

## **Aria Protected Funds®**

### **Research Note**

#### **DISCLAIMER AND NOTICES**

---

This document and the information contained herein is neither an offer to buy or sell securities, funds, or an OTC derivative product, which includes options, swaps, forwards and structured notes having similar features to OTC derivative transactions, nor a solicitation to buy or sell funds, securities or an OTC derivative product. The information contained in the foregoing is not a complete description of the terms of a particular transaction and is subject to change without limitation.

Any investment decision should be based only upon final documentation such as the relevant prospectus or termsheet. This information does not purport to identify or suggest all of the risks (direct and indirect) which may be associated with the proposed investment nor does it define the appropriate conditional terms which may be attached to any product guarantees. If you are a private customer you must speak with your financial adviser. Not to be disclosed to a third party without Product Innovations' written consent.



**May 2009**

**© Product Innovations Limited, 2008<sup>1</sup>**

---

<sup>1</sup>

Aria Protected Funds® is a trademark of PIL International Holdings Ltd.

*Executive Summary:*

*Liquidity and Custody*

**Jurisdictional and Structural Integrity**

The two issues of Liquidity and Custody are in their own ways quite important when assessing the risks of the Aria Protected Funds. These are particularly important for both large and small potential investors; it is as important to understand the protections in place for both Mr & Mrs Average's SIPP as much as for the trustees of charities and pension fund investors.

For the wrong reasons, the public has become aware of aspects of these issues and fortunately, the Aria Protected Funds offer both Jurisdictional and Structural solutions to these potential problems. This research note will expand on how the Funds handle issues of *Liquidity* and *Custody* and the comfort that can therefore be had by how the funds operate.

*Liquidity.* What has destroyed a number of funds' reputations is that client's cannot get their money back when they want. Redemption risk is broken down into some basic questions:

- How does it normally work?
- Are there any exceptions?
- What could prevent the fund redeeming?

Structural issues around the use of indices and the swap should resolve these matters to ensure that redemptions can indeed be met on a timely basis.

*Custody.* Custody is not simply accounting or banking, in Luxembourg, this is much more about what security is in place to ensure Madoff, Stanford, or the like does not happen again. The issue is as much how to prevent the schemes developing but also what if something does go wrong. Luxembourg's custody regime provides the best possible protection for investors assets:

- Removing the element of pure trust
- Monitoring and compliance
- Safe-keeping of assets
- Investor Protection

## **Liquidity and Custody**

### **Liquidity**

Recently, the question of liquidity risk has resurfaced in the trades (especially regarding Arch Cru, Brandeaux, and other direct property funds) and it is both topical and timely to provide an overview of the question of liquidity for investors in the Aria Protected Funds.

Liquidity risk covers two particular areas of concern; one, how quickly redemptions can be processed, and secondly, what is the price impact of these redemptions on the fund. If we consider these two as separate categories, redemption risk and liquidity mismatch risk, then we will be able to use these terms in describing to current and future investors what risks are relevant.

#### Redemption Risk

##### *The Normal Process*

The Aria Protected Funds trade either weekly or daily and in the normal course of operation of the fund, as long as the redemption request is received by the cut-off time, then the prospectus describes as "T+5" the normal turnaround time:

- T - the valuation day for which the order is received
- 5 - 5 business days after.

So, in the normal course of business, a redemption request for a fund received before noon on Wednesday (for Dynamic Growth or GEMs), will be processed on the Thursday (the dealing day) and payment should usually be received on or before the following Friday.

"Normal". Over the past 20 months, we have seen exceptions to this. Normally, this is due to outstanding due diligence information on behalf of the subscriber. Signed subscriptions are accepted for the appropriate dealing day even if there are gaps in the KYC or AML process. Where these gaps exist, the subscriber (SIPP, Offshore Bond, or direct) are informed as part of the application process. If for some reason, there is a delay in receiving this information, the redemption payment can be delayed although the redemption will be made on the requested date. In this case, the investment is held in cash until the information required is received by the Fund Administrators. Usually, we inform the IFA if there is a problem during the application process but if it comes from an insurance wrapper, this is not always possible (but we do try).

"Exceptional". Are there exceptional circumstances where redemption risk is outside of the normal operation of the fund? Can redemptions be suspended?

## FOR PROFESSIONAL ADVISERS ONLY

Is there a real redemption risk if everyone wanted their money back on the same day?

The real answer to the above is that redemption risk is virtually nil. If everyone wanted their money back on the same day, it would indeed cause an operational headache but there is no reason why if enough people could physically handle the requests, the money would not be returned in a timely fashion (ok, it might slip a few days but this is just getting the paperwork done). Unlike investors who have and are suffering from the impact of redemption risk (Cru, life company property funds, and others), the more important aspect of redemption risk is liquidity mismatch.

### Liquidity Mismatch

Once again, there are a number of issues around liquidity mismatch which can effect the redemption process and the ultimate amounts that investors receive. Broadly, these are:

- Asset Pricing
- Asset Realisation
- Dilution Levy and associated trading costs

#### *Dilution Levy*

This is an issue which is most textbooks and an important consideration in assessing any funds operational efficiencies (and is disclosed in a fund's prospectus). Funds which charge a dilution levy, and by association have other trading costs, can have a significant impact on the price an investor receives in the case of large redemptions. This is particularly a problem where there is a loss of faith by investors who all want to move out. As the fund unwinds, the costs of doing so are magnified by the size of the redemptions and this borne by the investors directly.

Aria Protected Funds cannot charge a dilution levy and because the exposure is a managed risk exposure, the Funds' performance does not include any impact costs of trading (either up or down). This cost advantage of using a swap is part of the efficient portfolio management process used by the funds.

#### *Asset Pricing*

One aspect of the recent controversy around Cru and other funds of this type is the reliability or certainty around the underlying asset pricing. The idea of liquidity mismatch is made worse when it is up to the manager to determine the price of an asset whose public pricing does not match the redemptions available for the fund. In short, a daily trading fund which invests in a monthly priced structure has a big problem; in the case of redemptions, how you value

## FOR PROFESSIONAL ADVISERS ONLY

the investment? This is bad not only for those redeeming but also those who remain in the fund and there is no way to treat everyone fairly and equally. And this is the first premise of a collective fund! It is difficult to protect against this or spot the potential conflict if one is not on top of the asset allocations being made. Actually, this is the responsibility of the manager and yet it is the investors who suffer.

The underlying investments which are reflected in the valuation of the Aria Protected Funds are for the most part indices and/or ETFs. Does this solve the problem? ETFs and indices "tick", i.e., price like a security on a stock market every few seconds. This is good but not the whole story. Because investments are made by an investment bank, any bank has to be allowed to trade and price the underlying (and hedge the risk). This means that banks will only trade in those instruments which are very large and meet their rigorous criteria for investment (as much down to size as much as who the counterparty is). Not all ETFs are created equally and therefore, the only underlyings which are included in the Aria Protected Funds are those with substantial assets (hundreds of millions minimum size) and those where the obligation rests on the investment bank to price. Taken these two aspects together, the availability of the real price of an asset should never be in doubt at any time irrespective of the size of redemption requests for the Aria Protected Funds.

### *Asset Realisation*

This means the ability to get a fair NAV in a timely fashion and the ability to return the money to investors.

If the assets can be priced fairly but not sold then there is no chance of the investors being paid. Once again, the key to this structure is the liquidity and size of the underlying investments. By using large ETFs and recognised indices, these structures are by their nature, highly liquid. Investors get exposure to infrastructure and property-type investments without risking the illiquidity of direct investments. This is one of the primary benefits of using the index-based approach to investing and a major benefit to investors in the Aria Protected Funds.

### **Custody**

"May you live in interesting times". Thanks to Allen Stanford, Bernard Madoff, Jon Maguire, and a host of hedge fund managers who have quietly salted away their performance fees to ride off into the sunset as their funds collapse, we do. The process of fund due diligence must take on an entirely new dimension, one which most funds are ill-equipped to deal with. The big question which should be asked of all with whom money is entrusted is "How much do I really have to trust you" and perhaps more importantly, "what processes are in place to ensure someone does not run off the funds"?

## FOR PROFESSIONAL ADVISERS ONLY

We have seen where too much trust and too little due diligence leads to.

As the Aria Protected Funds approach 100,000,000, we have seen an increase from pension funds, trustees, charities, and the like. For these types of clients, a financial adviser is needed now, more than ever, as the legal duties of the trustees means they cannot sit in cash but what to do. More importantly, how to answer those two critical questions.

"How much do I really have to trust you"

"What processes are in place to ensure someone does not run off the funds"

*"How much do I really have to trust you"*

It is a matter for concern that trust or faith or belief plays such a large role in asset allocation. Surely, there should be some structural and jurisdictional certainty in place which means that trustees, advisers, investors, auditors, etc. are not just entrusting their money?

Custodian. A Luxembourg Custodian.

Luxembourg is a small, fought over, country with a bit of wine (on the Rhein) some good seafood, and the largest centre of fund management in the world (OK, the US has more total funds but not in one place and with lots of different rules). Why is this?

Key to Luxembourg's success over the years in building this industry is the role of the Custodian. Every Luxembourg regulated fund has to have an approved Custodian who is subjected to the highest level of supervision in Luxembourg. Custodian's act as gatekeepers, and protectors, of the Luxembourg Brand; they take the ultimate risk in the establishment and operation of any funds.

To find a custodian and to be approved by a custodian is the first and most difficult part of establishing a Luxembourg fund. The Custodian acts as a sponsor to the fund in presenting the file to the regulator because it is the Custodian who has the responsibility for ensuring the fund and the managers act accordingly. The Custodian carries the risk if it all goes wrong and as such, there are very few Custodians who are authorised to act as such in Luxembourg. Custodians are some of the biggest names in the banking and fund world (State Street, RBS, JPMorgan, etc.) and there are only a handful who meet the capital requirements to cover the risk of acting as Custodian.

The importance of this is worth stating again. The Custodian has to make sure all funds act correctly or they pay the cost. The due diligence done at the outset by the Custodian, as gatekeeper, has to be of the highest level; in terms of the people involved and the processes involved in any Funds.

## FOR PROFESSIONAL ADVISERS ONLY

Custodians, therefore, ensure that structural integrity of the Luxembourg funds industry functions without issues and that there is a strong, well-capitalised entity in place who guarantees to the regulators that funds can operate without risk to the industry as a whole.

There have been instances where it has gone wrong and in these cases, the Custodians had to step in to compensate investors and maintain the image of stability (most recently UBS and Madoff). No one wants to invest in someone they don't trust but the structural and jurisdictional position of a Luxembourg Custodian provides a substantial additional comfort.

“What processes are in place to ensure someone does not run off the funds”

Madoff and Stanford as the most high profile were primarily guilty of misappropriating funds and not doing what they said they were doing. The latter is a particular problem of many funds (although not in the same way as the two villains). Whether it is called style-drift or as in Cru's case not putting the money where they were supposed to, to outright fabricated investment practices, the Custodian has two important roles to play; monitoring and safe-keeping.

### *Monitoring*

Because the Custodian maintains the ultimate responsibility for the fund's assets, there are procedures in place in all Custodians to make sure the assets being purchased, and in fact, the investors best interest, is maintained throughout the operation of the fund. This is no small task and again one of the reasons why Custodians turn away more funds than they accept because they have to have the risk monitoring in place to ensure funds do what they are supposed to do.

More importantly, and this is what caught out UBS, the Custodian is responsible for the safe keeping of the assets. Monies paid to the fund and the assets purchased by the fund are the responsibility of the Custodian to ensure they are not mis-used. This covers a whole range of things from charges to the fund by the manager to investment decisions (and more importantly) the exact nature of what is bought. This is where UBS failed with Madoff; their liability was because when the decision was made to purchase Madoff, the Custodians allowed it to happen. When the legal case was made, it was the Custodian (most importantly the deepest pockets around) who was been found liable for the investor losses. UBS failed in safe-keeping; allowing investors funds to be mis-used and therefore paid compensation.

Compensation to the amount of more than 20,000,000. Imagine if this was the UK and the FSCS stepped in with their offer of 48,000. Gosh, that is a comfort.

## **FOR PROFESSIONAL ADVISERS ONLY**

For those with compliance issues about, "well it is not protected by the FSCS", thank goodness!

The Custodian, RBS for the Aria Protected Funds, provides the best possible security around the operation and investor protection for the Funds. The responsibility of Custodian for safe-keeping of assets means that investors can take comfort that there is a kind of insurance in place behind the Aria Protected Funds-- the jurisdictional and structural security offered by Luxembourg, in general, and RBS in particular, is not to be underestimated in assessing the Aria Protected Funds. For trustee investors, and of course advisers, this creates exactly the kind of legal framework which can allow them to make investment decisions in the knowledge that their client monies are protected; not only by collateralised guarantees but also the certainty of the role of the Custodian and the importance of the Custodian in the operation of the Aria Protected Funds. Perhaps the FSA should take note.

## **FOR PROFESSIONAL ADVISERS ONLY**

### **DISCLAIMER AND NOTICES**

---

This document and the information contained herein is neither an offer to buy or sell securities, funds, or an OTC derivative product, which includes options, swaps, forwards and structured notes having similar features to OTC derivative transactions, nor a solicitation to buy or sell funds, securities or an OTC derivative product. The information contained in the foregoing is not a complete description of the terms of a particular transaction and is subject to change without limitation.

Any investment decision should be based only upon final documentation such as the relevant prospectus or termsheet. This information does not purport to identify or suggest all of the risks (direct and indirect) which may be associated with the proposed investment nor does it define the appropriate conditional terms which may be attached to any product guarantees. If you are a private customer you must speak with your financial adviser.