

BlackRock Strategic Funds

Employing the wider powers of UCITS III

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The BlackRock Strategic Funds (BSF) range has been designed to utilise some of the wider investment strategies available under the UCITS III regulations. This flyer gives an overview of UCITS III and what it means for investors.

Background to UCITS III

UCITS stands for Undertakings in Collective Investment in Transferable Securities, which is a European Union (EU) directive dating back to 1985. The basic premise underpinning the legislation is to provide a common regulatory framework, allowing investment funds to be marketed cross-border within the EU.

The regulations have evolved to allow for the inclusion of more specialised investment products and in 2002 the directive was amended into what is now commonly known as UCITS III. Funds had five years to make adjustments to meet the UCITS III requirements. That deadline was in February 2007.

What does UCITS III mean for BlackRock Strategic Funds?

The biggest single change with UCITS III is an ability to use financial derivative instruments for genuine investment purposes. Previously, UCITS funds were largely restricted to only using derivatives for efficient portfolio management purposes, for example, hedging. The BSF range features funds which, together with traditional investment techniques, utilise derivatives to provide both absolute return and relative return focused funds. Each fund has a specific investment mandate governing how the wider UCITS III investment strategies are employed but these could include a combination of the following:

- ▶ Traditional long-only investing
- ▶ Synthetic short investing
- ▶ Pair trades
- ▶ Cash as an asset allocation tool rather than as a short-term holding

A key investment focus for some of the funds in the BSF range is the generation of enhanced 'alpha' from the stock-picking talents of BlackRock's investment professionals. Where once these types of products would have been the preserve of hedge funds and high net worth individuals, UCITS III has enabled these more flexible strategies to be available within regulated funds to the wider retail market.

The ability to invest on a synthetic short basis allows funds to pursue a positive return from a wider range of opportunities than a traditional long-only fund. These funds can make money by picking stocks that subsequently rise in value. However, if the fund manager believes a stock will fall in price, he/she can only add value by avoiding it. By contrast, funds employing synthetic short investing are able to turn stocks that they expect to fall in value into potential money-making opportunities.

Chart 1: Traditional investing

Generate returns from rising stock prices
Avoid falling stocks

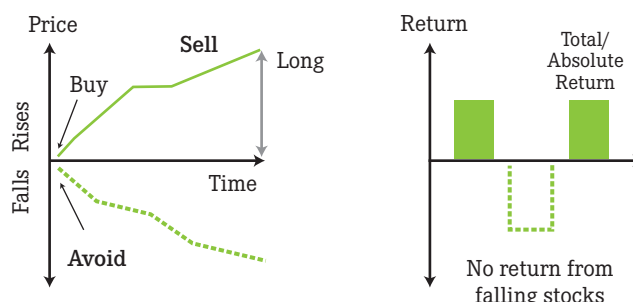
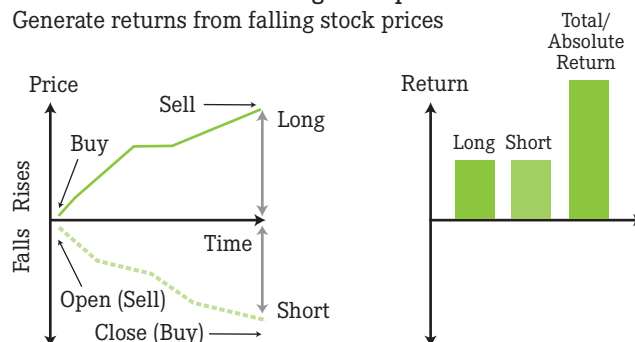


Chart 2: Long/short investing

Generate returns from rising stock prices
Generate returns from falling stock prices



Therefore fund managers utilising some of the wider investment strategies of UCITS III have the potential to add additional value when compared to a traditional long-only portfolio.

How are these investment strategies employed?

- ▶ Traditional long-only investing is the usual route employed by fund managers where they invest in a stock they believe will increase in value in the future.
- ▶ Synthetic short investing is employed when a fund manager believes a stock will fall in value (for absolute return funds) or underperform a benchmark (for relative return funds). As UCITS regulations do not permit the physical short selling of securities, portfolios can 'synthetic' short invest via derivatives: for example cash settled Contracts for Difference (CFD), although similar derivative instruments can be used. CFDs allow the full participation in the price performance of a stock but without taking actual ownership. To comply with UCITS regulations, funds must ensure they have sufficient cash to cover their open 'short' investments.

- ▶ Pair trades are a combination of long and short investments. They are often used to neutralise an element of market risk as well as to make profits from astute stock picking. For example, if we decide that Oil Company A is a very good investment, but think the reverse of Oil Company B, we can agree to buy shares (go long) in Company A and sell shares (go short) in Company B. As both are in the same industry, by buying stocks in one oil company and selling another, we remove a large degree of market exposure. Instead, we are exploiting the expected differential of performance between the two investments. The perfect result would be that Company A goes up in value and Company B falls, resulting in a good profit. Furthermore, the money-making opportunity for this strategy is not limited to this. To make money, Company A simply needs to outperform Company B, regardless of whether the market is falling or rising. Therefore, so long as their stock selection is successful, it is possible for the manager of this type of fund to make profits from their stock picking skills, whatever the prevailing market conditions.
- ▶ Cash can also be employed by some funds within the range as a tactical investment by switching up to 100% of their portfolio into cash at any given time, if considered appropriate with regard to the prevailing market conditions.

Risk Controls

UCITS III funds are required to employ a risk management process that is appropriate to the complexity of the fund. This is especially the case when financial derivative instruments are used. The oversight function must be performed by a team independent of the investment management group. Within BlackRock this is a role performed by the Risk & Quantitative Analysis group. They conduct daily Value at Risk (VaR) analysis of each portfolio. ROA also performs both stress and back-testing on the portfolios. The full Risk Management Process is documented and is available on request.

What to look for when choosing a UCITS III fund

- ▶ For an active manager, proven stock-picking expertise is essential. The ability to pick stocks that are going to increase as well as those that will decrease is still dependent on a manager's stock-picking ability. The increased investment flexibility derived from using the wider investment strategies of UCITS III will not cover up any shortcomings in this area.
- ▶ Strong systems and risk management techniques are vital. Short investing adds another complex layer to the management of a portfolio. Without the systems or processes to manage this effectively, fund managers could be taking risks they are not fully aware of or not be able to effectively execute their trades.

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