

# THE PRODUCT INNOVATION PARADOX

Socio-demographic trends, macroeconomic conditions, technology, regulation and taxes are strong drivers of product innovation. In financial services, product innovation is an evolutionary process whereby companies seek to diversify investments, increase returns, decrease costs and structure investment solutions around liabilities.

However, the current crisis is certain to have influenced the nature of recent innovations as investors, both institutional and retail, seek greater transparency and security. Asset managers now face an “innovation paradox”.

## The impact of the crisis on product innovation

The current crisis has not prevented the industry from innovating, although capital preservation rather than speculation will probably dominate investor behavior over the coming years (even if many investors have already relocated part of their wealth into stocks in the hope of recouping some of their losses). This will drive retail investors to look for packaged solutions that meet their specific needs around their life-cycle, and institutional investors to look for products that offer opportunities for alpha performance (not correlated with the markets) to match their liabilities.

The industry has reacted by developing new types of products including the following (or a combination of the following):

- “cheap beta” products (e.g. ETFs);
- outcome-oriented products (asset and liability matching, income/capital protection, lifecycle funds);
- products offering alpha performance (better asset allocation, alternative investment strategies).

The paradox here is that, while clients will demand simple, cheap and safe solutions, asset managers will have to use sophisticated or even complex products and investment strategies to deliver the goods.

## The resulting trends

Asset managers are increasingly using financial derivatives and the border between UCITS and non-harmonised funds is becoming increasingly unclear. In particular, many UCITS funds are now using alternative investment strategies through the extensive use of derivatives and, to a certain extent, have come to re-

semble alternative investment products. A PwC report prepared for the European Commission <sup>1</sup> indicated that the UCITS III Directive resulted in an increasing use of derivative products within UCITS funds while not modifying the risk profiles of these products.

## Fostering product innovation

The Luxembourg government actively encourages innovation through the legal and regulatory framework. The expertise of fund service providers is another important factor. In 2009 alone, Luxembourg UCITS have won four innovation awards from Feri EuroRating in several countries and from the German Euro magazine.

In the non-harmonised universe, the specialised investment fund (SIF), introduced by the law of 13 February 2007, is itself an innovative legal vehicle with

UCITS product innovation has crystallised in the use of derivatives to offer more flexibility and reactivity. Asset managers can:

- increase the duration of the portfolio at lower cost by using interest swaps (i.e. paying Libor and receiving a fixed longer term interest rate) rather than changing their strategic asset allocation;
- get exposure to other asset classes, e.g. credit risks, through a credit default swap rather than buying corporate bonds;
- short securities through derivatives products to take advantage of a downside view on this security (short positions on physical assets remain forbidden for UCITS);
- increase their market exposure through derivatives (leverage);
- manage risk (hedging purposes).

unprecedented flexibility coupled with the assurance provided by supervision under a robust regulatory regime.

Numerous innovative products have been launched through the SIF regime such as, in June 2008, a SIF investing in the complex and illiquid asset class of transport containers. SIFs have also been used to allow managers to invest in infrastructure, forestry, wine and intellectual property rights. SIFs are also widely used by promoters as incubators to test a new strategy before selling it to the public.

Luxembourg is also well positioned in new asset classes such as sustainable and responsible investments (SRI) and especially in microfinance, with half of the top ten largest microfinance funds being domiciled in Luxembourg.

Luxembourg has an answer to the paradox highlighted earlier, that is, how to reconcile investors' need for simple, cheap but also safe solutions with the fact that delivery of these solutions is through the increas-

ing sophistication of products. The flexibility of the Luxembourg regulatory framework coupled with the assurance that both UCITS and non-UCITS are administered under a robust regulatory regime, gives asset managers the opportunity to develop innovative strategies while offering investors a high level of confidence.

(1) PwC, February 2008: "Comparative analysis of use of investment powers, outcomes and related risk features in both UCITS and non-harmonised markets."

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## PHILANTHROPY TAKES ITS PLACE AT THE HEART OF THE FINANCIAL CENTRE

The recently launched *Fondation de Luxembourg* makes philanthropy easier by enabling private individuals to set up their personal foundation under an umbrella structure.

At the Davos summit in 2008, Matthew Bishop, editor at The Economist magazine and one of the leading researchers on philanthropy, said that "a web of wealthy, motivated donors has set out to change the world. Their focused donations may be the greatest source for change in our world".

People are becoming increasingly concerned about the environment and world poverty. Many wealthy individuals have adopted the viewpoint that if you want equilibrium in society, you need to share your wealth and they see themselves as potential providers of seed

capital for social change. Moreover the economic crisis, while putting a break on the sums donated, has clearly broadened the impact of this change of attitude. Engaging in philanthropy is perceived as a way of taking responsibility in times of crisis.

### Increasing demand for advice on philanthropic services

One challenge banks are facing in Luxembourg is that many high net worth individuals (HNWI) wish