



Putting the breaks on Ucits

Ucits funds were meant to be so simple that anybody could understand them. There are now fears that regulators or fund managers have gone too far in adopting risky strategies, finds Nick Fitzpatrick

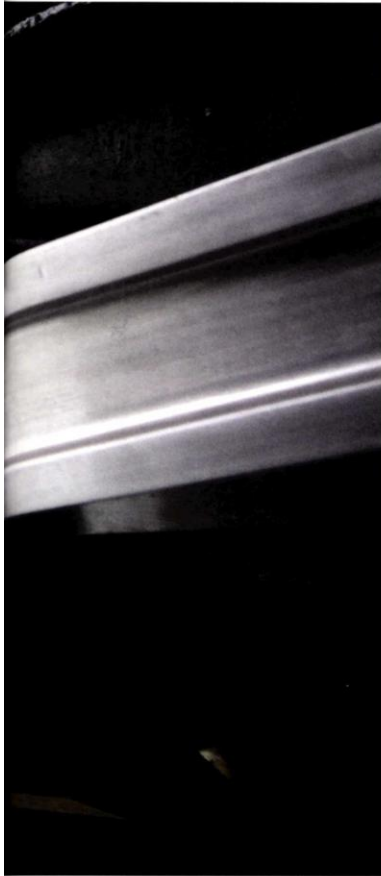
Have regulators gone too far in allowing alternative strategies to be packaged as Ucits funds, which are supposed to be simple and safe enough for members of the public with no specialist investment knowledge to invest in? Or are fund managers, especially hedge funds, dangerously testing the regulatory limits of what strategies can be included in a Ucits product?

Either way, there is a growing concern that a Ucits blow-up is on the horizon, spelling a potential disaster for the highly successful Ucits funds industry.

"I do not think politicians were originally aware that Ucits would evolve into something that would let you do all the things that you can do now," says Charles Müller, deputy director general of Alfi, the Luxembourg

funds industry association. "If they had known then what they know now, they might have taken a different approach."

Over the years the Ucits tag has acted as a quality mark for those investment funds permitted to carry the label. These well-regulated funds have raised in excess of \$6.5trn (€4.8trn), not just from Europe where they were invented, but also from Asia and



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same time causing a squeeze at the exit? Both types of investments are allowed in Ucits funds since their regulations – originally adopted in 1985 – were updated 18 months ago to include more sophisticated strategies and complex instruments.

“Certain methods can be used to get less liquid assets into Ucits III funds. It’s a risk. I’m not saying it’s wrong but it’s a risk because Ucits III funds should remain liquid, particularly in moments of stress,” says Werner von Baum, partner and head of business management at LGT Capital Partners, a fund manager that runs a managed futures Ucits fund based on its most liquid non-Ucits strategy.

“There are credit and event-driven strategies structured to exploit certain illiquidity premiums, and middle and small-cap long-short strategies that are less liquid and present more risk to Ucits III funds.”

It may never happen, of course, but the uneasy feeling in the fund management world that the string of financial shocks that began with Lehman Brothers is not yet over makes some fund professionals worry about the next one, and whether the mishap will be fund management related. After the spike in Ucits products in the alternative strategies sector – which are referred to often as ‘newcits’ funds – it isn’t surprising that Ucits is seen as a potential flash point.

There have already been questions about the performance of the new Ucits funds, which in many cases mirror existing alternative strategies run by pure hedge funds domiciled in places like the Cayman Islands, where investment restrictions are virtually

non-existent. Most notably Brevan Howard, Europe’s largest hedge fund, was unable to replicate the performance of a flagship offshore bond hedge fund with a Ucits version. The fact that different teams worked on each fund was part of the reason.

Matthew Feargrieve, a partner at law firm Appleby, says regulatory restrictions could hinder Ucits funds. “Because of restrictions on leverage and shorting, Ucits funds may not get the alpha that pure hedge funds can, which may lead to a drag on performance.”

But whereas enlightened investors may accept poorer performance in exchange for the tighter regulation and extra safety of a Ucits alternative fund, a liquidity problem could be a disaster exactly because Ucits rules are designed to deal with this.

Feargrieve says: “It is easy in volatile market conditions to get into illiquid assets if you are running a less vanilla strategy.”

In Ireland, John McCann, managing director of Trinity Fund Administration, says: “It can be a bit dangerous in that it provides a false comfort for investors. They think that because a fund is Ucits-compliant, it must be safe, but there is the potential for liquidity issues.

“The funds have to ask themselves if the liquidity of their underlying market in times of stress would be able to adhere to Ucits liquidity requirements. A substantial percentage of all funds in 2008 were illiquid, including many Ucits funds, no matter whether they had a high or low VAR, as the global financial and liquidity crisis was indiscriminate across the international market-place.”

Rule breakers

Dario Cintioli, global head of risk at investment analytics firm StatPro, says: “I do not think there is a danger with allowing hedge funds into Ucits as long as they follow the rules. Regulators have to make sure the regulations in place are respected. Ucits IV [a revision of rules due to come into force in July 2011] will mean fund managers have to follow a specific liquidity risk process, especially in complex securities.

“But the risk is that some funds will not follow these rules and that’s why I think there should be an active control exerted by Esmā [the EU Securities and Markets Authority].”

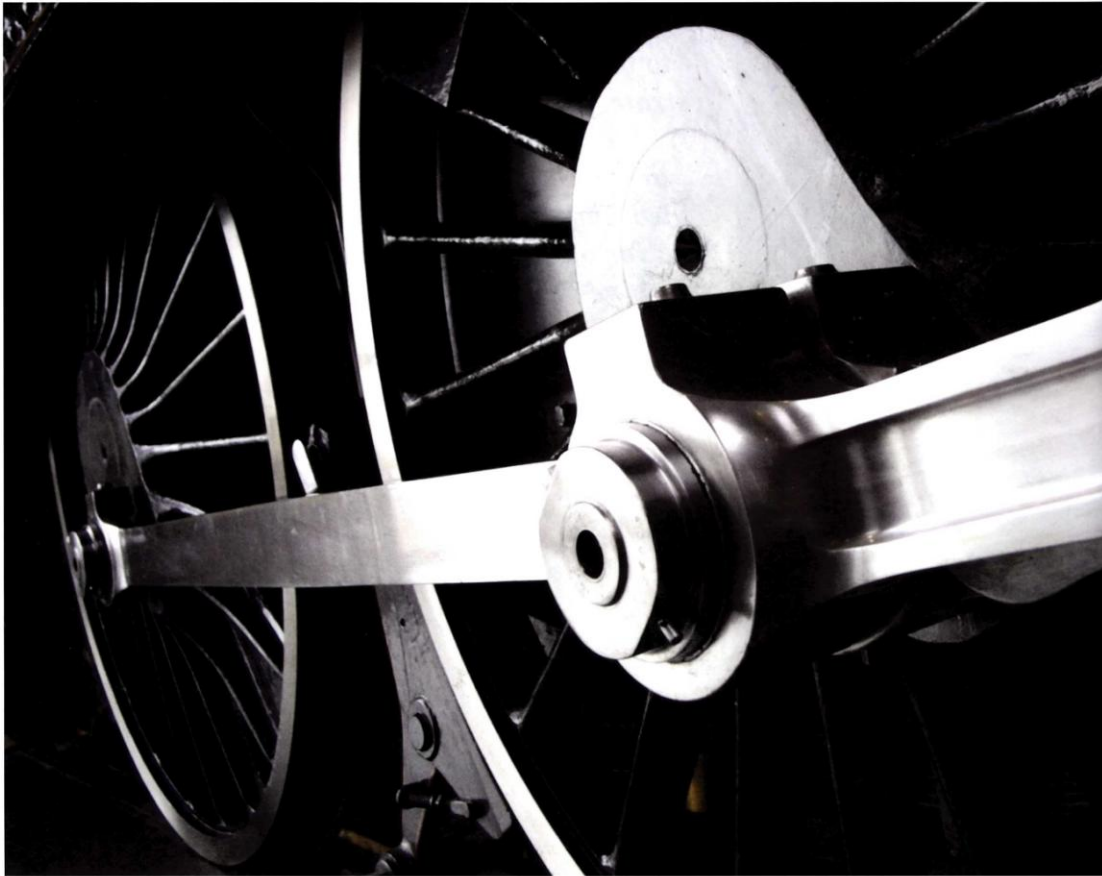
George Cadbury, director of funds at Merchant Capital, an asset management firm that works with other managers to provide a Dublin-based Ucits III business, says: “It is

Latin America where the Ucits brand is seen as a gold standard by regulators and industry alike.

One of the biggest selling points of Ucits funds is their liquidity, which has attracted institutional investors as well as retail clients. These liquidity requirements mean Ucits funds should not get into the same fix as hedge funds did when their investors tried to pull their cash out in the 2008 financial meltdown but found they couldn’t do due to the illiquid investments they were in.

Potential risks

So what happens if a fund manager invests a Ucits long-short fund in, say, a small and medium-cap equity fund that has grown to an unwieldy size by the time that market movements mean the fund has to be sold short quickly? Or what if an event causes all event-driven funds to head for the door at the



inevitable that occasionally some funds may try to bend the rules a little and platform providers like us have to be careful who we work with.”

He says that Merchant Capital employs a test, called Ucits-Safe, to determine whether a portfolio sits comfortably within the Ucits framework.

That there are concerns about Ucits in Luxembourg is not surprising given Ucits is such big business that the integrity of these fund structures is virtually an issue of national stability.

Müller, of Alfi, says: “The Ucits label may lead some regulators to believe that all Ucits funds are suitable for retail investors, but some of our members, although they are theoretically allowed to market to retail customers, in practice tend to have high minimum investments to close retail investors out of certain funds.”

And in Hong Kong, a major Ucits market where 70% of authorised funds are Ucits, fund officials would like counterparts in Europe to keep them informed more about Ucits product trends and associated risk management.

Keep it simple

Sally Wong, chief executive of the Hong Kong Investment Funds Association, says: “I think from a Hong Kong or some other Asian industry participants’ perspective, there is a need to keep abreast of the latest trends and the implications to the Ucits brands. As you may be aware, even two years after the saga of mini-bonds, there is still some nervousness in Hong Kong when products are associated with derivatives, leverage, and counterparty risks.”

There are a wide range of strategies and instruments allowed in the Ucits framework.

As well as traditional long-only and exchange-traded funds (the latter which, incidentally, are themselves becoming ever-more pulse-raising for some people who worry that the next financial shock might centre on funds), these strategies include long/short equity and credit, convertible arbitrage, commodity index funds, managed futures, event-driven funds and funds of Ucits alternative funds, which have particularly emerged over the past year.

Through Ucits, regulators were attempting to bring these strategies to a wider audience, mainly retail investors. But the wisdom of this is now being questioned.

Back at law firm Appleby, Feargrieve says: “Ucits was never meant to be an alternative strategy. It was meant for widows and orphans. It is not a tried-and-tested vehicle for alternatives.” ■