Holding up in the face of competition

Luxembourg overhauled its law on specialist investment funds in February this year, presenting competition for German Spezialfonds.Luxembourg SIFs are less regulated than their German cousins, but it remains to be seen to what extent they will attract the interest of German investors. The year 2006 saw a reduction in the numbers of Spezialfonds-KAGs. But growth in Spezialfonds assets was still in double digits even if this was less than 2005. **Till Entzian** presents his annual survey of the market

As in 2005, German Spezialfonds (investment funds 'specially' set up for 1-30 institutional investors) were able to grow their assets under management in 2006 – by €63bn over the year. The growth rate of 10.4% is slightly lower than the 13% achieved in the previous year. The net asset value of €673bn achieved at year end are a new record, and the figures for the first five months of 2007 continue this positive trend.

Larger average fund volume

The decline in the number of Spezialfonds has further accentuated a positive trend for the sector. Some 300 mandates were closed during the past year, either by merger or termination – the same as the average of pervious years. This left 4,367 Spezialfonds under administration at the end of 2006. The decline in the number of mandates is positive because it leads to strong growth in the average fund size, which is more economical from the point of view of German Kapitalanlagegesellschaften (KAGs; investment fund management companies). The average size of a Spezialfonds now stands at €154m (end 2006), €20m more than in the previous year, and more than twice the size of 10 years ago (1996: €69m). The average size of a Spezialfonds is rapidly approaching the size of the average retail fund, which fell from €196m to €182m over the course of 2006. Until around the year 2000, the average retail fund was two to two and a half times the size of the average Spezialfonds. Since then, the number of retail funds has continued to rise, to more than 1,500. The market is clearly showing a constant demand for new product ideas, each of which necessitates the launch of a new investment fund.

New competition: Luxembourg SIFs

Luxembourg passed a law on Special Investment Funds (SIFs) in February this year. This law created an instrument that could make things difficult for German Spezialfonds. This was precisely the intention of Luxembourg's legislators. Luxembourg SIFs are distinguished by the absence in principle of any kind of regulation. Nonetheless, the new law runs to more than twenty times the number of pages of the previous law of 19 July 1991. In principle, however, there are no prescriptive guidelines affecting the legal structure, the management or the investment process behind the assets. And any regulation in the Luxembourg SIF law turns out not really to be a restriction.

For example, investors must, in principle, invest a minimum of €125,000. But you only need to show a letter from a bank telling that you are sufficiently experienced, and any lower amount will be accepted as well. There is also a rule stating that a SIF must have assets of €1.25m after one year is designed to prevent an investor from putting a smaller sum into an investment fund only available to himself. But this rule can be circumvented by setting up an umbrella fund.

So, even with only a small proportion of assets to invest, an individual investor can have his personal subfund managed only for himself, since the minimum size is calculated on the basis of the umbrella fund and not on the basis of the sub fund. As far as the range of eligible assets is concerned, the Luxemburg SIF has no restrictions at all. It is easy to satisfy the risk diversification principles, which are defined very broadly, since there are no investment limits (like the 5/10/40% rule for UCITS) or any other investment restrictions.

In theory, a private investor could place all of his personal assets in a SIF or a subfund and manage them there for the future.

If he manages to invest the fund's assets in securities that generate no regular income via interest payments or dividends (in certificates, for example), the German investor pays tax on his profits only when he cashes in his units or at distribution, allowing him to choose the moment when he pays taxes. Provided, that is, that the Federal Finance Ministry does not introduce new regulations, which would in any case be difficult and are not currently planned, even if it will eventually become unavoidable.

The investment amendment

The draft "Investmentänderungsgesetz" (investment amendment Bill) will bring about changes that will be of fundamental significance for domestic Spezialfonds. The change likely to be of most interest is the possibility of deviating from legal requirements by reaching an agreement in civil law via a contract, in this case solely in the form of an agreement between the KAG and the investor.

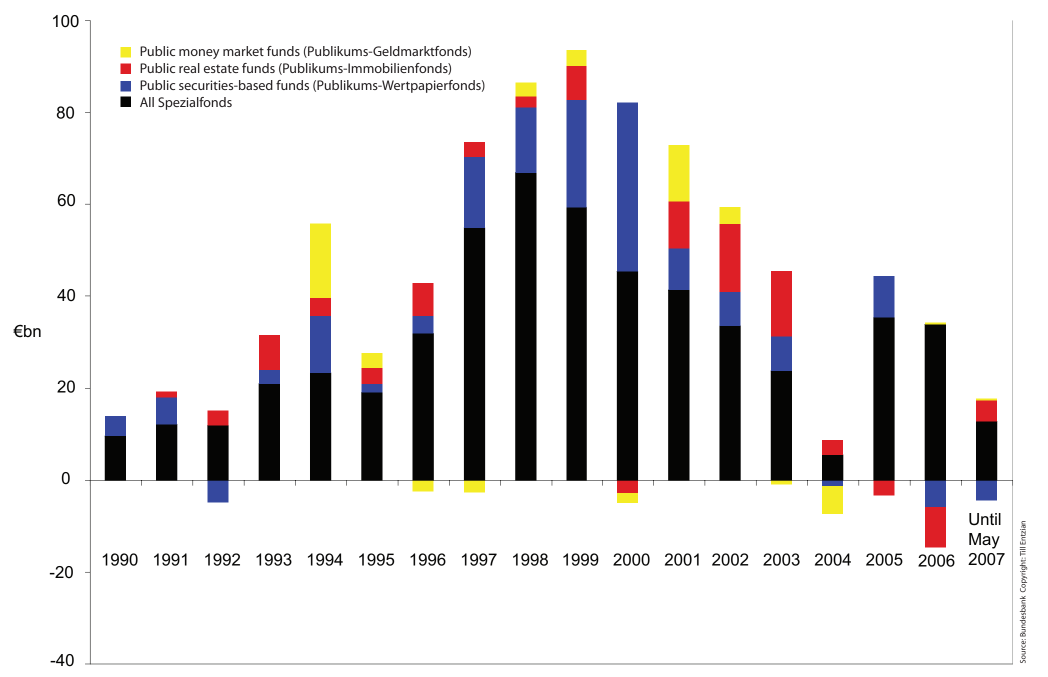
But this possibility will only affect the investment limits that can be waived eventually. And, unfortunately, the proposal does not yet foresee freeing up investment restrictions to the extent that Luxembourg has. Under the existing draft, domestic Spezialfonds must retain the character of the fund types described in law (ie, funds according to UCITS directive, real estate funds, hedge funds, and so on). A broad mix of securities, derivatives and real estate will probably not be allowed, let alone other assets like art or yachts. At least there is already a solution for the investors that want to have that kind of mix of assets – if the assets are wrapped in delta one-certificates, they are already eligible.

Natural persons as investors

Domestic Spezialfonds are no longer restricted to non-natural persons like corporations (limited companies, trusts and so on). Even if the law on investment continues to deny natural persons access to Spezialfonds, natural persons now can invest in a Spezialfonds via a partnership.

This is really a change and this change was possible because BaFin, the German financial regulator, changed its earlier view that a partnership could

Figure 1: Receipts by domestic investment funds since 1990, €bn



only be an investor in a Spezialfonds if none of partners was a natural person.

This position has been revised so that any partnership (unlimited partnership like a "Gesellschaft bürgerlichen Rechts" or limited partnership like a "Kommanditgesellschaft") is seen as a non-natural investor, meaning that partners are excluded from scrutiny. This new interpretation is made possible despite the fact that the wording of the Investment Act has not changed, since the law does not explicitly specify whether a company is to be seen as a non-natural investor or whether the natural persons behind the company are decisive.

Even if this means it is already possible in Germany to invest in so-called "millionaires' funds", by founding a GbR with a second partner who may have only a microscopic share of the business, the legal situation in Luxembourg is even more generous. There, a natural investor can invest in a SIF directly and does not need a second individual who might thereby get access to the fund's annual report and have a claim on personal assets.

Figure 2: SIF inflows from insurance entities as a proportion of smoothed annual amounts, €m

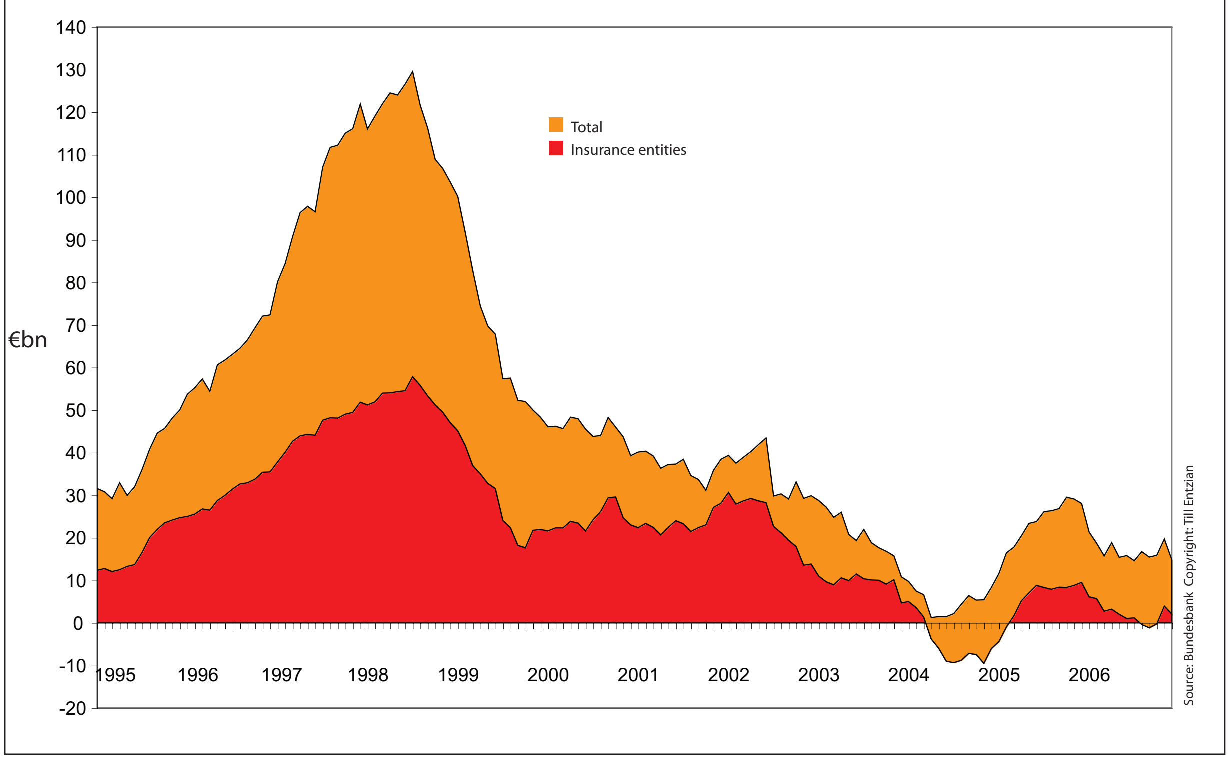
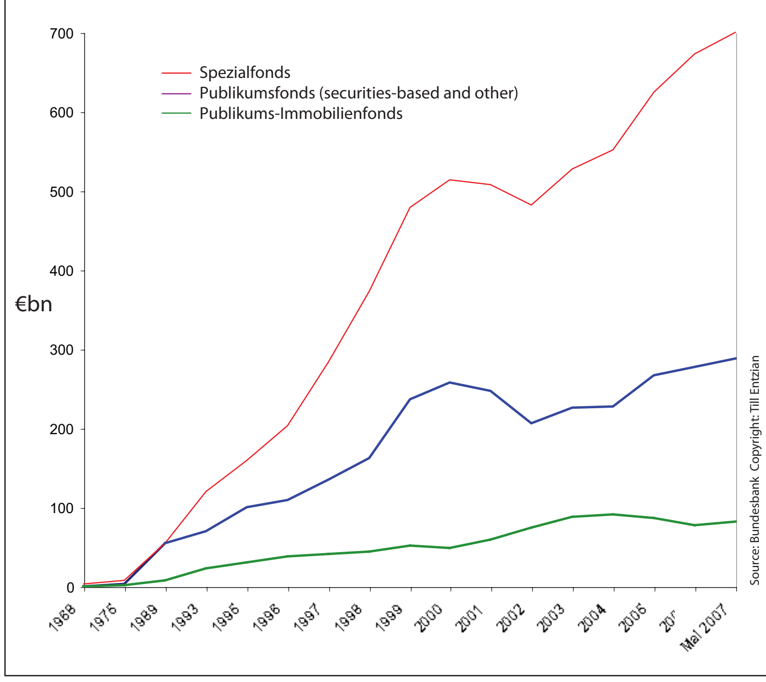


Figure 3: Growth in fund volumes, €bn



No restrictions on investor numbers

A further change should see the maximum number of investors in a domestic Spezialfonds, which was first raised from 10 to 30 in 2004, being abolished completely. If you leave aside DEFO, which was unable to convert its large 'individual funds' into a Spezialfonds in 1990 because it had more than 10 investors, the restriction to a maximum number of investors has not constrained business. On the other hand, there are no clear reasons to restrict the number of investors. It would in any case make sense to follow the Federal Association for Investment and Asset Management (BVI)'s proposal for a restriction to 100 investors in order to preserve compatibility with the taxation framework.

The crucial question relating to the reform of the Spezialfonds regulations is not about the form of the vehicle but about the fundamental issue of whether there should be any deviation from the regulations affecting retail funds. For 15 years, respected representatives of the investment industry have been warning that few changes should be made to the fundamentally similar regulations affecting both groups of funds. The reason for this warning was the fear that Spezialfonds with different investment regulations to retail funds might be treated differently for tax purposes. Clearly, these fears are now no longer relevant, partly perhaps because the tax treatment of the investor is no longer decisive when deciding between a Spezialfonds and another investment vehicle. For example, one argument that is often cited is that capital gains realised within the funds can be accrued tax free (they become taxable on redemption of the fund's units or on distribution of the gains). Since the reform of the corporate tax system, investors can take tax free capital gains from equity holdings, and are therefore no longer forced to use an investment fund to shelter profits taken.

Even aside from this, the investment industry had few criticisms to make concerning this fundamental change. Furthermore, legislators look serious in their intention to relax investment restrictions on Spezialfonds.

Nonetheless, it must be concluded that the current draft does not go far enough in creating a domestic vehicle equivalent to Luxembourg Specialised Funds.

Eligible assets

A new definition of securities will have a greater effect on Spezialfonds investment opportunities than the planned abolition of investment restrictions on a contractual basis. Until now, the position was that risks from non-eligible assets could not be acquired, neither directly nor indirectly using derivatives, regardless of whether the derivatives were offered as a standalone product or as a certificate (a derivative wrapped inside a bond). This has changed. Only derivatives offered as stand-alone products will in the future continue to be prohibited if the underlying asset is a non-eligible. But, from now, certificates are allowed without regard to their underlying assets or risks, as long as they pass certain more formal tests.

The base value of a certificate of this nature, whether it is the price of gold or crude oil, a share price or the price of a basket of shares, is irrelevant both during acquisition and when calculating investment limits. This means assets or risks that were previously non-eligible can now be incorporated into the portfolio. The significance of the legal investment limits (5% /10% /40%) is also changing. If the base value of a certificate is set by a share, for example, the default risk associated with that share will no longer be calculated towards the issuer limits. Responsibility within the KAG for reasonable risk management is borne in such cases not by the investment ceiling auditors but only by the risk manager.

The possibility of holding precious metal and commodity certificates as well as other assets in the fund (inventory warrants are still off limits) opens the way to new types of product. The crucial point is that risks are about assets; betting on circumstances like weather conditions continues to be off limits. Options of all kinds can be acquired, wrapped in certificates, as can shares in closed ended investment funds.

Figure 4: Composition of Spezialfonds

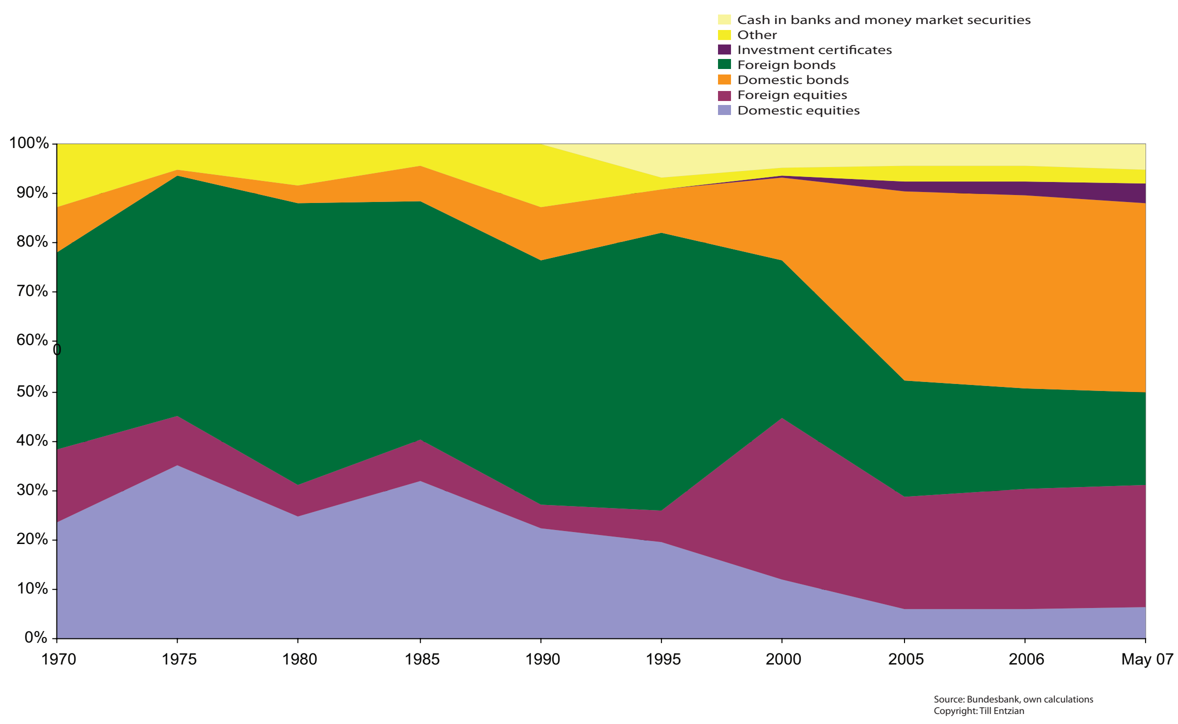


Table 1: Market share changes in 2006 compared to 2005

Change in:	fund numbers		fund volume		market share
	Number	%	€bn	%	% points
Major and regional banks	0	0.0%	-97.4	-47.9%	-17.2
Private banks	5	0.6%	14.2	11.6%	0.8
Savings banks/central savings banks	58	4.4%	37.7	31.8%	3.6
Cooperative banks	-19	-4.7%	4.0	10.7%	0.2
Insurance companies	232	70.1%	105.6	138.0%	13.7
Foreign bank subsidiaries	-61	-22.0%	-3.3	-13.0%	-1.1
Others	24	53.3%	2.2	8.6%	0.0
Total	239	5.3%	63.1	10.4%	0.0

Source: Till Entzian

Table 1: Market movements 2006 compared with 2005 (on the basis of table 5)

Change in:	fund numbers		fund volume		market units
	Number	%	€bn	%	% points
Large listed and regional banks	0	0.0%	-97.4	-47.9%	-17.2%
Private banks	58	4.4%	37.7	31.8%	3.6%
Savings banks	-19	-4.7%	4.0	10.7%	0.2%
Co-operative banks	232	70.1%	105.6	138.0%	13.7%
Insurers	-61	-22.0%	-3.3	-13.0%	-1.1%
Other	24	53.3%	2.2	8.6%	0.0%
Total	239	5.3%	63.1	10.4%	0.0%

Source: Till Entzian

Table 2: Structure of Spezialfonds investors, %

	1999	2000	2001	2002	2003	2004	2005	2006
Domestic Spezialfonds investors	99.3	99.4	99.6	99.3	99.4	99.4	99.6	99.4
of which:								
Insurance companies	35.1	38.5	37.8	37.0	37.7	35.9	38.1	36.1
Statutory/government social insurance institutions	2.1	1.3	1.3	1.5	1.4	1.4	2.5	1.1
Institutionalised pension providers	17.1	14.2	15.1	14.4	15.3	19.5	17.6	19.9
Credit institutions including banks	22.3	24	24.6	26.7	24.5	23.7	21.4	21.1
Other commercial enterprises	16.3	14.3	12.7	11.6	12.3	11.4	13.0	14.2
Churches, foundations, religious-charitable organisations, associations, trade unions and others	6.4	7.1	8.1	8.0	8.2	7.5%	7.0	7.0
Non resident Spezialfonds investors	0.7	0.6	0.4	0.7	0.6	0.6	0.4	0.6
Total	100	100	100	100	100	100	100	100

Source: Till Entzian

Concerning the the tests the certificate has to pass to qualify as eligible asset, the most important is the so-called 1:1 ratio ("delta one") between the risk and yield of the base asset and the certificate. If a certificate contains a capital guarantee that protects the investor from excessive losses, it is not a delta one certificate and the KAG must look to the underlying asset to decide if it can be acquired, and can only buy the certificate if the underlying would be permitted for direct investment. There are further conditions, like maintaining a certain level of fungibility, which is in any case measured on the fund level.

Changes to KAGs

A year ago the number of Spezialfonds-KAGs was stable at 52, since ABN Amro's surrender of its KAG licence was counterbalanced by the founding of the DEKA Fundmaster. However, the number of Spezialfonds-KAGs has now fallen by six providers to 46 without the creation of any new Spezialfonds-KAGs.

Last summer, Merck Fink Invest and JPMorgan KAG both returned their KAG licences. Both companies are now concentrating on asset management and are leaving Spezialfonds administration to other KAGs. Merck Fink will use Universal Investment exclusively, while JPMorgan has chosen various providers.

Two further companies, Gerling Investment and SüdKA, have disappeared from the market via mergers. Gerling Investment, which managed €4.3bn in nine Spezialfonds at the end of 2005, became part of AmpegaGerling Investment GmbH following its acquisition by Talanx. The 33 Spezialfonds managed by this company have total assets of €6.6bn. SüdKA, which had €10bn under management in Spezialfonds, joined forces with BWK Baden-Württembergische KAG to form BW-Invest Baden-Württembergische Investment Gesellschaft mbH, which now has €18bn in 53 Spezialfonds. BW-Invest is 64% owned by the state bank (Landesbank), meaning it is now one of the KAGs owned by a Landesbank or a Land savings bank. The remaining 36 per cent belong to W&W Asset Management, a company owned by Wüstenrot & Württembergische AG.

Unlike in the above cases, MK Münchener Kapitalanlagegesellschaft, which was taken over by Commerzbank, still exists, but no longer offers Spezialfonds. DWS has also ceased to offer Spezialfonds.

There have been many changes to company structure and affiliation. At the beginning of 2006, Frankfurter Service KAG became the legal successor to BHW-Invest. The owner is BHF Bank, meaning Frankfurter Service KAG is one of the commercial bank-owned KAGs. It runs eight Spe-

Table 3: Market shares of provider groups

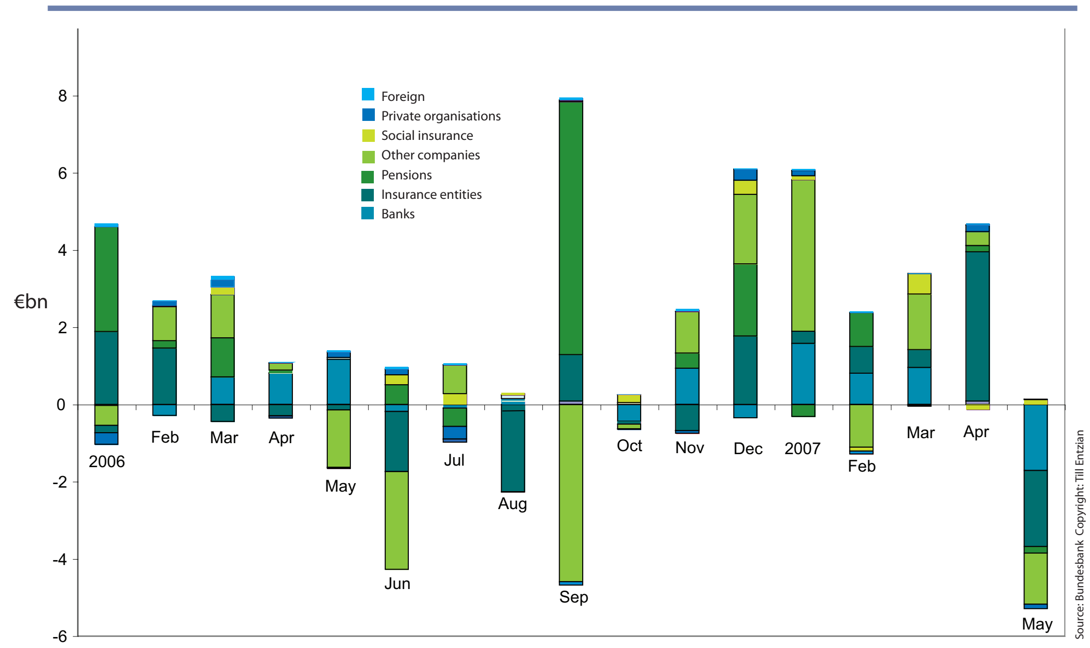
	2006				2005			
	Number		Fund volume	Market share	Number		Fund volume	Market share
	KAGs	Funds	€bn	%	KAGs	Funds	€bn	%
Major and regional banks	7	1,353	105.8	16.1	9	1,353	203.2	33.4
Activest, BB-Invest (new name 2005: Landesbank Berlin Investment), Cominvest, dit,dbi, DeAM, DVG, DWS, Nordinvest								
Private banks	7	807	136.8	20.9	7	802	122.6	20.1
Frankfurt-Trust, Inka, Metzler Investment, Monega, Oppenheim, Universal, Warburg								
Savings banks/central savings banks	8	1,369	156.0	23.0	7	1311	118.3	19.4
Bayern-Invest, Deka, (added 2005: Deka Fundmaster), Helaba Invest, Nordcon, Südka, WestAM (new name 2005: WestLB Mellon Asset Management KAG)								
Cooperative institutions	3	382	41.6	6.3	3	401	37.6	6.2
Union Investment Institutional, Union Investment Privatfonds, Union Panagora								
Insurance companies	9	563	182.2	26.3	11	331	76.6	12.6
AL-Trust, AM Generali, Ampega, AXA Investment, BWK, Delta Lloyd Investment, GCR, Gerling Investment, Hansainvest, MEAG Munich Ergo KAG, MK								
Foreign banks	7	216	22.1	3.1	9	277	25.4	4.2
ABN Amro Asset Management (dropped out 2005), CSAM KAG, Goldman Sachs, Invesco, JPM, Lazard Asset Management, Merck Finck Invest, SEB Invest, UBS Invest, Veritas SG								
Others	5	69	27.8	4.2	6	72	24.9	4.1
BHW (legal successor: Frankfurter Service KAG, First Private IM KAG, Lupus Alpha, Maintrust, Postbank Privat Investment, SKAG								
Total	52	4,520	609.2	100	46	4,759	672.3	100.0

zialfonds with €1.3bn in assets. In renaming itself LBB-Invest, the former BB-Invest has made clear that it belongs to the Landesbank and Sparkasse (savings bank) camp. The state of Berlin has now moved its 81% stake in the holding company to a company established especially for this purpose by the German Union of Credit Banks (DGSV), meaning LBB-Invest can still be labeled a Landesbank institution. Nordcon Investmentmanagent AG also belongs to a savings bank, since it has been 100% owned by Nord LB for some time.

After its takeover by Italy's UniCredit, Hypovereinsbank's funds business was also reorganised. Activest was renamed Pioneer, and now manages some €38bn in 191 Spezialfonds.

There were also name changes at AMB Generali, now known as Generali Investments Deutschland Kapitalanlagegesellschaft mbH and at Generalcologne Re Capital, now Gen Re Capital GmbH. At the beginning of the year, DIT Dresdner Investment Trust and dbi dresdnerbank investment management joined to form AGI Allianz Global Investors Kapitalanlagegesellschaft mbH. AGI was classified as an insurance KAG. In any case, DEKA and dim had created the same kind of combined retail and Spezialfonds company inside a single KAG several years earlier.

Figure 7: Asset in and out flows by investor group (€m) to May 2007



Market shares

Changes to client structures within individual KAG groups have been more striking than usual this year. The reason for this is the regrouping of the individual companies described above, since a change in a KAG's ownership does not immediately change the structure of the Spezialfonds investors. It is remarkable, for example, that the number of insurance investors in KAGs belonging to major or regional banks has declined noticeably, while insurer-owned KAGs have seen the proportion of their business coming from finance houses (including lenders) rise significantly. KAGs with foreign partners have also seen the proportion of their business coming from insurance investors fall. It is striking that the social insurance providers have returned substantial sums to KAGs owned by private banks in particular.

Composition of the investor base. It can be concluded that during 2006, no single investor group caused outflows. This was not the case in earlier

Figure 5:Investment units in bank ownership, €bn

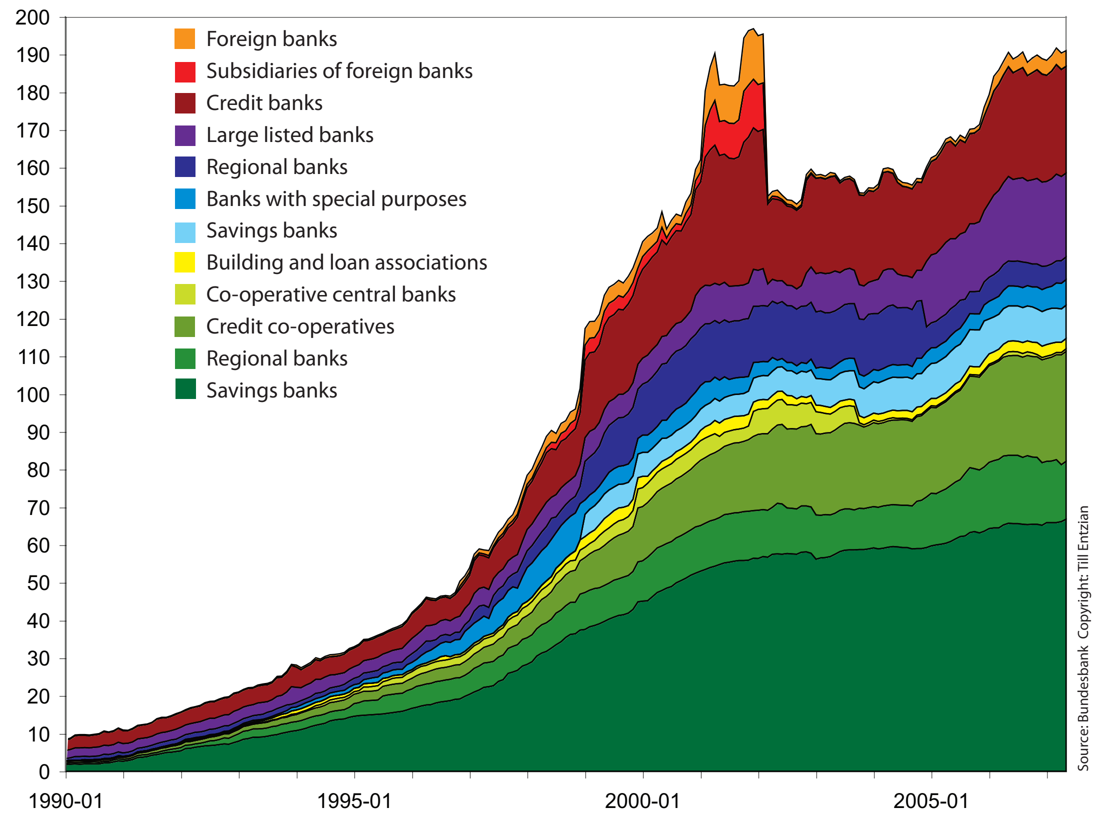
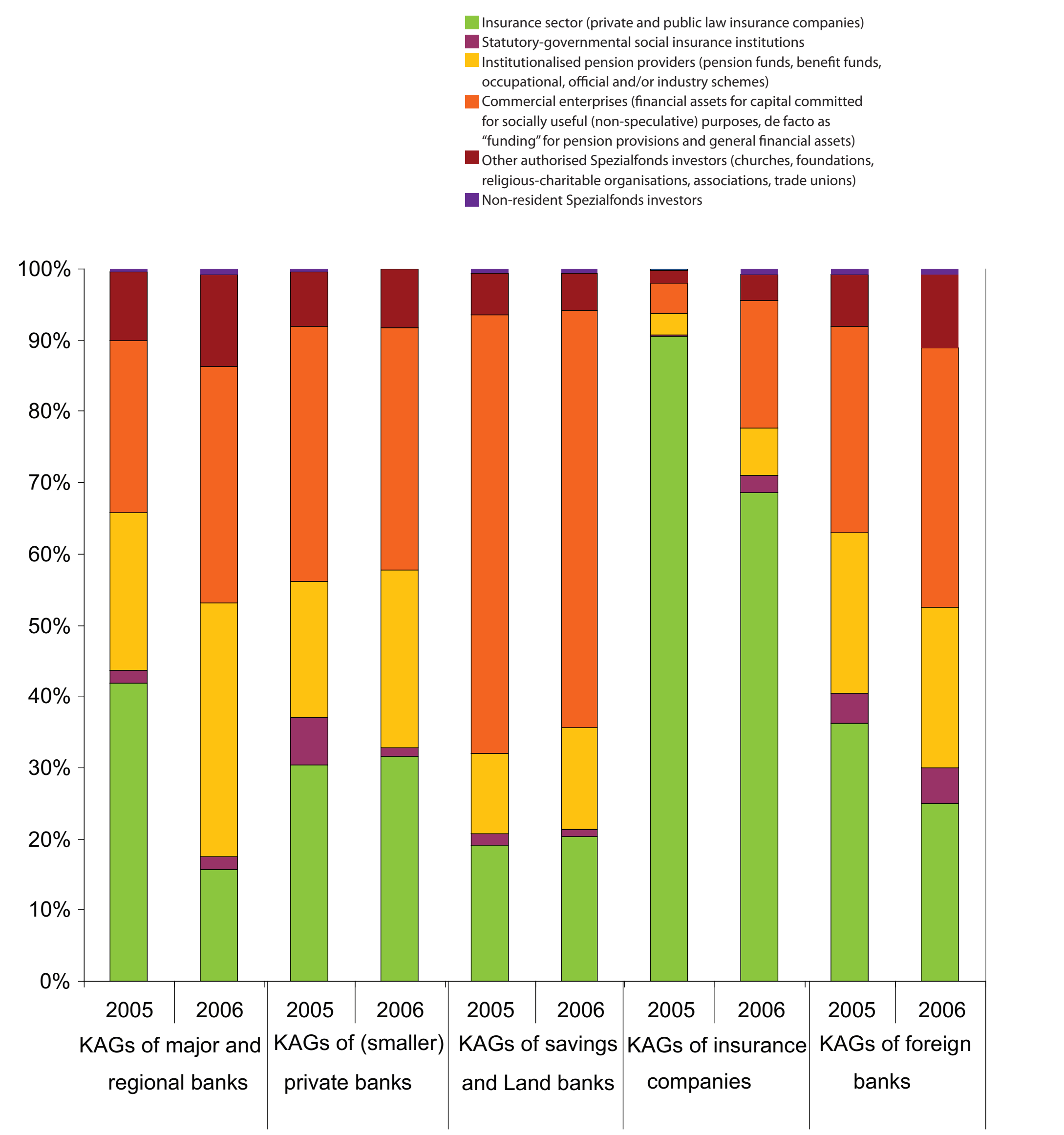


Figure 6: Structure of Spezialfonds investors according to KAG group type



years, when there was always one group of investors or another which cut its Spezialfonds share. These included the insurers in 2005, which cut their Spezialfonds exposure by €18.5bn. This reduction, which resulted from returning units and market losses, was largely compensated for in 2006 – with gains of €13.5bn. In the first five months of the current year, the insurers' Spezialfonds grew a further €6bn, bringing their value to €242bn. Credit institutes' Spezialfonds volumes have shown relatively steady growth.

In 2005, this growth level was particularly high at €11.7bn. Only €6.5bn was posted in 2006, though this was still higher than the average of previous years. Over the current year, credit institutes' Spezialfonds have gained a further €4.4bn, meaning this group of investors was managing a total of €156bn in May 2007.

Institutional pension schemes achieved the highest relative growth levels with 24%, although this is partly to be explained by the fact that some KAGs have only now started to declare these Spezialfonds as pension investors and not insurance investors in their reports to the Bundesbank. Up until 2003, the Bundesbank did not distinguish between these two investor classes, meaning that some assets may still be misclassified.

According to the Bundesbank's formal statistics, only around 13% of the Spezialfonds asset volume is pension related, while the Bundesbank's own survey suggests the number is closer to 20%.

Spezialfonds growth was also seen by the social insurance providers (a gain of 10.2%, taking them to €21bn) and churches and other investors (gaining 17%, reaching €36bn).

Foreign investors have increased their Spezialfonds investments substantially, seeing growth of 22%, though the absolute sums are relatively small at just €3bn – or 0.5% of the total volume of assets in Spezialfonds. The relatively high level of growth gives no reason to expect increased interest from foreign investors in Spezialfonds, since there have been similar levels of growth in previous years, without any sustained growth following.

Investment by credit institutions

Credit institutions' investment in fund units appears to be stabilising at around 10% of their total securities inventory. The highest level, a full 12%, was reached at the end of 2002, before the proportion fell below 10% over 2005. In the middle of last year, it climbed above 11% once again.

Unit holdings as a proportion of total securities holdings fell from a high of 12.5% at the end of 2001 to less than 10% in May 2007. During this period, the fluctuations in this number closely followed the fortunes of the equity markets. If banks had not carried such high equity risk

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in the funds as in their direct holdings, they would have had to return their holdings in falling markets.

Importance of fund units for the various banking groups

There are astonishing differences between the various banking groups' approaches to using investment funds as investment instruments. Between 1994 and 1997, credit associations had invested a very high proportion of their securities holdings – 20 to 22% – in fund units. This high level had already been reached before, in 1978, but had then fallen to less than 6% over the years that followed. Since 1998, this figure has fluctuated between 10 and 13%.

The savings banks, or Sparkassen, are the other important group of investors. Here, the picture is completely different. Until 1990, when Spezialfonds were created by the KAGG law in the first Law on Promoting the Financial Markets, these banks had almost nothing invested in investment funds (the average is around 1% of total securities holdings since 1970). From 1990, there has been a continuous rise in this proportion, with Sparkassen investing some 27% of their total holdings in fund units.

Since 1990, the central banks have also been raising their allocation to fund units. Nonetheless, they have been fairly restrained about this, allocating no more than 7% of their total securities holdings.

The co-operative central banks reached higher levels – 9% in 2000 and more than 11% in 2001 and 2002. In 2003, they began selling Spezialfonds en masse, since when DZ-Bank and WGZ have held less than 1% of their securities in fund units on average.

Asset composition of Spezialfonds

Most of the trends described last year relating to fund managers' choices of asset class have continued. Spezialfonds have continued to reduce their exposure to domestic fixed income, both in absolute terms (from €135bn to €120bn) and in relative terms (from 23.7% to 20.4% of assets under management).

The fall in domestic fixed-income exposure has continued this year. But the shift is not favouring foreign bonds. Although the absolute sum invested rose €10bn to €227bn, foreign fixed income's share of the total stayed more or less stable at 38%.

Domestic equities remained largely stable at the relatively low level of about 6%. Absolute equity exposure rose a good billion euros to €36bn. This means Spezialfonds now have a market capitalisation equal to the seventh or eighth most heavily capitalised company on the DAX (DaimlerChrysler and RWE at the moment).

The low allocation to domestic equities can be explained by the fact that many fund managers have diversified their equity portfolio, which leads to global capital diversification. This means Spezialfonds have far more invested in foreign equities – 24% of the total, up two percentage points from the end of 2005.

The use of target funds continues to grow. At the beginning of 2003, they made up only 0.1% of total Spezialfonds assets. Over 2006, they grew from 2% to 3% of the total, and at the end of May 2007, they had climbed above 4%. This means €25bn of Spezialfonds assets is currently invested in target funds.

The investment in bank deposits, money market instruments and other assets and obligations – not counted here - has been relatively stable at about 8% over the past four years.

Conclusion

Special funds continue to be an outstanding instrument for managing institutional investors' securities investments. The Luxembourg SIF, which is now being marketed very aggressively, has grown into a strong competitor for the German Spezialfonds. But Germany's legislators have already reacted with proposed changes to the investment law and relaxed many of the regulations and restrictions. Legislators may, it is hoped, implement these changes consistently, acting fully to remove the investment guidelines for Spezialfonds as well as restrictions on the investor's side. This would, at the very least, help boost Spezialfonds in the future.

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THE KANDLBINDER REPORT

For over 30 years Dr Hans Karl Kandlbinder, the orginator of the Spezialfonds concept, presented the Kandlbinder Report on Spezialfonds for the previous year. This year's report is authored by Till Entzian.

A German version appeared recently in the Zeitschrift für des Gesamte Kreditwesen published by Frankfurt-based publishers Fritz Knapp Verlag