

UCITS DIRECTIVE

Unlocking greater freedom to develop assets

Stefano Pierantozzi, head of EMEA fiduciary oversight and research, at Citi unveils how investment theory developed in order to accommodate the idea of 130/30 strategies and how they can fit into the Ucits Directive. These strategies may not necessarily perform better than traditional ones, but they allow for greater freedom

In recent months the investment fund industry has been debating over how to bring together alternative investment strategies and retail products such as Ucits.

We analyse here how so-called '130/30 strategies' can fit into Ucits, and what these may imply for the asset manager.

Prior to analysing the pros and cons of so-called '130/30 investment funds', we should provide a definition of what these funds actually are.

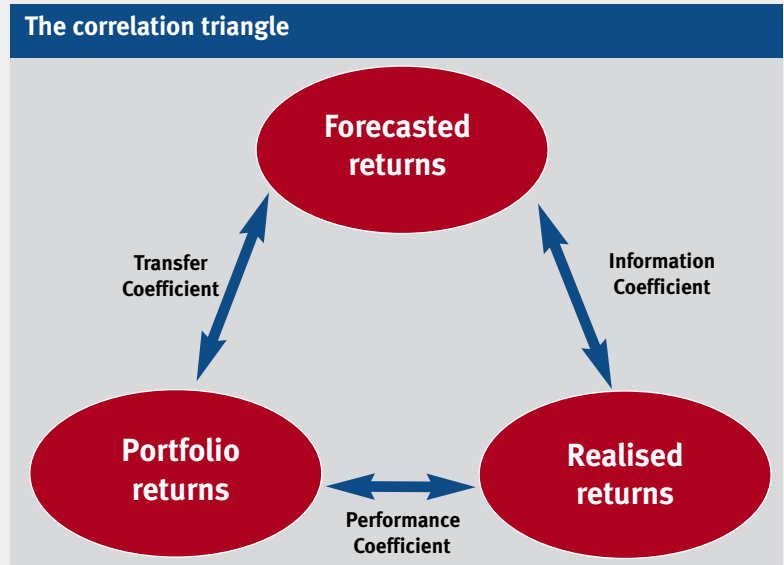
As no official definition exists, we will provide our own definition: a 130/30 investment fund is an investment fund which combines a long only equity portfolio (which could be defined as a 100/0) with an added 30 per cent leverage exposure on the long-side financed by a 30 per cent synthetic short sell.

SUPPORTING THEORY

In 1989, Richard R. Grinold published in the 'Journal of Portfolio Management' a paper entitled 'The fundamental law of portfolio management'.

According to Mr Grinold, excess portfolio returns (i.e. excess over the portfolio's benchmark) are a positive function of the number of independent forecasts (M) made by the portfolio manager and the square of the portfolio manager's skills in making these forecasts (c), hence the fundamental law: $\text{Excess Returns} = Mc^2$.

The fundamental law suggests that a basic flaw could exist in traditional investment fund management techniques: if a portfolio performance is so heavily influenced by the actual execution of the forecasts (c),



is the performance of an investment fund negatively impacted by the fact that the portfolio manager has to comply with strict investment restrictions, and hence cannot put in practice all his/her forecasts?

This issue was further examined in 2001 by R. Clarke, H. de Silva and S. Thorley in a paper, entitled 'Portfolio constraints and the fundamental law of active management', aiming at identifying the impact of constraints such as prohibition of short selling and concentration limits in the selection of optimal portfolio positions.

The basis of their analysis was 'the correlation triangle', which shows that the correlation between a portfolio's forecasted and realised returns are a function of the portfolio manager's forecasting skills (which they define as 'information coefficient').

The correlation between forecasted returns and actual portfolio weights is a function of the degree to

which the portfolio manager's insights are actually applied, or transferred in, the portfolio, hence the name 'transfer coefficient' (TC). Finally, the 'performance coefficient', at the base of the triangle, is the value added by the portfolio manager. (The degree to which the weight placed on individual stocks by the portfolio manager match up with the actual performance of these stocks.)

Hence, they produced a 'generalised fundamental law', expressed as follows: $PC = TC \cdot IC$.

This states: "The expected correlation of active weights to realised returns (PC) is equal to the correlation of active weights to forecasted returns (TC) times the expected correlation of forecasted returns to realised returns (IC)".

In their paper, Clarke, de Silva and Thorley analysed different portfolio strategies against the S&P 500 benchmark, with the purpose of identifying the influence of con-

straints (or in the investment fund world, investment restrictions) on the performance of a portfolio.

Additional analysis and optimisation studies carried out in following years suggest that for portfolios with a small tracking error, allowing for even a small portion of short sales can significantly improve a portfolio's transfer coefficient and hence, allow the portfolio manager to put into practice what he/she determines as the optimal portfolio allocation.

In particular, R. Clarke, H. de Silva and S. Sapra analysed, in their 2004 article entitled 'Towards more information-efficient portfolios' a series of geared portfolios against a long-only strategy.

Their article suggests that higher tracking error strategies are better off (i.e. the transfer coefficient is higher) if they allow higher levels of shorting. On the basis of their analysis, for example, for a portfolio with a 1 per cent tracking error, a 120/20 strategy seems to be providing the highest transfer coefficient while for a 1.5 per cent tracking error, a 130/30 strategy seems more suitable. These figures should not be taken as a recommendation or advice, since they are based on the analysis of historical data.

PUTTING YOUR STRATEGY INTO PRACTICE – IS SHORT SELLING POSSIBLE IN A UCITS?

True, short selling is not permitted in a UCIT. The question is how can a UCITS portfolio manager can increase his/her transfer coefficient if short selling is not allowed under the UCITS framework?

The European Commission's (EC) Recommendation of 27 April 2004 on the use of financial derivative instruments for UCITS (2004/383/EC, the 'EC Recommendation'), allows for the creation of synthetic short positions under UCITS.

Article 7.3 of the EC Recommendation states that "where the financial derivative instrument is cash-settled [...] Member States should consider allowing UCITS not to

hold the specific underlying instrument as a cover". Under these circumstances, alternative acceptable cover includes cash, liquid debt instruments, or other categories of highly liquid asset.

A fund portfolio manager willing to create a synthetic short equity position could buy a put option on a particular stock and just hold cash as cover instead of the underlying security. This would create a synthetic short position, substantially equivalent to a short sale.

The same fund portfolio manager could increase the fund's leverage on the long side, increasing its exposure to other stocks or to an index (buying call options, or futures for instance), and hence replicate de facto a long/short strategy.

However there is the possibility that such a strategy could incur relevant transactional costs, most of all if the short positions (and additional investment) are made on single stocks rather than on a basket of stocks.

Alternatively, the fund portfolio manager could make use of equity swaps (usually on a consistent basket of stocks or an index of stocks rather than on single stocks). For example, a portfolio manager of an equity fund tracking a particular stock index may decide to short sell the entire small cap sector and gain additional exposure to blue chip companies (providing it is inline with the investment fund's rules).

REBALANCING THE PORTFOLIO

One of the typical issues a portfolio manager of an index-tracking fund with a 130/30 investment strategy may experience is how to rebalance the portfolio and follow the underlying index weighting. While this may be easier in the case of short/long positions on single stocks, the same result may be more difficult to achieve with short/long positions on a basket of stocks.

Due to the number and complexity of derivative instrument transactions required to construct an effective 130/30 investment fund, the

involvement of one or more counterparties is often recommended.

RISK AND COMPLIANCE CONSIDERATIONS

Would a UCITS adopting a 130/30 investment strategy be considered a 'sophisticated' UCITS or not? This is a matter for discussion with the applicable regulator, and much will depend upon the complexity of the transactions used to achieve the investment strategy.

We consider it likely that a UCITS adopting a 130/30 investment strategy will be considered 'sophisticated', and so the fund portfolio manager may have to ensure that a robust Risk Management Process (RMP) is in place.

Some additional considerations are required in terms of compliance with UCITS, with investment limits in general, and in particular to the investment guidelines associated with derivatives instruments.

- The first consideration is around the nature of the financial derivative instruments used to obtain the synthetic short and synthetic long positions, i.e. is the derivative an eligible asset under the rules, as it is possible that over-the-counter (OTC) financial derivative instruments may be used.

It is key to note here that under Article 19(1)(g) of the amended Directive 85/611/EEC (the UCITS Directive), a UCITS may invest in OTC derivatives as long as those are "subject to reliable and verifiable valuation on a daily basis and can be sold, liquidated or closed by an offsetting transaction at any time at their fair value at the UCITS initiative".

The counterparty needs to be subject to prudent supervision. The work carried out by the Committee of European Securities Regulators (CESR) and the EC in terms of eligible assets for UCITS investment has helped further clarifying the above requirements.

In particular, the recently published Eligible Assets Directive clarifies that "reliable and verifiable valuation" shall be understood as a ref-

erence to a valuation which fulfils both the following criteria:

- a) The basis for the valuation is either a reliable up-to-date market value of the instrument, or, if such value is not available, a pricing model using an adequate recognised methodology;
- b) Verification of the valuation is carried out by either an independent third party (which may not be the OTC derivative counterparty and must be equipped for such purpose) or a unit within the Ucits, which is independent from the department in charge of managing the assets.

The rationale for imposing both a valuation and an independent verification of the valuation of OTC derivatives lies in the combined reading of articles 19(g) and 21(1) of the Ucits Directive (on investment policies, and risk management process respectively).

For a more detailed analysis, we recommend you review the recently published Eligible Assets Directive.

● Another thing to consider is that if an additional 30 per cent long and 30 per cent short exposure is required to create a 130/30 portfolio, particular attention should be paid at ensuring that counterparty exposure and risk concentration limits are complied with.

● Fortunately, the previous reference to the EC recommendation provides that Member States should allow Ucits to net their OTC derivative positions, only if made "vis-à-vis the same counterparty".

Furthermore, with reference to counterparty risk concentration, the EC Recommendation states in article 5.4.2, that "the exposure to counter-

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party risk on a given entity, respectively group, after taking into account any collateral received from that entity, or group, may not be higher than the 20 per cent limit" as also defined in the Ucits directive.

This should not cause material concerns for OTC equity swap contracts, where collateral is normally used to offset the expected mark to market exposure of the transaction.

The use of collateral, however, does not eliminate all risks, and actually entails legal, custody, operational and funding liquidity risks.

The more intensively collateralisation is applied, the higher the funding liquidity risk may become, especially where large market movements can affect both the exposures of OTC derivatives, and the value of collateral posted (depending upon its nature).

● Some final thoughts relate to the requirement for the investment fund manager to look through the derivatives instruments used for creating the synthetic long-short position.

Article 21 of the Ucits Directive provides that financial derivatives

instruments are eligible for investment, however the exposure to the underlying assets must be accounted for, when calculating investment restrictions limits.

This means that any financial derivative instrument used must be 'unbundled' and all its underlying instruments identified and taken into account when considering compliance with spread and concentration requirements. This requires effective and sophisticated investment compliance tools, and cannot be managed on a manual basis. Such unbundling requirements may however not apply to derivatives on an appropriate index, as further stated under the same article 21 of the Ucits Directive and in article 6.2 of the EC Recommendation.

CONCLUSIONS

There are a few things to consider. The first one is that 130/30 Ucits are not a new product, but only an implementation of an existing one – just like would be a 120/20 Ucits, a 140/40 Ucits and so on. Hence, these products are often referred to as "1X0/X0" investment funds.

Another consideration is that the theory does not suggest that a 130/30 strategy performs better than a 100/0 one. It merely suggests that the ability to short sell increases an investment fund manager's transfer coefficient, i.e. his/her freedom to manage assets.

The importance of implementing a robust risk control system to monitor and report on any deviations from counterparty and investment restrictions as well as assisting in monitoring the 130/30 strategy closely are a necessity.

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STATEMENT**



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