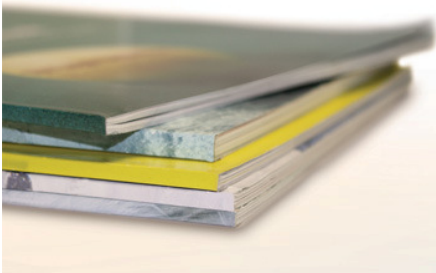


UCITS and Hedge Fund Managers: Not a Match Made in Heaven

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In a world that professes itself chastened by the excesses of the pre-2007 era, transparency and liquidity are sacrosanct. Regulators and political bodies in the EU and US are responding to the new financial world with legislation that will circumscribe the freedoms previously enjoyed by banks and fund managers. The Alternative Investment Fund Managers Directive in the EU, and the HIRE Act and Frank Dodd Bill in the US, all unprecedented pieces of wide financial reform, have serious implications for financial institutions on both sides of the Atlantic. Meanwhile, the economic outlook for the US and eurozone remains uncertain.

Enter UCITS. The EU regime for Undertakings for Collective Investment in Transferable Securities has been around for years, but UCITS (or “Newcits”, to use the current, sensational sobriquet) are apparently what everyone now talks about over dinner. The financial press is crammed with comment about UCITS. Seminars are held to discuss UCITS. Fund

managers launching UCITS products are hailed as pioneering visionaries. UCITS has been transformed from a boring retail brand to the vehicle of choice for managers pursuing the most “alternative” of investment strategies. The hyperbole shows no signs of abating.

Many professionals advising hedge fund managers on choice of vehicle for their investment funds will have difficulty suppressing a groan when reading much of the excitable commentary about UCITS. True that UCITS is a brand that has attracted billions of investment. True that some hedge or “alternative” strategies can be replicated in UCITS. Here we take a contrarian view: the drawbacks of UCITS outweigh the merits.

So, what of the UCITS upside? From a manager’s viewpoint, this can be summarised in a single word: distribution. Being an EU regulated investment product, UCITS can be sold throughout the EU to

both institutional and retail investors. This automatic “passporting” is particularly attractive given the barriers to EU entry erected under the draft AIFM Directive. More importantly, UCITS facilitate capital raising by hedge fund managers in the EU, by opening up a previously *verboten* client base: retail investors.

From an investor’s viewpoint, the benefit of UCITS is found in the built-in protections that are normally associated with investments sold to widows and orphans. So a manager of a UCITS product must observe strict rules about liquidity and portfolio diversification. Direct borrowing is not permitted, only synthetic leverage achieved with derivatives. Similarly, physical short selling is not permitted (and naked shorting is *totally* out of the question); instead, the manager must use derivatives to replicate short exposure.

Leverage, shorting, derivatives; these are some of the key tools at the disposal of a hedge fund manager in the pursuit of the hedge holy grail: uncorrelated returns, or *alpha*. Restrictions and prohibitions on them bring us to the first serious downside of UCITS: lower investment returns. Achieving returns not correlated to any index is harder in a regime intended for long-only, retail products. The impact on performance, compared to a similar non-UCITS hedge fund product, can be as much as 50 basis points per month. And here is the second drawback of UCITS: lower fees. Whilst good news for investors, a manager who is not achieving the kind of returns possible in a non-UCITS model will not be

able to command the same level of fees. So, whilst the traditional “2 and 20” fee structure is theoretically possible in a UCITS, the reality is that a manager will be charging significantly lower fees.

The problem of lower returns and lower fees is compounded for investors and managers alike by the higher organizational costs involved. A UCITS with a vanilla equity long/short strategy can cost up to EUR100k to set up. A complex strategy, with the additional regulatory burden involved, can boost costs to EUR200k. The same strategy could be launched using the traditional offshore model (in the Cayman Islands, for example) at significantly lower cost. Time to market becomes an issue for the manager keen to exploit market opportunity. A UCITS product conservatively takes 2 to 6 months to launch. Offshore, that time is dramatically reduced.

Ultimately, of course, UCITS is just one product in a universe of investment products. If investors and managers have an appetite for relatively lower returns, lower fees and higher costs, then so be it. But what is worrying is that these drawbacks are accepted as the price of “better” regulation. The higher level of regulatory oversight is considered by many investors as a guarantee of the *safety* of a UCITS investment. The paradox is that the UCITS regime is in fact a relatively untested model for hedge or “alternative” investment strategies.

Whilst core alternative strategies like equity long/short, market neutral and absolute return are

being replicated (at higher cost) in the UCITS framework, the prohibitions on shorting and restrictions on leverage, derivatives and other tools, combined with the liquidity requirement, mean that some core alternative strategies – those focused on commodities, managed futures, distressed and fixed income arbitrage, for example – are difficult if not impossible to replicate. This stems partly from the prohibition on investing in commodities or commodity derivatives, which are not sufficiently liquid to satisfy the UCITS requirements or which contravene the exclusion of physical assets. These restrictions are forcing managers to create or invest in indices which are regarded as the asset *per se*, and which reference the underlying physical assets or financial instruments, including traditional offshore hedge funds and other types of “risky” products. In this way the UCITS product becomes a “wrapper” for multiple underlying assets.

This is a far cry from the retail, long-only product that UCITS was originally intended to be. Managers and regulators alike are pushing the UCITS envelope. New UCITS regulation is pending to keep pace with this evolution. But alternative, risky and potentially illiquid strategies are being forced into the UCITS model. The liquidity requirements will not protect retail investors in UCITS if some market risk materializes to render an investment illiquid, or difficult to value. Indeed, it is liquidity that will harm smaller investors if the institutional investors withdraw their money, and move the market with them.

There is a growing feeling that a UCITS failure is likely. Such a failure could trigger the exodus of billions out of the brand. Here we make our final and most serious health warning. The regulators in the main UCITS jurisdictions, Ireland and Luxembourg, are relatively inexperienced in matters pertaining to hedge funds. A UCITS blow up of any size will severely test their ability to respond. And with 700 pieces of Madoff-related litigation eating up court time in Luxembourg, the capacity of the judicial system there to deal with a large fund failure is questionable. Contrast the Cayman Islands, with thirty years of regulatory experience and a legal system underpinned by the courts in England. Ultimately investors and managers will need to decide in whose legal system they wish to place their trust.

UCITS is not a tried-and-tested regime. Its continuing development will be driven by the needs of managers more than investors. Managers big enough to be able to absorb the higher costs of UCITS (like Brevan Howard, BlueCrest, Cheyne Capital and Jabre Capital, to name a few) will continue to use the model in addition to their existing offshore products, at least until the economic cycle improves and raising retail monies becomes less important. The majority of managers will dip their toe in the UCITS waters by using distribution platforms set up by investment banks like Deutsche and Merrill Lynch. For the vast majority of hedge fund managers, UCITS will continue to be too expensive and too restrictive. This will forge a divergence (that has already begun) between

managers of vanilla equity long/short strategies, who will use offshore funds in the Cayman Islands and will seek to use UCITS, and managers of more other leading offshore domiciles. complex, more truly “alternative” strategies, who

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