# UCITS III: The Opportunity

**Thinking about UCITS from the investment manager's perspective:**

Those of us faced with the reality of European hedge fund regulation will be familiar with UCITS III. You get points for knowing what UCITS actually means: Undertakings for Collective Investment in Transferable Securities, quite meaningless and proof positive of its European provenance.

In 2008, hedge funds lost money, on average some 20% of it in 2008. Traditional long only strategies lost about twice that but lets not split hairs. Some funds trafficking in illiquid investments when faced with high volumes of redemptions were forced to limit liquidity, gating or suspending redemptions in an effort to save their own businesses and or to save investors from selling off assets in a firesale. The need for liquidity and regulatory oversight thus brought UCITS firmly into the spotlight. Did Madoff really run a number of UCITS funds? Technically not. Madoff apparently never ran any funds UCITS or not.

In any case, in the wake of gates, suspensions, losses, regulators and investors are now looking towards more regulation. The hedge fund industry has proactively tried to head off what could be crippling regulation, first with active engagement of regulators by AIMA and the Hedge Fund Standards Board, and now with the embracing of UCITS III. Hedge fund managers have typically operated in an unregulated arena and are thus prohibited from marketing to individuals and are restricted to selling their funds to sophisticated investors such as institutional or professional investors. Naturally, hedge fund managers see UCITS as an alternative to onerous hedge fund regulation.

UCITS III, implemented in 2007, represents the third

incarnation of the original UCITS directive which emerged in the mid eighties. This latest iteration is less restrictive than the original directive and allow managers the flexibility to use derivatives up to 100% of NAV for more than just efficient portfolio management and hedging purposes, the use of leverage within funds (up to 200% of assets), the creation of fund of fund structures and the ability to market the fund across international borders.

UCITS III allows previously long only portfolio managers the scope to utilise “short extensions” through the use of listed and OTC derivatives for more than simple hedging purposes. Quite how safe this is remains to be seen. It provides managers with powers hitherto out of their reach in order to introduce greater flexibility when constructing and managing portfolios. It also provides managers with powers hitherto out of their experience to introduce greater risk if misused, even and especially if unintentionally.

There are a number of important restrictions. Portfolio managers are not allowed to run net short or outright shorts. They can’t short sell stock or write uncovered call options. They have to demonstrate that they have sufficient risk controls to monitor exposure, including the OTC counterparty risk which is limited to 10% of NAV to a single counterparty. There are risk limits based on VAR and Tracking Error to some relevant benchmark.

Importantly, UCITS III provides hedge fund managers a regulated investment vehicle which may negate the need for further hedge fund regulation. This is the main attraction as regulators tighten regulation and investors are increasingly leery of unregulated investment vehicles.

**Marketing and Product Positioning:**

As investors fled risky investments in the wake of 2008, it has shifted bargaining power in favour of investors away from

hedge fund managers. Liquidity terms are moving to be more in line with portfolio liquidity rather than the size of the ego of the manager. Liquid portfolios are matched with liquid terms and illiquid portfolios with liquidity constrained terms. Fee compression has become more of a reality.

The knee jerk reaction to all these developments, assuming that one hadn't disenfranchised all one's investors and had a queue of redemptions equal to 100% of NAV, has been to:

1. Keep running the hedge fund. Improve liquidity terms if possible but certainly not to run a liquidity mismatch. Consider lowering fees or redesigning fees for better alignment and less optionality. Try to raise capital for the hedge fund.

1. Offer managed accounts.

1. Launch a UCITS III fund.

1. Think the unthinkable.

Offering multiple products is not an enterprise to be taken lightly. It is one likely to be taken lightly given the DNA of the hedge fund manager who concentrates on the management of investments instead of product positioning and pricing.

Consider this; you have a product for which demand has shrunk and margins of which are likely to come under pressure. You have the capability of offering a similar product which is currently an emerging market where pricing strategy in the industry is uncertain. The marginal cost of offering the product is low as it is effectively the same product in a

different wrapper, delivered to a customer base where there is considerable overlap in one area plus a previously untapped market. The new product is highly scalable and is likely to be more of a volume driven rather than margin driven business. How should you position your products to maximize profits.

The market for your existing product is or was highly inelastic. It is likely that the market has become more price elastic. How do you position the existing product? You can treat the market as highly efficient and homogenous (which it isn't) and equate marginal cost to marginal revenue, push down pricing and try to capture market share. You can decide that the market is highly inefficient and heterogeneous (which it is in the world of skill based investing), hold up pricing, but more importantly try to move up the value chain and offer more specialized and bespoke product, avoiding the commoditization of the product, and try to equate marginal cost and marginal revenue in each sub-market for your product, effectively defining your own markets. This would include providing bespoke mandates, managed accounts, with bespoke liquidity terms and fees, targeting the professional and institutional investor. A balance between bulk pricing and bespoke mandate pricing is struck but it is struck with each client and is transparent only to each client and not to the market.

The market for the new product is likely to be inelastic as it is a new market. The natural conclusion jumped to is that the new product being offered to a wider retail audience is more price elastic. Given the general opacity in retail investment products, this is not clear. Retail products typically measure cost based on a total expense ratio. Hedge fund fees and expenses would naturally inflate this number relative to traditional UCITS funds. On the other hand, retail and mass affluent investors might be appreciative of absolute returns.

In this nascent market for UCITS III hedge funds, pricing and product positioning is still uncertain. A first mover only has

an advantage if they can confront the issues and plan strategically for the eventual maturity of the market.