Editorial
Catherine Alexander

Changing seasons, changing markets

Welcome to the first edition of Institutional Insights for 2014 – a new year and in fact a new editor! We have left the dark throes of winter and brighter days are now here. As with the seasons, the markets move in their cycles and we continue to see changes in sentiment, investor appetite and trends. The first few months of this year have not been any different – equity markets have experienced a good run but now we are seeing signs of fixed income bouncing back, as are emerging markets after a tough few months, helped somewhat by the recent volatility spike in the region. Developments in regulation continue to roll out and the industry is on the steep learning curve, adjusting and adapting. As always, the markets do not disappoint in providing points for discussion and debate and we hope to cover a number of key, current aspects in the following pages.

In this edition, Katy Kaminski returns with a piece looking at the fast growing world of ETFs. Since their introduction in 1993, the ETF market has seen rapid growth and not just in the U.S., as is the common misconception – interest and growth in the European ETF market has exploded with roughly USD 400 billion invested.
and looks to continue that way. In particular, Katy explores the concept of “create-to-lend” in the ETF market whereby ETF shares can be created and sold short, which offer several unique features that provide an incentive to invest and consequently is fuelling demand for ETFs.

For our interview in this issue I am delighted to welcome Andrew McCaffery, Global Head of Alternatives at Aberdeen Asset Management, and Renaud Huck, Senior Vice President Buy Side Relations at Eurex Exchange. Andrew was kind enough to join our Hedge Fund Lions Den initiative in 2013 as an industry “Lion” – listening to pitches from three emerging managers and providing constructive feedback and advice on how to survive in this ever complicated and competitive industry where greater barriers to entry in the form of regulation now exist. Regulation seems to be the one constant in the industry right now; we know it is here to stay; it is more a matter of how to deal with it. As a leading asset manager, Aberdeen has to be aware of all the new rules and Andrew discusses the impact of EMIR and other regulations on his company and the industry as a whole, while highlighting the strategies he thinks will be the flavour of 2014 – an insightful interview with a leading figure in the industry.

In “Clearing insight”, Renaud looks at the hot topic of segregation and portability, which is a sensitive issue for investors following such high profiled defaults as Lehman and MF Global. Both buy and sell side clients now demand higher protection from co-mingling of assets and misuse of assets and thus individual segregation is requested, which Eurex Clearing introduced in August 2011. Separately, at the time of writing this editorial we received the much anticipated news that Eurex Clearing has received authorization as a Qualified Central Counter Party (Q CCP) under EMIR. Well done to the team!

Lastly, Simon Marks, Brussels Correspondent at MNI, looks at the new rule adopted by the European Commission on 24 March aimed at stamping out bank secrecy and tax evasion. This rule had been in the pipeline for five years but faced opposition from Luxembourg and Austria with fears their banking systems would be at a competitive disadvantage with tax havens like Switzerland, until it was recently revised.

I hope you enjoy this edition of Institutional Insights. As always, I welcome any questions or comments you may have regarding the content of the magazine so please do get in touch with any thoughts: catherine.alexander@eurexchange.com

Catherine, on behalf of the team
Thought leadership

Kathryn Kaminski and Valeri Sokolovski

The short on shorting ETFs: The art of create to lend

Similar to stocks, Exchange Traded Funds (ETFs) or even more broadly Exchange Traded Products (ETPs) are portfolios of securities which are traded on an exchange. Since their introduction in 1993, the ETF market has ballooned to a size of over USD 5 trillion. Currently, close to 40 percent of all U.S. trading volume is in ETFs. The oldest and largest ETF, the SPDR S&P 500 ETF (also known as the “Spider”), has a colossal market size of USD 150 billion making it the most liquid and actively traded security in the world. Although ETF growth has been strong in the U.S., the European ETF market is not far behind. Interest and growth in the European ETF market has exploded with roughly USD 400 billion invested. Despite its humble origins almost 20 years ago, ETFs have become a formidable asset class. Today’s ETF market offers both breadth of options and depth in volumes to such a point that futures contracts are even offered on individual ETFs. The ability to sell short, a wide array of investment options, and the overall ease of use of ETFs is fuelling demand. Outside the larger highly liquid ETFs, more specialized and esoteric ETFs are emerging to fill this increasing demand.

Short selling in ETFs

Perhaps even more interesting, ETFs also provide a new avenue for taking short positions. Unlike individual stocks or securities, ETFs can be easily sold short and they have never been subject to the “uptick” rule. Short selling accounts for a non-negligible proportion of the ETF trading volume. For example, the average short interest for U.S. common stock is typically less than 2 percent, while short interest in ETFs is typically around 10 percent. Unlike common stock, it is not unusual that short interest percentages of shares outstanding are over 100 percent.1 ETF short sales are often made to reduce, offset, hedge, or manage risk. Highly liquid ETFs, such as the Spider (ticker SPY) or the Cubes (ticker QQQ) which tracks the NASDAQ 100, are in direct competition with index futures.

For the specific case of shorting ETFs, there are several unique features which may provide some incentive for their use in short selling. In most cases, management fees drag performance. For the case of shorting ETFs, management fees

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1 A short interest percentage above 100 indicates that the average share the fund has outstanding has been lent and re-lent several times with a round-robin effect.
For example, there have been cases where a hedge fund may short sell an ETF and establish a long position in all but one or possibly several hard to borrow securities. This net portfolio allows the fund to short only the difficult to short securities.

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hundreds of billions or even trillions of dollars of market value”. This mechanism allows for ETF shares to be created for the sole purpose of facilitating short selling. “Create-to-lend” is a unique feature of exchange traded funds.

Demonstrating create-to-lend: a case study of the U.S. financial ban of 2008
On 18 September 2008, the U.S. Securities and Exchange Commission (SEC) temporarily banned short sales in 797 financial stocks. This ban was enacted on 18 September and subsequently lifted on 8 October. ETFs were, however, exempt from this particular ban. Karmaziene and Sokolovski (2014) show that a substantial portion of shorting volume moved to the most liquid SPY (Spider) ETF during the ban on short selling in financials. For this particular period, liquidity was a serious issue even for ETFs. As a result, short selling in financial ETFs was substantially more difficult. For the period before, during and after the short selling ban, Figure 2 plots the value and share of stocks on loan for the SPY. Immediately after the ban announcement, short interest in the SPY began increasing. At one point, close to USD 5 billion new short sale positions were created using the Spider ETF. For the period before, during, and after the short selling ban, Figure 3 plots the total market capitalization and total number of shares for ETFs. Driven by rapid share creation, market capitalization of the SPY grew during the ban – arguably to fill the corresponding rise in short selling demand. Combining the effects in both Figure 2 and Figure 3, →

Short selling accounts for a non-negligible proportion of the ETF trading volume. For example, the average short interest for U.S. common stock is typically less than 2 percent, while short interest in ETFs is typically around 10 percent.

Despite this, the “create-to-lend” process remains somewhat misunderstood. Put into more simple terms, if a prime broker is faced with a request to borrow ETF shares which are not readily available, the broker can dip into the pool of underlying securities and create new ETF shares. These shares are created and subsequently lent out to a short seller. Since ETF providers are often active participants in the securities lending markets, the availability of the underlying securities to borrow is seldom an issue. The creation-and-redeemption process makes it possible to create shares for the sole purpose of short selling or create-to-lend. In a recent academic study, Karmaziene and Sokolovski (2014) uncover evidence of this behaviour during the 2008 shorting ban for U.S. financial securities.

3 The size and depth of financial ETFs most likely made short selling more difficult.
this demonstrates how shares were essentially created for the sole purpose of short selling. This case study demonstrates how the create-to-lend mechanism in ETFs facilitated the short selling during the U.S. financial ban. This was obviously neither anticipated nor welcomed by the regulators.

The short on shorting ETFs
Despite the extreme example in Karmaziene and Sokolovski (2014), it demonstrates how the create-to-lend process works and that it worked even in a rather difficult moment for short selling. Outside the world of derivatives, short selling in ETFs provides a new avenue for investors to short sell with relative ease.

The ETF market has grown substantially over the last 20 years. Product offerings, market depth, and liquidity continue to expand in ETF markets to fill the increase in demand for this type of product. Although many investors use ETFs for investment, short sell interest is non-negligible. The unique creation-and-redeemption mechanism provides new avenues for using ETFs for short selling.

References


Trading insight

Renaud Huck

Eurex Exchange’s German fixed income futures and options are the benchmark for the European yield curve and serve as the standard reference when comparing, evaluating and hedging interest rates in Europe. These form the core of our interest rate product suite and provide the market with instruments for triple A-rated Eurozone debt.

Trading opportunities
Investors are able to use these products to create the following trading opportunities:

- **Cash equitization**
  Reinvestment of coupon income and investment of new flows or funds generated via asset sales by purchasing fixed income futures

- **Hedging portfolio value**
  Sale of futures / buying of puts or collars to protect portfolio value

- **Transition management / tactical asset allocation**
  Sale of equity index and simultaneous purchase of fixed income futures to assist in the reallocation of funds from equities to bonds or vice versa

- **Portfolio beta / duration adjustment**
  Purchase/sale of fixed income futures to adjust portfolio beta/duration

- **Alpha duration**
  Sale of fixed income futures against purchase of bonds to isolate or negate market risk

- **Portfolio yield enhancement**
  Sale out-of-the-money options to benefit from limited market moves / range bound market conditions

Eurex Exchange’s Euro-Bund, Bobl, Schatz Futures enjoy consistently high open interest. Therefore, they rank among the most liquid fixed income derivatives in the world and attract a broad range of market participants.

Eurex Exchange’s Euro-Buxl® Futures contract is particularly attractive to fund managers undertaking liability-driven
The advantages offered by a listed derivative product—particularly cost-efficient straight-through processing.

For the Eurex Block Trade facility, the transactions are subject to minimum Block Trade thresholds.

To facilitate basis trading, the Exchange for Physicals (EFP) and Exchange for Swaps (EFS) facilities allow for simultaneous purchase (sale) of futures along with a sale (purchase) of the underlying bond, vanilla swap or another futures contracts. Such transactions are not subject to a minimum number of contracts.

Mitigating risks through CCP clearing
With Eurex Clearing, Europe’s leading Clearing House for securities and derivatives transactions, as the central counterparty to all trades, you benefit from mitigated counterparty risk. Eurex Clearing provides effective CCP, risk mitigation and collateral management services thus improving operational efficiency as well as market safety overall.

Institutional Insights
May 2014

Order book volume
Open interest

Euro-Buxl® Futures: volume & open interest (in thousands)

strategies. The 30-year product allows them to effectively manage risk by alleviating duration mismatches between assets and liabilities whilst maintaining their asset allocation strategies.

Trade Entry services
With the aim of complementing the OTC interest rates derivatives market, European fixed income derivatives listed at Eurex Exchange can also be traded outside the order book, and subsequently booked to Eurex Clearing via the Eurex Trade Entry facilities.

Much of Eurex’s fixed income options volume is generated through the Eurex Trade Entry offering. This means that, when it comes to position keeping and the clearing and settlement of transactions, investors benefit from all of the advantages offered by a listed derivative product—particularly cost-efficient straight-through processing.

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Segregation and portability have become increasingly important because of client (buy side) demand and regulation.

After the Lehman and MF Global defaults, the demand for segregation increased as clients have faced issues around uncertainty of porting, double funding, mutualization of client and Clearing Member risks from co-mingling of assets and potential misuse of client collateral.

EMIR article 39 requires CCPs and Clearing Members to offer at a minimum omnibus and individual segregation models.

ESMA finally provided clarity that individual client segregation requires the segregation and portability of the actual client assets. Models which merely segregate the value of collateral due to the accounts of clients, “do not meet the requirement to offer individual client segregation” (ESMA Q&A, 5 August 2013).

Individual models are intended to secure the positions and the collateral assets at all times in the event of default of a Clearing Member or other clients of the Clearing Member.

Some local investment laws require asset managers to segregate assets at the fund level to prevent co-mingling of positions and assets between the clearing broker, other clients and funds of the same fund company.

Both buy side and sell side clients are requesting protection from additional risks including transit and liquidation risk.

**Elementary Clearing Model (ECM)**
The ECM enables Clearing Members to distinguish the positions and assets (collateral) held for the account of their clients (omnibus client segregation) from their own collateral and positions.

Historically, the ECM was Eurex Clearing’s default net omnibus model for listed derivatives. This model offers an EMIR-compliant solution that will come at no extra operational complexity to Clearing Members.

What are the attributes?

- Undisclosed client positions can be segregated into one or more positions accounts, i.e. net omnibus segregation.
- Disclosed clients can be registered under the ECM. Registered Non-Clearing Members (NCM) and Registered Customers (RC) have their own position accounts (and can execute listed derivative and OTC transactions), which are maintained on a gross-position keeping basis and initial margined on a net basis per account. This set-up effectively allows gross margining for NCMs and RCS, with a single commingled collateral pool.
• 4 percent capital charge (subject to final rules).
• Porting is possible where all clients (undisclosed and NCMs/RCs) agree to port to a single replacement CM.
• Inherent in this clearing model are fellow customer, liquidation, replacement and transit risks.

Where are the positions?
Separate positions accounts are maintained to segregate proprietary (P/M Account), client (A Account) and NCM/RC positions.

Individual segregation
Individual Clearing Model (ICM) provides full physical segregation of client’s assets and positions and allows porting on Clearing Member (CM) default.

Eurex Clearing introduced the ICM in August 2011. The ICM provides CMs with:
• Full physical segregation of actual assets
• Very likely porting
• Efficient pass through or direct delivery & withdrawal of the client’s collateral to the CCP and
• Compatibility with industry standard and bespoke CM documentation

What are the attributes?
• 2 percent capital charge (subject to final rules)
• Segregation and porting of client’s actual collateral
• Direct delivery of securities to separate physical accounts at the CSD or tagged
• Porting window can be extended to 5 days under our interim participation concept.

The ICM will have a higher degree of operational complexity because CMs will individually segregate clients at the CCP level (therefore offering the greatest level of protection envisaged under EMIR).
• Eurex Clearing will not charge additional fees based upon segregation model chosen.

ICM ensures maximum portability through individual position and collateral accounts, as well as it offers alternatives in a default situation and facilitates the handling of segregated clients after close-out netting.

There are three options an NCM/RC can choose from:

1. To receive a final pay out of the cash settlement amount, the liquidation process begins.
2. Immediate re-establishment under new relationship (with a back-up CM)
3. To become an Interim Participant and benefit from a 5-day window to have the positions and collateral ported to a new CM.

Thanks to Eurex Clearing’s ICM, the highest level of collateral protection and position portability is given to the buy-side community in the case market conditions were to become challenging and it is specifically, in these conditions that buy side clients will need a reliable OTC clearing model which will help them to protect and port their positions and collateral.
In this issue, Renaud Huck talks to Andrew McCaffery, Global Head of Alternatives at Aberdeen Asset Management PLC, about the impact of EMIR and other regulations on his company and the industry as a whole.

**Huck:** Andrew, can you tell us a bit about yourself?

**McCaffery:** Yes, of course. I am currently the Global Head of Alternatives at Aberdeen Asset Management. At Aberdeen we have moved all of our alternative strategies and illiquid asset investment into one division. Our goal is to deliver our capability in all these areas through a combination of direct and indirect allocations, which includes hedge fund strategies, private equity, real estate and infrastructure investments, and access to other niche strategies, to our clients. We are looking to be a “trusted adviser” in this process and work with investors, whether as a manager or adviser capacity, to deliver effective solutions to meet their objectives and needs. Fortunately we work closely with our Investment Solutions colleagues to incorporate traditional and non-traditional investment ideas into a range of client portfolios as well as those managed purely in alternative strategies and assets. My background is not entirely an asset management one, I started my career in the bond markets in the early to mid-1980s.

Through that period I worked primarily for investment banks and finished that part of my career as Managing Director at UBS where I was responsible for the interest rate derivative business in Europe, but also ran the global hedge fund coverage that we provided as a firm across the breadth of investment banking services. When I left I looked at various ideas, and I decided upon a role as CEO for a fund of hedge funds business. Since then I have been involved in the asset management side of the financial industry, with Aberdeen Asset Management today, and prior to my role with BlueCrest Capital Management for just under three years.

**Huck:** You are the head of one of the biggest asset management firms, how would you define the profile of Aberdeen Asset Management?

**McCaffery:** I am just responsible for a small part of it! We are very fortunate in that one of the great things about Aberdeen has been its continuity and stability through its first thirty years, driven by the fact that we’ve had a very strong senior management team. Our CEO, Martin Gilbert, is known as a very charismatic and successful industry...
figure, and it is important to bear in mind that he, and other key members of the management team, are still with the firm today having been here at the beginning and still managing the larger business today. Others such as the Head of Equities, Hugh Young, and Anne Richards, our CIO, bring a great deal of value in their investment and business skills. It is also reflected in the continuity they also bring to the firm overall, along with the overall management team, to support and develop the company’s culture.

One of the key things for us is defining our profile and who we are as a firm. As you may be aware we went through, and are continuing, a high profile branding campaign last year to present ourselves as “simply asset management” and the principle of asset management being all we do. We are not affiliated to any other organization; we are independent with a sole focus on asset management and providing a range of investment capability and asset management services to our clients. The culture of the firm is, in my opinion, a very important part of the firm. We are long-term oriented in thinking, very focused on our own fundamental research and our proprietary due diligence processes – whether an equity that we are buying or a hedge fund manager we are allocating to – and it is important to understand the management of the company, have confidence in their approach and develop a strong, professional relationship. In the specific case of hedge funds we must have confidence in their ability to repeat their process, and to demonstrate the ability to make money for us.

Huck: What are your aims for Aberdeen Asset Management and how would you like Aberdeen Asset Management to be regarded in the 21st century?

McCaffery: First and foremost, none of us know exactly what the future holds. One of the skills of Aberdeen has been the ability to adapt and build out businesses through time into a very strong platform, which can generate organic growth and integrate acquisitions effectively. The performance of the company in recent years shows our ability to generate investor confidence and increased asset inflows. The deal to acquire Scottish Widows Investment Partnership (SWIP) at the beginning of April reflects our ambition and our strength to recognize opportunities to become a more successful asset manager. Obviously, given my personal bias, I would love to see Aberdeen recognized as a broader, more diversified asset management business and to be seen as a premier alternative investment provider within that. The SWIP acquisition is a very positive move in that direction for the firm overall and within the Alternatives Division.
This will take the building blocks of clients perceiving us as a global, full service investment manager with a well-resourced and clear structure to deliver the capability we have and that any investors can utilize. One of the key things Aberdeen has built is the strong culture that can sustain this. Another aspect will be our ability to manage and adapt as regulation changes significantly, as this will continue to influence how we manage our business and how we interact with clients. Also, the nature of how investors approach their investment needs will develop further, in terms of how capital will flow as a whole, whether across asset classes and/or differing alternative strategies, the demands around managing their portfolios will continue to evolve.

Aberdeen would like to think that through the 21st century we will continue to evolve with our clients, and hopefully eighty plus years from today the company will continue to demonstrate the ability to respond and deliver for our clients – and that the highest quality service and top rated performance.

Huck: One word is on everyone’s lips – EMIR. How does it impact you?

McCaffery: As an asset management firm that transacts in the exchange-traded and OTC derivatives markets and has a large European presence, then it has had a significant impact. We have had to commit the necessary resources to understand and comply with the initial reporting requirements, and the longer-term record keeping needs demanded. I think that every firm has found certain challenges with this, but it is now in place and we are aware of our obligations to meet the regulations in the financial markets that we invest and trade in on behalf of our clients’ portfolios. It is one thing capturing and reporting information and data, but it is also important to understand why these regulations have been created. The after effects of the “Global Financial Crisis” (GFC) has produced some natural consequences and the way regulators have responded in this example is by seeking much greater transparency in some markets as a start. The burden on the business can be notable, with increased resources required, but it is part of the environment we now have to contend with. However, it is something we have to incorporate as an issue for all participants, and key for us is to ensure that our clients are confident, comfortable and continue to receive positive results from us, whatever the reporting requirements and other demands end up on the regulatory front.

Huck: What is your reaction when you see regulation whether it be MiFID, AIFMD, EMIR, DFA piling up in front of you?

McCaffery: I think that the key reaction is to appreciate that this is part of a process which is still flowing out from
a very large shock to the system, i.e. the systemic shock waves from the GFC. This was a very large shock to regulators, as well as to the marketplace, and they have had to adapt as a consequence. The evolution of the regulations is continuing at a considerable pace. However, key for us is the opportunity to have a dialogue with regulators, across various jurisdictions, and participate in discussion plus understand what the regulator is looking to achieve, and assist the regulators by giving measured and useful input throughout the process. In this way we are not only being a “good citizen” but we are developing an understanding of the regulators goals and can provide constructive perspective back on their potential impact, intended and unintended. The harsh reality is that all users of financial markets, and especially managers of investors assets, will have an increased cost burden in a variety of ways but we need to adapt quickly, deploy the necessary resources to overcome initial difficulties and create efficient environments to ensure our clients can continue to work with a high degree of confidence.

Huck: Moving on towards the experience you had with The Hedge Fund Lions Den (HFLD). What did you take from such an initiative?

McCaffery: First and foremost, it was very enjoyable! Enjoyable because it was great to have the opportunity to be involved in something that I think is making a large step forward for promoting new and emerging hedge fund managers. Eurex and Hedge Funds Review should be commended for bringing to light new managers and promoting both education and a constructive profile for the industry, plus the challenges emerging managers face in the industry today. The evolutionary nature of the hedge fund industry is important to maintain and develop, as it has felt threatened in recent times. However, part of this is a maturing of many businesses still labelled “hedge fund managers”. They are, or are becoming, asset management firms with a platform and multiple products and funds to offer. Barriers to entry have increased for new managers, partly as a result of the increased regulation, but also the additional costs of starting with “institutional style” infrastructure to attempt to attract institutional investor flows.

“Barriers to entry have increased for new managers, partly as a result of the increased regulation, but also the additional costs of starting with “institutional style” infrastructure to attempt to attract institutional investor flows.”
insights throughout, and hopefully my input also adding some value to the process, there was an opportunity for people to hear and see aspects of advice and discussion that could prove very useful for them. Overall, it is important to take away that the challenges are significant but a clear business strategy and investment approach, a stable structure and the ability to produce good returns, will entice investors!

Huck: The series was showcasing emerging portfolio managers; do you think that it is an area of strong development for the asset management industry?

McCaffery: I hope so. However, it has been a challenging environment and the alternatives, for example where a talented trader joins a larger “platform” firm, have become more attractive. Stepping back, it is not just about a trading capability though, it is also about being an entrepreneurial business venture and the appeal and excitement attached to this element.

It will be important to see growing capital made available again to new and talented managers, and there are some signs of hope I will come on to. However, as I have stated, the process to move out “on your own”, and the barriers attached, have become more onerous. Also, investor activity, being mainly institutional in nature and often consultant led, has produced very large and concentrated flows into a limited number of managers, with little “trickle down” effects to note today.

Being more constructive for the future, last year many hedge fund portfolios, e.g. several FoHF products, have notable outperformance versus the headline broad hedge fund indexes of single manager performance. This raises the likelihood of value being found outside the larger managers and gives some hope that capital could flow again throughout the universe rather than just to the very largest firms. The jury is out, but there are some signs of life. Overall though, I am excited to see that we have some new managers, with excellent new funds, that are not just on large platforms. I hope ideas like HFLD, and improving recognition of small/new manager performance coming through, will give the emerging manager category more profile and will provide the momentum for reinvigorating this entrepreneurial and dynamic sector again.

Huck: What type of strategy do you think investors are looking for?

McCaffery: There has not been one strategy in particular, but there have been trends in hedge fund strategy selection and broader investor needs prompting renewed activity in some areas. Following on from a very strong developed equity market environment in 2013, which prompted greater flows into long-biased equity strategies, long/short equity strategies and kept capital
moving into “activist” event-driven exposure, we are now seeing subtle changes. First, with dispersion at a stock and sector level that have been attractive, there has been a move into more conservative managers, with an emphasis on less equity “beta” and more on the active management of short as well as long stock exposures. We have also seen more flows towards Europe, as sentiment has improved, with some allocations from other strategies but also from U.S.-orientated exposure, and other developed and developing equity market exposure. Overall, anything with a degree of “beta” has done well but with this kicker and so dispersion, so some hedge fund managers really stood up. This is looking back at markets, however looking ahead, the challenge will be the degree to which that dispersion is maintained so the stock picking, the idiosyncratic performance and the opportunities around that continue in quite the same vein. I think for the moment they can continue, so those managers who demonstrate the ability to manage their portfolio risk selectively and efficiently will do well. However, it is something to monitor closely, along with overall beta risk levels, as markets may see greater tests of the positive expectations that had been built into markets. What will also be interesting at some point through this year is the degree to which global macro and long volatility-biased strategies, show signs of stabilising, and even picking up. Basically, putting some protection, and true convexity, into the portfolio may finally be worthwhile and reasonably well-priced from here.

In collating these thoughts, I would suggest we are slightly wary about increasing those exposures that would give higher market beta-style risk. When we add in the conversations we are having with many investors it is interesting to see “diversification” being brought up, but versus bond risk as much as equities, which is an interesting challenge for several hedge fund strategies to consider and build a portfolio around. The other topic is general “protection”, some against markets seeing losses and some against longer-term concerns around deflation or inflation. Again, several hedge fund strategies, such as those that are long volatility-biased, could prove interesting.

Huck: What type of strategy is Aberdeen Asset Management interested in for 2014?

McCaffery: Well, I would highlight a move towards fundamental conservative style long/short managers, so again taking advantage of that dispersion I mentioned earlier but avoiding the lighter levels of direct market risk. We have also maintained exposure to mortgage-backed relative value and credit, structured credit especially where possible, with fixed income relative value featuring highly. We think discretionary global macro, where managers are very nimble and manage capacity very conservatively,

About the interviewee
Andrew McCaffery is the Global Head of Alternatives, responsible for all alternatives globally, including hedge funds, private equity, infrastructure and property multi manager. Andrew joined Aberdeen in 2011 from BlueCrest Capital Management, where he was a founder member of the Alignment Investors division. Andrew joined the investment industry in 1983, and has held senior roles in fixed income, capital markets and asset management prior to joining Aberdeen.
and deploy an opportunistic trading-orientated approach, can be successful with the increasing opportunities appearing across various markets.

However, as per my broader comments before, as we enter the second quarter, we are starting to get a little bit more cautious. Whether activist event-driven, more aggressive equity long/short or even mortgage-backed linked exposure, we are looking to book good relative gains and tone down some of our risk profile where we can. We are very wary that if markets not only started to stall, with global liquidity declining (read Fed actions) and uncertainty over asset pricing increasing as position risk has been built to considerable levels again, but saw more concerted losses, then the environment could deteriorate quite quickly as market-based liquidity, e.g. dealing spreads took a toll on trading activity and risk management. For now, becoming more concerned about the risks to some managers in more market sensitive strategies, but not completely avoiding risk, just taking down and building a little more protection for portfolios where we can.

Simon Marks
Brussels Correspondent, MNI

Europe adopts new rules to combat bank secrecy
The European Commission adopted new rules in March aimed at stamping out bank secrecy and tax evasion more than five years after it originally made the proposal to member states.

The proposal, which obliges all 28 members of the European Union to share information on interest payments so they can properly tax their citizens, has for years been opposed by Luxembourg and Austria due to fears their banking systems would be put at a competitive disadvantage when compared to tax havens such as Switzerland.

But both Luxembourg and Austria agreed to adopting the new rules at a summit in Brussels mid of March after receiving assurances from the European Commission that Switzerland and other tax havens →
are now on the same page when exchanging information on the amount of interest paid to account holders.

“After 6 years of hard discussions, the EU savings tax directive was formally adopted by member states this morning,” said Algirdas Semeta, the EU’s commissioner for taxation and customs, at a press conference in Brussels. “Loopholes exploited by evaders will be closed.”

The EU’s decision to adopt the new rules comes as the Organization for Economic Co-operation and Development is putting the final touches to global standards on the free flow of banking information. G20 countries are expected to endorse the OECD’s rules on global standards when finance ministers and central bank deputies meet in September.

The Commission decided to revise the rules after identifying a widespread use of offshore jurisdictions as investment locations, a situation that led to billions of euros in lost revenues for countries at a time when the sovereign debt crisis risked crippling regional economies.

The new rules now cover new types of savings income, and products that generate interest or equivalent income. This includes life insurance contracts, as well as a broader coverage of investment funds.

“I know that this file is of enormous national significance for them and I am glad that they are now reassured that their interests are protected and respected,” Semeta said referring to the concerns raised by Austria and Luxembourg.

“I believe they were particularly encouraged by the report that I gave to finance ministers on the progress we are making in negotiations for stronger tax reviews with our closest neighbours. Switzerland and the four other countries (Liechtenstein, Monaco, Andorra and San Marino) now accept that an automatic exchange of information must be at the core of relations with the EU in taxation.”

Semeta said talks would continue with these countries on bank secrecy with the aim of reaching solid conclusions before the end of the year.

EU officials say that billions of euros in taxes are lost every year in the Eurozone due to funds and individuals placing money in offshore jurisdictions after exploiting loopholes in the EU’s original directive on savings taxation. In 2009, member states reported EUR 2.3 billion in interest payments, though the actual amount paid is believed to be much higher.

“It is in general very difficult to say something about the size of the markets and how they have developed. And it’s very difficult to say how much of this is due to the savings directive,” said an EU source, who spoke to reporters on the condition of anonymity.
It remains to be seen how successful countries will be in abiding by the new rules, though there are talks underway in Brussels to implement harsher penalties on those that do not disclose the correct information.

“I don’t think at this stage I would speculate on other types of measures that could be envisaged, though I recognize the European Council has made reference to this in the provisions. But I think it is clear that we are definitely not at this stage today,” the EU source said regarding punishments for non-compliance.

Since the end of the 1990s, the OECD has encouraged tax havens to exchange information with other countries on the basis of bilateral tax treaties, but until 2008 most tax havens declined to sign such treaties.

Though some countries such as Switzerland and France have since signed treaties to exchange information, tax evaders have easily responded by transferring their funds to havens that have no treaty with their home country.

Member states must implement the revised rules by January 2017.

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