UCITS Alternative Quarterly Industry Review – Q4 2010

INTRODUCTION

From Nice to Have to Must Have

The year 2010 will remain the most decisive year for the UCITS hedge funds industry to date. Over the last 12 months the alternative industry has evolved from a situation in which it was nice to have UCITS products to one in which one must have some to be competitive. Even though the EU Directive was originally designed to outline and harmonize public distribution, the majority of UCITS hedge fund promoters are actually only marginally targeting retail investors. The only exception today is probably the UK where numerous funds concentrate on the retail market through IFA networks. Promoters have realized that (former) offshore hedge funds investors are more and more requesting vehicles which offer a higher level of regulation and investor protection. They are also aware that part of their future evolution will be achieved via regulated products such as UCITS.

MARKET COMMENTARY

Funds and Asset Growth

The number of single UCITS hedge funds grew by 78% in 2010, increasing from 324 in January to 578 funds at the end of December. In terms of assets under management (AUM), the aggregate amount of money managed by UCITS hedge funds has grown from EUR 60.6 billion to EUR 92.2 billion during the same period, resulting in a progression of 52%. In terms of distribution of AUM, the 3 largest strategies account for 70% of the total assets managed into UCITS hedge funds. These strategies are Fixed Income, Macro and Long/Short Equity accounting for respectively 28%, 22% and 19% of the total AUM.

With respect to funds size half of UCITS hedge funds have less than EUR 50 million assets under management at the end of 2010. The 20 largest funds represent 40% of the total AUM. Larger funds are attracting the bigger part of the cake in terms of new assets. Several observations can be made with these figures. Firstly, despite a number of new launches, only a handful of funds are able to grow their funds above the EUR 100 million threshold. While being a UCITS fund offers numerous advantages in terms of visibility and investor interest, this qualification is not sufficient to make every new launch a success. To rapidly exceed EUR 100 million, the most important factors seem to be a specialized hedge funds sales team, the reputation of the manager and the size of the promoter. Indeed groups without

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experienced hedge funds sales teams – such as long only managers – seem to be less successful in asset raising than groups with existing experienced alternative specialists.

Investment Style and Geographical Exposure

At the end of 2010, 73% of all UCITS hedge funds managers are using a discretionary approach while 27% are using a systematic investment style. In terms of geographical exposure 65% of all UCITS hedge funds have a global geographical exposure while 24% focus on Europe, 4% on the UK and 3% on the US. It is important to precise that while the share of managers having a pure US exposure is small, the reality is quite different as the vast majority of the funds that have a global exposure have de facto exposure toward US markets.

Location of Funds and Managers

At the end of 2010, managers are mainly located in the UK (44%) followed by France and Germany with respectively 22% and 11%. As for their legal domicile, 49% of the funds are registered in Luxemburg, 19% in Ireland and 18% in France.

Liquidity of Funds

In December 2010, 85.4% of the funds are offering daily liquidity, 14% weekly liquidity and 0.5% bi-monthly liquidity. The picture is fairly similar from a year ago. The situation for funds of funds is quite different, as 53.1% are offering daily liquidity, 44.9% weekly and 2% bi-monthly liquidity.

Funds of Funds

Funds of UCITS hedge funds experienced a strong growth in 2010. The number of UCITS funds of hedge funds surged by 148% during the year, growing from 23 to 57 funds. In terms of AUM, the progression represents almost 200% to reach EUR 2.6 billion. The average size of funds of UCITS hedge funds is still relatively small. Only 12.3% (or 7 funds) have more than EUR 100 million in AUM. Even funds of funds launched by large financial groups seem to encounter some difficulties in raising assets beyond the captive customer base. We are however witnessing a strong activity among the fund of UCITS hedge funds providers. It seems that all the big players want to have a UCITS product within their offering. We expect this trend to continue in 2011. In terms of performance, the UCITS Alternative Fund of Funds Index finished the year just slightly negative at -0.33%. This follows a modest +1.64% in 2009. It seems that UCITS fund of funds managers still have to find their marks in order to fully exploit the UCITS hedge funds opportunities.

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UCITS HEDGE FUND PROMOTERS

Presently UCITS hedge funds promoters can be divided into 5 main groups:

Former Country specific promoters

Former country specific promoters are managers who were previously targeting investors exclusively from their own country. The lack of harmonized regulation was indeed drastically limiting trans-border market activities. By transforming their existing products into UCITS compliant funds, a huge new market is suddenly materializing for them. While a number of these groups still lack international distribution capabilities, they can often count on robust structures with long proven track records.

Offshore hedge funds group

Some hedge funds groups have rapidly identified the opportunity offered by the UCITS framework to expand their business - if not to enable it to survive the 2008 crisis. They often entered the market with reserves. For them having a UCITS compliant vehicle was more construed as insurance should the demand of offshore funds completely vanished than a real long term asset gathering opportunity. The year 2010 is a turning point to this respect as more and more offshore hedge funds groups are now using their UCITS funds not as a second tier product anymore but rather as their main driver for future growth.

Long only players

For the last few years, a number of long only asset managers have started to use the flexibility of the UCITS framework to launch absolute return version of their main long only products. While not every initiative was successful, a number of these managers have now become large players in the UCITS hedge fund space. They are now capitalizing on their experience by launching additional products.

Platform providers

A number of UCITS platforms are now available, with different levels of service. For the time being, it seems that the most successful ones are investment bank sponsored platforms. Their reputation and distribution capabilities allow them to attract the most successful managers. On the other hand, smaller platforms are playing an important role in the development of the UCITS hedge funds space by focusing on smaller more niche type of managers, therefore helping to increase the global UCITS hedge fund offering. From a manager perspective, teaming up with a platform provider allow them to enter the UCITS framework rapidly without having to set up their own – often heavy – infrastructure.

Newcomers

New hedge fund managers are more and more considering the UCITS framework as their main if not unique structure. They perceive that the best way to attract money is via regulated onshore products. This trend shall continue over the next years, despite the greater infrastructure required than for offshore funds.

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