## INTRODUCTION

# PROPERTY CRISIS COULD AFFECT CONFIDENCE

As foreign providers flock to Germany's mutual fund and investment products industry, the lacklustre performance of heavily-sold open-ended property funds, combined with hostility towards new hedge fund offerings, may undermine investor confidence, Yuri Bender reports

Germany's mutual fund and investment product industry is a healthy one, with a queue of foreign providers such as Merrill Lynch, JPMorgan and Schroders ready to take on the German giants of DWS, Cominvest and Union. But there are some local matters which need to be resolved, if a crisis confined to several products does not spread to hamper investors' confidence.

The most urgent of these has been the lack of liquidity in heavily-sold open-ended property funds, a highly popular vehicle among German retail investors, who have lodged close to €90bn in the asset class.

DekaBank decided to dig into group reserves, stumping up more than €2.2bn for customers who wanted to cash in their holdings in the group's €6bn real estate fund. But Deutsche Bank decided to temporarily freeze a similar sized fund before Christmas, meaning that customers were left out in the cold without access to their savings.

Deutsche Bank and its associated fund companies have become understandably twitchy about the situation, which could threaten the group's image and product range. One highly placed source said that one in five retail customer enquiries were currently about holdings in real estate funds. "The customers are not speaking with logic, but with emotion, and this is putting a huge stress on our advisers," said the source.

Another senior manager in the group says: "The situation amounts to a crisis in the German fund industry. Every real estate fund in Germany has some problem with valuation of properties."

The problem is that although these open-ended funds are theoretically tradable on a daily basis, the assets are not liquid, as unlike equities you cannot sell a Frankfurt office block or hotel overnight. Small numbers of investors can redeem, as the funds run a substantial cash position. But if there is bad publicity and a run on the fund, the promoters can be in trouble. However, the senior manager added: "There is a furore and an outcry. The image of the product group as a whole is damaged. But the damage is restricted to open-ended real estate funds. There will be no impact on other products. This product group is now under pressure."

Siebel: German office market on way to recovery

Although the BVI, the association representing Germany's mutual fund managers, claims to have been caught unawares by the events and "quite surprised to see the active closing of a fund", its fire fighting skills have been called into action, in order to keep things calm until the fund re-opens. "We are not allowing the bad news to spread outside the Deutsche Bank group to the rest of the industry," says the BVI's managing director Rudolf Siebel.

"Our members are clearly indicating to us that the German office market is on the way to recovery again."

Investors seem unconvinced, with a smaller Munich-based asset manager having to freeze a fund in mid-January. The events are leading to very uncomfortable questions being asked about Germany's leading banks and fund houses – who can be trusted to correctly explain, advise and sell products to retail investors?

"These funds were sold as a kind of money market product without risk," says a source within one of Germany's premier brand groups. "Many investors have discovered for the first time in their life that real estate prices can drop, and thus real estate fund prices too. That was for many investors not part of the deal."

The BVI, whose members have been very active in selling such funds has called for both investor education and some changes to the way products are manufactured. "One of the lessons going forward is that we need to educate more actively the investor base that real estate funds are open-ended funds," says Mr Siebel. "Their values can go up and down. This will be easier now. We won't need to actively start a dialogue, as it's obvious, and we can all talk openly.

"Plus we need to make a product fit for the future, fit for the Ucits directive, but also able to control liquidity and inflows or outflows."

Few groups predict any lasting damage, while some even suggest that with all the negative publicity about real estate, it is a good time in the cycle to invest.

"What will change is that real estate has been sold as a safe haven product for orphans and widows, and as such it was clearly mis-sold," says Martin Theisinger, head of Germany for Schroders in Frankfurt. "These funds have a huge tax impetus, and Germans are obsessed with saving tax. But look out of the window and see how many Frankfurt skyscrapers are empty and ask yourself – how can you expect returns? Is this damaging to the whole fund industry? No, but damaging to the German real estate market."

Mr Theisinger says the answer is real estate investment trusts (reits), which are tradeable, liquid and transparent. "I will be optimistic and say that this experience will lead to a functioning reits market in Germany."

Lack of liquidity, with redemption periods of up to six months, bad-mouthing from politicians and regulators, as well as poor performance, have also hampered Germany's experiment in retail hedge funds. Although Germany's largest retail funds group, DWS, boasted that it alone would have €1bn in hedge funds by the end of 2005, the experiment has generated assets of just €1.2bn across the entire industry, held in 25 products. And the question is whether the product's image will ever improve among investors.

"According to our regulator, BaFin, hedge fund are dangerous," says Mr Theisinger. "With that kind of idea in the market, we will need huge efforts to make it an attractive product offering. I think hedge funds will eventually re-

**"HEDGE FUNDS WILL EVENTUALLY RE-APPEAR THROUGH NORMAL PRODUCTS UNDER THE UCITS III DIRECTIVE"**
**MARTIN THEISINGER, SCHRODERS**

appear through normal products. Let's look at Ucits III structures through traditional funds. This directive allows you to do long/short. So a product previously only available in the hedge arena becomes common market practice and a product for the retail investor."

More popular has been the use of structured products, in particular certificates, in investors' portfolios. Sal. Oppenheim, Germany's largest private bank says that two years ago, a typical private client's portfolio was split 50/50 between mutual funds and equities. Today it is one third equities, one third bonds, and one third "alternative concepts". Of the latter segment, only 5 per cent is generally in hedge funds, and the rest is structured notes. This is some indication of the market's huge potential, and of course it's threat to traditional mutual fund providers.

Here, even the BVI, which 12 months ago stood firmly against further proliferation of certificates – certain players blamed investment banks for stealing money earmarked for hedge funds with 'fake' lookalike products – has toned down its criticism. "In the retail area of market timing, investors who take one decision each month by buying a structured product end up with a not very well constructed portfolio reflecting 12 decisions," says Mr Siebel. "They would have been better off to by one long-only fund."

But mutual funds invested in structured products are "totally acceptable in the hands of a skilled fund manager." The reason for this softening stance is that DWS, the association's largest corporate member, headed by its vocal CEO Axel Benkner, who once opposed structured products on behalf of the BVI, has now come out in their favour. DWS hired Stephan Kunze from ABN Amro to head up distribution of both mutual funds and structured products across Europe. It has already launched a fund investing in certificates, and plans more ventures combining the use of certificates and actively managed mutual funds.

"We are the first mutual fund company going in this direction. It is very innovative," says DWS director Thomas Richter. "Both kind of products have their legitimacy. It would not be clever from our perspective not to enter this growing structured products market."

However, Mr Richter stressed that mutual funds, currently worth €110bn, will remain the core business at DWS, with the company looking to sell, in particular, flexible asset allocation products manufactured under Ucits III legislation aimed at the retirement market, and the Bric Plus emerging markets product.

Although DWS treads carefully in the politically sensitive German market, it is currently enjoying a particularly fruitful period. The sell-off of the UK's troubled institutional arm has meant more attention has been drawn to retail profitability within Deutsche Bank. DWS has clearly been upgraded within the group and friends of Mr Benkner say

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he is walking with an extra spring in his step.

Any internal wranglings between DWS and Deutsche Bank's retail network over the latter's decision to stock funds from third-party providers also seem to have dissipated. "My personal feeling is that the initial friction with DWS is now a thing of the past," says Dominic Blum, head of products for private and business clients across Deutsche's German and international branch networks. "DWS has seen profits from third-party distribution and they have seen that guided architecture is not a question of taking money away from them, but having stronger distribution and more net inflows for everybody."

As well as making peace with its internal funds producer, the Deutsche Bank branches are working in closer partnership with some of their preferred providers, such as Schroders and UBS, in terms of product creation.

Indeed, distributing products to German retail banks has proved a particularly lucrative occupation for some foreign fund companies, such as Merrill Lynch Investment Managers (MLIM), a preferred partner for both Deutsche Bank and Deka. "Now we have access to the regions all over Germany," says Achim Küssner, Merrill's country head for Germany.

The success in Germany has led MLIM to changing its business model there over the last five years from distributing through the much more volatile fund of funds business to the more stable flows available through over the counter fund sales in bank branches. Mr Küssner estimates that his 25 staff are generating "a couple of million euros in distribution inflows each day." Last year his team made €3bn of net sales in Germany. Core products sold include the flagship natural resources fund, as well as US equities and regional emerging market products.

Although Schroders works closely with Deutsche, it says that national retailers such as Deutsche, Dresdner and Commerzbank account for just one third of the German market, and the successful firm must penetrate the savings and co-operative bank sectors.

Deka, which is itself part-owned by the *Sparkassen* savings banks, operates a fund selection and partnership system. "But branches don't have to follow this system and its recommendations," says Mr Theisinger. "The degree of autonomy in a savings bank is much higher than in a local Deutsche branch. But if you have a foot in the savings or co-operative banks, then it's big time, and you have much more potential than just working with HVB."

These distributors also provide opportunities for niche players and specialists, who can't get onto Deutsche or Commerzbank preferred provider lists because their brands and often their funds are not big enough. "Deka has a fund research team, which services the *sparkassen*, but they are not obliged to use this," confirms Evi Vogl, managing director at Baring Asset Management in Frankfurt. "They are more fragmented and independent. This provides more opportunities, so you can get in whether you are on the list or not. And as a small boutique, we don't face any political pressures."