ESTABLISHING A FOOTPRINT IN EUROPE FOR US BOUTIQUE MANAGERS

Large US asset managers are highly-visible in Europe's asset management industry – and building European scale has been integral to their success. How can US boutique managers follow suit?

EXECUTIVE SUMMARY

Choosing target market(s)

Boutiques should research the characteristics of each country they are targeting, giving careful thought to where funds are registered for sale. It is usually productive for them to focus their planning initially on a particular market segment, or a relatively small number of countries where certain strategies are attractive.

Market nuances and distribution channels

Managers should identify suitable distribution partners and should ensure their investment products meet their needs. Where a strategy at home has proven successful, a similar approach in Europe can sometimes be productive. Distribution channels that include a heavy bias to domestic funds or which are resource-intensive may be less useful.

Choice of fund domicile

Considerations include manager preference, existing relationships and past experiences. Ireland and Luxembourg have emerged as the most-used European fund domiciles for cross-border distribution, particularly when setting up for the first time in Europe.

Fund structure and operating model: Different fund vehicles are favored by certain ranges of potential clients and likewise certain strategies tend to suit different fund structures. Managers can leverage their partners' expertise to design an operating model most suitable for their distribution and investment strategy.

Regulation

European managers are generally more heavily-regulated than their US counterparts and compliance may be more cost and resource-intensive. Europe has seen a scaling-up of regulation in recent years aimed at enhancing consumer protection, transparency and choice, and incoming managers should be aware of its scope.

IN THIS PAPER:

Ideas for getting European distribution right first time

ESTABLISHING A FOOTPRINT IN EUROPE

Europe's appeal to managers seeking to build assets is generally well-understood. The industry's value stood at €22.5 trillion at the end of 2017 – a ninth consecutive year of growth,[1] and is forecast to comprise over 27% of global investment assets under management (AUM) by 2020.[2] Europe is predicted to maintain its position as the world's second-largest global investment market[3] into 2025 and beyond, despite strong projected asset growth for Asia-Pacific, Latin America, Middle East and Africa.

2018 was a more challenging year for the investment industry globally; money market funds suffered net outflows for the first time since 2013 and global stock markets saw their worst year since the 2008 financial crisis .[4] However, Undertakings for Collective Investment in Transferable Securities (UCITS)[5] and Alternative Investment Funds (AIFs), two of the main European fund types, continued to show positive net sales – illustrating that funds in the region remained attractive despite 2018's unsettled environment.[6]

Looking forward, demographic trends suggest the market should continue to remain attractive in the future. The EU market has a population of over 500 million people who make up 7.3% of the world's consumers. Europe's low birth rates and higher life expectancy compared to other regions means that significant long-term demand exists for investment products, to meet the requirements of aging populations[7]

It is no surprise then, that the industry's giants-turned-global-powerhouses from the United States (US) have spent years positioning themselves in Europe, achieving strong market penetration. As a result of their global aspirations, US managers already make up eight of the top ten asset managers by size globally,[8] and are a mainstay of the European industry.

But that is only part of the story. Look at smaller US asset managers, and the picture is different. Of the 10 best-selling boutiques in Europe in the first quarter of 2018 – defined as those with less than €25 billion in AUM – five were from the UK, two from Denmark, and one each from France, Germany and Sweden.[9] None originated from the US.

In Europe, boutiques' nimble and innovative focus is frequently seen as a valuable differentiator and source of fresh investment ideas

1. THE OPPORTUNITY FOR BOUTIQUES

Boutiques are valued in Europe by institutional investors, and can offer a useful and dynamic counterpoint to large and mid-tier houses. Their nimble, innovative, and sometimes niche focus, often specializing in comparably small numbers of asset classes, is frequently seen as a valuable differentiator and source of fresh investment ideas.[10]

Their smaller scale can also provide opportunities for differentiation through strong client service and close investor liaison; investors may enjoy the more readily-available access to portfolio managers and the investment team, for example, which they can offer compared to larger houses.

Some have been quick to make their mark – for example, GQG Partners launched the GQG Partners Emerging Markets Equity Fund in Europe in February 2017, raising funds of close to $150 million[11] in four months, which had grown to over $515 million[12] close to two years later. Our experience however, is that many often struggle to gain traction.

So what explains the lack of smaller fund houses making significant inroads into Europe from the US? America is itself, after all, the largest and one of the most dynamic investment markets in the world, and an engine of global growth – so US managers clearly have notable investment expertise to offer clients in Europe.

Boutiques generally do not, however, have the same sales and distribution firepower as their larger competitors. Without comparable budgets, smaller firms have to think about accessing the market in more targeted, and sometimes more creative ways than larger peers. Margins are often tight and the business case for distributing into Europe in this context may be difficult to make.

In addition, many asset managers continue to find themselves under pressure from a variety of macro-economic and industry-related trends: well-documented trends include the rise of low-margin passive products, the increasing cost of regulatory compliance and interest-rates that around the world remain low by historical standards.

All these continue to impact on the asset management industry, making distribution into new markets a challenge. Nonetheless, with careful planning and a keen awareness of the countries being targeted, Europe remains a viable, sustainable growth market for overseas managers.

Managing complexity

Incomers to Europe are presented with significant opportunity, but also a wide range of decisions as they look to expand there. These range from identifying distribution channels, to tackling regulatory requirements, navigating cultural nuances and determining which investment vehicles work best for their business.

With this in mind, it is important that entrants undertake extensive research into their new target markets and channels when making decisions. With generally limited budgets, it is important that managers make the right calls first-time as they establish their European businesses and operations. Changing course later when reserves are exhausted may not be possible.

Developing realistic distribution plans will, however, help them get it right first time. This, in turn, allows managers the best chance of growing their client base, building investor flow and assets under management – gaining revenue faster, with less unnecessary cost incurred.

European Investor Markets
Headlines at a glance[13]

27 disparate markets

Largest markets: UK, France and Germany comprise 62% of AUM

Distribution channels and marketing rules vary by country

Overarching fund frameworks include UCITS and AIFMD regimes

Importance of cost control:

Countries across Europe do not have like-for-like regulatory requirements; this means that unforeseen costs can stack up rapidly. Each market entry should be carefully planned and costed.

For example, ensuring marketing materials (such as fund factsheets) comply in every jurisdiction where a manager is registered can be a costly exercise.

2. CHOOSING TARGET MARKET(S)

Europe is home to a varied and competitive asset management industry. It is comprised of 27 markets, and has over 4,200[14] asset managers directly employing more than 110,000 people and another 500,000 indirectly employed in functions servicing the asset management industry.[15] This scale and complexity presents great opportunity – but also challenges and potential pitfalls.

A key difference between the US and Europe in this respect is that, despite a high degree of regulatory harmony, the latter is not one cohesive market, and fund industry distribution channels, and investor appetites vary from country to country.

Equally, many US investors will be largely used to a single currency, set of regulations, and well-understood industry culture. This is rarely the case in Europe, where each market brings its own challenges and rewards. The market-place is comprised of multiple countries, and this collectively makes it more complex (and heavily regulated) than US-based managers may be used to.

So US managers should strive to understand each individual market in Europe (rather than seeing it as a uniform whole) and draw-up sales and marketing plans suited to the characteristics of each. In the same vein, if a manager's strategy is sector-orientated, they should work to understand the composition of that sector across Europe and tailor their plans accordingly.

For example, setting up UCITS structures does not necessarily mean that registering in different European countries will be an identical experience each time. Different countries have varying types and levels of cost – from the cost of registration, to legal fees and various annual charges for routine functions such as registrations. Ongoing charges in particular have the capacity to be significant over time, while countries' investment marketing rules can vary significantly.

Country registration

As part of their research and planning processes, managers should think carefully about where to register their funds for sale. A potential pitfall for managers is to register in many European countries at once – but without having developed suitably detailed or realistic sales and distribution plans to support that footprint.

It often means that significant registration and fund operating costs are incurred before the manager has been able to accumulate assets under management (and accompanying revenue). For firms in the early stages of European growth, incurring a wide array of costs tends not to be commercially-viable. Cross-border distribution can fast drive a fund's total expense ratio upwards, so cost-control in this situation is highly-important.

Our experience is that it is often better to take a more targeted approach – instead 'testing the water' by focusing on a particular market segment, or smaller number of countries where certain strategies are attractive.

Product focus example:
ESG and sustainable investment

European investors are increasingly seeking fund products that integrate ESG factors into their programs or offer sustainability characteristics.

According to a recent survey from Aon, out of 223 institutional investors around the world, 47% of European investors have a responsible investing policy in place compared to just 30%[16] of their US counterparts.

This focus is being bolstered by European regulators' scrutiny, with the European Commission having issued proposed regulation requiring asset managers to demonstrate how their investments align with ESG factors.

In addition, UK pension funds are mandated to disclose the risks of their investments, including ESG considerations, by 1 October 2019.[17]

3. MARKET NUANCES AND DISTRIBUTION CHANNELS

As well as identifying target markets at the outset, boutique managers need to identify suitable distribution partners and ensure their investment products meet their needs. Many distributors look for evidence of reasonable scale, preferring funds with at least €100 million in AUM, and the reassurance that other investors have invested, as well as a three-year track record before they invest in a product, or add it to their buy-lists.

Funds that do not meet these criteria may be best to focus on seeding their funds, perhaps internally, with existing investors or targeted relationships, before embarking on a broader cross-border sales plan.

Gaining access to fund buyers

In certain circumstances, decisions regarding distribution channels are best made before those regarding markets. If their strategy in a home market has proven successful, managers might consider if they can follow a similar approach in Europe.

Perhaps there are global consultant relationships that can be leveraged to open doors in markets like the UK, where the consultant community are the gatekeepers to pension funds. If so, this approach to cross-border distribution can make for particularly effective use of manager resources. Equally important is to rule out channels where boutiques may have limited success due to there being a domestic funds bias, captive assets, or perhaps where the channel is highly resource-intensive.

The UK's retail marketplace, for example, has a significant channel of independent financial advisors (IFAs), which account for 84% of the advice firms operating in the country, according to FCA data.[18]

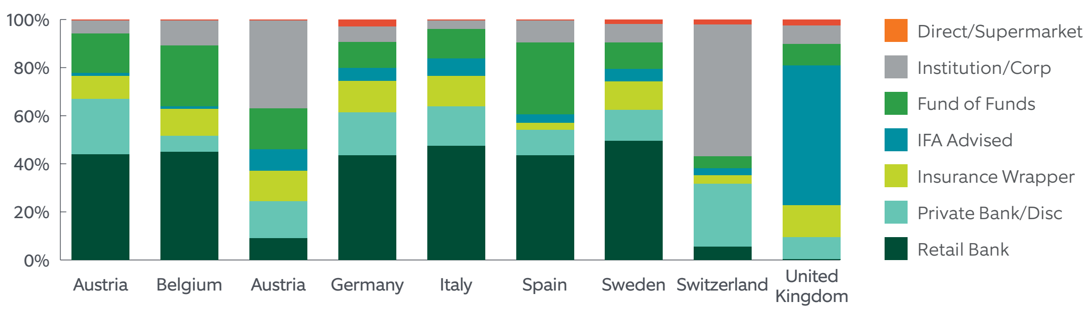
Whilst its size may seem appealing, this market is dominated by UK funds. In addition, advisors across the UK tend to require ongoing education and product support for managers to facilitate successful sales strategies via this channel. So achieving success in this segment usually requires a broad sales presence on the ground as well as, potentially, a UK fund range.

Distribution channel example:
UK: The role of consultants

In the UK, the 12 largest investment consultants in the institutional space advise on over £16 trillion of AUM.[19]

Consequently, it is difficult to do business with institutional investors there without discussing your products with an investment consultant.

ESTIMATED MARKET SHARE OF DISTRIBUTION CHANNELS BY COUNTRY, DOMESTIC ASSETS ONLY



Estimates as of December 2017
Source: Mackay Williams, a Broadridge company

European banks – who function as the 'guardians' of distribution – make up at least 80% of distribution in many countries outside the UK.[20] However, most of these banks have captive assets managed by large in-house asset management teams, which makes it challenging to penetrate as a channel.

However, managers should not rule out the banks, but consider targeting their fund of funds channels, which tend to be more open to foreign fund houses.

Whether to establish a European team?

Decisions on market and channels will determine resource requirements – whether to establish a sales team locally in Europe – or – whether to find a partner to market and sell their products for them. Equally, the amount of resource a manager can commit will dictate the best approach to channel or market selection.

Even with the support of a third-party agent, managers will need to plan for regular 'fly-in, fly-out' support from CEOs or portfolio managers to build-up their business and achieve momentum. A targeted sales plan with committed resource gives managers the best chance at success.

Even with the support of a third-party agent, managers will need to plan for regular "fly-in, fly-out" support from CEOs or portfolio managers, to build up their business and achieve momentum.

4. DOMICILE: WHERE TO BASE MANAGERS' FUNDS

Managers entering Europe must meet regulatory requirements to locate a fund management company within the EU. This will usually be made hand-in-hand with the decision of where to domicile.

Several considerations typically come into play for a manager deciding where its fund should be domiciled. These may include where they would like to focus their distribution efforts and their intended client base. For example, certain European countries may have a bias towards UCITS funds established in certain domiciles.[21]

Ireland and Luxemburg: Europe's global cross-border distribution centers

Ireland and Luxembourg have emerged as the most-used fund domiciles for these purposes. Both offer cross-border fund distribution – together accounting for over 88% of European fund registrations during 2017.[22]

As Europe's two premier fund domicile centers, both professional communities possess the specialist knowledge and experience to help launch a wide range of international funds. To provide a snapshot of their status, for September 2018 the value of Luxembourg-based UCITS funds was €3,574 billion, for Ireland, the value was €1,908 billion.[23]

Historically, Ireland has attracted strong flows from US managers and a home for their funds, due to a number of factors, including cultural roots between Ireland and the US, its short distance to London (as home to the UK funds industry), and expertise in certain types of traditional and non-traditional fund structures. Servicing hedge funds is among its specialties' – 40% of global hedge fund assets are administered in Ireland.[24]

UCITS funds are well-recognized by the global investment community as offering potential investors both a high degree of transparency and a respected brand.

Located in the heart of continental Europe, Luxembourg has grown as a leading hub for managers originating from surrounding European countries, and is the largest center for cross-border funds globally. UCITS continue to be a core product for Luxembourg, but it is also building strong momentum as an alternative asset class hub for funds such as private equity, which saw a 17% increase in AUM in 2018.[25]

IRELAND AND LUXEMBOURG: A COMPARISON OF FUND JURISDICTIONS (OVERVIEW)

	Ireland	Luxembourg
Overview/Strengths	Common law legal system with a clear, practical regulatory framework. €2 trillion in Irish domiciled vehicles. 40% of global hedge fund assets administered in Ireland	Second-largest investment fund center in the world. Modern legal and regulatory framework
Distribution	Major hub for cross-border fund distribution, with funds sold in 70 countries across the Americas, APAC and EMEA	Largest center for cross-border funds globally, particularly for distribution into continental Europe. Skilled and multi-lingual workforce to support investors
Common fund legal structures	Investment company, ICAV, unit trust, CCF	FCP, SICAV, SICAF, SLP
Categories of regulated funds	UCITS, QIAIF, RIAIF	UCITS AIFs: UCIs, SIF, SICAR Indirect regulation through AIFM: RAIF
Average approval/ authorization	**QIAIF:** Can be 24 hours **Other funds:** six to eight weeks **AIFM authorization:** Up to three months	**Regulated funds**: Eight weeks **Overall:** Up to four months **RAIFs:** Three weeks, authorization not required as it is not a regulated fund

For both fund centers, assets from US-based managers are growing. For Luxembourg, they accounted for approximately 20% of its €4,065 billion in assets under management in 2018 – the largest country of investment origin.[26]

Similarly notably, 52% of the Irish UCITS market comprises funds managed by US-based promoters.[27] A decision of which domicile to choose will generally come down to individual manager preference, their relationships and past experiences.

5. FUND STRUCTURE: OPTIONS FOR SUPPORTING STRATEGIES

Another key decision for asset managers entering Europe is the type of fund structure they use to distribute their funds. In doing so, they may choose from an array of options, with – broadly speaking – each investment vehicle targeting a different range of potential clients, and also in the knowledge that different investment strategies broadly suit different fund structures.

Some jurisdictions, for example, are widely used for specialist alternative investors, but they tend to target a small pool of sophisticated investors. Others are used more broadly.

Many managers would do well to look to the UCITS fund regime, which, while originally designed for retail investors, has been widely adopted for institutional investment. UCITS funds are recognized by the global investment community as offering potential investors both a high degree of liquidity, transparency and a well-respected and recognized brand.

Managers operating funds under its auspices can enable distribution of their products to be carried out via the UCITS passport right across Europe – as well as across other jurisdictions and regions where it is recognized and well-regarded – from Asia-Pacific to Canada, South America and South Africa.

As mentioned previously, while the UCITS 'passport' provides the ability to register and market a fund across 27 European countries, doing so immediately is certain to build-up costs (without necessarily bringing-in AUM). Careful planning is required to grow assets in a sustainable, cost-effective way.

Using an established platform can also help increase the speed of a fund launch, as the core UCITS structure will have already been approved by the regulator. It can also prove reassuring for any investors with concerns about the operational efficiency of new market entrants.

Operating model and partner choices

When establishing the framework and legal structure of their funds, managers should leverage the expertise of providers and partners – administrators, tax advisors, legal counsel, and others – to ensure their fund operations fit with their marketing plans and overall distribution strategy.

They may wish to make use of management companies (or "Mancos") to provide outsourced services to support their operations with functions such as company administration or regulatory compliance. Many Luxembourg and Irish Mancos serve in this way as operating platforms for the €6.8 trillion[28] of fund assets domiciled in both countries.

However, whilst UCITS requires an EU based Manco to be set-up, its' location does not necessarily need to be the same as the fund's domicile Depending on a manager's strategy, locating the Manco in a different market may assist with distribution, as investors perceive the fund as more "local". In some circumstances, this may help with raising assets.

Fund administrators should be able to facilitate market access via fund registration services, local agent provision, introductions to local participants and efficient operational connectivity to platforms.

For managers with limited resources, allowing the board and the Manco of a UCITS platform to take primary responsibility for functions such as compliance, corporate governance and risk management processes can often be useful. This can be highly cost-effective and help limit the administrative burden and time required to establish a fund.

By outsourcing these functions, managers can focus more exclusively on 'core' functions (i.e. portfolio management). In the US, this is sometimes known as a 'turn-key' solution, and has proved very suitable for resource-light managers.

Using an established platform can also help increase the speed of a fund launch, as the core UCITS structure will have already been approved by the regulator. It can also prove reassuring for any investors with concerns about the operational efficiency of new market entrants.

IRELAND AND LUXEMBOURG: COSTS OF DOING BUSINESS (OVERVIEW)

	Ireland	Luxembourg
Capital requirements for Mancos/AIFMs	**Minimum:** Greater than €125,000 or three months' expenditure plus additional tiers	**Minimum:** €125,000 plus additional tiers
Tax environment	**No net asset tax** **Tax exempt** from income and capital gains taxes at the fund level **Withholding tax** on payments made to Irish taxable investors **No withholding tax** on payments made to non-resident investors, apart from Irish Real Estate Funds (IREFs), which hold interests in Irish real estate **Generally VAT exempt**	**For UCITS: Annual subscription tax** of 0.05% of net asset value **Tax exempt** form income and capital gains taxes **No withholding tax** on distributions made to non-resident investors **Some services attract VAT.** No stamp duty is payable on the issuance or transfer of shares or units, except a fixed registration duty of €75 upon incorporation of the fund
Regulatory fees	**Minimum levy** of €1,700, with contributions per sub fund rising to a max of €5,900	**Initially:** Varies from €3,500 to €10,000 **Annually:** Varies from €3,000 to €30,000 (depending on number of sub-funds)

Asset servicing: the roles of the fund administrator and depositary

Whatever their approach, managers should require that all providers that are party to a European fund have the technical expertise and global model to help design a cross-border distribution strategy tailored to the needs of the manager.

In particular, their fund administrator should also be able to facilitate market access via fund registration services, local agent provision, introductions to local participants and efficient operational connectivity to distribution platforms.

Also, while US managers will be familiar with the role and responsibilities of the administrator and custodian to a fund, the selection and appointment of an onshore depository is a key consideration that some managers may be less accustomed with.

Both the UCITS and AIFMD directives require authorized investment funds appoint a 'depositary' to ensure safekeeping of the fund's assets. This role also involves overseeing the fund's affairs, to ensure it complies with the obligations outlined in relevant laws and the fund's constitutional documents. The UCITS directive, in particular, imposes a strict standard of depository liability for any loss of fund assets.

High-quality depository services are readily available in both Ireland and Luxembourg and – while independent – are often coupled with administrator and custodian services to enhance efficiencies and help reduce costs.

6. EUROPEAN REGULATION

Finally, while asset managers around the world are used to operating under investment regulations, those entering Europe for the first time should be aware of its regional scope and cost. European managers are generally more heavily-regulated than their US counterparts, and compliance may be more cost and resource-intensive than some managers are used to.

Europe has also seen a host of significant new regulation in recent years aimed at enhancing levels of consumer protection, transparency and choice. For example, MiFID II – implemented in January 2019 and intended to increase investor levels of transparency for investors across European equity markets – continues to have implications for managers – not just on investment conduct, but across a broad set of reporting and data requirements.

Its corporate governance rules require distributors to provide information on their third party providers – from performance reviews, to sales and charging information. They are also requited to collect data on their target markets for funds.[29]

European Investor Regulation
Key EU-wide regulations include:

- Markets in Financial Instruments Directive II
- European Markets Infrastructure Regulation
- Alternative Investment Fund Managers Directive
- Packaged Retail Investment Products Regulation

US BOUTIQUES: THE EUROPEAN OPPORTUNITY

Europe continues to be an excellent place for asset managers to do business and grow AUM – offering plenty of opportunities for fund manager entrants from around the world. It is particularly important to be smart and strategic about how they make inroads in the region – managers should be both positive and realistic in their planning.

Northern Trust suggests incoming managers plan each entry carefully, making a business case for each target market or channel – aiming for careful execution and a sustainable build-up of their assets. When investor appetite is successfully tested and progress is made they should revisit these steps for further expansion at a pace their asset growth allows.

Decisions around how and where to structure funds are important – but building successful sales and branding strategies, accessing distribution channels and investing in local relationships, as well as being able to navigate the regulatory landscape – are equally critical.

There is great potential for sustainable, vigorous asset growth in Europe for boutique managers. Our experience is that the well-prepared ones inevitably prove most successful.

TO LEARN MORE

For more information on how Northern Trust can help accelerate asset managers' European growth, contact:

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