

**The Actuarial Profession**  
making financial sense of the future

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Fresh Perspectives  
Hugh Gittins



## Investor beware: alternative investments

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### Catalyst for this talk

- 'Regulated investments just like unregulated, except no access to Financial Services Compensation Scheme with unregulated'
- Is this right?
- How concerned should we be about what our trustee clients are told about alternative investments?

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## What I plan to cover...

- Quick recap on trustees' investment duties
- What are 'alternative investments'?
- The regulated, the unregulated and Lucky Lad at the 3.30 in Doncaster ...
- Why trustees should be wary of alternative investments

## Investment duties

- Invest in accordance with the terms of the trust
- When selecting investments:

*"take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide"*

(Re Whitely (1886))

## Investment Regulations 2005

- Invest in the **members' best interests**
- Scheme assets must consist predominantly of investments traded on **regulated markets**
- Investment on **unregulated markets** must be kept to a **prudent level**

## Investment Regulations 2005

- Investment in derivative instruments made if it avoids excessive risk exposure to a single counterparty, and it:
  - contributes to a reduction of risks; or
  - facilitates efficient portfolio management
- Investments must be **properly diversified**
  - Strategy should be “*calculated to ensure the **security, quality, liquidity and profitability** of the portfolio as a whole*”

## What are alternative investments?

“An alternative investment is an investment product other than the traditional investments of stocks, bonds, cash or property. The term is a relatively loose one and includes tangible assets ... and some financial assets such as commodities, private equity, hedge funds and financial derivatives.”

Wikipedia

## What are alternative investments?

Regulated



Unregulated



## Regulated investments

- Types of UK Authorised Investment Fund

- UCITS
- NURS
- QIS



- Legal form

- Authorised Unit Trust
- Open-ended Investment Company
- OEIC is a legal person only

## Regulated Investments : UCITS

- Undertakings for Collective Investment in Transferable Securities (UCITS)
- A set of European Union Directives
- Aim to allow CISs to market freely throughout the EU
- Single authorisation from one member state

## Regulated Investments : NURS/QIS

- Non-UCITS Retail Scheme (NURS)
  - Authorised fund: includes retail investors
  - Outside scope of UCITS
  - Investment powers wider than UCITS funds
- Qualified Investor Schemes (QIS)
  - Wider investment and borrowing powers than UCITS funds or NURS funds
  - Can be marketed only to 'qualified' investors

## So what's so special about Authorised Funds?

- Product level regulation under English law (COLL Sourcebook)
- Different levels of regulation:
  - **Gold – UCITS**
  - **Silver – NURS**
  - **Bronze – QIS**

## Authorised Fund - effect of jurisdiction

- All UCITS type funds intended to have a level regulatory playing field throughout Europe
- Directives not Regulations
  - e.g. Dublin funds previously allowed physical shorting
- NURS/QIS – UK specific but equivalents in other jurisdictions. Rules change depending on jurisdiction in question

## More murky – hedge funds

- Difficult to define
- Traditionally offshore based funds – e.g. Cayman Islands/Isle of Man/BVI
  - Low tax/low regulation
- Funds aim to achieve absolute return (1980s)
  - Obtain a return in a falling market
- Other funds now come in
  - Take advantage of the structure

## Hedge funds (cont ...)

- 2 types of hedge fund
  - Traditional : offshore
  - Recent : onshore - in the EU (eg Malta, Ireland)
- Regulatory worries (2012)
  - Tougher on non-EU funds selling into the EU
  - Alternative Investment Fund Managers (AIFM) Directive?
- Recent EU Funds : light regulation/tax efficient

## Private Equity Funds

- Commonly established as Limited Partnerships
- Nature of Asset:
  - Illiquid
  - Medium to long term investment (e.g. 5-10 years)
- Invests in private unlisted companies



## Private Equity Funds (cont ...)

- Returns earned over medium term
  - Improve performance of portfolio companies
- High leverage common
- English Limited Partnerships - not legal persons
- Channel Isles/UK

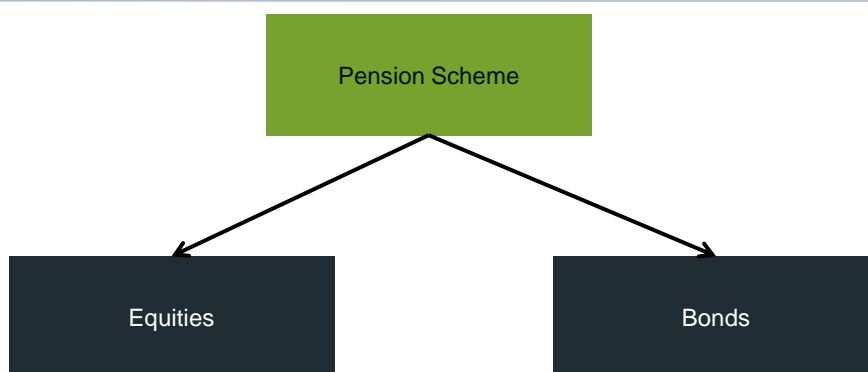
## Derivatives

- Must be used to hedge against another risk (Investment Regulations 2005)
  - Inflation/interest rates/FX/longevity
- Use of ISDA documents
- Typically collateralised and often daily
  - “In the money” – fund receives collateral
  - Collateral usually transfers absolutely

## Fund structures and risks

- Start with direct investment
- Collective investment schemes
  - Authorised
  - Hedge funds
  - Private equity

## Classic Investment Portfolio



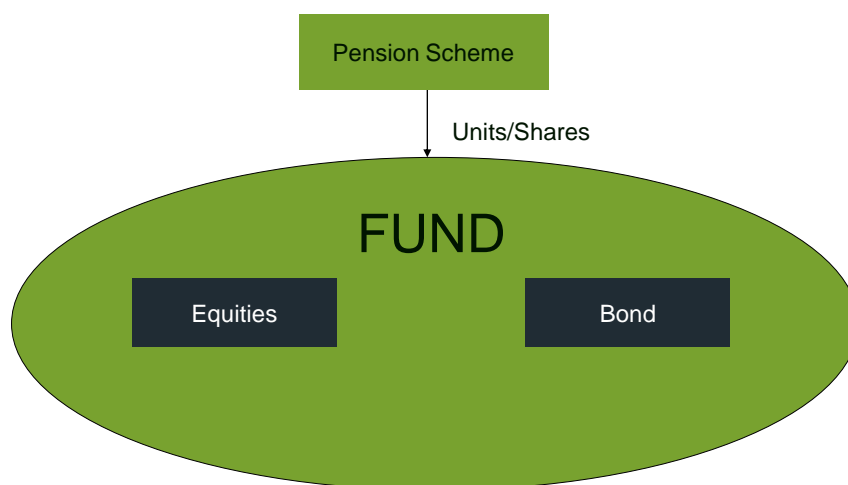
## Classic

- Managed portfolio of bonds and equities
- Investment Management Agreement
- None of the following
  - Wrapper
  - Pooling
- Long only – returns in a rising market/losses in a falling market

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## Collective Investment Scheme 1 UCITS/NURS/QIS/Hedge Funds



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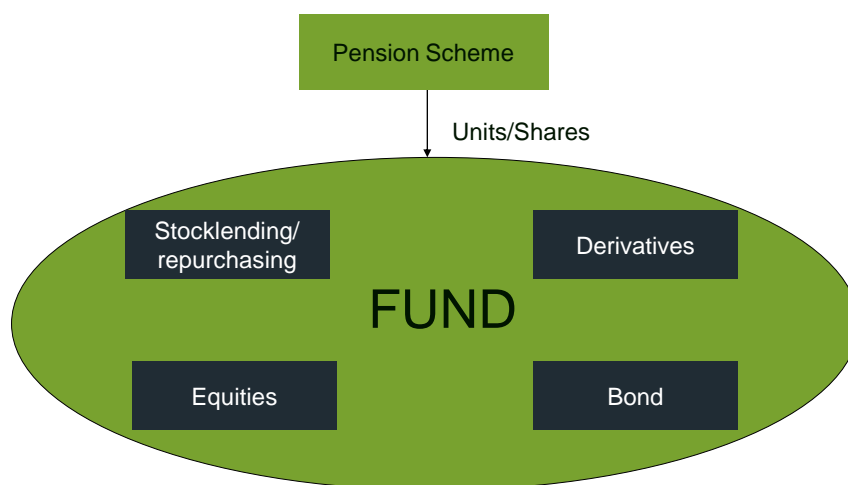
## Collective Investment Scheme 1

- Same assets but held within a 'wrapper'
- Trustee's investment pooled with others
- Trustee no longer owns physical shares/ bonds
- Instead has units whose values rise or fall based on the value of the assets within the Fund
- Investment risk profile is more or less the same
- Economies of scale

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## Collective Investment Scheme 2 UCITS/NURS/QIS/Hedge Funds



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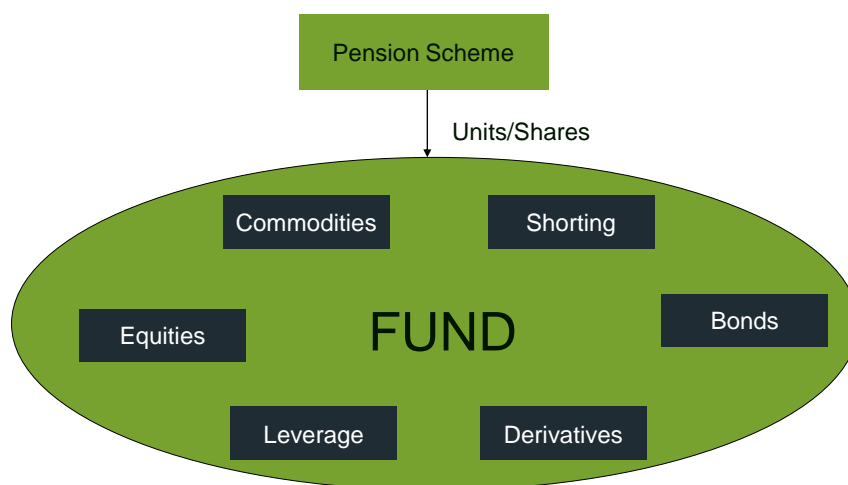
## Collective Investment Scheme 2

- New assets introduced
- Derivatives and Stocklending/Repos
- Contingent liabilities introduced
- Further credit risk introduced
- Could still be a UCITS Fund if limits on use of derivatives/stocklending

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## Collective Investment Scheme 3 Hedge Funds



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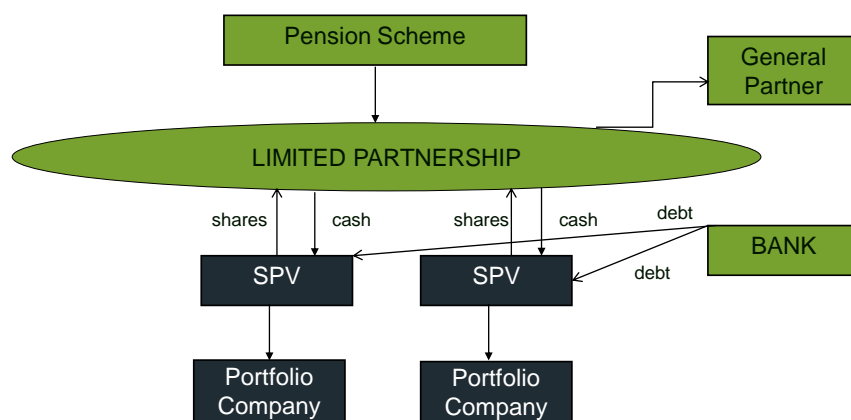
## Collective Investment Scheme 3

- Hedge Fund
- Commodities – speculative and volatile
- Shorting – borrowing a security and selling it in the market in the hope that its value will fall before it must be returned to the lender
- Leverage – borrowing to invest (multiplies gains and losses)
- Likely to be less liquid (i.e. harder to get out) than UCITS

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## Collective Investment Scheme 4 Private Equity Fund



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## Collective Investment Scheme 4

- Private Equity Fund
- Trustee typically becomes a Limited Partner
- Often highly leveraged – but most borrowing not at Fund level
- Illiquid (not open-ended like UCITS)
- Medium to long term investment

## What is Fund regulation for?

- Developed due to concerns that retail investors would be subject to unacceptable risks of fraud and abuse
- COLL Sourcebook
- Significant limitations are placed on:
  - Illiquid investments (real estate, private company interests)
  - Short selling
  - Leverage
  - Highly concentrated positions
  - Derivatives strategies

## Unauthorised Funds

- Investors are left to negotiate the limits – often difficult
- Such limits as there are appear in the governing documents of the Fund
- These should be reviewed critically so that the Trustees know what the terms are that apply to the investment

## What questions should be asked?

- Is this a regulated or unregulated fund?
- If unregulated:
  - Limited liability?
  - Who owns the underlying assets (trustee/custodian/manager) – where is it based?
  - What oversight obligation is placed on the trustee/depository over the manager?



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## What questions should be asked?

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- What are the investment restrictions, in particular regarding
  - Derivatives
  - Shorting
  - Commodities
  - Leverage?
- What voting rights are available to investors (corporate governance implications)?
- How often can investors redeem?
- Any redemption restrictions?

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## What questions should be asked?

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- 'In specie' redemptions?
- Are the reporting obligations sufficient?
- Does the tax treatment of the investment work?
- What law governs the investment?

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## And last and perhaps least ....

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What are the returns like?

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## New tax transparent UK funds

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- UK currently has no authorised tax transparent collective investment vehicle to compete with Luxembourg and Irish funds
- Chancellor announced intention to introduce new tax transparent fund vehicle in Budget 2011
- Consultation published on 9 January 2012
- New, regulated tax-transparent fund vehicle under UCITS IV

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## New tax transparent UK funds

- Primary intended use is as the “master fund” in an international “master-feeder” structure
- Overseas “feeder” funds from could invest without losing their overseas tax status
- Multinational corporations could use these vehicles to set up a global collective investment fund
- Manager would need to be authorised

## Investing in infrastructure

- Government’s announcement
- “Pension infrastructure platform” (Pip)
- Memorandum of understanding between Treasury, NAPF and PPF
- Could take a number of forms e.g. limited partnership

## Investing in infrastructure - areas of uncertainty

- Structure
- Who operates the fund?
- How will construction risk be “bypassed” – Government guarantees?
- Charges
- How will Pip affect other infrastructure funds?



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## Any Questions?

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