

# What are the Risk Management Implications of UCITS 'Hedge Funds'?

This research is supported by



Research chair

“Risk and Regulation in the European Fund Management Industry”

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**June 2<sup>nd</sup>, 2010**

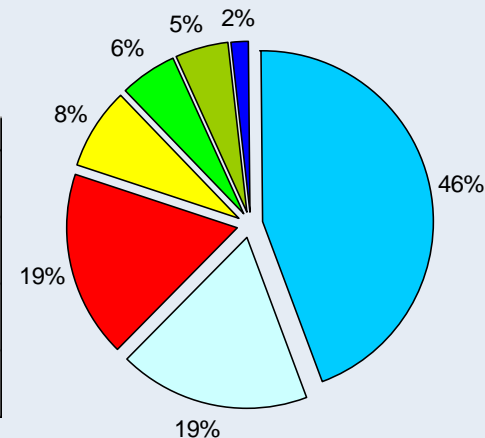
Sofitel Kirchberg

# A survey of views on hedge funds packaged as UCITS

437 respondents. Cumulative AUM > €13Trn (Fund managers' AUM ≈7Trn)

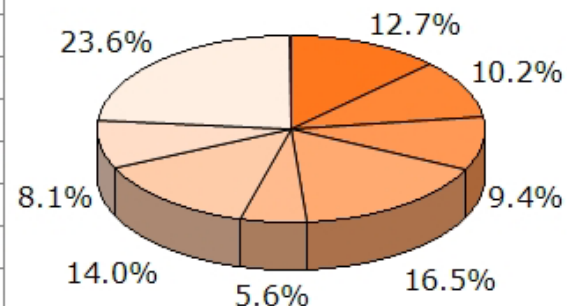
Are you mainly:

	% cit.
Managers	46.0%
Advisory-consulting	18.9%
Fund investors	18.5%
<i>of which, institutional investors</i>	8.1%
Asset management servicing	5.8%
Distributors	5.1%
Investment services providers	5.1%
Regulators	1.8%



Indicate the assets under management of your firm

	% cit.
Less than €100mn	12.7%
Less than €500mn	10.2%
Less than €1bn	9.4%
Between €1bn and €5bn	16.5%
Between €5bn and €10bn	5.6%
Between €10bn and €50bn	14.0%
Between €50bn and €100bn	8.1%
More than €100bn	23.6%



# *Agenda*

- 1) A context that pushes towards HF-UCITS
- 2) Structuring HF strategies as UCITS
- 3) Costs of structuring a HF as UCITS?
- 4) Is the UCITS framework really appropriate?
- 5) Conclusion: other market impacts

# *Agenda*

## 1) Context: a confused regulatory agenda pleads for structuring HF strategies as UCITS

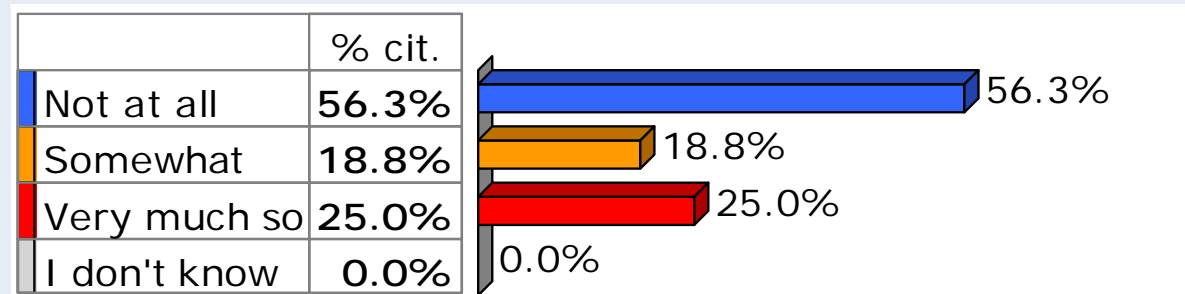
- AIFM directive (AIFMD) uncertainties
- Madoff and investor-protection issues
- Attractiveness of UCITS framework

# AIFMD: a passport to sell but not to buy

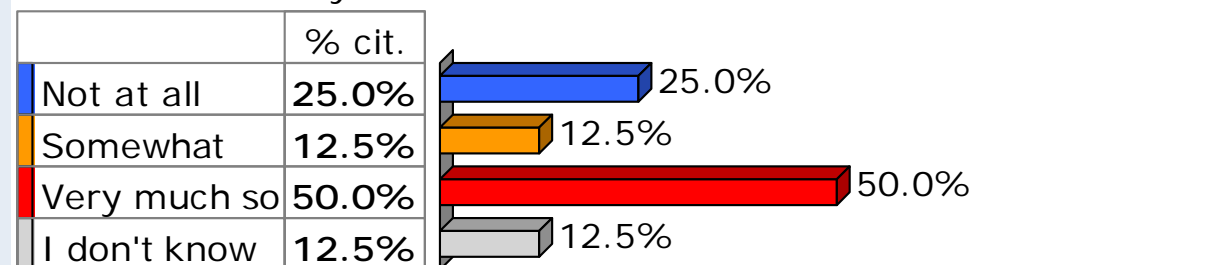
Institutional regulations apply and will whet investor appetite for UCITS

Do you envisage asking promoters/managers to restructure HF strategies as UCITS?

Pension funds free of quantitative restrictions



Insurance companies are bound and prefer UCITS

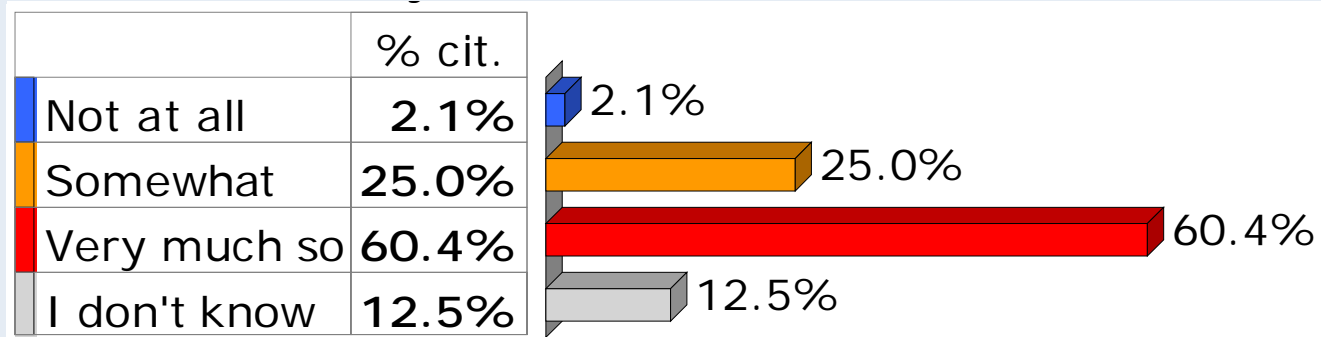


# AIFMD's uncertainties will push AIFs to structure as UCITS

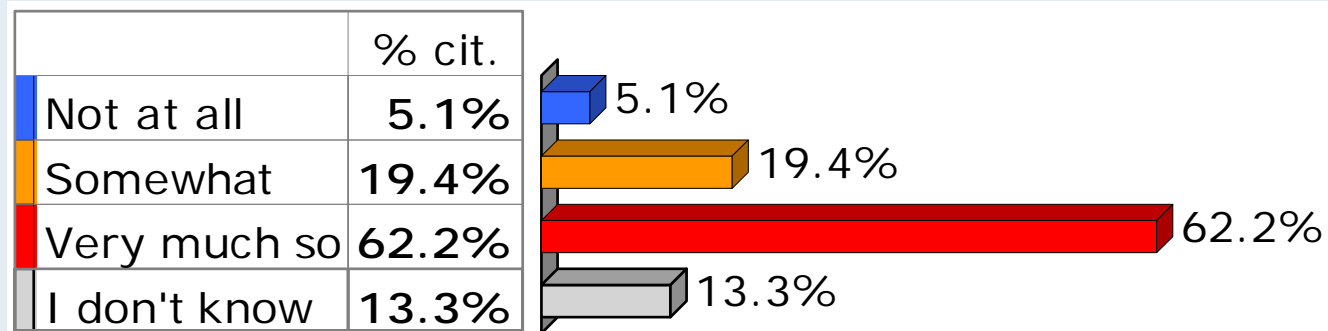
- AIFMD in a nutshell:
  - A passport for the marketing of hedge funds to professionals
  - Institutional regulations apply, and retail is regulated at the national level
  - Obligation to take on a depositary
  - 3-year exclusion for off-shore HFs
- Agenda and negotiation process blurred
- Impacts decision-making of off-shore and on-shore funds.

# Alternative managers feel that AIFMD will be penalising

1) Does AIFMD lead to uncertainties on the distribution of funds?



2) Is the 3-year exclusion penalising for off-shore funds?

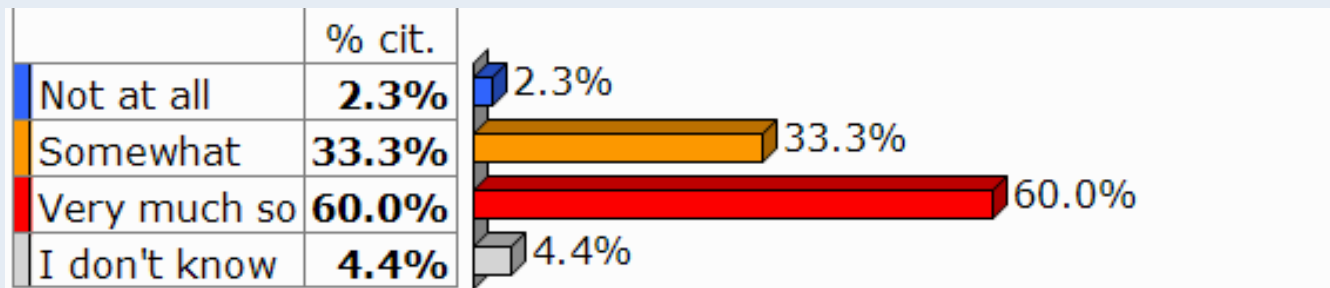


# Madoff raised awareness of op. risks & investor protection

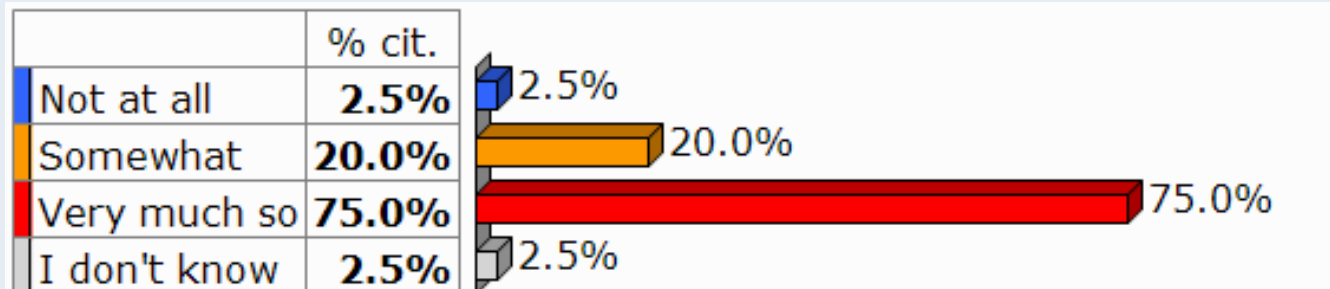
- Failure to supervise sub-depositories and disappearance of assets of a UCITS
- Varying state interpretations of obligations and liabilities of UCITS depositaries
- Political agenda: definition/homogenisation /strengthening of depositaries' obligations and liabilities yet vagueness in AIFMD
- Cost of asset servicing: enhanced obligations of control and due diligence
- Recognition of restitution risk and preference for regulated funds

# Madoff made you more aware of restitution risk

Have recent developments made the investment community more aware of restitution risk?



How relevant are restitution and operational risks to your investment decisions?



# Conclusion: enhanced attractiveness of UCITS funds

AIFMD's uncertainties will push some AIFs to structure as UCITS

Institutional constraints whet investors' appetite for UCITS

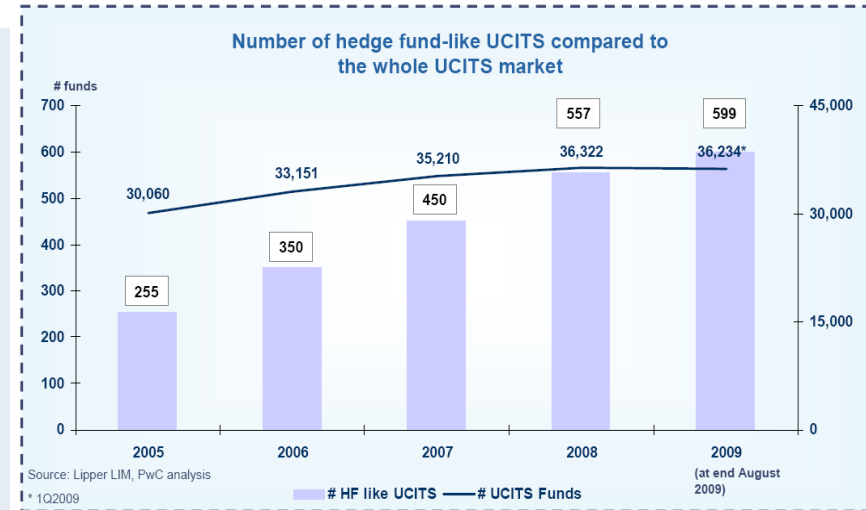
Sophisticated UCITS (w.r.t. UCITS II):

- Clear passport for distribution
- Expanded list of available instruments
- Improved possibilities for leverage
- Conform to institutional investors' constraints and appetite

# No wave of packaging HFs as UCITS in 2009 figures

Only a handful of HF UCITS.

The largest HFs have a UCITS offering



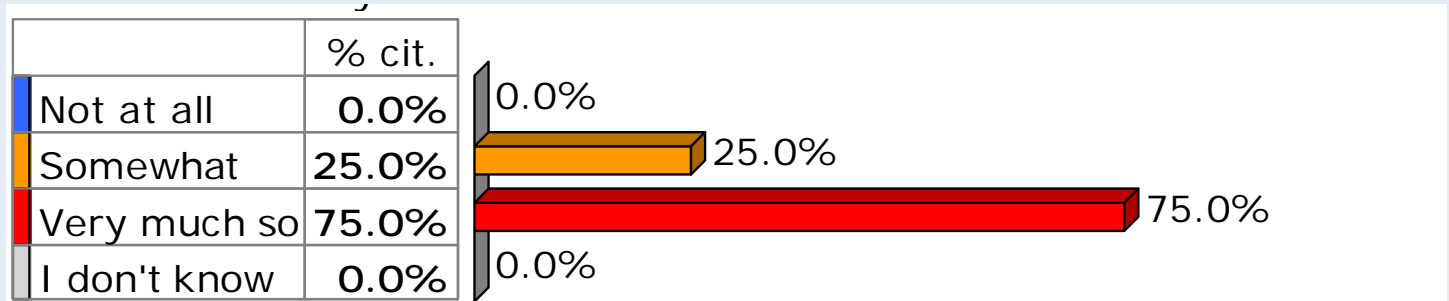
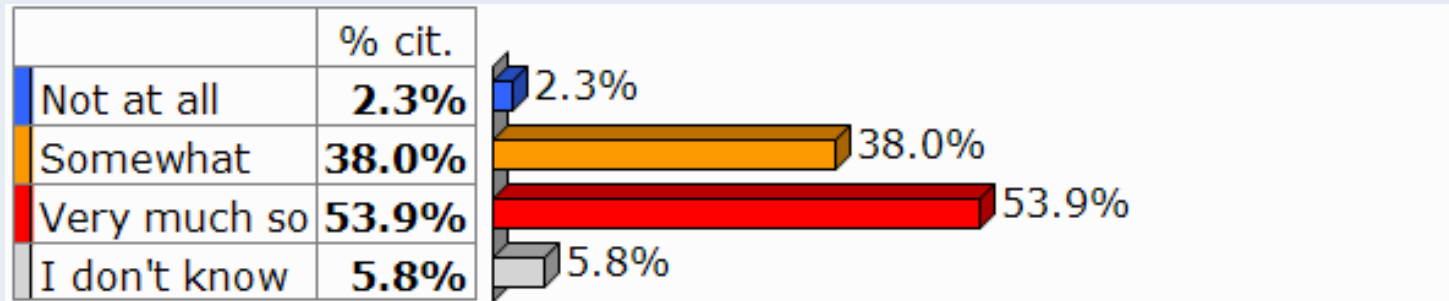
**Hedge fund-like UCITS launched or to be launched in 2009 - Examples**

Promoter	Fund name	Domicile	Strategy	Launch
BlueCrest Capital - ML	Blue Trend UCITS Fund	Lux	CTA	Feb-09
Aquila Capital	Pharos Evolution	Lux	CTA	Mar-09
SVM AM	SVM UK Absolute Alpha Fund	UK	UK Equity L/S	Apr-09
Aviva Investors	UK Absolute Return	UK	UK Equity L/S	Sep-09
Goldman Sachs	GS Fundamental Equity L/S fund	-	Equity L/S	Sep-09
Millenium Global - DB Select Alpha	Millenium Global Systematic Alpha	Lux	Mkt Nai country L/S approach + Mkt timing on currencies, fixed income, equities and cdties	Sep-09
SGAM	SGAM Invest Europe Absolute Research	France	Equity L/S - Pair trading	Sep-09
Threadneedle	Threadneedle L/S Credit Opportunities	UK	L/S Credit	Sep-09
Allianz GI	Allianz RCM Discovery Europe	Lux	European Equity Mkt Nai	Oct-09
RWC Partners	US Absolute Alpha Fund	Lux	US Equity L/S	Oct-09
Schroders - NewFinanceCapital		Lux	Equity L/S	Oct-09

# The survey suggests wave of hedge-fund UCITS gathering momentum

Do you see a trend towards packaging HF strategies as UCITS?

(all respondents)



# *Agenda*

## 2) Structuring HF strategies as UCITS

- UCITS ever friendlier for hedge fund strategies
- Quantitative VaR assessment: how many strategies would pass an empirical VaR test
- Qualitative assessment: binding constraints for main classes of strategies
- (Infra-)structural obstacles to packaging hedge funds as UCITS

## UCITS friendlier for HF strategies...

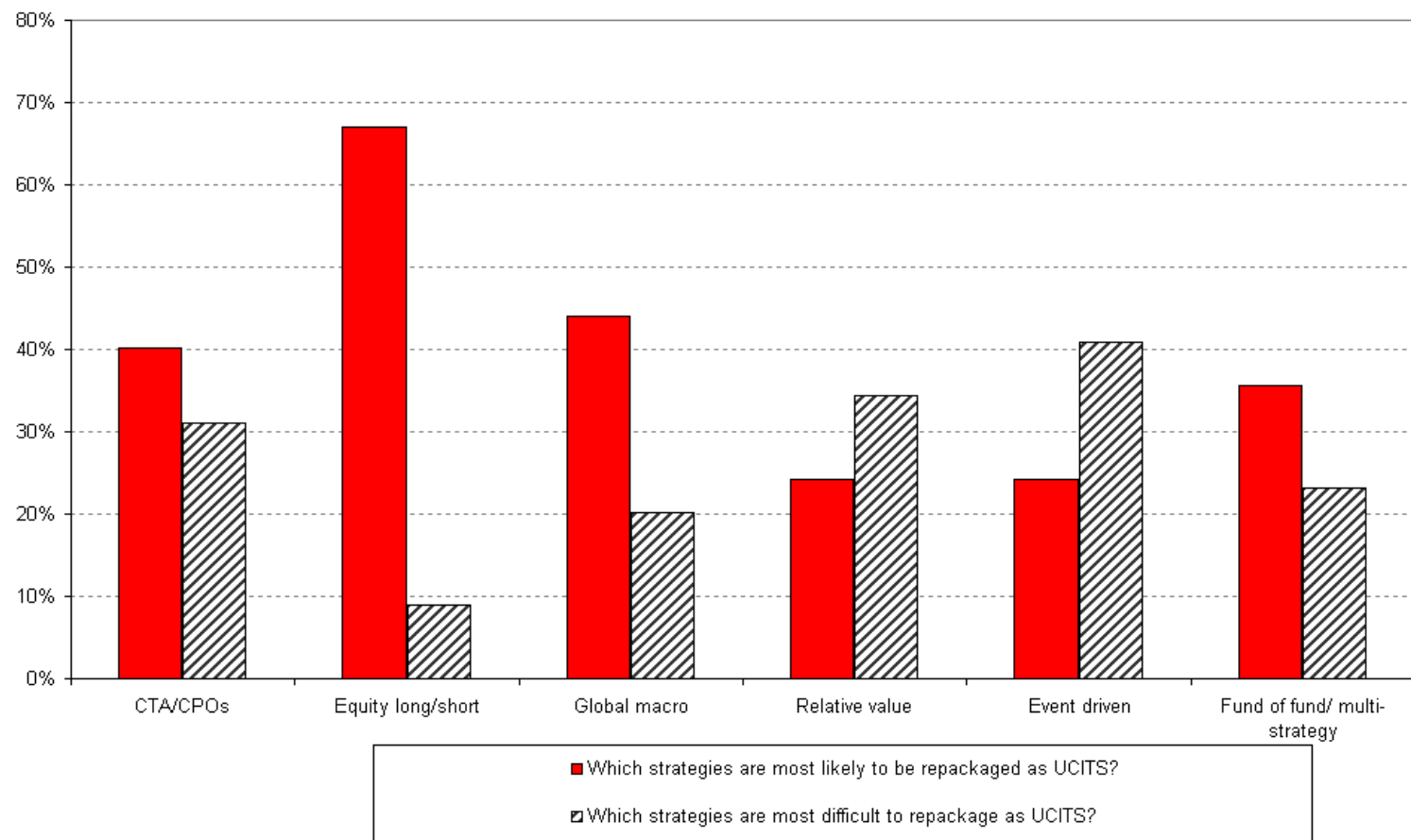
EC recommendation: leverage can be measured by the VaR approach

- Absolute VaR limit 20% monthly 99% VaR
- A less relevant relative VaR limit

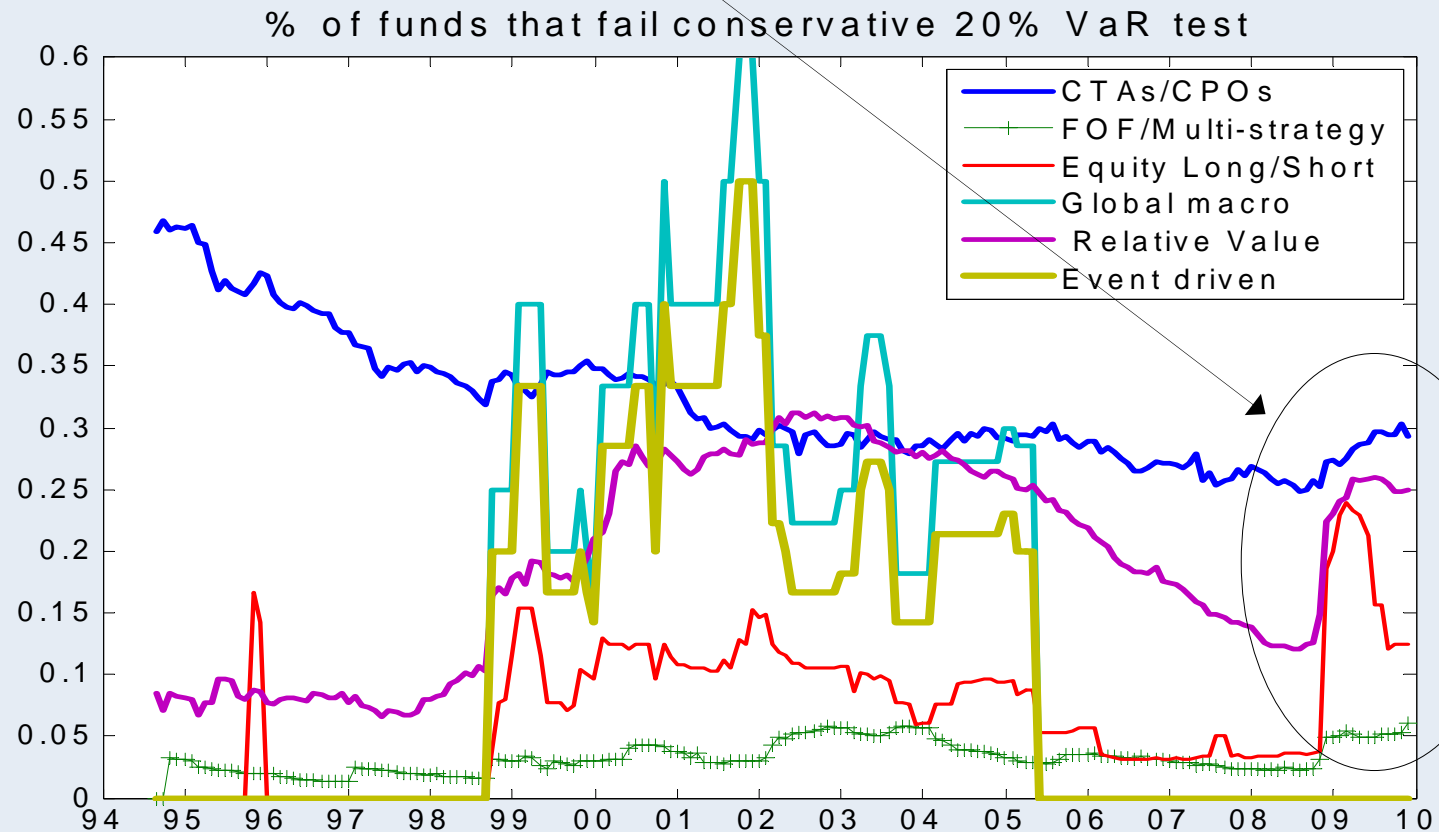
CESR's guidelines on eligible assets:

- Liquidity: units redeemable bi-monthly
- Derivatives on indices of ineligible assets
- Unleveraged derivatives on CDOs
- 10% "other transferrable securities" (trash-ratio)

# Respondents opinion: equity long-short easily packaged as UCITS, event driven least compatible



More than 70% of live HF in each strategy meet UCITS VaR requirement (max empirical/semi-parametric)



Directional single strategies (ELS / Event-driven / Global Macro) have been affected by volatility in earlier episodes

## Other UCITS constraints

### Quantitative restrictions (measured by the commitment approach)

- Concentration (issuer ratio): 5% - 10%.
- FDI counterparty (5%; 10% with credit inst.)
- Total deposits + FDI + instruments: 20%
- Concentration exception: 25% for a credit inst. and up to 100% for govt bond (if each bond < 30%)

Borrowing limited to 10%

Reporting/transparency

Concentration risk may be more binding than VaR

## Concentration risk

Measured by the commitment approach

Penalises concentration far more than leverage

- Fixed-income arb. low VaR but possible high concentration after leverage
- Long-only strategies may have high concentration and/or high VaR

## Counterparty risk

- Central counterparties should significantly alter this problem

## Other constraints may be binding for some strategies

### Liquidity constraints

- Liquid assets; bi-monthly NAV.
- An issue for: distressed securities, private placement strategies (direct financing, convertible arbitrage), buy-out and restructuring,... and long-term assets.

### Ineligible assets

- Non-financial assets as well as commodities (unless through cash-settled derivatives), precious metals.
- Direct mortgages, some specialised CPOs, target hedge funds.

# Brief strategy overview of HF UCITS

Type of style	Name of strategy	Easily structured as UCITS?	Excluded	Changes needed	Issues
<u>Tactical</u>	CTA, Global Macro	Yes: most players invest on indices	Old-fashion pure commodity	(Possibly leverage)	VaR reliability
<u>Equity long-short</u>		Yes	Specialised concentrated funds	Short synthetically	Cost of shorting
<u>Event-driven</u>	Distressed; Merger Arb., Event-Driven	Yes with adaptations	Distressed	Liquidity and concentration	Depositary controls, due diligence and safe keeping
<u>Relative value arbitrage</u>	Convertible and other firms' instruments	Harder to short non-stock firm securities	Specialised, concentrated "capital" arbitrage	Short synthetically	Costs, concentration, and depositary controls
	Fixed Inc., Equity Market Neutral	High concentration and low VaR happens		Short synthetically. (Possibly leverage)	Depositary control of concentration limits
<u>Funds of funds and multi-strategy funds</u>		Yes		FoHF: use of swaps (max. 30% direct invt in other funds)	Depositary issues for direct investment in HFs



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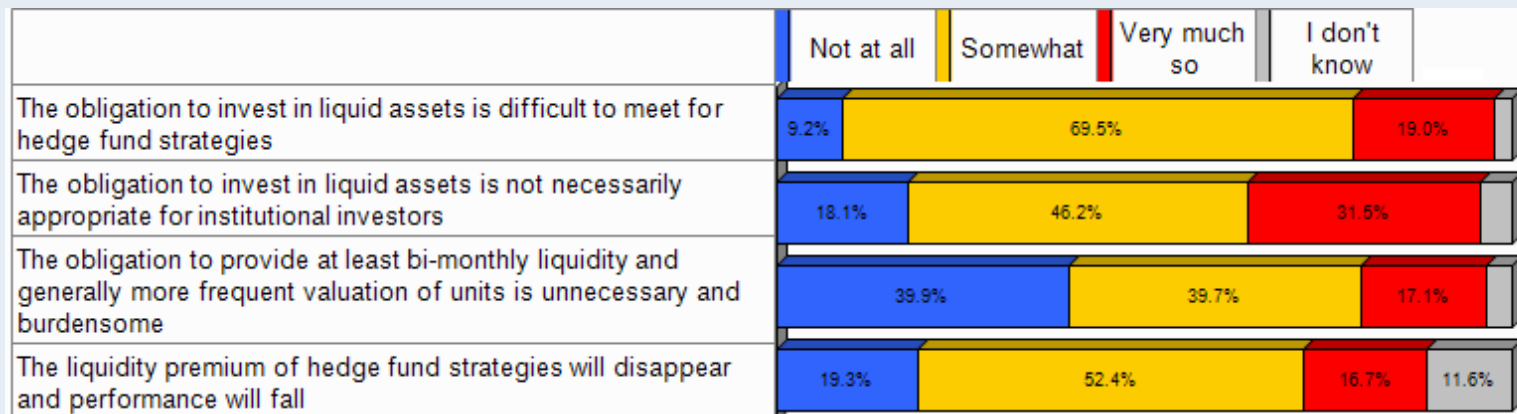
## Obvious structuring and “access” costs

### c.f. Charles River’s FSA AIFMD study

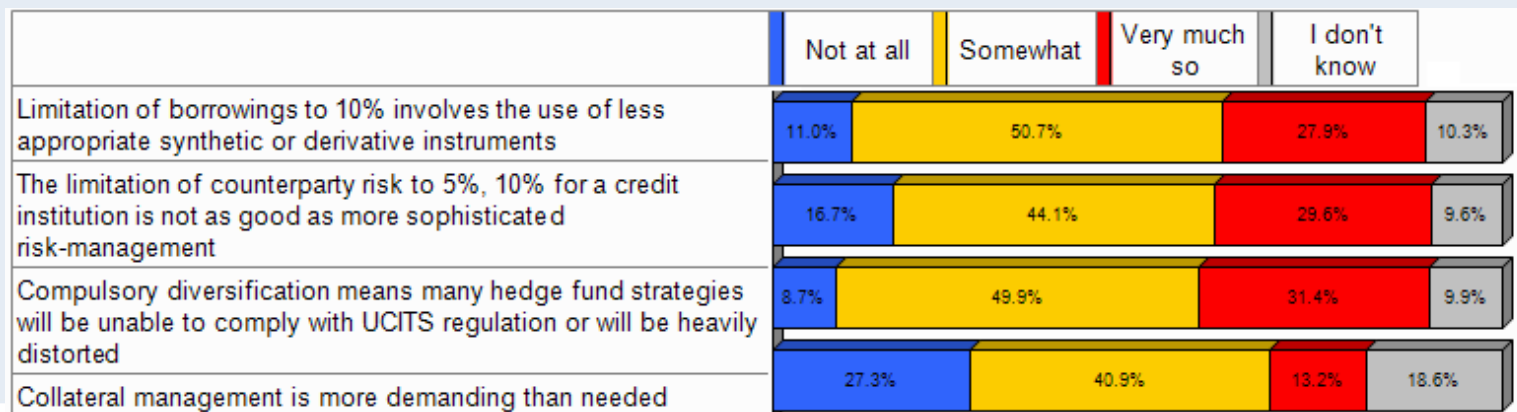
- One-off legal-structuring costs
  - Relocation to Europe + structuring/compliance
  - Total 62 bp for HFs
- On-going costs
  - 1.2 bp (or higher?) for HF
  - 14 bp for Private Equity, 25 for venture capital.

# Quantitative restrictions and liquidity requirements distort HF strategies

## Liquidity



## Quantitative restrictions



# Distortions when structuring a HF strategy as UCITS means investment costs

## Investment costs

- Liquidity premium forgone by short-term strategies.
  - US Stocks: Amihud 2009 discount of 14%.
  - HFs: Aragon's quantification 2004 at 4-5% for value-weighted and 7-8% for equally-weighted.
- Cost from the use of derivatives.

## Other issues

- Diminished leverage: impact on risk-adjusted performance only if fixed costs
- Risk-spreading require altering original strategies

## Short-selling and structural issues

- Naked short sales forbidden and borrowing limited to 10%
- Short-selling via financial derivatives more costly (cost of borrowing + margin)
- Costs will increase if hedge funds massively structure as UCITS
  - Pool of available securities to borrow from the prime broker diminishes, external financing increases

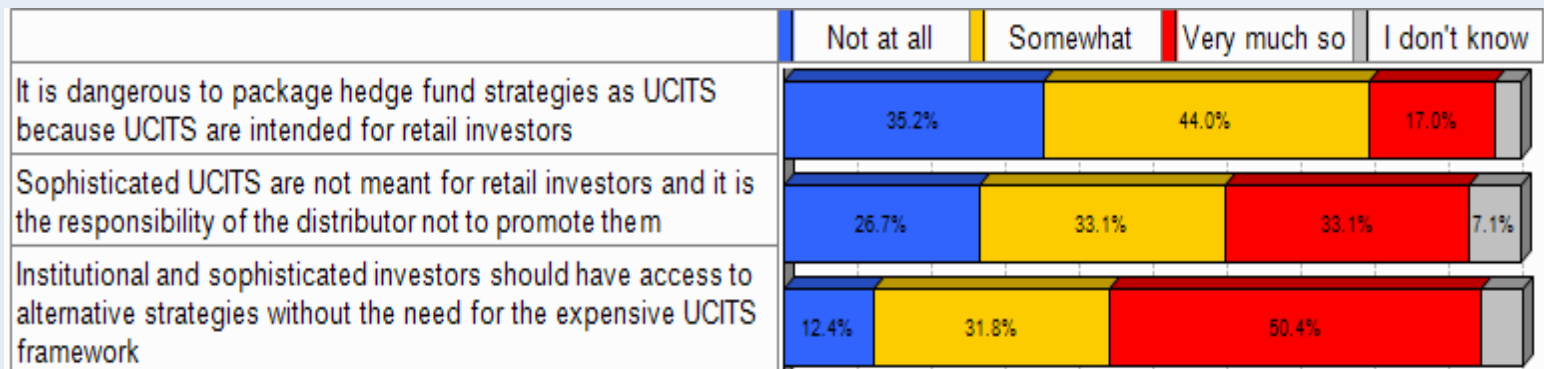
# *Agenda*

## 4) Is the UCITS framework really appropriate?

- Summary of investors' opinions
- Comments on depositaries' obligations

## HF-UCITS raise distribution problems for both retail and institutional investors

### 40% of AIF aware of UCITS-HF distribution problems



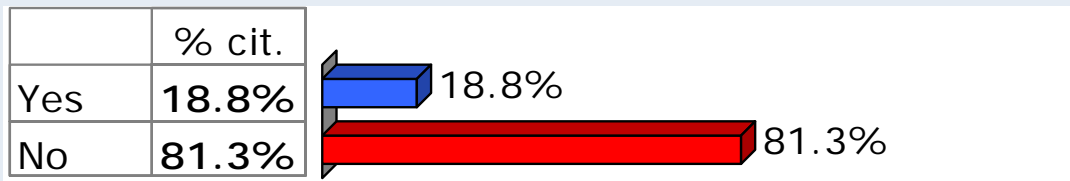
Answers similar across the board

97% of institutional investors think that UCITS should not be necessary to access HF strategies

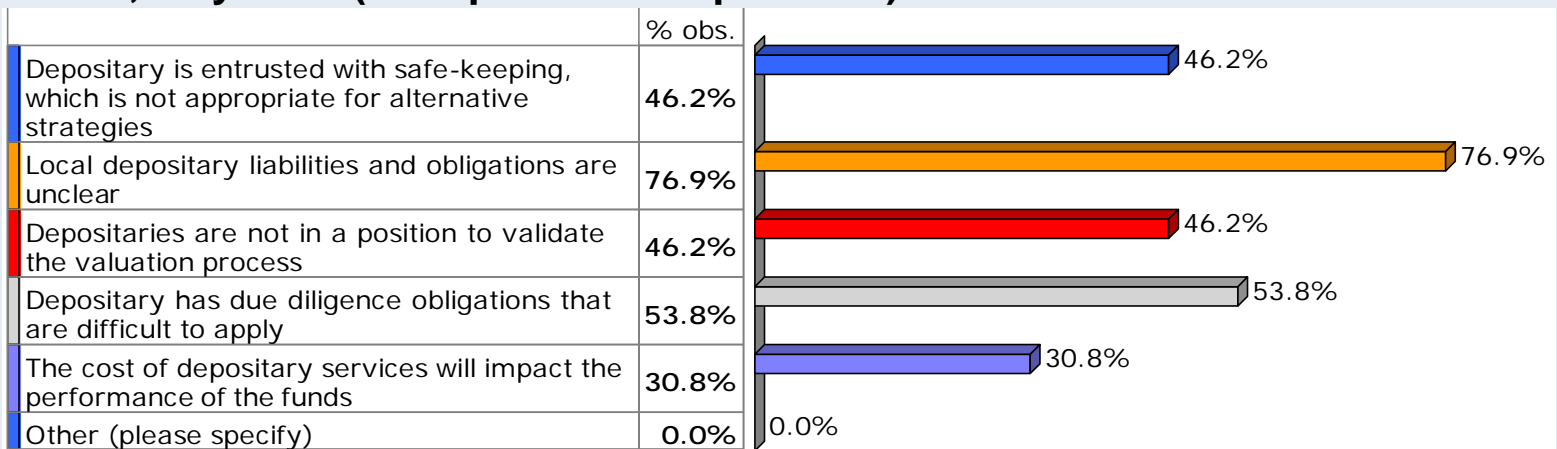
# UCITS-HF raise depositary issues neglected by most respondents

## Views of depositaries and custodians

Is the definition of the depositary appropriate?



**If no, why not? (multiple choices possible)**



# Primary concern on opacity of local obligations and depositary liabilities

## Local obligations/liabilities differ

- Countries with large domestic markets have focused on consumer protection (but may differ in their legal origins)
- Luxembourg originated a fund industry whereas Ireland originated a service industry (UK rules as a benchmark)

## Local depositary obligations unclear

- Practice of due diligence and its adequacy
- Unclear legal responsibility for losses

## AIFMD:

- Liability unless contractual exemptions; due-diligence and monitoring required

Due diligence obligations difficult to apply; necessary harmonisation to avoid regulatory dumping

## Local depositary obligations and liabilities unclear

- Due diligence from difficult to impossible or costly?
- Safe-keeping issues with alternatives:
  - Asset classes that need dedicated safe-keeping
  - Reuse (prime brokers). Investments in target hedge funds or markets that involve sub-custody
- Excessive depositary liabilities (France) and their capital adequacy
  - Systemic fragility from mass switching of assets from fragile sub-custodians?
  - Risk of regulatory dumping would undermine each and every country
- Contractual exemptions in AIFMD but liability-sharing raises the question of capital adequacy of asset managers

# Responsibilities of other actors, capital requirements and risk-management

## Capital adequacy in the value chain

- Liability-sharing
- Non-financial risks insured by one or managed along the value chain?
- Capital requirements as incentives not an insurance!

## AM companies retain the primary responsibility for:

- Valuation process, choice of eligible assets and due diligences, compliance with quantitative restrictions, legal information & KID

## The distributor:

- Must distribute products that conform investors' profile
- As a member of the board, may share responsibility w.r.t. investor losses

# *Agenda*

## 5) Conclusion

- Harmonisation
- Better regulations

# Conclusion (1): harmonisation

- Use of UCITS to distribute HFs to professional investors is a perverse outcome of a messy regulations
  - Liquid strategies subject to structuring costs, other strategies altered
  - Need for illiquid assets and adequate structuring strategies
- Towards harmonised regulation (primarily concerns depositaries)
  - Lack of harmonisation and clarification of depositary liabilities (UCITS, AIFMD) makes it hard to reach definitive conclusions
  - Packaging a HF as UCITS means transferring some operational risks to the depositary
  - Moral hazard for investors? Cost of risk transfer?
  - Responsibilities and regulatory capital in the value chain (see (2))

## Conclusion (2): better regulation

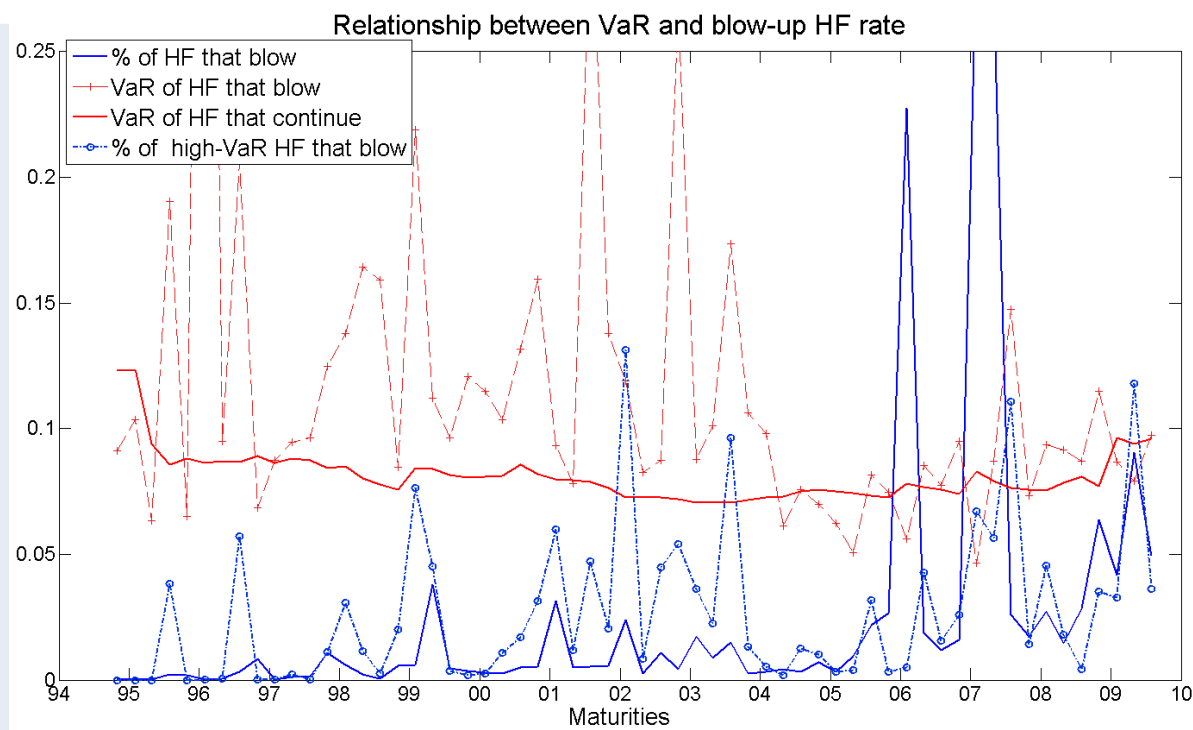
- Towards improved regulation of investment funds and properly designed incentives
  - Illiquid assets and closed-end funds?
  - Incentive for compliance to AIFMD and alignment of regulations of institutional investors
  - Incentives to manage rather than to insure non-financial risks: defining responsibilities of distributors, asset managers, depositaries, and valuers and requiring adequate regulatory capital
  - Within regulated funds: lower capital requirements through risk-based regulations (of non-financial risks)?
  - For all funds, are non-capital incentives possible? (organise distribution rewards for good management practices)?

# EDHEC-Risk

Thank you !

Questions and answers

# Does the UCITS VaR constraint protect against operational risk?



HFs that imploded after '98 and 2000 were high-VaR.

2008 is different. This reflects:

- better risk management
- a specific “model risk” crisis.