UCITS Benefit Offshore Investors By Reducing Costs And Improving Structure

Most investors around the world can open an account and buy a US registered ETF like any other equity or fixed income issue. ETFs trade like a stock or bond. If you can buy General Motors or Apple, you can buy an ETF. An ETF provides a widely diversified, inexpensive, regulated, transparent, and liquid basket of stocks or bonds.

Of course, they couldn't buy US mutual funds because under the Investment Company Act of 1940, mutual funds are registered at the state level, and fund investors must be residents of the state where the funds are registered (Blue Sky). ETFs do not suffer from that regulatory constraint.

From a cost, diversification, quality, transparency, disclosure, and regulatory perspective purchasing a US ETF may be a great deal better than what they might be offered at home. But it may subject them to unnecessary taxation at multiple levels. Lower costs may or may not be offset by tax inefficiency.

For starters most dividends paid to a foreign national is subject to a withholding of 30%. That rate may be waived or reduced by bilateral tax treaty depending on their country. But to reclaim any overpayment the investor must file a return with the US Treasury each year. And they must keep on file a current W-8ben with the IRS. Such filing is aggravating and may be expensive.

Even worse, funds held in the US by an alien were subject to draconian estate taxation. That estate taxation might be avoided by ownership through an offshore trust or company, again adding complexity and expense.

Mutual Funds registered "offshore" have long been available to foreign investors. While they might have solved the US tax problem, until very recently they were egregiously expensive managed funds with little transparency and incomplete disclosure. These funds were characteristically offered by huge banks that had a virtual monopoly. And of course, whenever an organization has monopoly power they will exploit it brutally. So, they did.

Typically, until recently offshore funds were only available to very large investors because minimum fund purchase size might be $100,000 and up.

And then, there was the nightmare of regulatory complexity. For instance, funds available in France were not available in Germany. So, when an investor moved, his/her entire portfolio might have to be liquidated and re-invested.

The New World for International Investors

That was then, the Bad Old Days. And this is now. Today, global investors have far better choices at far lower costs.

Beginning in 1985 the European Union propagated rules for marketing and regulating cross border investment products aimed at retail investors. These rules, UCITS (Undertakings for Collective Investment in Transferable Securities) have been continuously upgraded and strengthened to the point where security, transparency, and disclosure rules meet global standards.

Unlike US mutual funds, UCITS are designed to be marketed cross border, and are available far beyond the European Union. They are currently available to the vast majority of non-us retail and institutional investors.

Standardized regulations providing the opportunity for cross border marketing to a greatly expanded population provided the catalyst for exponential growth of products available to individual investors. Those same regulations establish world class standards for disclosure, transparency, and safety comparable to US regulations. Competition, fee transparency and disclosure requirements drove down costs.

Neither costs nor adoption have reached the levels of US ETF products. In that respect European markets look like US markets 10 to 15 years ago. Presently European ETF hold about $860 Billion in assets only about one third US size. However, starting from a smaller base, the percentage gains are higher.

New regulations (MIFID II) in Europe take effect in January 3, 2018 and should further encourage adoption through increased transparency, improved best execution requirements, and providing better information on costs of trading and investing. As investors become aware of the lower costs and improved efficiency, they will naturally gravitate to the cheaper and better structured products. In a virtuous circle, economies of scale and increased competition will further lower costs.

While expense ratios on European funds are somewhat higher than similar US funds, they are a small fraction of traditional European investment costs. And the higher expense ratios of the UCITGS funds are offset by greater tax efficiency for many non US investors. Additional expenses such as transaction fees, bid-ask spreads, and custody fees must be considered when determining the total cost of ownership.

Because local taxes may still be due when the funds declare dividends, a structure that does not pay dividends but accumulates them as an increased net asset value is receiving increased interest especially in Latin America where evolving tax treaties require increased fund reporting. This format defers taxation and potentially converts it to long term gain.

Like the US, adoption of lower cost, passive investments is irreversible and inevitable. Adoption of low cost passive vehicles has and will continue to accelerate, and pricing will fall dramatically. Catch the wave and benefit.

Each investor must carefully weigh the impact of costs and taxes on their unique situation when choosing an optimum structure for their portfolios. They should be guided by their professional advisors, accountants, and attorneys.