

The UCITS III opportunity for fixed income investors

The increased investment powers allowed within UCITS III have given fund managers a far broader toolkit. Fixed income managers now have the ability to focus more on the generation of absolute returns within a less constrained universe.

So what exactly are these new powers and why have they generated so much excitement? The key is the usage of derivatives. Under UCITS III a sophisticated fund has the ability to put on short selling strategies via the use of derivatives. This means they can position their fund to profit when bond prices are falling, either in an absolute or a relative sense. This ability to implement a negative market view opens up the range of investment opportunities. This is particularly true in credit markets where the risks are asymmetrical: the potential loss on a corporate bond or emerging market bond is greater than the possible gain. The ability to express negative views on these instruments reverses this asymmetry in favour of the investor. Any fund seeking to generate absolute returns in both rising and falling markets needs to have this flexibility.

UCITS III also allows the use of leverage, or gearing. Used sensibly, leverage can increase portfolio diversification and allow relative value strategies, which are typically low risk in nature, to make a meaningful contribution to performance. For example, it currently costs more to insure against a default (using credit default swaps or CDS) of Marks & Spencer over the next five years than it does over the next ten. If we think this differential may change we can look to profit from it. However, in order to allow trades such as this, where we are looking for moves of just a few basis points, to have an impact on performance, you need to invest a meaningful amount into the strategy. Furthermore this strategy is “market neutral” in that the overall direction of the corporate bond market or even the retail sector has no impact. Incorporating these ideas into a fund alongside views on market direction increases its diversification and leads to a better risk profile.

Moreover, the performance of traditional bond funds is dominated by the manager’s ability to predict whether bond yields are going to rise or fall – his duration decision. Using leverage to allow micro type strategies to contribute to returns is one way of reducing the dependence on getting this one market bet right, and allowing a host of other strategies to contribute to returns.

Derivatives can also be used to hedge out unwanted exposures, or to create more targeted or alpha focused positions. The case of Marks and Spencer above is one such strategy. In another example we purchased a new issue from South Africa. What attracted us to the bond was the fact that it was very cheap compared to South Africa’s existing bonds. So we bought the new issue and used derivatives to remove, or hedge out, the country risk associated with South Africa, the interest rate risk and the currency risk. We were left with the cheapness of this bond relative to South Africa’s other issues. If subsequently some negative political or economic news caused South Africa’s bonds to sell off, our trade would not have been affected.

Both leverage and derivatives have had negative press in recent times. Hedge funds and other highly geared investors have been forced to unwind positions, either because they have lost a lot of money, or because their banks have reduced the amount they are prepared to lend them. Derivatives have been blamed for causing extra market volatility and their use to hedge positions in the underlying physical bond market has at times not worked.

This does not mean that either leverage or derivatives are risky or dangerous per se. They both need to be used sensibly. Indeed, the example above shows how leverage can be used to diversify risk within a fund.

It is worth digressing here to look at what we mean by risk within a bond fund in any case. Bond risk is typically measured by duration, or a bond's sensitivity to moves in the market. The longer the duration the more your bond price will move as yields go up and down. A ten year bond has a duration of around seven years, while a two year bond has a duration of 1.75 years, or a quarter of that of the ten year. You could therefore put four times more money into the two year bond, or be four times geared, before reaching the level of risk associated with the ten year. This is a simplified example but it illustrates that using leverage does not have to mean taking on more risk.

Likewise, it is not derivatives that are risky but how they are used. They have hugely increased a manager's opportunity set, allowing them to profit from the downside in markets, to hedge out unwanted exposures, or to apply low risk relative value strategies. The lesson learned by many last summer was that hedging a physical bond position with a credit default swap or derivative based index does not always work. Back then, investors were selling corporate bonds to raise cash so prices were falling. Many managers had sought to protect their corporate bond portfolios by using credit derivative indices to hedge, or reduce, market exposure. However, these derivative indices were not affected by the liquidity problems. So, as the market for physical bonds fell, the indices (where they had gone "short") actually rallied. The result was double losses.

Since then many managers have adapted the way they manage their corporate bond market exposures. But the fact that the derivatives market remains more liquid than the corporate bond market and that it facilitates so many different types of investment strategy represents an ongoing source of interesting investment ideas.

Moreover, we are talking about using leverage and derivatives within the UCITS III environment. Alongside the increased investment powers, the regulator has imposed a rigorous risk management structure. This requires daily reporting of the VAR (Value at Risk) on each instrument held in a fund, along with sensible limits on exposures. Indeed, being successful as a UCITS III manager is not just about having experience in making sensible use of short selling strategies and leverage, it is also about having the right risk systems in place. Without a risk system that can provide daily reporting on complex derivative structures, a manager will be constrained in his ability to exploit the UCITS III investment powers.

This article has focused on the additional capabilities allowed by UCITS III. These powers are important because they allow investment managers to create more robust bond funds that are better diversified and able to make money in both positive and negative markets. And this of course brings us to the Absolute Return fund concept.

This universe is very broad, with different types of fund structure and differing levels of manager success. However, one key question for your manager should be about the extent to which he has adopted sophisticated UCITS III. If you are looking for a robust well diversified fund that really can deliver absolute returns, then it will almost certainly need to be one that is fully exploiting the UCITS III opportunity.

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*28 April 2008
This article first appeared in Investment Week*