

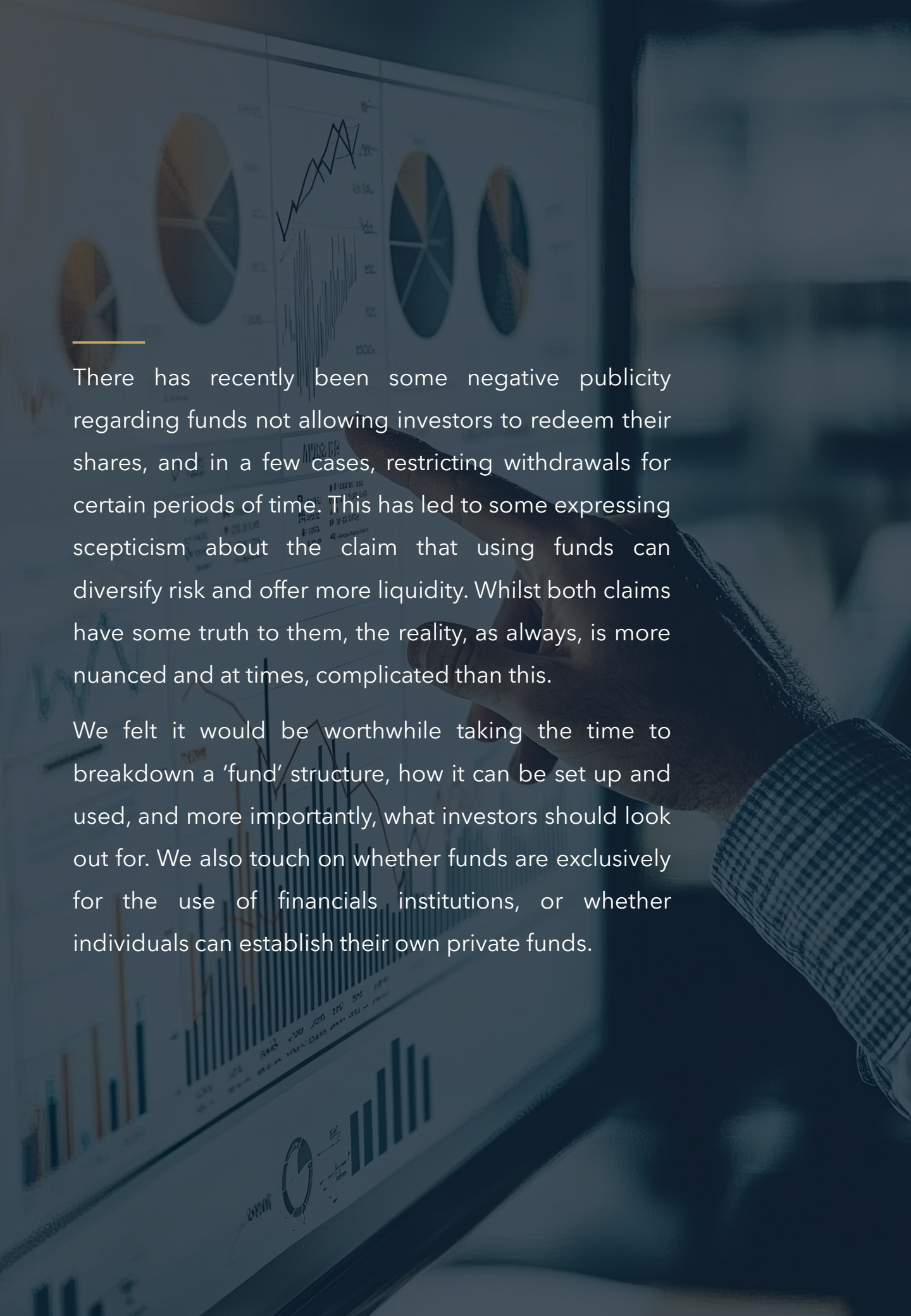


JUPITER WEALTH

Funds

Looking through the lens

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There has recently been some negative publicity regarding funds not allowing investors to redeem their shares, and in a few cases, restricting withdrawals for certain periods of time. This has led to some expressing scepticism about the claim that using funds can diversify risk and offer more liquidity. Whilst both claims have some truth to them, the reality, as always, is more nuanced and at times, complicated than this.

We felt it would be worthwhile taking the time to breakdown a 'fund' structure, how it can be set up and used, and more importantly, what investors should look out for. We also touch on whether funds are exclusively for the use of financial institutions, or whether individuals can establish their own private funds.

What is a Fund?

This may sound like a simple question – from an investor’s perspective, this is usually a pooled, or collective, pot of money provided by a number of investors which is then used to invest into assets on behalf of those investors. The legal structure of a fund can vary enormously, from a simple corporate structure such as a private limited company, to an investment trust, to a partnership structure. The exact legal structure will depend to a large extent on a number of factors including:

- Target investors
- Target investments and location of these
- Regulatory considerations
- Tax efficiency, where possible
- Investor protection
- The fund’s ability to increase or reduce its size/capital during its lifetime

By way of an example, where international investors are looking to invest into the US markets, a limited partnership structure is used, where investors have a passive role in the partnership i.e. they are limited partners (or invest via other collective funds, which are themselves limited partners e.g. feeder funds). The general partner typically manages the fund activities and as such the general partner’s liability is often unlimited. For this reason, as well as operational efficiency, general partners tend to be established as limited liability companies.



The reason for the use of a partnership structure can be tax driven and also to distinguish between the different roles - limited partner vs general partner. In partnerships, profits and liabilities are generally passed through to the partners in pre-determined proportions.

The justification for the choice of jurisdiction is based on reputation, investor friendly regulation, investment, and tax efficiency or neutrality, and of course expertise in fund administration. Commonly used locations include Cayman Islands, Luxembourg, Ireland, Singapore, UK and the US, to name a few.

Where it is likely that there will be a number of investors from particular regions e.g. Europe, an appropriate structure could be used for such investments such as a Luxembourg registered legal structure (SICAV, SICAF, FCP etc).



Who are the key parties to a fund

Each role in a fund has a purpose and irrespective of the type of vehicle used as the fund, or the names given, the following are the main roles you would find in a fund:

- **Investor** - you provide the capital to the fund in the expectation of a return
- **Manager** - the manager has the experience and capabilities to manage the fund's investments in accordance with its mandate and needs to balance the needs and interests of all investors in the fund
- **Administrator** - the administrator handles the day to day functions and operations of the fund, liaising with the other parties and ensuring the fund is managed in a professional and compliant manner, such as providing updates on the values of each investor's shares or units in the fund
- **Custodian** - the custodian holds the assets of the fund for the fund's investor and the fund itself, carrying out any transactions on behalf of the fund and providing regular reporting to the administrator
- **Auditor** - an external auditor is key for ensuring oversight of the fund and making sure that it continues to function, operate and report in the way in which it was intended



What are the benefits of a fund?

Funds are considered as an asset class in their own right, despite the fact that many funds themselves invest into asset classes which investors could directly invest into e.g. equities, real estate, bonds, commodities etc. So why use a fund and create more layers?

Diversification { investing into various assets within the fund, rather than single assets, reducing the concentration risk

Cost benefits { transaction and operational costs can be spread over the investors, easing the burden on individual investors

Economies of scale { and access to investments and markets otherwise inaccessible

The collective power of investors enables them to better use the combined funds than would be the case if they had tried to invest individually. However, what is important is that there is a collective understanding and agreement of the direction of travel of the fund. Investors need to be aligned with the aim of the fund and what its investment objectives are. Here, the constitutional and core investment documents are important to better understand what the fund can, and cannot do, with your money.



Fund Prospectus and Legal Framework

Key decisions that would need to be taken when establishing the fund would include whether the intended investors are to be retail investors, where the rules governing the fund itself are more prescriptive in order to provide better protection to such investors, or professional investors. In the case of professional investors, the investment parameters are often not as regimented and there is more flexibility within the fund since professional investors are assumed to be more financially sophisticated and more able to withstand losses.

Legal constraints that would be considered at the outset would include whether the fund would be limited in scope of the number of investors and its size i.e. it would be a closed-ended fund. Alternatively, the fund could allow for subscriptions and redemptions on a periodic basis, with the fund size expanding and contracting to meet investor demand (sometimes known as evergreen or open ended funds*). This would in turn be dictated, to a large extent, by the investment strategy and objectives. This would be a key consideration, particularly where an investor has a known investment time horizon which is shorter than the expected duration of the fund.

**An important distinction between evergreen and open ended funds is the potential investor liquidity. For evergreen funds, these are typically not as liquid as open ended funds, and as such, in times of market stress, there may be restrictions placed on withdrawals or redemptions, as was recently experienced with private credit funds.*



Restrictions are not necessarily a sign of distress within a fund, but more often a case of prudent investment management by the manager. As the manager needs to consider the interests of all investors, this includes departing and remaining investors. Using up all the liquidity in a fund (of which a prudent manager usually retains a portion of in cash or near cash) to meet withdrawal requests and other costs could hamper the manager's ability to operate the fund effectively. Equally carrying out a firesale of some assets to meet liquidity needs for some withdrawing investors could disadvantage those investors who choose to remain invested, so a careful balancing act is required.

For some funds, the investment objectives might be widely drafted, allowing for investment into a variety of asset classes, with no geographic or market restrictions, but could be more specifically focussed, in order to attract investors targeting the designated scope of investments. The use of leverage within the fund could also be stipulated in the investment objectives.



What to look out for

The fund prospectus will usually set out all of the key information that would be relevant to investors and required to be disclosed from a regulatory perspective. Some of the highlighted points to look out for before investing would include:

- Redemption periods, and any restriction terms that might be imposed by the manager
- Ability to use leverage within the fund - this can boost the returns, but can also expose the fund to exaggerated losses in a rising interest rate or inflationary environment
- Basis for valuation - this should be on a mark to market basis as much as possible
- Auditor - a reputable auditor should be selected to audit the fund on an annual basis
- Investment Objectives, track record and experience of the manager in the sector and asset class of the fund



Use of Private Funds

“Can a private fund be established, or are these limited to financial institutions? ”

This is a question we are often asked. The reasons for someone wanting to set up their own fund vary - from institutionalising the ownership of their assets, or attracting other investors into their business and injecting capital, or setting up a fund to manage their own family monies as well as others.

There are flexible legal and regulatory frameworks around the globe to permit such structures to be created. However, certain minimum requirements would need to be met in order for these private funds to be established and operated including use of regulated providers as administrators and managers, auditing requirements, prospectus issuing requirements, to name a few.

For those individuals interested in setting up such funds, there is a question of cost - setting up and maintaining a private fund can be quite expensive, but in some instances, there are options available where individuals can ‘piggy back’ on existing fund structures, for lower costs, whilst still being afforded segregation of assets and control of investment policy.



How Can Jupiter Help?

For professional investors based in the markets we serve, our team regularly conducts thorough reviews of funds that are recommended to our clients, making sure we highlight the relevant key facts so our clients invest with eyes wide open. We look at all of the above factors and analyse these on an ongoing basis, ensuring the funds remain aligned to our clients' best interests. For individuals interested in setting up their own funds, we have, and can support those individuals, guiding them through the process and connecting them to relevant professional advisers to ensure the appropriate advice is provided and they obtain the most appropriate solution for them.

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