



## Regulated Alternative Funds: The New Conventional

### Convergence

In what is beginning to seem like the distant past, a clear line had once separated traditional and alternative investment products. Yet, three major global financial market crises in a ten-year span have dramatically transformed investor attitudes. As a result, asset managers and advisors are grappling with how to adapt to this new era. Their responses, along with those of regulators and distributors, are redefining investment product structures. As investors faced multiple market crises and rising volatility, fund managers responded with a range of innovative products designed to better manage volatility and offer alternatives to long-only investing in traditional markets.

### Exotic is Now Mainstream

As investor segments and products converge, alternative strategies are increasingly being packaged within registered fund structures originally designed for retail buyers, but also used by institutions and other fund selectors. A growing number of alternative funds are being launched as UCITS, a fund vehicle accepted for sale in the European Union and many other nations. Alternatives also are becoming more prominent within US mutual funds (registered under the Investment Company Act of 1940 or, in some cases, under the Securities Act of 1933). The growing popularity of these funds is clearly evident in strong asset flows, product proliferation, and a growing presence in Asian markets.

One factor driving the popularity of alternative UCITS and mutual funds is the detailed requirements around risk measurement and management, liquidity, counterparty diversification, and limits on leverage. However, the increased use of derivatives and their associated counterparty and operational risks continue to concern investors and regulators alike. The regulatory environment remains

A key facet of this evolution is the convergence of strategies previously segregated along retail versus institutional lines as well as traditional versus alternative investment approaches. Retail investors and their advisors now are gravitating towards the greater diversity (and complexity) of alternative strategies that before were pursued mainly by institutional and high net worth individuals. Institutions meanwhile continue to seek diversification through alternatives, but increasingly appreciate the transparency, liquidity, and regulatory controls found within regulated pooled products, previously associated primarily with retail investors.

in flux as new rules on hedge funds take shape in Europe, and as the framework around UCITS gets reviewed amidst the expansion of more complex products. Yet this too is encouraging further innovation.

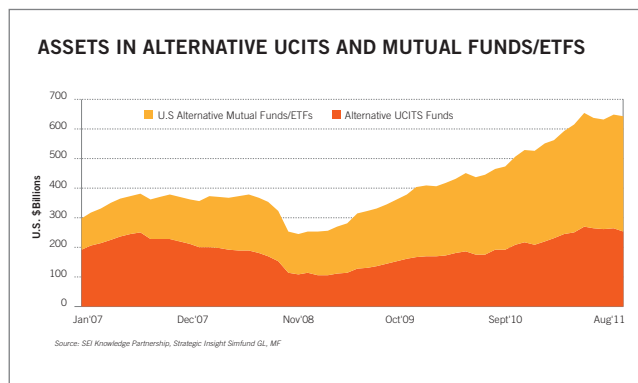
Meanwhile, new frontiers are emerging. Europe and the US have led the way in the adoption of alternative strategies, but other markets are developing a taste for non-correlated funds. One of the biggest retail fund launches in Japan this year was an alternative managed futures strategy. Demand for alternatives is growing among sovereign wealth funds and national pension funds in Asia, Latin America and the Middle East. Wealthy individual investors around the world are also expected to consider alternatives more seriously after their recent experiences with traditional asset classes. Although institutions and high-net-worth individuals can access hedge funds and alternatives directly, they may see the benefits of sourcing such strategies through regulated structures, just as their European counterparts have done.

## Looking to the Future

Growth in the global retail market by alternative UCITS and mutual funds will be spurred mostly by smaller institutional investors. In the US, a greater number of financial advisors are adding alternative funds to retail portfolios as risk and volatility management become higher priorities in advisor-client discussions. In Europe, retail and institutional investors alike are gradually migrating toward UCITS, attracted by the fact that they are relatively liquid, transparent, and regulated.

However, it would be a mistake to view UCITS and '40 Act mutual funds as some sort of panacea. They work well as vehicles for some investment strategies, but illiquidity factors prevent them from working for other strategies. Ultimately, they are just one more way for managers to expand and diversify their investor base.

Despite this caveat, assets in alternative-strategy UCITS and US mutual funds should top \$1 trillion in 2014, assuming only modest performance gains over the next few years, and barring a dramatic bear market. By 2016, assets in



such funds should more than double the current \$644 billion. Absolute return, hedge fund-like strategies, and global tactical allocation funds are likely to be major drivers of this growth. Commodity funds may also grow as portfolio diversifiers, but demand is less certain as they often mirror erratic commodity prices movements. Geographically, any slowdown in growth in the US and Europe will likely be partly offset by growth in Asia and other newer regions.

## What Managers Can do to Succeed

A market of \$1 trillion or more, and growing at a robust pace, means opportunities lie ahead for both retail and institutional managers interested in alternative strategies. With the development of regulated non-UCITS funds such as QIFs and SIFs as vehicles for alternatives, the market is even more substantial.

As managers jockey for position and vie for the attention of investors, intermediaries, and gatekeepers, product innovation and distribution expertise will be key factors in determining the winners. And as the market matures, assets will ultimately coalesce around managers that are able to effectively combine both of these attributes with a sterling reputation, an institutional quality process, and proven performance.

Traditional fund managers should be able to leverage their existing relationships with distributors as they roll

out alternative funds. Those with experience in educating investors and advisors are likely to have an additional advantage that will enable them to secure additional market and mind share. Hedge fund managers wishing to enter the market for regulated alternative funds may prefer to find a retail-oriented manager with whom to partner or enter into a sub-advisory relationship. Such partnerships, combining the investment expertise of one firm with the distribution prowess of another, will almost certainly become more common as managers of all stripes look for ways to gain a foothold in one of the most dynamic and growing parts of the asset management business.

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