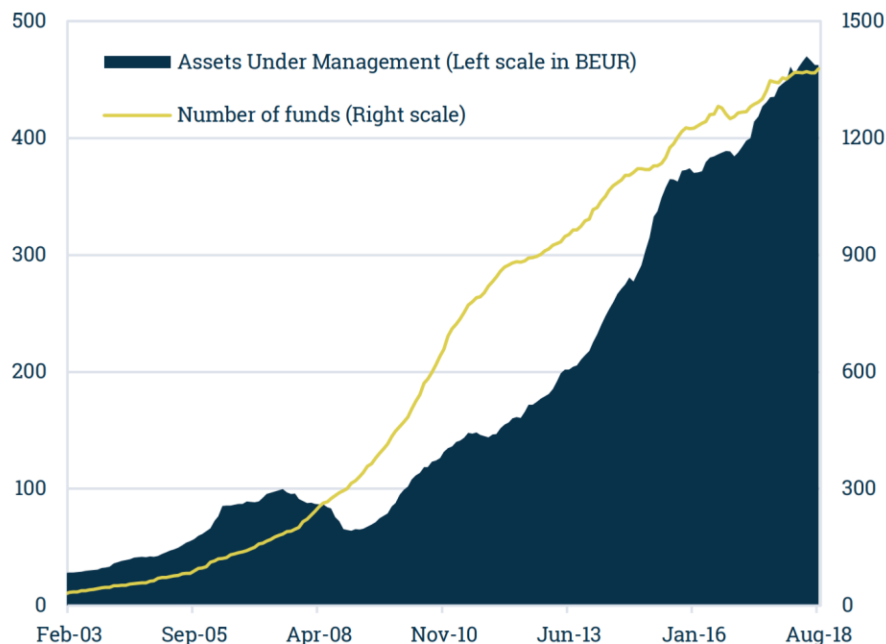
Liquid Alternatives - Alternative UCITS

The Universe of Alternative UCITS

Originally UCITS funds were only set up in the segment of traditional investment management. Over the years the effort evolved, and the scope expanded. UCITS III directive set the basis for the triumph of the alternative UCITS as it softened the rules on the use of derivatives. From there on, managers were able to include exchange traded derivatives and over the counter derivatives instruments not only for risk migration and hedging, but also within their investment process.

Chart 1: Evolution of Alternative UCITS



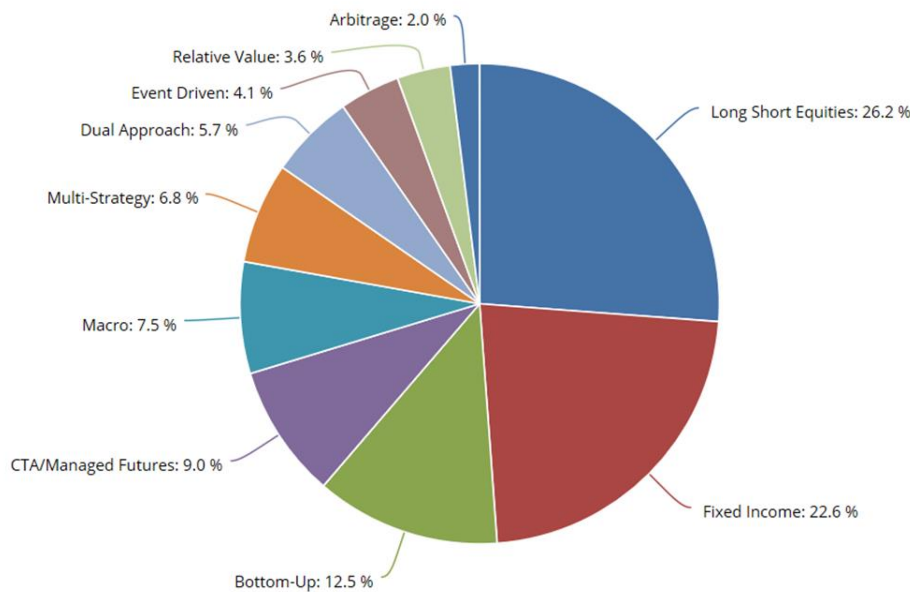
Source: LuxHedge

A Different Kind of Universe

The UCITS III directive has opened the door for some hedge fund strategies to be implemented within the UCITS framework, but certainly not for the entire spectrum. The restrictions related to eligible assets, concentration as well as liquidity have put a cap on certain strategies. Looking at the hedge fund universe and comparing it to the alternative UCITS space, the picture looks quite different: There is a clear bias within the alternative UCITS space towards strategies focussing on equities and liquid asset classes. Therefore, if you look at the universe as a whole, a higher correlation to equity markets is expected. In addition, as UCITS regulation is a European effort,

there is a heavy bias towards European markets. Even some US managers are tapping the UCITS space to gain access to the pool of mostly European investors. The prolonged existence of UCITS has given it an unrivalled retail distribution footprint in markets outside of the EU. Also Asian investment managers are more and more attracted by the UCITS format, that allows them to diversify their client's base. However, as the UCITS structure is more familiar in Europe, European managers account for the vast majority of the issuers.

Chart 2: Overview Alternative UCITS Strategies



Source: LuxHegde

Offshore Versus UCITS

The UCITS framework aims to tackle the following offshore hedge funds' shortcomings: lack of transparency, lack of strict regulation, lack of liquid alternatives (e.g: monthly or quarterly terms with notice periods) and operational risks. If on one side the regulation helps investors by giving them more protections, on the other side, it restricts the investment universe. It needs to be assessed whether a strategy can deliver attractive risk adjusted returns within the additional limitations of the UCITS framework. For example, commodity trading via futures is prohibited. A work around via swaps would be a possibility but is frowned upon since the manager is then exposed to counterparty risk and he has no access to a liquid and reliable (clearing house) source

of trading alpha points. It is also hard to find a sensible rationale behind this restriction, but regulators are not always logical.

Moreover, alternative UCITS funds may not directly invest into real estate. However, investments into real estate investment trusts (REITs) are an option. An alternative UCITS fund may also not act as lender.

In addition, various regulations on concentrations and liquidity prevent alternative UCITS funds to get active in certain segments. The enhanced level of liquidity is a very important criteria which render certain asset classes and strategies unattractive for the UCITS space.

Let’s take a look at some of these concentration limits outlined by the UCITS framework:

- Maximum 20% exposure to single OTC derivative
- Maximum 10% of aggregate exposure to instruments not listed or traded at recognised exchanges
- Maximum 10% of net assets are transferable securities from a single issuer
- Maximum 20% of net assets invested in cash deposits with one credit institution
- On fund-of funds level a maximum 10% of net assets may be invested with a single UCITS fund.

In the fast-developing universe of hedge fund managers, numerous players offer UCITS as well as offshore investment vehicles. Others continue to stick to their offshore funds. Studies have shown that the UCITS limitation can lead to a significant performance drag on certain strategies. On the other hand, long/short strategies as well as systematic strategies are hardly affected by this issue. In this case the investment philosophy and the trade implementation can be perfectly translated or easily adapted. Limitations on shorting, on cash holdings as well as on sovereign bond holdings are among those restrictions leading to deviations. While this might be irritating at first, it should rather be viewed as an element that just naturally comes with the structure and higher security standards.

Expressing Short Ideas and Risk Management

Implementing short ideas has certainly always been a characteristic of hedge funds in general. While it can definitely boost returns, it is not the only source of alpha. Within the alternative UCITS framework covered short selling is not permitted. However, it is allowed to express views through synthetic shorting via the use of derivatives. Instruments used are swaps, options, stock futures and CFDs (contract for difference). A contract for difference (CFD) is an agreement between two parties - the investor and the CFD provider - to pay each other the change in the price of an underlying asset. Depending on which way the price moves, one party pays the other the difference from the time the contract was agreed to the point where it ends. In other words, one party (the broker) pays the performance of an asset to another party (the UCITS fund). As the parties involved to not have to own the assets, no borrowing or shorting costs arise.

The UCITS framework protects the investors’ interest through a strict set of regulations on the risk management side. Two approaches are laid out:

1. Commitment approach: net exposure of derivatives cannot exceed 100%
2. VaR approach (preferred by UCITS fund using derivatives; strict guidelines on how VaR is calculated are defined e.g. time horizon equivalent to 1 month):
    a. Relative approach: ratio of up to 200% between VaR of portfolio and VaR of reference portfolio
    b. Absolute approach: chosen if there is no reference portfolio or benchmark; allows the one-month-VaR to be up to 20% of the NAV

Key Characteristics in Nutshell

If we want to draw a picture of the average alternative UCITS fund, we probably say that: The alternative UCITS fund is strongly biased toward the European market and focussed on long/short equities strategies. It is likely to have a higher beta on average than comparable offshore hedge fund. Liquidity terms, on the other hand, are significantly better than in the offshore space.

Hidden gems are available but hard to find being outside of the mainstream. To detect these alternative UCITS funds, one needs to dig deeper into the market and perform a solid due diligence on the investment process in order to arrive at a good level of understanding of the actual potential of a fund.

Remaining Challenges for Investors

The defined goal of the UCITS framework is to provide better visibility to the investor. In many aspects this goal has been achieved: Risk management guidelines, rules on concentration, liquidity requirement as well as regulations on investor information tools (e.g. KIID) are clearly laid out.

However, numerous risks remain, which the regulator is just unable to address: On the one hand operational topics remain to be assessed by the final investor. Is the setup of the manager able to deal with and control the limits imposed by the UCITS framework? In any case, the organisational structure overall ought to be reviewed in order to be comfortable with a manager.

Certainly, regulators cannot tell which strategy or manager is going to perform. As highlighted, finding the best suited hedge funds is like the classic search for a needle in a haystack. A lot of chaff must be discarded before finding good candidates. On some occasions, valuable portfolio managers can be persuaded to setup a UCITS, when supported by a commitment from an experienced investor.

UCITS funds have to offer bi-weekly or better liquidity, nonetheless it needs to be assessed whether this liquidity requirement can be delivered in a fair manner to all investors at any given time. The portfolio may not show liquidity mismatches, which would put redeeming investors at an advantage. Being able to analyse and assess the quality of a portfolio as well as of an

investment manager delivers paramount levels of information, which make all the difference to active investments.

Higher regulatory standards may help investors to feel more at ease with hedge fund investments but selecting the best fit within the universe has not necessarily become easier due to the increasing choice available over the recent years. Moreover, the strong bull years lifted all boats. It takes the know-how and experience to efficiently filter through mainstream long biased strategies and detect those who truly add value.

Conclusion

Alternative UCITS have seen enormous growth and the liquid nature of the vehicles helped UCITS to gain popularity in recent years. To extract maximum value from the space, one ought to have a stringent risk management in place and be able to source the top tier managers, since even in the alternative UCITS space performance is not consistent year on year. Therefore, continued monitoring and evaluation, whether superior risk adjusted return remain achievable in the near future, needs to be done. Once willing to rely on this quality proposition is possible to arrive at an investment, which makes a difference to a traditional portfolio and truly captures opportunities that are uncorrelated to equity markets.

We are looking forward to your feedback. Please feel free to share your ideas with us and continue the dialogue.

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