

APPLICATION OF UCITS FUND TECHNIQUES IN THE NEW REGULATORY ENVIRONMENT

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Drivers of UCITS fund features

Regulation / Taxation

- UCITS > UCITS IV
- Tax Reporting
- Gradual adoption of IFRS
- RDR (UK) - "Distributor" share classes

Cross border sales growth

- Multi-currency Share Classes
- Hedged Share Classes for "non base" investors
- Valuation issues:
 - Convergence of Valuation Points
 - Increasing use of Fair Value

"Fairness" & Investor choice

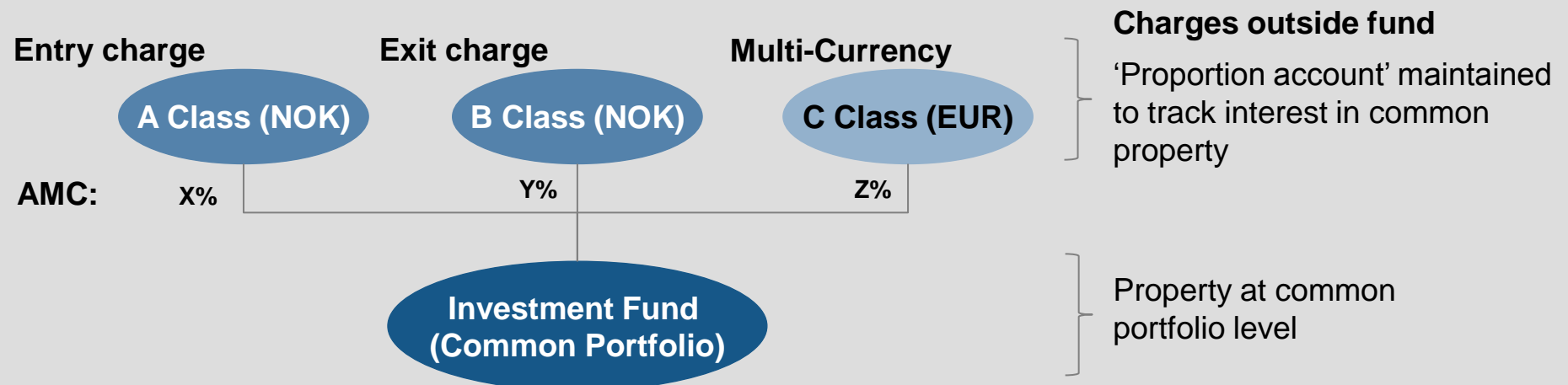
- Swing Pricing / Dilution Levy
- Accumulation / Distributing share classes
- Hedged Share Classes for "base" investors seeking to eliminate currency risk
- Differing commission / fee models

Growth of Fund Promoter sophistication

- Multiple Share Classes
- Increasing use of performance fees
- Export of fund features from:
 - US fund promoters
 - Alternative managers

Multiple Share Classes—the basics

- Share class accounting used to track proportionate ownership in common fund
- Separate unit price calculated for each class
- Fund documents explain class rights and how proportionate ownership is determined
- Fund financial statements are prepared at fund level
- Classes can be differentiated by a variety of ‘Characteristics’



Share class differentiators – Fees

- Management Fees specific to share class:
 - Retail Front end fee
 - Retail Deferred fee or exit charge
 - Institutional Lower management fee
 - Clean Used for feeder or funds of funds
 - “Distributor” class New trend in IFA classes launched for UK RDR
- Fee Caps also possible at share class level

Share class differentiators – Performance Fees

- Class level performance fees increasingly used in Alternative type UCITS funds
 - Investor level (hedge funds) model not seen as viable in daily priced market
- One model dominates:
 - Outperformance of hurdle or benchmark
 - High water mark (HWM)
 - Average unit calculation basis
 - Periodic crystallisation & on large redemptions
- Note: Share class performance fee is not an exact science!
 - Subscriptions can undeservedly benefit from:
 - A rising NAV up to HWM
 - A falling NAV when NAV is higher than HWM
 - Existing investors may suffer dilution

Share class differentiators–Hedged Share Classes

Predominant strategies and uses

1. Multi-currency hedged class
 - To eliminate currency risk to fund base
2. Base currency hedged class
 - Offering hedge against portfolio currency risk
3. Newer strategies
 - Duration
 - Currency basket
 - Commodity

Common operating techniques

- Hedge rolled monthly & on each investor transaction
- Tolerance level monitored to allow for slight deviation during month e.g. 5%
- Fund allocation ratio can include or exclude the hedge gain/loss–no set rule
- “Swap” model increasingly used to:
 - Eliminate timing impact of difference from shareholder FX to hedge FX
 - Reduces non-hedge caused divergence to other classes

Swing Pricing/Dilution Levy–Introduction

- Counter-dilution techniques that seek to address the impact that investor in/outflows have on fund operating costs & performance
- Recognised as being for the benefit of the fund and its investors, differentiating from commission type charge
- Originated in the UK, and now commonly used in cross border UCITS market

Dilution levy

- All investors in a particular class deal at the un-diluted NAV per share
- A separate charge is applied over the subscription price or as a deduction from redemption proceeds

Swing Pricing

- Results in an adjustment to the un-diluted NAV per share to reach a “swung” price
- All investors in a particular class deal at the same published price
- “Full swing” – used every time shareholder activity occurs
- “Partial swing” – Triggered by significant fund inflow or outflow

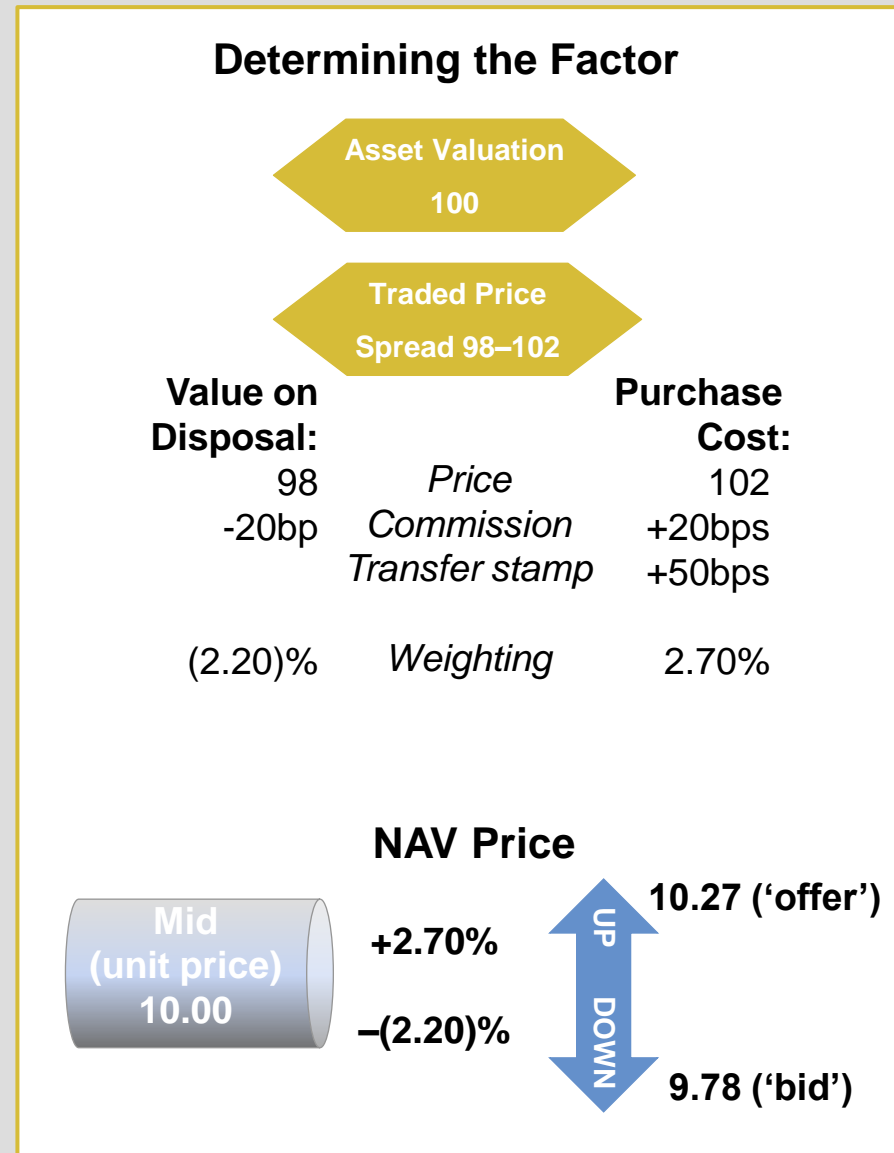
Swing Pricing–Mechanics

Determining the swing factor

- Assets priced on a bid & offer basis
- Analysis undertaken to determine trading costs
- Assessment made by manager & pricing committee to arrive at offer factor and bid factor

Calculating the Swung NAV

- The factor is applied to the unswung NAV per share
- If the NAV has been swung, this becomes the published price



Swing Pricing–Trends

- Statistics indicate that Swing Pricing has become the common anti-dilution technique in cross border UCITS funds
- Reasons:
 - Fair for investors because it takes account of net activity and actual securities dealing impact at any point
 - The same NAV per share is applied to all investors for both inflows and outflows
 - Simple for platforms and transfer agent, as the dealing price is the published price, and allows to differentiate any commissions
- Note: Fund performance statistics can be distorted when looking at published swung or unswung fund prices

Swing Pricing–Statistics

Findings from 2011 ALFI Survey¹

- 18 promoters in sample (est. 55% of Lux AUM)
 - 13 employ Swing Pricing
 - 62% partial swing
 - 15% full swing
 - 23% mix
 - Swing trigger thresholds:
 - 39% <1%
 - 38% 1-5%
 - 8% 5%
 - Swing factor:
 - Mostly 10-50bps
 - Some >200bps
 - Swing factor typically determined / reviewed quarterly
- Partial trigger based swing predominates
- Mostly 1 - 2% trigger threshold
- Swing factor mostly 10-50bps determined quarterly

¹ ALFI Swing Pricing Industry Survey–Published Feb 2011. Available on www.ALFI.lu website

QUESTIONS?