase in the level of outsourcing across both participants and the wider industry. Given this backdrop its worth noting that we did not find any notable increase in the level of outsourcing of risk and compliance functions, with 68% of participating advisors choosing to retain 100%

of their risk and compliance functions in house.

The shift in focus on operational risk is of particular interest. Counterintuitively we have seen the focus reduce from the previous study. We believe this is not necessarily becoming less of an area of focus but more that it is returning to a more normalized level of risk. In 2014 operational concerns were, along with market risk, joint top of the listings. In contrast for US Advisors it was far less of an area of focus, ranking fifth on their list of risk management priorities. However this was with the backdrop of the European Industry grappling with the implementation of AIFMD and with both the clearing and reporting obligations coming from EMIR. With Advisors now having weathered the regulatory storm and many service providers having developed enhanced offering in this space we see operational concerns of European Advisors moving to a more normalized level and more aligned with their US counterparts.

While you can draw varying conclusions from the interplay of certain risk priorities, it is quite apparent that Advisors areas of focus are ever changing. Each advisor has their unique perspective on risk, but understanding the areas of focus of both their peers and the wider industry is of paramount importance.

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Home and dry: When can investors be confident that distributions will not be clawed back?

By Ulrich Payne, Partner, Giorgio Subiotto, Partner, and Paul Murphy, Senior Associate, Ogier

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Home and dry: When can investors be confident that distributions will not be clawed back?

When an investor secures a redemption payment from a fund that subsequently goes into liquidation, the investor - understandably - derives an enormous sense of relief that he managed to abandon a sinking ship in time. However, the recent Cayman Islands Court of Appeal ("CICA") decision in the Weavering Macro Fixed Income Fund Limited ("Weavering") litigation serves as a stark reminder that redeeming investors cannot rest so easily. Those funds may have to be returned and distributed amongst the remaining investors.

In this article we will take you through a quick recap of the law in relation to the so called "clawback" provisions and discuss the latest developments in this area in light of the CICA's recent decision.

Quick recap

The Cayman Islands Companies Law empowers a liquidator to apply to the court to have a payment to a creditor declared invalid when that payment was made within six months of the commencement of a liquidation and the payment was made with a view to preferring a creditor over other creditors. This type of claim is called a voidable preference.

The mischief that the section is designed to prevent is a violation of the principle that all creditors of an insolvent fund should receive distributions on a pari passu basis – in other words, every creditor must share in the misery generated by a fund's insolvency. If a fund bypasses this principle by preferring one creditor over another then the payment is invalidated, and it must therefore follow that the payment should be paid back, so that it can be distributed equally amongst all of the fund's creditors.

Of course, if the fund pays a related creditor in preference to other creditors - for example, a subsidiary - it seems only fair that the related creditor should return the money to be distributed equally amongst the creditors (indeed, there is statutory provision that automatically deems that a related party will have received a payment in preference). However, if a third party investor has the foresight to redeem out of the fund (thereby becoming a creditor) and is paid without being aware of the insolvency or potential insolvency of the fund, it might appear unfair that they would be subjected to a clawback action.

It is this tension that lies at the heart of two recent Cayman Islands decisions...

A tale of two cases: RMF and Weavering

Before the CICA's latest decision in Weavering, the leading authority on clawback claims was the Chief Justice's decision in RMF Neutral Growth v DD Finance. After a comprehensive review of Cayman and English case law the Chief Justice held that before a payment could be declared invalid the liquidators of a fund would have to show that the dominant intention of the fund was to prefer a particular creditor – the mere fact that the consequences of the payment were that a creditor got paid in preference to other creditors was not enough.

In other words, a liquidator must establish the fund's motive in making the payment.

This concept is perhaps a little confusing and it stems from the fact that there a number of ways that the word "preference" can be used. A "preference" can be defined as "one that is preferred" – in other words an investor who, as a matter of fact, receives a payment ahead of all other creditors is an investor that has been preferred.

However, "preference" can also be defined as intentionally giving an advantage to some over others. It is this second usage that the court is seeking to employ when it states that the dominant intention or dominant motive of the fund must be to prefer a creditor before a payment can be called a preference.

By way of illustration, where a director pays his best friend before all other creditors it can be readily inferred that he is intending to give his best friend an advantage over all other creditors. However, where a director pays a creditor that is threatening the fund with legal action, the director's dominant intention is to relieve the threat rather than to give the investor an advantage over other creditors, even if this is a natural consequence of his actions.

This principle was expounded in the 1956 English decision of In re Cutts and was citied with approval in RMF. In In re Cutts the judge cited examples of payments to oldest friends or closest relatives being clear examples of preferential payments. The payment in In re Cutts was held to be a preferential payment on the basis that it was made to the debtor's most important client.

Conversely, the Judge in In re Cutts went on to say that if a debtor steals from his employers till and elects to reimburse the till over other creditors in order to avoid detection this would not be a preferential payment. He went further and said that if a debtor pays a particular creditor because of some pressure or a threat or to obtain some immediate and material benefit or to fulfil some particular obligation then the dominant or real intention will not be to prefer (i.e. pay out of turn) but to achieve some other goal. In these circumstances the inference that there has been a preferential payment may be displaced.

In RMF the Chief Justice found that, in making payments to a redeemed investor, the director was responding to pressure and concern that, absent the payments, the redeemed investor would insist on regulatory intervention by the Financial Services Authority and take legal action against the fund. And so, although a consequence of this payment was that the redeemed investor was preferred, the dominant intention in making the payment was to relieve the threat. The dominant intention was not to give an advantage to that redeemed investor over other investors.

This brings us to the recent decision in Weavering.

Weavering and where next?

Skandinaviska Enskilda Banken AB's (Publ) ("SEB") acquired shares in Weavering as custodian for two Swedish mutual funds. It was paid approximately US$8 million in redemption proceeds shortly before it was discovered that the investment manager had entered into worthless interest rate swaps with affiliated counterparties to disguise huge losses.

The redemption payments that formed the subject of the dispute were made in December 2008, January 2009 and February 2009 before payment of redemptions was suspended. When the investment manager came to decide who the December 2008 redemption payments should be made to he directed that "Swedish investors that have switched into [an affiliate] Fund" should be paid immediately.

Ironically, SEB was a custodian for two investors that had shown no interest whatsoever in investing in the affiliate fund and SEB's name had seemingly been mistakenly highlighted as one of the Swedish investors investing in the affiliate fund. However, as a result of what appeared to be a mistake, SEB was paid its redemption proceeds in December 2008, January and February 2009.

Weavering subsequently went into liquidation and the liquidators sought to recover the redemption payments from SEB. SEB's defence to the clawback claim was, in essence, that:-

a)There should be some element of dishonesty in the mind of the investment manager decision before a payment is treated as a voidable preference;

b)The fact that the investment manager had made a mistake highlighting SEB as an investor that would invest in an affiliate fund meant that he did not actually intend to prefer SEB over the other creditors; and c)Even if there was an intention to prefer SEB in relation to the December 2008 payment (on the basis that SEB was preferred in the mistaken belief that they would invest in an affiliate fund), there was no evidence to suggest that this was the case for January and February 2009 payments given that a subsequent email clearly identified the investors that should be paid out -SEB was not one of them.

The dishonesty point was dealt with quickly and decisively by the CICA. The element of dishonesty in a voidable preference claim was the inherent inequity of a payment being made in circumstances that subverted the rule in relation to pari passu distributions amongst creditors of an insolvent company. Therefore, it was not necessary for a liquidator to show that the fund manager had been dishonest according to the definition applied in other contexts, only that his dominant intention was to prefer a creditor.

The CICA also dealt with the "mistake" point in short order. It held that, even where the investment manager mistakenly included SEB in a class of investors that were intended to be preferred on the basis of their investment in an affiliate fund, SEB still fell within that class and had been paid. It was the investment manager's motivation that was important, regardless of whether he had made a mistake or not.

Finally, the CICA agreed that the emails that clearly identified investors other than SEB in relation to the January and February 2009 payments demonstrated that SEB was not intended to be preferred at that time. However, the CICA found instead that a policy implemented by the investment manager in December 2008 to pay out all the December 2008 redeemers was sufficient to ground a finding that SEB had been paid in preference on the basis of the policy instead.

The nuances of the CICA's decision demonstrate the difficulty with clawback claims. For example, an investment manager could decide to pay all investors from the US because he believes (mistakenly) that the all of those investors are related entities. The CICA's decision implies that any payment to a US investor that it is no way related to the investment manager is liable to be clawed back because that investor was mistakenly included in a category of which the investor was never a member.

In the same case the CICA also held that a defence of "change of position" is not available to an investor in these circumstances. A "change of position defence" is premised on the inequity of a recipient having to return funds which have been spent or passed on in reliance on the payment. In the present circumstances SEB argued that it had paid the funds onto the underlying investors and should therefore not be ordered to repay the money because it no longer had it.

The CICA held that no "change of position" defence was available in these circumstances and that a consequence of a payment being found to have been made in preference to a creditor was that the creditor was obliged to return the money regardless of whether it had been paid out to third parties. The primary reason for this finding was that the underlying purpose of the voidable preference section of the Companies Law was to ensure compliance with the basic principle of insolvency law that the distribution of the insolvent estate should be pari passu amongst its creditors.

The decision does leave some points unaddressed.

In RMF it was held that, where the dominant motive of the director was to remove the threat of litigation, the payment was not a preferential payment. But what about the circumstances in Weavering? Arguably, the point could have been taken that the investment manager was making a payment to investors on the basis that they would invest in an affiliate fund. The investment manager's dominant intention or motive was not to pay these investors in preference to other creditors. His dominant intention was to secure their onward investment, which arguably falls within the list of non-preference circumstances set out in In re Cutts. Unfortunately the CICA did not address this issue.

One significant outcome of this line of cases might well be a lack of willingness on the part of investors to politely stand in line and await their payments. Exerting commercial pressure to be paid ahead of others may yield the best chance of avoiding a finding that the payment was a preference, whilst still getting paid.

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FX: What lies ahead for currencies in Trump sell-off?

By Erik Norland, Senior Economist and Executive Director, CME Group

Currencies, bonds, equities and metals reacted strongly to Donald Trump's victory in the U.S. elections on November 8 and Republicans retaining control of the Senate and House of Representatives. The U.S. Dollar (USD) and industrial metals soared while bonds sold off sharply on the prospects of a highly stimulative fiscal policy. If Trump's agenda to cut income taxes and spend on infrastructure was to be enacted, it would likely expand the federal budget deficit from 3% to around 5% of gross domestic product (GDP) and offer at least a short-term boost to growth. Meanwhile, a cut in the corporate tax could prove bullish for the U.S. dollar as corporations repatriate profits held in foreign subsidiaries, and as corporations based in other countries consider the United States as a more attractive investment option.

As the various markets digest their initial post-election reaction, it's worth examining which markets are likely to continue with their trend and which ones are likely to reverse course. In this piece, we will focus on currencies and discuss the other asset classes in subsequent articles.

Currencies

Although most currencies sold off against the U.S. dollar since the election, the degree of decline was highly variable (Figure 1).

Figure 1: Uneven Post-Election Dollar Strength.

Here is what we think is the most likely scenario and associated risks going forward:

The Mexican peso (MXN) has been hit the hardest as a result of Trump's campaign rhetoric regarding building a wall and deporting 11 million undocumented immigrants, most of them Mexican.

Since the election, Trump has softened his tone, suggesting that his administration will deport 2-3 million undocumented immigrants with criminal records or who are criminals, and that part of the wall might actually be a fence or could simply be augmented border security.

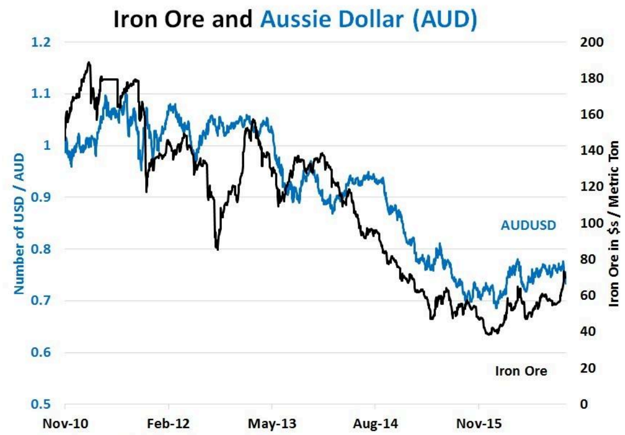
The market has interpreted this stance as positive for MXN yet those holding short positions in the peso should be warned that Mexico has its strengths. Mexican short-term interest rates are over 5%, up from 3% in late 2015. The Mexican economy is growing at a decent pace and the peso offers an attractive carry versus USD. The peso might be significantly oversold and susceptible to a sharp rebound in coming months.

The Metals Currencies: The South African rand (ZAR), Brazilian real (BRL) and Australian dollar (AUD) have all fallen on news of Trump's victory. All of these currencies depend heavily on the export of metals. While iron ore and copper prices soared, these currencies have fallen.

The divergence from the usual correlation patterns might offer investors an opportunity where AUD and BRL could outperform iron ore (Figures 2 and 3). While the prospect of fiscal stimulus should be bullish for both Federal Reserve rate hikes and the U.S. dollar, bigger fiscal deficits in the United States should ultimately be good news for metals exporters.

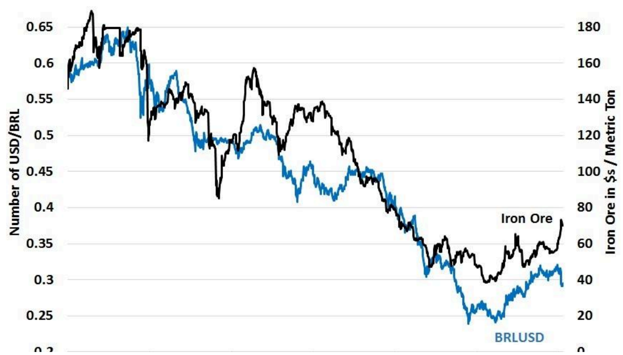
These currencies could prove to be outperformers, especially given the extremely attractive interest rate carry on BRL and ZAR. Brazil and South Africa still have messy domestic political situations, but Australia is much more solid politically and economically.

Figure 2: AUD has Fallen While Iron Ore has Risen Post-Election.



Source: Bloomberg Professional (TIO1 and AUD)

Figure 3: BRL has Fallen While Iron Ore has Risen Since the Election.



The Majors: euro (EUR), pound (GBP) and yen (JPY). The outlook for the euro, pound and yen might ultimately be more bearish. U.S fiscal stimulus probably won't help these currencies as much as it might help commodity exporters. Moreover, Europe and Japan are still beset by problems. Japan's total debt-to-GDP (public + private) level is close to 400%, well above that of the United States (252% of GDP). While, the Bank of Japan's (BoJ) negative interest rate policy appears initially to have had the unintended consequence of supporting the yen by contracting rather than expanding monetary supply, the BoJ's latest move to buy unlimited quantities of Japanese government bonds at pre-specified interest rate levels has been pushing the yen back down and may continue to do so.

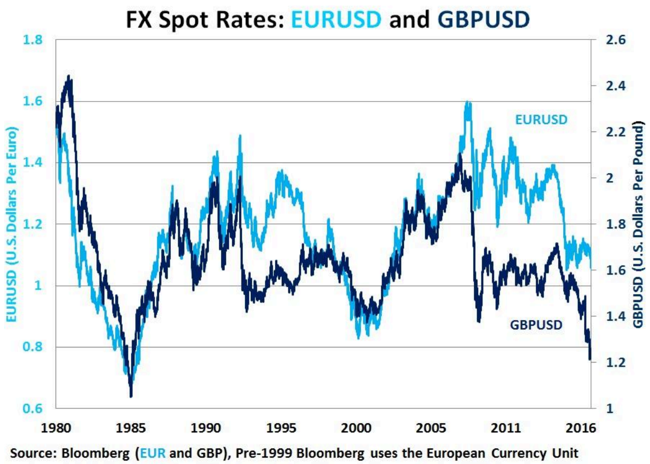
Meanwhile, Europe remains a political mess. The European Central Bank (ECB) still needs to support economic growth with an easy monetary policy as Europe's recovery is in a much earlier stage than that of the U.S. The U.S. expansion began in 2010 and unemployment has fallen by slightly more than

half from 10.0% at its peak to 4.9%. By contrast, the eurozone's recovery began only in 2013 and has been even slower than that of the U.S. European unemployment has fallen from 12% to 10%, a much more modest decline.

On the political front, Europe faces a series of potentially destabilizing elections beginning with the Italian constitutional referendum on December 4, to be followed by elections in the Netherlands (March), France (April, May and June) and Germany (September). Trump's win might add to the already considerable momentum of Europe's various nationalist and Eurosceptic parties. These elections have the potential to leave Europe with a much more fractured political landscape. If EUR breaks through its February 2015 low of 1.04 versus the U.S. dollar, it will likely test parity next and could eventually fall towards its low of 0.823 from September 2000 (Figure 4). Be warned, however, negative interest rates might be supporting EUR as much as they did for JPY, by contracting rather than expanding the money supply.

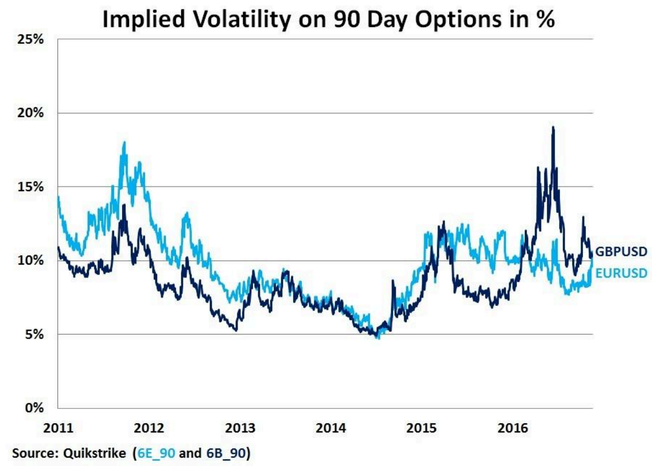
Finally, the British pound (GBP) has been relatively supported since the election, perhaps as a result of Trump's assurances that the U.K. will go to the front of the line in negotiating a new post-Brexit trade deal with the U.S. Even heading into the U.S. election, the pound already had upside momentum stemming from a court decision that requires the Westminster Parliament to take up the issue of Brexit before Article 50 can be invoked, initiating the process of leaving the European Union. Prime Minister Theresa May is appealing this decision, which will be reviewed by the U.K.'s Supreme Court in December. While the pound may have interpreted Trump's comments and a slightly reduced possibility of Brexit as positive, we tend to think that things could get more confused for the U.K. going forward. If the Supreme Court rules in favor of the Prime Minister, allowing her to go forward with invoking Article 50 in March as planned without consulting Parliament, we expect the pound to sell-off on the news. If the ruling goes the other way, the pound might rally temporarily, but getting Parliament involved in Brexit may make the negotiations more cumbersome and could ultimately prove bearish for the currency in the long run. Finally, the prospects for a tighter U.S. monetary policy probably won't be helpful for GBP either. We wouldn't be surprised to see GBP retest 1.05 versus USD, its 1985 low, in coming months (Figure 4).

Figure 4: EUR and GBP have Fallen but are Far From Historical Lows.



One distinct possibility is that EUR options could resume their normal pre-Brexit pattern of being more expensive in terms of implied volatility than GBP options (Figure 5). Politics in the U.K. may be messy but Prime Minister May's government has a much more solid grip on power than do most of her European counterparts.

Figure 5: Implied Volatility on EURUSD Could Rise Significantly Versus GBPUSD.



The Petrol Currencies: Canadian dollar (CAD) and Russian Ruble (RUB): Both these currencies have been relatively supported since Trump's election. Perhaps this isn't too surprising. He's never discussed building a wall between the U.S. and Canada and, indeed, the Canadian government immigration website crashed on the evening of his election. Likewise, Trump and his incoming National Security Advisor, General Michael T. Flynn, see Putin as an ally against

Islamic extremists rather than as a rival. The Russian media, which is largely under Putin's thumb, has greeted Trump's election with glee.

Both CAD and RUB correlate closely with oil and their prospects depend to a significant extent on the price of crude oil. The crude market is heavily supplied, with inventories still growing and Trump is favorable, at least in principle, to removing further constraints on U.S. production. These factors could prove bearish for oil prices and by extension for CAD and RUB. That said, CAD has already fallen much further than crude oil in the past few months and might become a relative outperformer versus either crude or RUB (Figures 6 and 7). On the other side of the ledger, Trump's foreign policy team, including General Flynn and possible cabinet members Rudolph Giuliani, the former mayor of New York City, and John Bolton, the former U.N. ambassador under the presidency of George W. Bush, could take a very hawkish line towards Iran and other Middle Eastern countries.

The Iran nuclear deal decreased tensions and helped to send oil prices lower. Reneging on the deal or ratcheting up tensions with the Islamic republic or other countries in the region could have the opposite effect. It remains to be seen if Trump's presidency will prove stabilizing or destabilizing for the Middle East and its key oil producing nations. If the Middle East becomes unstable, or if non-Middle Eastern producers such as Algeria, Angola, Nigeria and Venezuela become unstable, it could send oil prices soaring to the likely benefit of CAD and RUB.

Figure 6: CAD has Underperformed Crude and Might Outperform Oil or at Least RUB Going Forward.

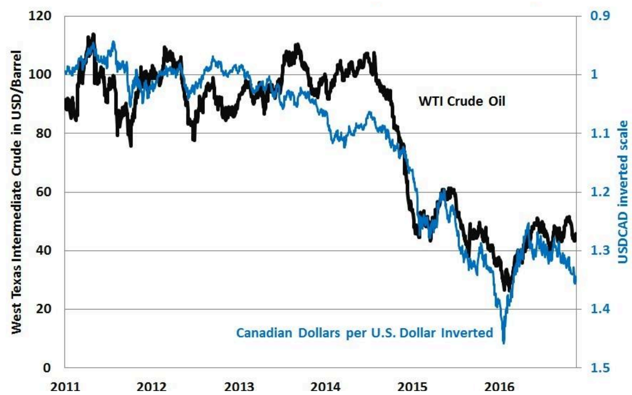
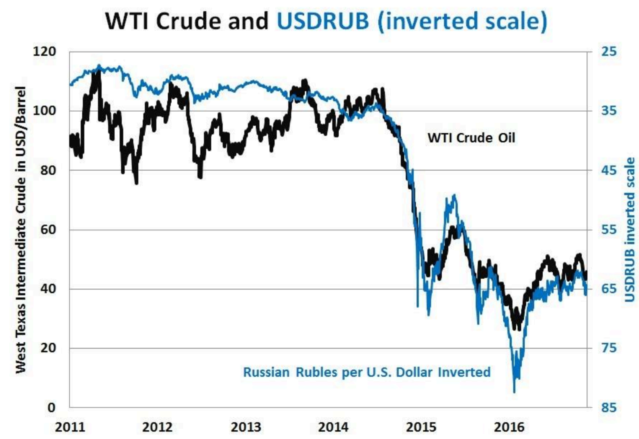


Figure 7: RUB has Performed in Line with WTI Recently.



Bloomberg Professional (USCRWTIC and RUB)

Chinese Renminbi (CNH): Trump's election might be extremely bearish for CNH. The renminbi benefited from a brief let up in downward pressure for much of 2016 as the yen rallied and emerging market currencies recovered. Since Trump's election, both the yen and the various emerging market currencies have resumed their downward trend (Figures 8 and 9). Trump's tax reforms are unlikely help China much. China might derive limited benefits from a U.S. tax cut, which could modestly boost U.S. consumer demand for Chinese-made goods. Trump's spending plans might be outright harmful to China by boosting materials prices as China is a big importer of metals and energy. Moreover, the likelihood of more Fed rate hikes will likely increase capital outflow pressures from China. At some point, China might choose to significantly devalue its currency in order to regain competitiveness. If this happens, we expect a major shock for both developing and emerging market currencies as well as commodity prices.

Figure 8: Emerging FX Resuming Downtrend vs. Renminbi Could Increase Devaluation Pressure.

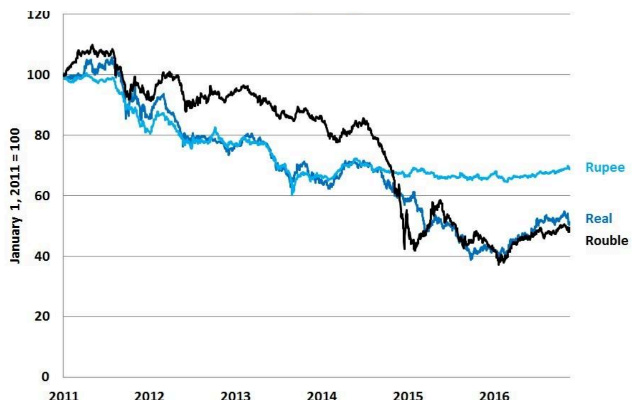
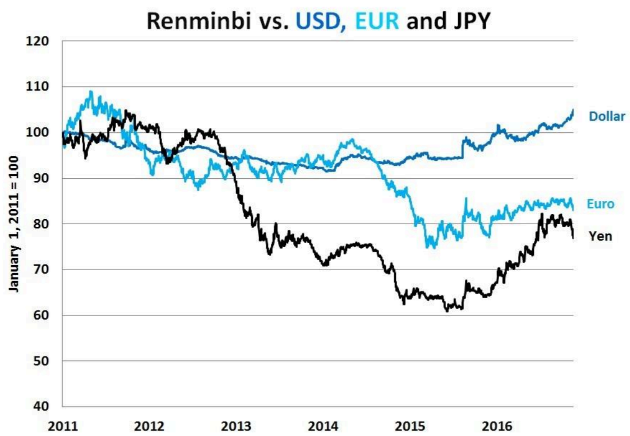


Figure 9: Emerging FX Resuming Downtrend vs. Renminbi Could Increase Devaluation Pressure.



Source: Bloomberg Professional: CNHUSD, EUR and JPY

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Volatility? What volatility?

By Jack Inglis, CEO, AIMA

Around the end of last year, The Economist declared that, "Despite renewed volatility, hedge funds underwhelm", and in the subsequent piece, the writer claimed that "hedge funds have had a measly few years". Such analysis is wrong. Assets under management by hedge fund firms are at record levels ($3.2 trillion, according to Preqin), and there have never been more pensions or other institutional investors allocating $1bn or more to these funds. Nor, as the Economist claims, was 2016 "the most volatile year for markets in a long while".

Volatility for most of last year was below historic averages, some notable political events notwithstanding. The long-term average (since 1990) for the Chicago Board Options Exchange Volatility Index (VIX), which reflects market expectations of near-term volatility, is 19.7. In 2016, the VIX average was 15.9 (in 2015 it was higher, at 16.6). Genuine volatility spikes are when the VIX breaches 30.

It may seem counter-intuitive, given the turbulent events of last year, but we are not in a period of high volatility by historic measures. Amid the European sovereign debt crisis, "vol" was considerably higher – for example, in June 2010 it was 34.54, while in September 2011, the VIX was at 42.96. It was also much higher during the financial crisis. From September 2008 to August 2009, the average value of the VIX was 39.46, with the peak being 59.89 in October 2008. The current period is more akin to the last periods of relative calm in the financial markets, from 1993-1995 and 2004-2006.

Even during the most volatile moments this year, following the 'Brexit' referendum and the US presidential election, the VIX hit 'only' 25.8 and 22.5 respectively. Within weeks, it had returned below the historic average.

How do hedge funds perform when volatility is higher? At AIMA, we have looked at hedge fund performance since 1990 during periods of peak volatility – when the VIX was 32.1 or above (the top 5% of VIX values). We found that, during these months (there are 17 of them), hedge funds as a whole and equity hedge funds outperformed the S&P total return index on the majority of occasions.

This does not mean that hedge funds only perform better during periods of high volatility. Indeed many individual hedge funds have performed very well in 2016. To the end of October, average hedge fund performance was about +5% (Preqin data), which was the same as the MSCI World equity index. In the final analysis, when the full-year numbers are in, we expect hedge funds to have shown they have performed better than commentators are suggesting. And that's in a below average year for volatility.

@JackInglis_AIMA

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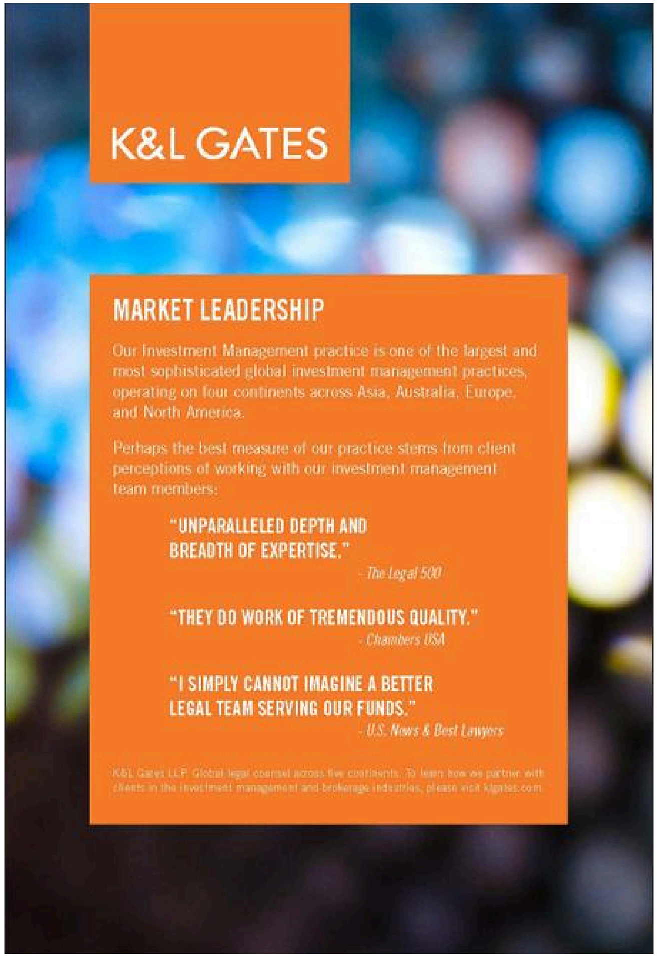

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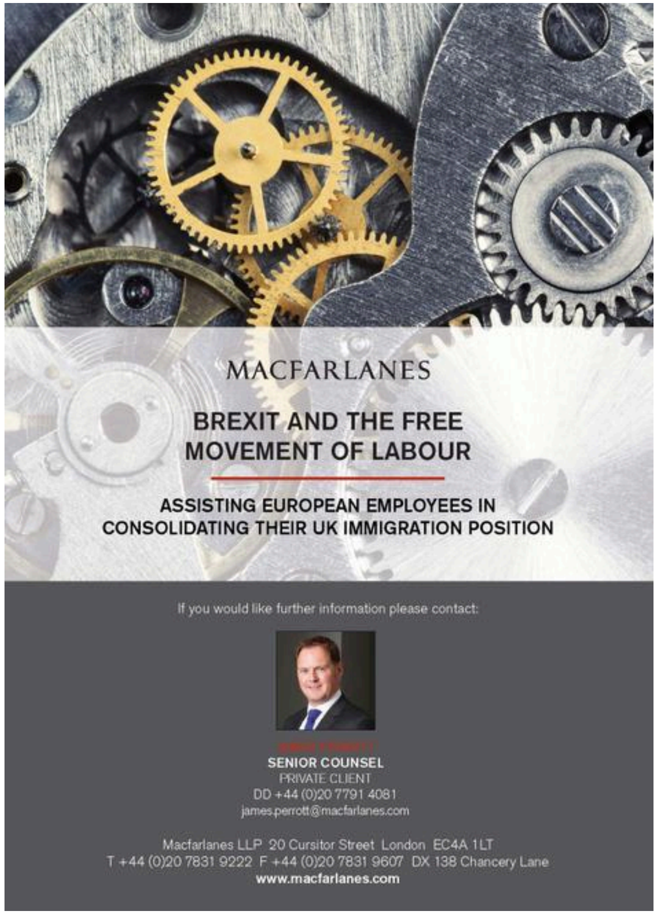

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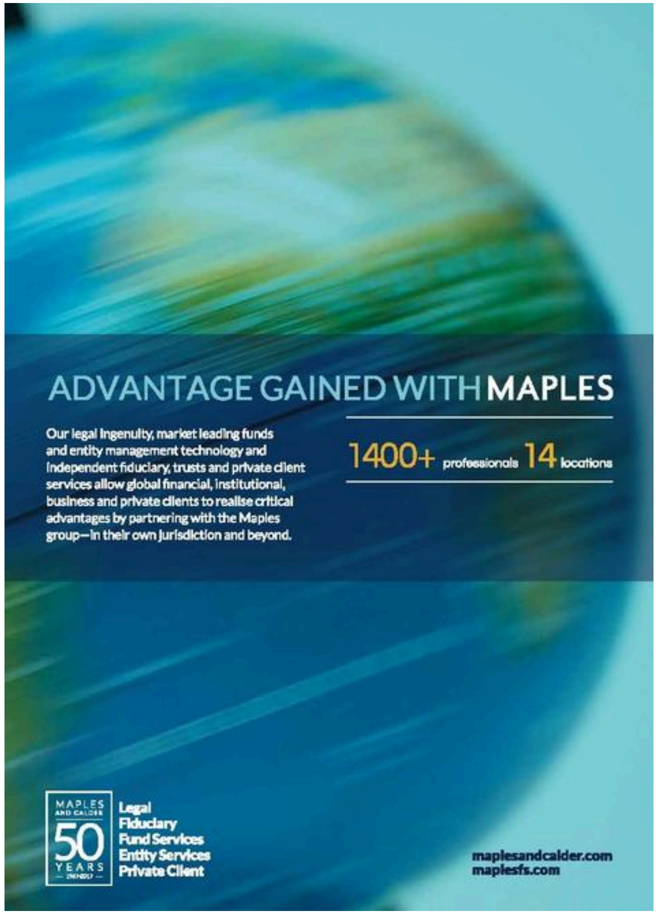

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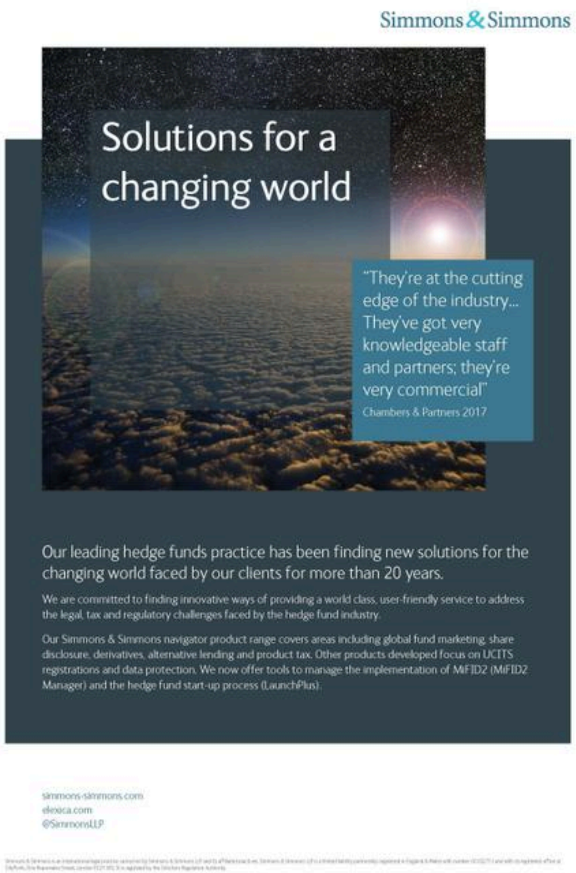

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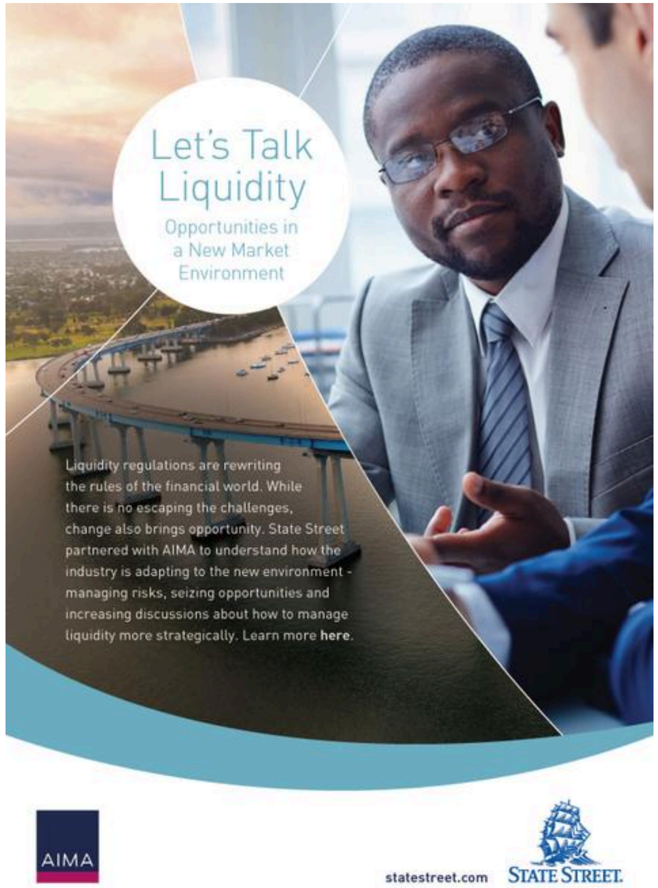

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