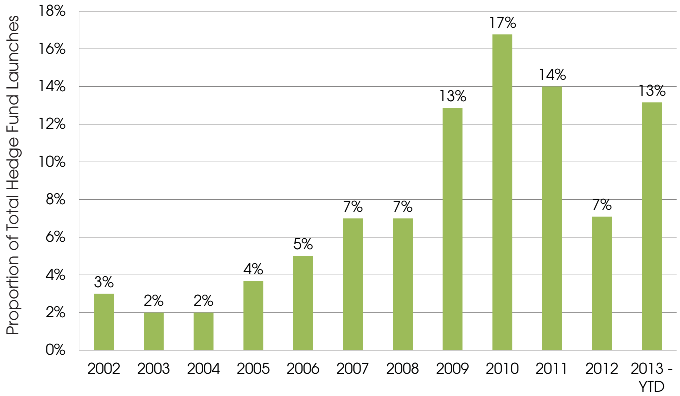
UCITS: Liquidity, Transparency and Lower Volatility

Why do investors target UCITS-compliant hedge funds? How have UCITS funds performed recently? Ross Ford and Joanna Hammond analyze the use of the UCITS structure as a wrapper for hedge fund strategies.

The use of the European-regulated UCITS (Undertakings for Collective Investment in Transferable Securities) structure as a wrapper for hedge funds became possible in 2001 with the third iteration of the Directive. This widened the use of financial instruments permitted under the regulations and allowed fund managers to hedge their holdings. Since this time, the use of UCITS as a wrapper for hedge fund strategies has grown rapidly. In 2002 seven hedge funds were launched which complied with UCITS regulations; now Preqin Hedge Fund Analyst tracks over 550 active UCITS vehicles.

Fig. 1 shows the growth of the UCITS structure through examining the proportion of total hedge fund launches UCITS vehicles have represented each year. Alternative UCITS funds offer investors increased liquidity, with the median redemption frequency of a UCITS vehicle being one day with a notice period of two days. Following the financial crisis in 2008, investors saw UCITS-compliant funds as vehicles that could satisfy their liquidity needs in an uncertain market. Alongside this, UCITS can offer both greater transparency on the underlying investments of the fund and regulatory oversight, which are attractive features to investors in the post-Madoff era. In 2009 the proportion of fund launches represented by UCITS funds almost doubled to 13%, and in 2010 this increased even further to 17% of all launches. In 2011, UCITS launches remained strong, representing over 14% of all funds launched that year. However, in 2012 alternative UCITS launches made up a much smaller proportion of all fund launches at 7%. Many managers in the UCITS sector decided to focus their attention on growing and consolidating existing products rather than launching new vehicles, following the implementation of new rules with the fourth UCITS Directive. So far in 2013, alternative UCITS fund launches have picked up again and represent 13% of all hedge fund launches in 2013 to date. The majority of alternative UCITS fund launches in 2013 are cases where hedge fund managers are launching an existing successful fund strategy in a new UCITS-compliant wrapper.

Fig. 1: UCITS Funds Launched Each Year as a Proportion of Total Hedge Fund Launches



Source: Preqin Hedge Fund Analyst

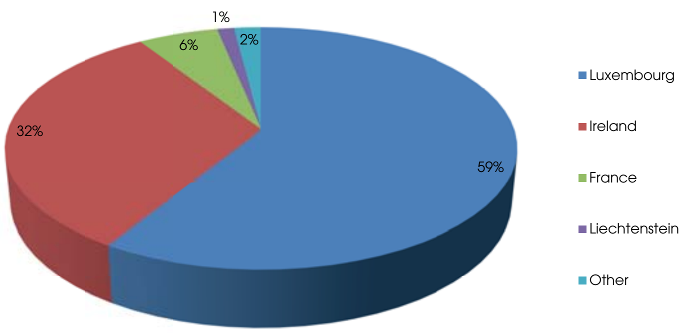
Forty-one percent of UCITS hedge funds are run by managers headquartered in the UK (Fig. 2). Interestingly, the US is the next most common base for UCITS funds, with 11% of all hedge funds regulated under the European UCITS Directive managed by US-headquartered fund management groups. French and Swiss managers are the next in line in terms of numbers of UCITS funds managed. As well as the US there are other non-European countries which run UCITS-structured vehicles, such as Hong Kong and Brazil.

Fig. 2: Top 10 Fund Manager Headquarters of UCITS Funds (As a Proportion of all UCITS Fund Managers)

Fund Manager Headquarter	Proportion of Fund Managers
UK	41%
US	11%
France	11%
Switzerland	9%
Luxembourg	4%
Germany	3%
Sweden	2%
Hong Kong	1%
Brazil	1%
Spain	1%

Source: Preqin Hedge Fund Analyst

Fig. 3: Breakdown of UCITS Funds by Domicile



Source: Preqin Hedge Fund Analyst

Fig. 3 shows a breakdown of domiciles for all UCITS funds. At 59% Luxembourg plays host to the majority of alternative UCITS funds. Although almost two-thirds of UCITS-compliant hedge funds are domiciled in Luxembourg, only 4% of fund managers have their headquarters located in Luxembourg. Ireland represents the domicile location for 32% of UCITS-compliant funds, and the other 9% of funds are domiciled across various European locations, with France picking up the most mandates with 6%.

Fig. 4 shows the current universe of UCITS hedge funds by strategy. Just over half (51%) of all UCITS funds follow a long/short investment strategy. Macro and relative value strategies are also commonly employed strategies amongst UCITS funds, representing 26% and 15% of funds in the space respectively. Unlike the wider hedge fund universe however, event driven, multi-strategy and other strategy vehicles are not yet as established in the UCITS universe, representing 4%, 4% and 1% of all UCITS funds respectively. The long-term, illiquid nature of many event driven and other strategy funds, such as asset-backed lending, do not easily lend themselves to the enforced liquidity requirements of the UCITS regulations and therefore uptake of UCITS by managers of these strategies has been low.

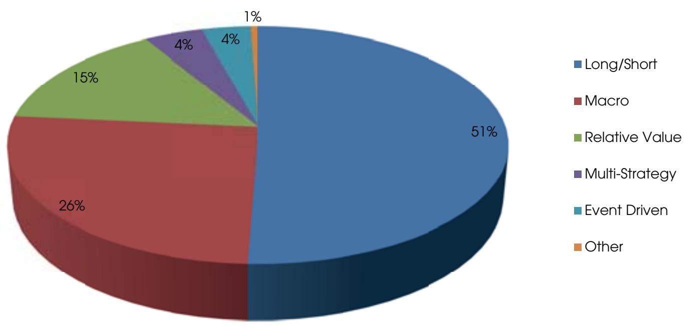
Fig. 5 shows that the breakdown of UCITS fund launches each year by strategy has remained relatively stable. The proportion of all UCITS fund launches represented by long/short vehicles decreased from 55% in 2010 to 45% in 2012, representing its lowest level since the financial crisis in 2008. However, with equity markets rallying in 2012, the start of 2013 has seen a boom in the number of alternative UCITS funds that follow a long/short strategy. Relative value launches have reached their highest representation since 2006, with a quarter of all UCITS-compliant hedge funds launched so far in 2013 being in the arbitrage space.

Performance of UCITS Hedge Funds

UCITS hedge funds had an average net return of 6.03% in 2012, which helped to mitigate the average loss of 5.02% experienced in 2011. Fig. 6 shows that with the exception of Q2 2012, UCITS hedge funds were outperformed by non-UCITS hedge funds throughout both 2012, and over the longer period. Q2 2012 was the only quarter that saw UCITS and non-UCITS funds make a loss, with non-UCITS hedge funds posting -2.63% compared to -2.57% posted by UCITS hedge funds. The first three months of the year provided the best cumulative returns for both UCITS and non-UCITS hedge funds, which made 4.27% and 5.68% in Q1 respectively. When looking at performance over a longer period, the difference between UCITS hedge funds and non-UCITS hedge funds becomes more apparent (Fig. 6). Two-year annualized returns for UCITS funds (0.35%) are almost a tenth of those of non-UCITS hedge funds (3.06%).

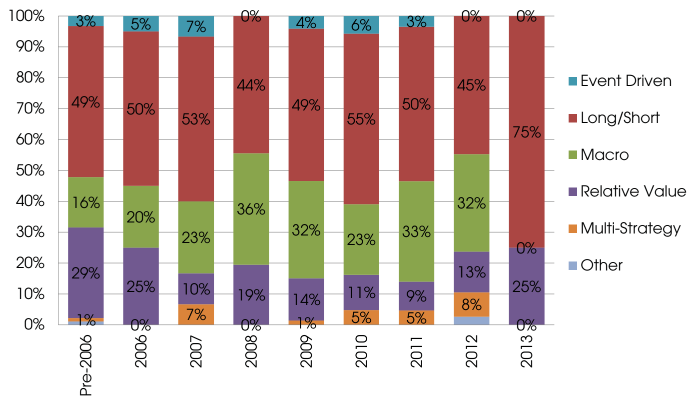
UCITS-compliant funds must adhere to regulations that do not apply to hedge fund managers. In particular, the limit on the amount of leverage that can be used, and controls on types of instruments that can be invested in play a role when comparing performance of UCITS and non-UCITS hedge funds. Fig. 7 shows that throughout 2012, the 12-month rolling return of UCITS hedge funds was constantly lower than that of non-UCITS hedge funds. Despite this, UCITS funds remain attractive to institutional investors seeking to add hedge fund

Fig. 4: Breakdown of UCITS Funds by Strategy



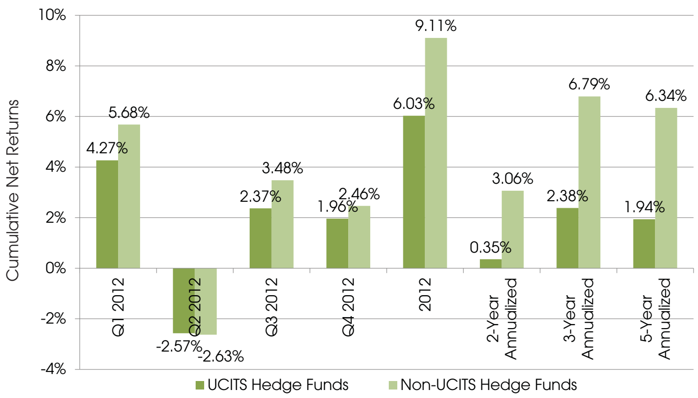
Source: Preqin Hedge Fund Analyst

Fig. 5: Strategy Breakdown of UCITS Fund Launches by Year of Inception



Source: Preqin Hedge Fund Analyst

Fig. 6: Performance of UCITS Hedge Funds (As at December 2012)



Source: Preqin Hedge Fund Analyst

strategies with a lower risk profile to their portfolios. Another advantage of UCITS hedge funds is that they offer a lower volatility of return than non-UCITS hedge funds. Over 2012, the volatility of UCITS hedge funds remained between 4.42% and 6.93%, compared to 4.93% to 7.59% for non-UCITS hedge funds. Equally, over the longer term UCITS hedge funds offer investors lower volatility, with an average of 4.88% over three years, compared to 6.05% for hedge funds, and over a five-year period the volatility of UCITS funds was over 2.5% lower than that of non-UCITS funds (6.13% to 8.67% respectively).

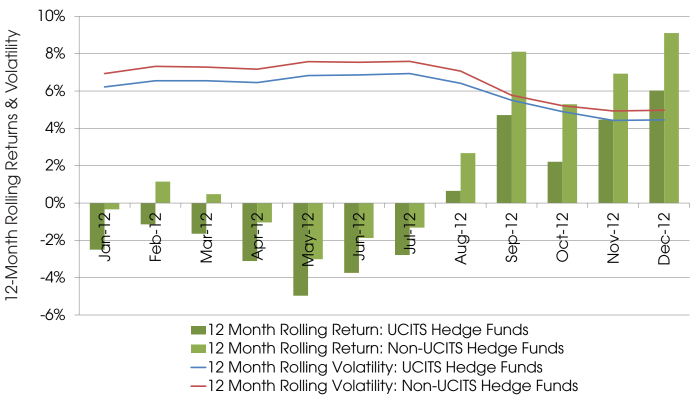
Comparison of UCITS Hedge Funds by Strategy

UCITS hedge funds are required to provide at least fortnightly liquidity as part of the Directive, and therefore not all hedge fund strategies can be easily replicated in a UCITS-compliant form. As previously mentioned, the illiquid and long-term nature of event driven strategies mean that there are few UCITS funds in this space. However, long/short funds make up over half of the UCITS hedge fund universe, with macro and relative value vehicles also representing common strategies for UCITS funds. Long/short funds had an average return of 8.17% in 2012, making long/short the best performing UCITS strategy (Fig. 8). This is not surprising given the strong performance of equity markets, but the strategy was still lower than the S&P 500 (13.4%). In contrast, in 2011, long/short was the worst performing UCITS hedge strategy, posting -6.71% for the year. Both macro and relative value funds also saw negative average returns in 2011 (-3.15% and -3.06% respectively) but were able to mitigate these with returns of 4.23% and 4.35% respectively in 2012. Two-year annualized returns show more parity between the strategies, although relative value funds were the best performing over this period, up 0.58% compared to 0.45% for long/short funds, and 0.47% for macro UCITS funds.

The returns of all three UCITS hedge fund strategies tracked by Preqin behaved similarly to the S&P 500 in 2012 (Fig. 8), but with lower volatility. As we have seen, investors seeking lower risk hedge fund investments may look to add UCITS funds to their portfolios, and relative value funds had the lowest 12-month rolling volatility in 2012 (2.38%). Long/short UCITS hedge funds were the most volatile, with annual volatility of 6.09%. Over the longer term the picture remains similar; long/short fund volatility remained between 3.92% and 9.44% since January 2010 onwards, whereas the volatility of relative value UCITS funds did not exceed 3.62% during this time (macro volatility ranged from 2.72% to 5.39%).

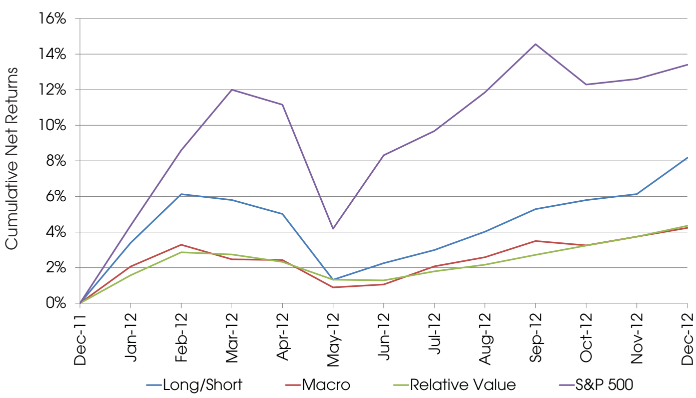
Despite higher returns from long/short UCITS funds, the strategy also experienced the longest and deepest drawdowns during 2012. All three strategies were in drawdown periods from February to May 2012, with drawdowns of 4.53% for long/short, 2.32% for macro and 1.49% for relative value funds. Long/short was the slowest strategy to recover, with a six-month recovery period, whereas macro UCITS funds recovered in four months. When considering the longer period, all three strategies began 2012 having not yet recovered from a drawdown that ended in September 2011. Despite the smallest drawdown (4.16%), relative value funds were unable to recover until December 2012, whilst long/short and macro strategies were unable to recover the losses until January 2013.

Fig. 7: Returns and Volatility of UCITS Hedge Funds Compared to Non-UCITS Hedge Funds, January 2012 - December 2012



Source: Preqin Hedge Fund Analyst

Fig. 8: Breakdown of Cumulative Returns of UCITS Hedge Funds by Strategy (January - December 2012)



Source: Preqin Hedge Fund Analyst

Role of UCITS in Portfolios

Since the Directive was introduced in 2001, UCITS hedge funds have been increasingly utilized among institutional investors. Investors may add UCITS hedge funds to an existing portfolio to improve liquidity, and are often willing to accept the trade-off between higher liquidity and lower returns (compared to non-UCITS hedge funds). Investors seeking to lower volatility and improve liquidity in their portfolios may also wish to consider the distribution of returns of UCITS hedge funds (Fig. 9). Despite lower returns than funds not part of the Directive, UCITS funds can play a role in reducing volatility, and in 2012 only just over one-quarter (25%) of UCITS funds tracked by Preqin made a loss. Furthermore, as shown below, just 1% of UCITS hedge funds posted cumulative returns of -10% or less, compared to 29% of funds that generated returns in excess of 10% in 2012. The two top performing UCITS funds tracked by Preqin in 2012 generated returns of over 37%. Both funds, GAM Star Global Selector – GBP and DB Platinum Tosca Mic Cap Equity Fund – I1C, pursue long/short equity strategies.

2013 Performance

UCITS hedge funds started 2013 positively, posting net returns of 1.98% in January, the highest monthly return for 10 months. This momentum was not maintained through February however, and the average UCITS hedge fund posted 0.27% to return 2.25% in 2013 to date. In terms of strategies, 2013 has continued in the same vein as 2012, with long/short funds outperforming other strategies. Long/short funds posted net returns of 3.40% in the first two months of the year, benefiting from the strong performance of equity markets during early 2013. Relative value UCITS funds gained 2.40% in the same period, while macro funds continue to lag other strategies, losing 0.63% in February to return -0.05% for the year to date.

Outlook

UCITS-compliant hedge funds continue to rise in prominence, with a significant increase in the number of launches in the space following the global market events of 2008. The crisis in 2008 led to investors calling for increased liquidity and greater transparency on the underlying investments of hedge funds as well as for funds which employ lower levels of leverage. Investors saw the UCITS framework as a way to satisfy these needs and as a result the number of UCITS funds in the industry has grown by 260% since 2009. The three main strategies utilized by alternative UCITS funds are long/short, macro and relative value. These three strategies better lend themselves to the liquidity constraints of the UCITS framework than other strategies, such as event driven, which have a much longer investment horizon. Following a year of strong performance in the long/short UCITS space there has been an uptick in the proportion of long/short UCITS funds entering the market place over the past few months. So far in 2013, three-quarters of all UCITS funds launched have a long/short focus.

Although alternative UCITS funds remain a niche part of the industry, representing around 5% of all hedge funds in the market today, they are an increasingly important part of the hedge fund landscape as we move into an era of regulation in the alternatives space. The latest iteration of the UCITS directive (UCITS IV) has had several improvements, including those to aid with the marketing of these vehicles. This includes fund manager passport and improved disclosure documents, as well as cutting costs of running UCITS vehicles by allowing fund mergers, the potential for master-feeder structures and allowing fund managers to move to more tax-favourable jurisdictions. These factors are proving attractive for fund managers when considering alternative structures to the off-shore commingled proposition when launching a new hedge fund.

Fig. 9: Distribution of 2012 Cumulative Returns: UCITS Hedge Funds

Source: Preqin Hedge Fund Analyst

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