Introduction

Gaining the Advantage of UCITS Power

As investment management continues to face a rapid growth in assets, managers are facing significant challenges related to regulatory transparency and increased demands from investors for sophisticated products. In this context, investment managers are reinforcing their risk management to protect investors, to safeguard their firm's reputation and also to improve operational efficiency. Effective risk management requires that the risk manager recognize and understand the source of the returns UCITS (Undertakings for Collective Investment in Transferable Securities) is earning and the associated risks.

UCITS III can be referred to as two separate directives: the product directive and the management directive. The objective is to create a level playing field among management companies and other service providers by introducing a European passport for management companies and extending their scope of activities. The extended use of financial derivative instruments is explained by the fact that they provide implementation flexibility, reduce risks and provide yield enhancement. However, they involve issues such as counterparty risk, valuation risk, and liquidity risk. They may, if markets move in unexpected ways, increase the fund's investment losses. UCITS is now permitted to use derivatives as part of its general investment policies as well as for hedging.

One of the key features of UCITS III is the emphasis on risk management as an integral requirement for any fund seeking sophisticated status. The increased regulatory requirements reflect the importance placed on being able to effectively calculate and measure the global exposure of a portfolio. Competence in investment risk management is set to be a key determinant of competitive success in an UCITS III environment. With alternative strategies now available for traditional managers, the hedge and long-only worlds will collide and the winners will be those who can combine alpha generation with sound risk controls.

While alpha generation is amenable to human judgment, risk control requires smart risk measurement systems that meet the needs of fund managers, investors and regulators. Under UCITS III world-regulated firms can design a much wider range of investment products to meet client needs. Derivatives can be used to gear up, to reduce risk and to manufacture returns uncorrelated to security markets.

Long-short equity, one of the most popular hedge fund strategies, is now feasible in a regulated environment. Relative value (long-short bonds) offers traditional fixed income fund managers a means of generating superior returns in a flat or rising yield market. Absolute returns will soon be available at a fund supermarket near you.

Consequently, UCITS III has transformed the European asset management industry since its European directives have been implemented. Regardless of the manager's background, a key challenge will be the successful and cost-effective implementation of the regulatory requirement of a formal "risk management process".

UCITS must establish an extensive system of risk management in order to ensure that the risks involved in using derivatives are properly managed, measured and monitored on an ongoing basis. This involves:

– designing, implementing and documenting a comprehensive risk management process in order to meet the key requirement of investor protection;

– extending disclosure duties;

– defining rule of conduct to ensure that companies act in the best interests of the UCITS, their investors and the integrity of the market.

Seen in the light of the financial crisis resulting from subprime lending in the United States, it is convenient to assume that the risk management function and its extension from banks to the asset management industry due to UCITS III requirements has gained further attention and recognition as a strategic discipline.

Before we get started

UCITS is a European brand and as such all EU countries can domicile UCITS funds:

– France;

– Germany;

– Ireland;

– Luxembourg;

– Spain;

– UK;

– etc.

Even if the European directives about UCITS should in theory be the same for all EU countries, some differences still remain in the way EU countries have translated the EU directives into their national laws. The differences are obviously not huge but they do exist. To avoid a summary of each UCITS specific criteria for each country, we decided to focus on Luxembourg domiciled UCITS funds as Luxembourg is the first country in Europe in terms of UCITS funds' domiciliation and therefore constitutes a major hub. The Luxembourg Laws as well as the Commission de Surveillance du Secteur Financier (CSSF) Circulars will be predominantly referenced in this book.

UCITS can also be formed under different legal structures. This book considers the view of UCITS being used by a management company and not according to the self-managed SICAV (Société d'Investissement À Capital Variable – Variable Capital Investment Company). Although of course the requirements that apply to them remain the same in terms of risk management.)

A book on risk management without risk figures would be quite unrealistic. Risk management cannot be conceived without the usage of an appropriate risk engine to compute all UCITS III requirements. In order to demonstrate that it is possible to generate all risk outputs as requested under UCITS III, we voluntarily adopted the risk engine installed at Kinetic Partners LLP London, which is our tailored portfolio and management system (PMS) conjointly developed with the vendor Much.Net AG Bonn.

Focus of the book

The purpose of this book is to present how asset managers, fund (independent) directors, management companies and risk departments can satisfy financial regulators in Europe that they have adequate risk monitoring procedures in place for the funds they manage or administer. The book will explain all the requirements for risk management under the new UCITS III regime as well as the universe of financial instruments that can be used by portfolio managers for their associated risks. The book can be used as a supportive document for portfolio managers and especially those hedge fund managers currently interested in launching UCITS products, fund administrators, board members, auditors, risk specialists, investors, lawyers, regulators, management companies and students in their endeavor to understand and comply with UCITS III requirements.