

A close-up photograph of a classical stone column, showing its fluted texture and the base. The column is dark and occupies the left side of the page.

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CAIA MEMBER CONTRIBUTION

Impact of the Recent Regulatory Changes on the UCITS CTA Market

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1. UCITS CTA Market Overview

UCITS CTA funds have experienced exponential growth over the last four years. The number of funds has grown from 9 to 55 funds from January 2008 to September 2012. The assets under management have surged from EUR 1.57 billion to EUR 6.09 billion over the same period. Exhibit 1 illustrates the progression of both the number of funds and assets managed by CTA managers in UCITS format. The first UCITS CTA funds were launched mainly by managers based in Europe who were advising onshore vehicles. The market really began to pick-up after the summer of 2009, with large offshore CTA managers coming into play. Since then, the assets under management for UCITS CTA funds have more than doubled.

Exhibit 2 illustrates the portion of UCITS CTA funds that are using index structures versus fund structures in terms of the number of funds and the assets under management (as of September 2012). Although the funds using the index structure represent only one quarter of all funds, they account for about half of all assets under management in the strategy. Of the 10 largest UCITS CTA managers, 7 managers are using the index structure.

This dichotomy can be explained by the fact that the leading and oldest CTA managers favor the index structure. While recent regulatory changes may only concern a subset of CTA managers, they will affect the largest and best-known firms.

2. Index Based Approach versus Direct Approach

Since its introduction in 1985, the UCITS Directive has banned investments in physical commodities or in products linked to commodities, such as commodities derivatives. For this reason, the first UCITS CTA funds launched have no allocation to single commodity instruments.

However, CTA managers have explored other routes to implement their investment strategies, while maintaining exposure to commodities and complying with the UCITS Directive at the same time. One solution, which CTA managers developed was to make use of the index section of the Directive, rather than focusing on the fund section. UCITS indices are governed by different rules than funds and the current rules governing indices are generally simple and flexible enough to accommodate most CTA strategies. In order to be eligible, an index has to meet the following criteria:

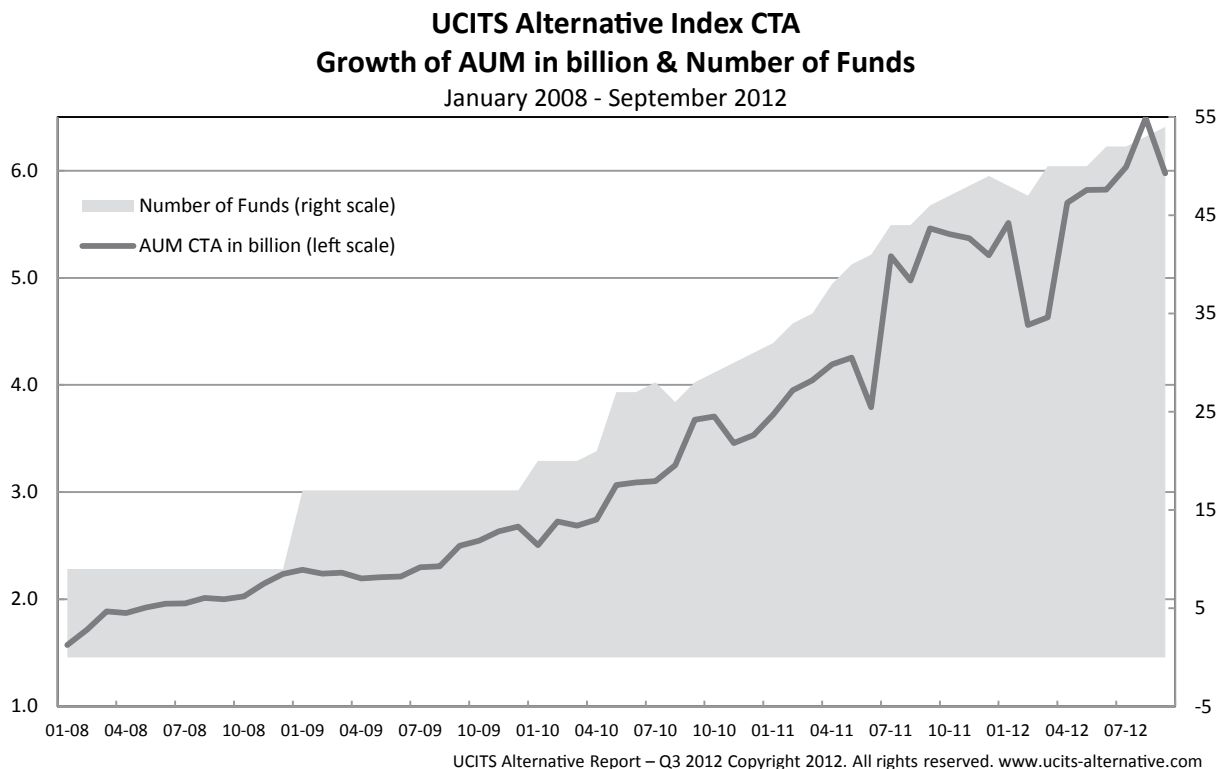
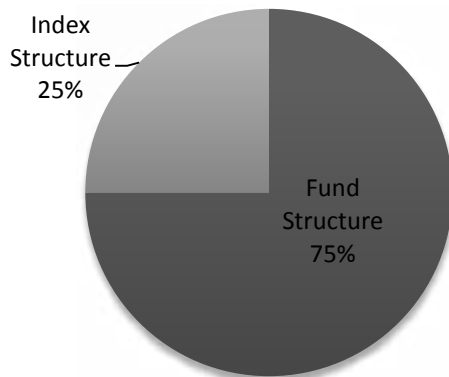


Exhibit 1 UCITS CTA Growth in AUM and Number of Funds
Source: Pirrong (2005)

Percentage of UCITS CTA Funds using Index versus Fund structure



Percentage of assets managed by UCITS CTA funds using Index versus Fund

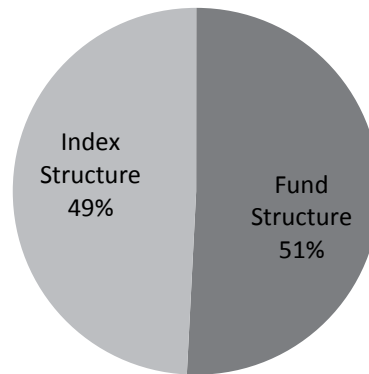


Exhibit 2 Breakdown of UCITS CTA funds using Index versus Fund structure

Source: Alix Capital / UCITS Alternative Index - www.ucits-alternative.com

- Provide sufficient diversification.
- Be representative of an adequate benchmark for the market to which it refers.
- Be published in an appropriate manner.
- Be independently managed from the management of the UCITS.

In practice, an index replicating the original strategy is created. The performance of this index is then replicated in the UCITS vehicle through a total return swap.

The use of this index structure offers several advantages. First, in terms of portfolio management, it allows an allocation into commodities instruments, as well as higher concentration limits. Second, it enables managers to handle only one pool of assets that can be then replicated in various investment formats, including offshore funds, UCITS, and managed accounts. Finally, it makes it possible to replicate the existing strategy without tracking error.

Nonetheless, using an index has a number of drawbacks. The performance replication comes at a cost and introduces an additional counterparty, the swap provider, which adds an extra layer of risk.

For many market participants, the rules governing UCITS indices were perceived to be too loose and were seen as a loophole in the regulation that could eventually damage the Directive's reputation. The UCITS index rules were designed to be as flexible as possible in order to accommodate most financial indices, but they were not developed as a way to circumvent the Directive's spirit by authorizing investment in otherwise non-eligible assets such as commodities. This dilemma motivated the European Securities and Markets Authority (ESMA) to review and strengthen the rules governing indices.

3. ESMA New Regulation Proposal-UCITS Eligible Indices

In the Report and Consultation Paper published on July 25th 2012, entitled Guidelines on ETFs and Other UCITS Issues: Consultation on Recallability of Repo and Reverse Repo Arrangements, ESMA introduces new guidelines governing the implementation on UCITS eligible indices. While the scope of the paper covers numerous issues, some of the guidelines directly impact UCITS CTAs that are using the index structure. ESMA's view is that an index shall be transparent and replicable if it is to qualify as UCITS-compliant and thereby benefit from the strong UCITS brand attached to the framework.

Specific sections of the paper have a direct impact on the use of this structure for CTA managers.

Rebalancing Frequency

ESMA declares that: "A UCITS should not invest in a financial index whose rebalancing frequency prevents investors from being able to replicate the financial index." Indices which are rebalanced on an intra-day or daily basis will not be acceptable in UCITS funds. This means that CTA managers who are rebalancing their portfolio more frequently than weekly will no longer be able to use this approach.

For some long-term trend following CTA managers weekly rebalancing may be acceptable, but many managers are employing shorter-term strategies that require more frequent rebalancing and they are directly impacted by the new regulation. The consultation paper specifies that technical adjustments may be made on an intraweekly basis and shall not be considered as rebalancing. Each regulator will have to determine what constitutes technical rebalancing.

Transparency

Calculation methodology

ESMA states UCITS should not invest in financial indices for which the full calculation methodology to, inter alia, enable investors to replicate the financial index is not disclosed by the index provider. The text further specifies that this includes providing detailed information on index constituents, index calculation, re-balancing methodologies, and index changes and indicates that this information should be easily accessible, free of charge, to investors and prospective investors.

This point is the most controversial one from a managerial perspective, as it concerns the development of intellectual property and competitive edge. CTA managers invest very substantial resources to develop and maintain their trading models. If the results are made directly available to everyone, they will think twice before choosing an implementation technique that obliges them to disclose those models.

Index constituents

ESMA states that: a UCITS should not invest in financial indices that do not publish their constituents together with their respective weightings. Again, the text specifies that the information should be easily accessible, free of charge, to investors and prospective investors. ESMA, however, adds that the weightings may be published after each rebalancing on a retrospective basis.

This is also a problematic issue for CTA managers and some managers have raised concerns over the possibility that competitors could re-engineer their models by analyzing the positions. For other managers, disclosing their positions would expose them to front running activities by other market participants and could have a severe impact on their returns.

4. Possible Outcomes

At this stage, a number of technical issues need to be clarified and each regulator may have a slightly different interpretation on how to implement the proposed changes. In any case, CTA managers will face a choice when these changes are implemented. Their options are described below.

4.1 Keep the Index Approach

Keeping the index approach means accepting the constraints described above. Managers will have to disclose both their methodologies and positions fully and they will also have to limit the rebalancing frequency to a weekly schedule. While this last point might turn out to be less restrictive in its application, the issue of transparency will prove quite difficult for CTA managers to navigate. One possible solution would be composed of two parts: (1) the regulators will accept a broad strategy description, rather than a comprehensive one, and (2) the managers will disclose the index methodology, but not too frequently, and the disclosure will occur with sufficient delay.

If that is the case, some managers could continue to use the index section of the Directive. However, it is difficult to know if and how many funds will continue to use this structure. All of the CTA managers we have discussed the proposals with (representing 50% of the CTA funds using the index approach) have stated that they could not accommodate the proposal as it is currently drafted.

4.2. Use the Fund Approach and Abandon Commodity Exposure

A number of CTA managers have built up competitive products and raised substantial assets without exposure to commodities by focusing on non-commodity futures. However, this is not applicable to all managers or across all investment approaches, as it depends on the relative contribution of commodities to the overall strategy. For managers with little exposure to commodities, this might be an acceptable solution; in fact, some managers are already working on models that exclude commodities and they will, therefore, adapt to the constraint. However, for most managers this option is not realistic, given the level of allocation already given to commodities, or taking their unique characteristics in terms of diversification and correlation into account. For those who proposed to abandon the commodity exposure, it could take some time to convince investors that they can effectively run their strategy without exposure to this asset class.

4.3. Use the Fund Approach and Maintain Commodity Exposure

Over the last two years, the development of new structured financial instruments such as certificates has allowed some CTA funds to gain exposure to commodities while using the fund section of the UCITS Directive. Certificates are debt instruments that fall within the categorization of transferable securities and are used to either replicate the performance of the commodities exposure only, or that replicate the performance of an entire portfolio. Certificates are bound to the same restrictions that govern other investments in a UCITS fund and they cannot represent more than 10% of the fund's allocation.

The composition of the certificate is not governed by the UCITS rules and it can invest in non-eligible assets, such as commodity derivatives. However, the regulator requires a certain level of diversification of the assets held. Certificates also have to meet specific constraints in terms of independent valuation and liquidity. They

require approval by the regulator and this is done on a case by case basis.

The use of certificates is not an ideal solution, since as with any structured instruments, they introduce an additional layer of costs for the UCITS; they pose additional risks as well.

In our view, a large portion of UCITS CTA managers with commodities exposure will select this route in the future, despite its drawbacks. Using certificates allows managers to maintain the desired commodity exposures while not having to comply with the upcoming index constraints.

5. Conclusions

While it is difficult to draw any final conclusions concerning the ultimate interpretation of the ESMA guidelines, it is clear that the majority of CTA funds using the index structure will have to rethink the way they implement their strategies.

The use of certificates seems to be the most obvious option to gain commodity exposure. It will be interesting to see the ESMA's position if all CTA managers start to use this approach. Commodities are an important asset class, which helps investors achieve diversification. A number of market participants are lobbying for their inclusion among the list of UCITS eligible assets. For example, the Alternative Investment Management Association (AIMA) recently published a position paper about UCITS V that advocates the inclusion of commodities instruments in UCITS. Among other issues, AIMA believes that the current treatment of commodity derivatives appears to be outdated and in contradiction with the investor protection concerns and the interest of investors in general. These restrictions are having a contrary effect to the spirit of the law.

Solutions for CTA managers to retain commodity exposure in the UCITS framework exist, but it is not beneficial to force managers to use complex procedures to gain exposure to a highly regulated, liquid and commonly used asset class. Further thoughtful discussion of these issues and appropriate adjustments will be helpful to the industry and the investors alike.

Author Bio

Louis Zanolin is currently CEO at Alix Capital, an advisory firm specialized in regulated alternative investments based in Geneva. Louis has over 15 years of experience in the alternative investment industry.

Before founding Alix Capital in 2010, Louis was CEO and co-portfolio manager at NARA Capital a specialized fund of hedge funds management company in Geneva. From 2001 to 2007, Louis was Managing Partner at Peak Partners (formerly Harcourt Partners), a Geneva based fund of hedge funds and before that he worked as hedge fund analyst with Agora Capital also in Geneva.

Louis holds a Bachelor degree from the Engineering School of Geneva, a degree in International Management from the ESM School of Management in Geneva and a Certificate in Quantitative Portfolio Management from the University of Geneva. Louis also holds the Chartered Alternative Investments Analyst (CAIA) designation since 2006.

Louis has published numerous articles about the alternative industry since 2003. He is also a regular speaker at conferences.

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