

UCITs III for Non-Dummies

We believe that all large US hedge funds will offer products under the European Union's UCITs III framework within five years. This may be a bold statement, seeing that many people on this side of the pond are at most only vaguely familiar with what UCITs is. However, we are now seeing more voices supporting our point of view.

What is UCITs III and Why Should US Managers Care About it?

For those of you not familiar with UCITs III, let's recap quickly. UCITs III is the European regulatory framework and fund structure that allows for hedge fund-type products to be distributed locally throughout the European Union. Most UCITs III funds are set up either in Luxembourg or Dublin.

Whereas over 80 percent of long-only mutual funds marketed in Europe are UCITs-compliant, it is only recently that alternative investment strategies have been offered. Most of these have been in the equity long-short, market-neutral, event-driven, relative value and CTA spaces.

UCITs III hedge funds are subject to certain limitations on the type of investments permitted and must offer frequent liquidity (typically daily or weekly). The resulting benefit is a far wider universe of potential investors than are currently invested in standard Cayman or BVI offshore vehicles (that typically offer monthly, quarterly or even annual liquidity).

UCITs III products may be distributed to both institutional and retail clients in the EU. There are no qualified purchaser limitations as there are in the US. Moreover, the UCITs structure has become very popular globally, with 40% of total UCITs mutual fund sales being generated outside the EU, especially from Asia.

Finally, not every strategy is suited for UCITs, and most managers who have offered UCITs III funds, have varied these from their core or flagship funds in order to meet the UCITs III risk, diversification and liquidity requirements. Nevertheless, we believe that most US-based hedge fund managers would be able to offer a UCITs III-compliant products derived from their core investment disciplines.

And so...

We believe that all large US hedge funds will offer UCITs products within five years; this despite most managers still not being familiar with the structure. In following, please note the comments of Morgan Stanley analyst Huw Van Steenis, as quoted by Bill McIntosh in Hedge Fund Journal, Nov 25, 2009,

“We see the early stages of a turnaround in hedge fund flows with redemption pressures easing and inflows growing...We think the market is underestimating the potential upsurge in demand for absolute return funds from private clients and smaller institutions via UCITS III.”

What does this tell us?

Firstly, that there is renewed interest once again from investors in absolute return strategies. **However**, this does not mean that everything is back to what it was prior to 2007. Investors are going to be more selective, and look for greater liquidity in the hedge fund space. Gone are the days where managers could play the “scarcity value” game, and demand from investors to rush their due diligence processes so that they could invest before the fund closed forever to new capital.

Secondly, the proposed changes in US and EU hedge fund regulations will make it more cumbersome for offshore funds to be fully compliant in a cost-efficient manner. This does not necessarily provide a clear competitive advantage to larger fund managers (as they would want you to believe), but Mr. Van Steenis notes that managers will have to have access institutional infrastructure in order to operate smoothly. Fortunately, there are a number of service providers in Luxembourg and Dublin that will allow for smaller management firms to focus on portfolio management, while outsourcing all other essential operational, administration, custodial and regulatory functions.

Thirdly, we also believe that there is still a first mover advantage for those managers who are willing to bear the expense of initial set up costs. The UCITs III hedge fund-like product range is still relatively small. We suggest that managers to “take the plunge” and set up UCITs III vehicles even on a loss leader basis, particularly for the reasons we list below.

Bring on the Cannibals

We are now at the beginning of a new chapter of the UCITs III story. We predict that given a wide enough choice, **European investors will begin to redeem out of their offshore Cayman or BVI funds in favor of UCITs funds**, owing to the greater liquidity benefit as well as the comfort of investing in a European-domiciled fund structure.

While this will not be true for every hedge fund strategy, we do suggest that managers who run more liquid strategies become pro-active rather than reactive and set up UCITS III funds sooner rather than later.

The question we often get from managers in this regard is “who will we distribute our UCITs funds to?” The answer is far nearer to home than one would expect – “your own clients”. Managers may have to cannibalize part of their existing offshore funds in order to set up a UCITS fund with sufficient size and scale. In other words, offer existing clients the option to transfer assets from the Cayman or BVI fund to the new UCITs III vehicle.

Of course there are costs involved, and there may be some initial disruption, but this is clearly a better alternative than simply waiting for one’s Cayman fund assets to leave out the door to a competitor’s UCITs III product.

Why Set Up a UCITS III Fund Now?

We estimate that an initial UCITs III structure would take 4-6 months to set up. This includes setting up of the legal structure and offering memorandum, and selecting counterparties, including administrators, custodians and directors. However, once the framework is established, it is relatively easy to set up subsequent funds, all of which may be held under the same fund umbrella. At that stage, investment management firms could also customize products for their larger clients within the UCITS framework.

Norman H. Chait, CFA
nhchedge@optonline.net
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