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Opportunities and Barriers in the Alternative UCITS Market

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The Rise of Alternative UCITS Funds

Despite periods of strong returns, a great example of which is the 10-month period following Mario Draghi's commitment to do 'whatever it takes' to support the euro, the aggregate performance of equity markets since the turn of the millennium has been hugely disappointing, especially for European investors. While Wall Street traders happily sported Dow 15,000 caps in early May this year, both the DAX and FTSE 100 indices began the month languishing below the levels established at the height of the technology boom in the first quarter of 2000. As such, it is not surprising that we have seen a rising appetite for hedge funds in recent years, as an increasing number of investors have sought to complement the traditional assets within their portfolios with hedge fund investments that aim to provide both diversification and risk mitigation.

However, particularly post 2008, the key issue for many investors has been how to access hedge funds within a format that they are familiar with and one which fits their requirements for highly regulated, liquid, risk-controlled investments. Typically, hedge funds are offered in an offshore format with limited regulatory oversight, monthly (or less frequent) liquidity and high minimum investments.

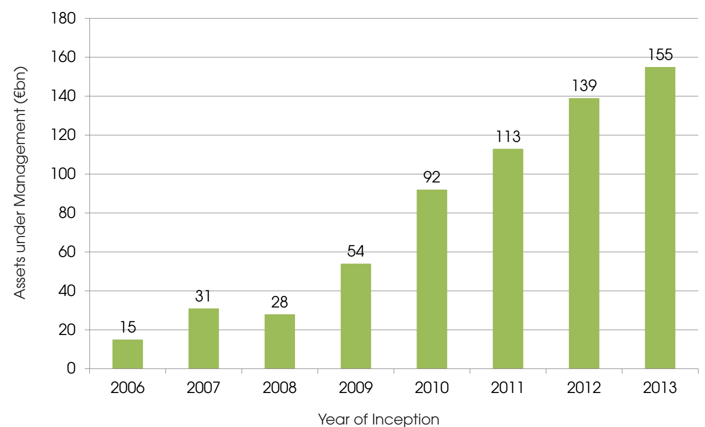
The process of bringing alternative investment strategies into the mainstream began a decade ago when the scope of eligible assets was significantly broadened with the introduction of the UCITS III framework which permitted, among other things, investments in financial instruments such as futures and options. This opened up the possibility for alternative investment managers to offer mainstream investors access to their investment strategies within the liquid, frequently priced, highly regulated, onshore UCITS format.

Consequently, alternative UCITS products have become extremely popular since the peak of the credit crisis in 2008 and assets under management have grown to €155bn[1]. While this is a sizeable absolute number, it constitutes only a small proportion of the broad UCITS industry which manages assets of around €6.7tn[2]. As such, alternative asset managers with strong track records and the ability to package their successful offshore investment strategies within a UCITS wrapper have a huge opportunity to attract assets.

A Huge Opportunity… But Only For Scale Players

While there is clearly an opportunity for alternative investment managers to capitalize on the UCITS market, the barriers to entry can be high and these restrict the ability of smaller players to offer quality alternative UCITS funds. Given the administrative complexities of UCITS regulations, considerable resources and expertise are required to structure hedge funds in a way that does not compromise the ability of the fund manager to harness alpha.

Rise in Assets under Management of Alternative UCITS Funds



Source: UCITS Alternative Index/Alix Capital

The key obstacles for alternative UCITS providers to consider are compliance with the Eligible Assets Directive (EAD) and other limitations relating to liquidity, diversification and leverage.

Eligible Assets

Introduced in 2007, EAD sought to provide greater clarification as to which assets could potentially be included in the portfolio of a UCITS product. EAD also determined that each instrument a fund manager invests in must be utilized in a cost-effective way either to mitigate risk or to generate additional returns at a level of risk consistent with the UCITS principles. For example, EAD reiterated the requirement that the potential losses relating to any asset or instrument within a UCITS structure must be limited to the amount paid for it. The guidelines in relation to eligible assets are designed to prevent irresponsible managers offering a product that is not suitable for mainstream investors.

Liquidity

The UCITS guidelines state that funds must provide at least bi-monthly liquidity, although in practice most offer weekly or more frequent redemptions. Given the additional requirement that fund managers must be able to redeem 10% of the net asset value of their portfolios on each dealing day, managers wishing to adhere to UCITS requirements inherently need to run highly liquid strategies.

[1] *Source: UCITS Alternative Index/ Alix Capital. As at 31 March 2013.*
[2] *Source: European Fund and Asset Management Association. As at 31 March 2013.*
[3] *As at 31 March 2013.*

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Diversification

The 5/10/40 rule that applies to UCITS funds is designed to protect investors from high concentration in single securities, or issuers. In general we welcome this as a positive risk spreading rule. However, for some portfolios, where the manager has a high conviction in a certain security, this can dilute potential returns when compared to a non-UCITS fund. As such, this needs to be taken into consideration prior to launching a UCITS fund.

Leverage

One area where the UCITS guidelines are slightly unclear, and a high degree of co-ordination with the regulatory authorities is necessary, is with regards to leverage limits. Typically, regulators will analyze the gross exposure of the portfolio without taking into account offsetting trades. As such, it is easy to quickly gain (what appears to be) a significant level of leverage in the portfolio and regulators unfamiliar with alternative investment strategies may decline approval for the portfolio when it is taken at face value. Where this is the case, it is important to have a strong dialogue with the regulatory authorities in order to fully explain the nature of the portfolio. Such discussions should include an explanation of how the risk management process ensures that high exposure is not actually detrimental to investors, but seeks to ensure that they receive enhanced risk-adjusted returns.

As such, to be able to offer successful alternative investment strategies within a UCITS framework, providers need scale, significant product structuring resources and regular dialogue with regulators.

Going Forward

There are several upcoming developments within the UCITS space which providers of alternative investment strategies need to consider.

1. ESMA: The ESMA guidelines on ETFs and other UCITS issues came into force in February this year (there is however a one year grandfathering period for some of the guidelines, specifically those relating to index-tracking UCITS funds). In short, these guidelines stipulate that investment managers provide clearer descriptions of the indices that the fund is tracking, more transparency on index calculation/the component parts and a slower re-balancing speed. This is expected to result in a number of funds, particularly ones running managed futures programmes, experiencing some difficulty in executing their strategies. Potential solutions include more complex structures that enable funds to trade the same strategy or alternatively narrowing the field of investments in order to allow the funds to continue trading.

2. UCITS V: The upcoming UCITS V changes will be primarily aimed at fund governance with three main areas being addressed:

1 - The depositary/custodian function will be harmonized to ensure consistency across all EU states.

2 - The introduction of manager compensation rules.

3 - Harmonization of the sanctions for breach of the main investor protection sanctions.

While these changes will need to be carefully considered by providers, they are not expected to have a huge impact on the types of funds that managers are able to be run within a UCITS framework and should provide investors with additional protection.

3. UCITS VI: There are still several unanswered questions surrounding the exact form of UCITS VI. Eight main topics have been raised for discussion so far and it is likely that they will have far reaching consequences for providers of alternative UCITS funds. Our assumption is that these changes will impact provisions around the list of eligible assets, how efficient portfolio management techniques are employed, OTC derivatives, liquidity management and the use of long-term investments. Consequently, we are already considering potential impacts on new fund launches.

Conclusion

The ongoing broadening of the UCITS framework that began in earnest in 2003 constitutes a tremendous leap forward in terms of both diversification and choice. However, it also provides some well-intentioned challenges that investment managers must overcome in order to comply with the series of directives. There is little doubt that genuine appetite for alternative products exists and that many investors are fully cognizant of the importance of diversifying their investment portfolios in the aftermath of the 2008 crisis and the broader 'lost decade' for equities. While there is considerable scope to capture assets, the UCITS framework acts as a form of quality control and only the larger-scale players are likely to have the capabilities necessary to satisfy the complexities associated with this opportunity.

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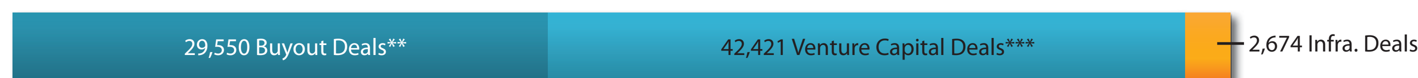
Deals Coverage: 74,645 Deals Covered; All New Deals Tracked



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