2010 Key Trends in European Hedge Funds

Eurekahedge
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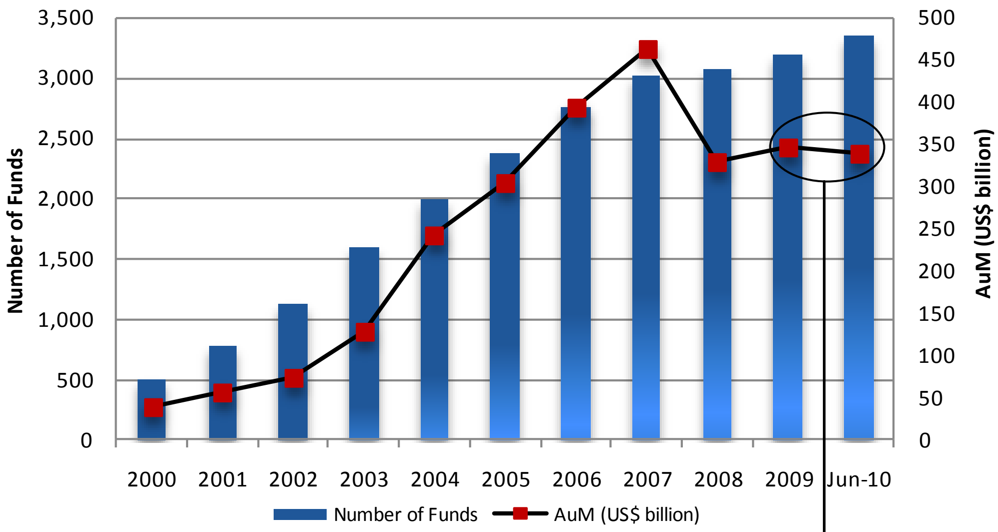
Introduction

While the European headlines in 2010 have been dominated by woeful tales of sovereign debt issues, the region's hedge funds have been delivering their mandated results by providing superior downturn protection and outperforming the underlying markets. The Eurekahedge European Hedge Fund Index is up 0.25% June YTD while the MSCI Europe Index has lost 8.56% over the same time.

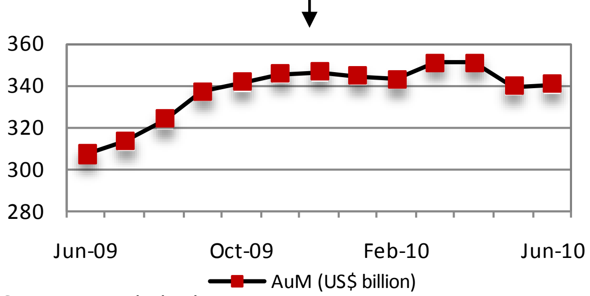
Currently, the size of the industry stands at US$340 billion, managed by a total of 3,401 funds. Figure 1 shows the growth trend in European hedge funds since December 1999.

Figure 1: Industry Growth over the Years



Source: Eurekahedge

The last 12 months have witnessed some remarkable movements in the European hedge fund industry. 2H2009 was marked by hefty asset flows as well as strong performances – the average European hedge fund returned 10% during this time. However, the start of 2010 marked yet another change in fortunes for the sector, with performance-based gains slowing down and asset flows turning negative. Concerns over the sovereign debt situation in Europe have dominated the markets, increasing risk aversion and leading to heightened volatility. Given the fickle nature of the markets in 1H2010, European managers have displayed a notable ability to protect investor assets while also delivering performance-based gains in falling markets.



Source: Eurekahedge

Industry Make-Up and Growth Trends

The following pages discuss the asset flows to the industry in greater detail while also looking at the changes in the industry over the years in terms of fund population, strategies employed, geographical mandates and manager locations.

Asset Flows

The European hedge fund industry reached its highest point in June 2008 with assets of US$472 billion before shrinking rapidly in the face of heightened volatility across all asset classes and massive redemptions in the latter half of 2008 and in 1Q2009. Redemptions in the last five months of 2008 alone accounted for US$100 billion, while performance-based losses of US$ 50 billion further added to the managers' troubles. The sector reached its trough at US$ 293.6 billion in March 2009 before climbing up again towards a remarkable recovery. The last nine months of 2009 saw managers post record returns while also attracting capital to bring the total assets under management back up to US$346.5 billion.

Since then, however, the net flows have been slightly negative due to increased risk aversion among investors and with marginal performance-based gains, the total assets have hovered around the US$340 billion mark.

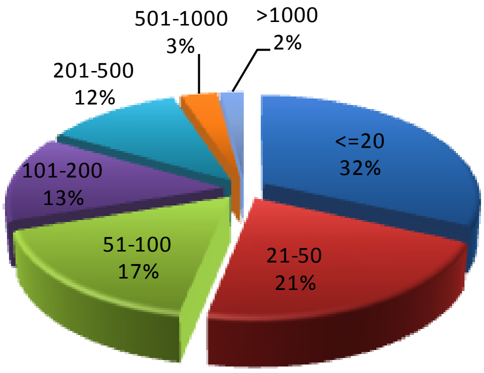
Table 1: Monthly Asset Flows across European Hedge Funds

Month	Net Growth (Perf)	Net Flows	Assets at End
Jan-08	(9.7)	(1.0)	453.6
Feb-08	8.6	0.1	462.3
Mar-08	(7.4)	5.7	460.5
Apr-08	3.6	(6.1)	458.0
May-08	7.8	0.3	466.1
Jun-08	0.0	6.3	472.4
Jul-08	(11.6)	3.6	464.4
Aug-08	(6.8)	(12.8)	444.8
Sep-08	(16.2)	(13.4)	415.2
Oct-08	(13.6)	(24.8)	376.9
Nov-08	(0.6)	(20.4)	355.9
Dec-08	0.0	(26.8)	329.1
2008	**(45.8)**	**(89.4)**	**329.1**
Jan-09	(0.2)	(20.5)	308.5
Feb-09	(0.7)	(10.3)	297.4
Mar-09	0.7	(4.5)	293.6
Apr-09	4.2	(3.9)	293.9
May-09	7.9	2.6	304.4
Jun-09	(1.3)	4.2	307.3
Jul-09	3.5	2.5	313.3
Aug-09	4.4	5.8	323.5
Sep-09	6.1	7.5	337.2
Oct-09	(1.7)	6.1	341.5
Nov-09	2.1	2.2	345.8
Dec-09	1.3	(0.6)	346.5
2009	**26.3**	**(8.9)**	**346.5**
Jan-10	0.3	(2.0)	344.8
Feb-10	(0.0)	(1.6)	343.1
Mar-10	7.2	1.1	351.5
Apr-10	1.8	(1.8)	351.4
May-10	(5.6)	(5.7)	340.0

Funds by Size

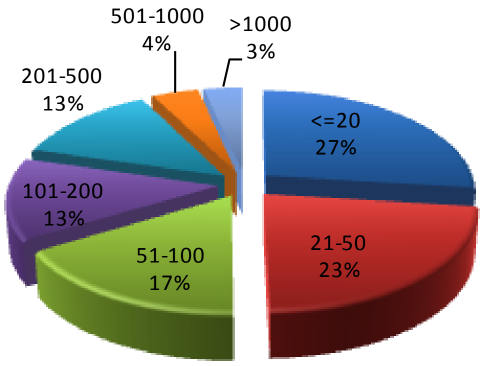
Figures 2a-2c: Breakdown of Hedge Funds by Fund Size

June 2005



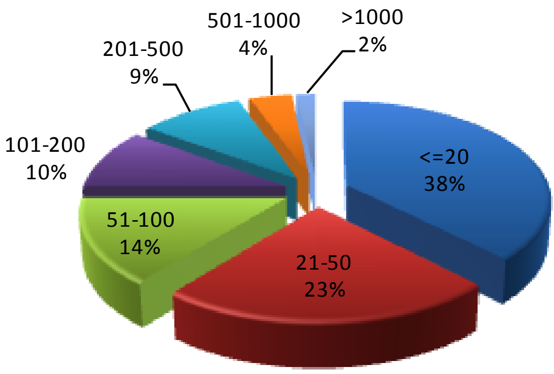
Source: Eurekahedge

June 2008



Source: Eurekahedge

June 2010



Source: Eurekahedge

The European hedge fund industry has gone through some notable changes over the last five years in terms of fund sizes, as shown in Figures 2a–2c. In the years preceding the financial crisis, growth in assets through capital inflows, as well as performance-based gains, translated into proportional changes in fund size distribution.

For example, the proportion of small funds with less than US$20 million decreased from 32% of that universe in June 2005 to 27% in June 2008. However, the subsequent losses and redemptions reversed this growth trend and currently, the number of European hedge funds with less than US$20 million stands at 38%. Additionally, new fund launches in the last 12 months have also served to increase this number while the average launch AuM of European hedge funds has also decreased (see Table 2).

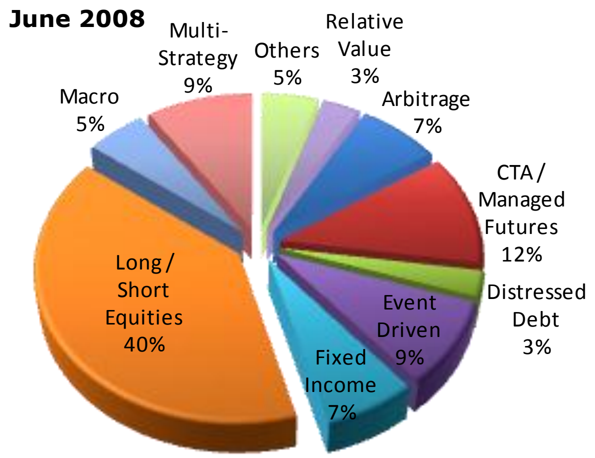
Similarly, the number of hedge funds with assets more than US$100 million made up 25% of the sector in 2005 and this number increased to account for more than 33% of the sector in 2008 as the funds grew in size over the years and hence, were "promoted" to the next AuM category. As of June 2010, this number is back to 2005 levels of 25% as the redemptions and performance losses also affected the larger funds. While 2009 saw some positive asset flows in the latter part of the year, they were not sustained in 1H2010 and have not been significant enough to offset previous declines.

It should also be mentioned here that a number of funds that closed down in 2008-2009 were those that had started in 2007 but fell short of reaching critical mass in the acceptable timeframe due to the credit crunch and the subsequent downturn. As such, although such funds might have reached a higher AuM level, failure to hit the required critical mass resulted in fund closures, hence, further altering the fund size breakdowns.

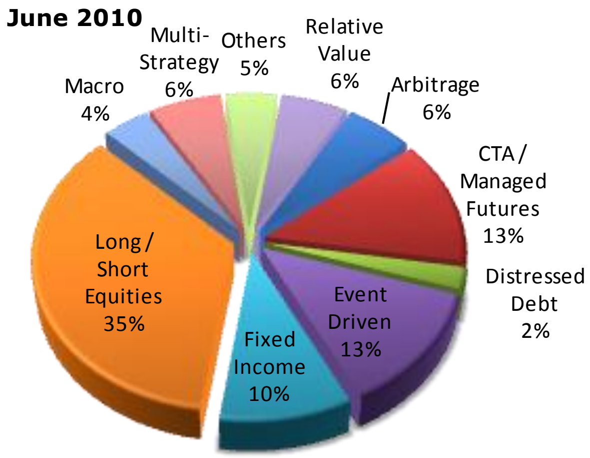
Strategic Mandates

The European hedge fund universe has also undergone significant changes in terms of the mix of strategic mandates. Being the hedge fund region which has undergone the most significant developments over the last few years, it is not surprising to see these movements affect the different strategies adopted by hedge fund managers in Europe.

Figures 3a-3c: Changes in the Strategic Mix of European Hedge Funds by Assets under Management



Source: Eurekahedge



Source: Eurekahedge

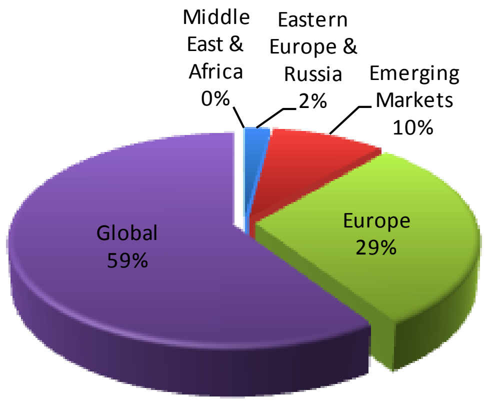
The most conspicuous change over the last five years has been the decrease in the share of assets in long/short equity funds, which decreased from 43% in June 2005 to 35% in June 2010. Although long/short equity is still the most popular strategy, it lost 8% market share through heavy losses seen in equity markets during the financial crisis. This was further aggravated by outflows from equity-based funds as investors looked for greater diversification and relatively less risky asset classes following the financial crisis. Additionally, the European hedge fund industry has rapidly matured in the last five years and other exotic asset classes have become available. As such, the proportion of new start-ups investing in equities has decreased while existing fund managers have also started to invest in new products.

However, in the subsequent recovery phase in 2009, we have seen an increase in allocations to event driven strategies which increased by 8% – most of it during the last 12 months. This is primarily because the financial crisis left a lot of firms in the lurch, thereby creating opportunities in spin-offs and the M&A space for larger firms to acquire cheap undervalued assets while restructurings and bankruptcies have offered prospects for the managers of this strategy to capitalise.

Geographical Mandates, Head Office Location and Fund Domicile

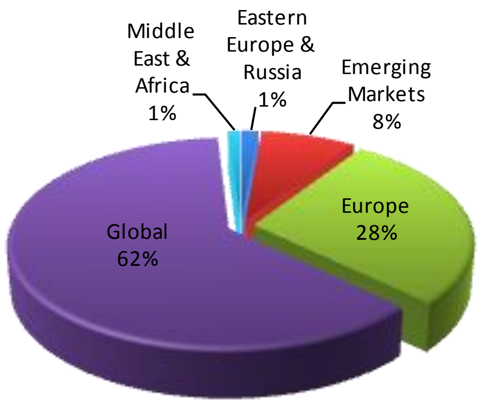
Figure 4: Geographic Mix of European Hedge Funds by Assets under Management

June 2005



Source: Eurekahedge

June 2010

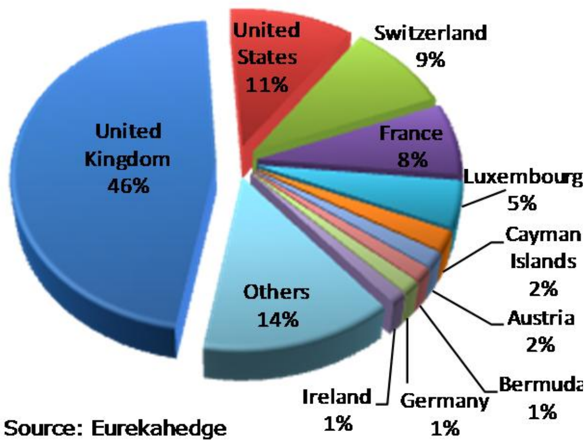


Source: Eurekahedge

The majority of European hedge fund assets operate with global investment mandate and this share has increased over the years to now account for 62% of the funds. This number is surprisingly large when compared with Europe-focused funds, which account for 28% of the assets. The reason behind this unusual large proportion of assets in global funds is that hedge funds, being an opportunistic asset class as compared with conventional asset managers like mutual funds, prefer not be restricted in terms of strategies employed, products used and the different kinds of markets accessed. As such, European fund assets are also distributed into other markets like the US, which is the largest hedge fund centre offering a wide range of instruments, and Asia, which has generated the greatest growth over the last few years.

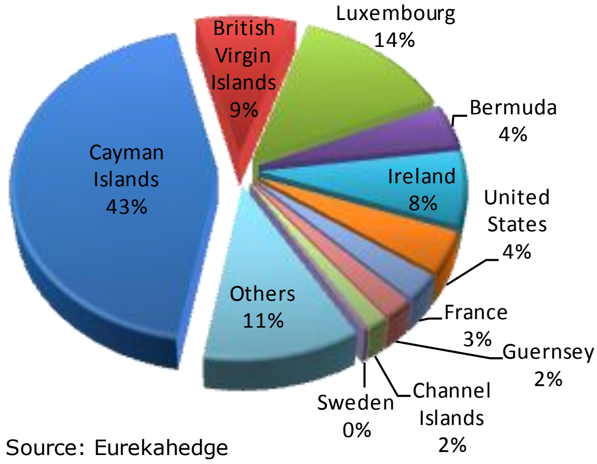
Figures 5a-5b: Head Office Location and Fund Domicile by Number of Funds

Head Office Location



Source: Eurekahedge

Domicile



Source: Eurekahedge

While the UK, the US and Switzerland continue to account for the majority of European hedge fund manager locations, the popularity of UCITS III hedge funds[1] post-2008 has seen France and Luxembourg increase their combined share from 5% of that universe to 13%. Since UCITS III funds are required to be domiciled in Europe, the share of Cayman Islands as the domicile of choice has decreased from more than 60% in 2008 to 43% as of June 2010.

New Developments in European Hedge Funds

The post-financial crisis landscape of European hedge funds has also seen a number of new developments and changes in other aspects of the industry which are discussed below.

Fund Launches and Launch-Assets under Management

The average start-up AuM of European hedge funds has shown a marked decrease in 2009 and 2010, when compared with the preceding years. The average start-up AuM fell from US$85 million in 2008 to US$34 billion in 2009 as liquidity dried up and investors shied away from hedge funds. Also, a number of fund start-ups in 2009 were launched by out-of-work investment bankers and as such, these funds were not a result of demand for hedge fund products in the market but rather, a manifestation of the large number of unemployed finance professionals. However, the strong launch activity seen in 2010 is accompanied by a simultaneous increase in the starting AuM of funds which has increased to US$49 million; however, some of this is also due to the popularity of UCITS III hedge funds, which are open to retail clients and hence, are able to target a previously untapped pool of investor money.

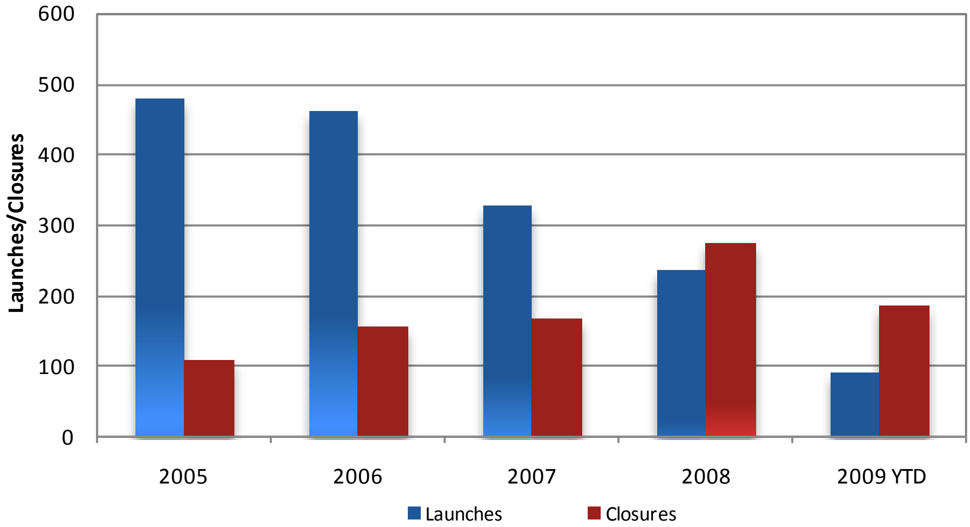
Table 2: Average Start-Up Assets under Management vs Current Assets under Management for European and Global Hedge Funds

	European Hedge Funds		Global Hedge Funds		North American Hedge Funds		Asian Hedge Fund	
Launch Year	Average Start-Up Size	Average Current AuM	Average Start-Up Size	Average Current AuM	Average Start-Up Size	Average Current AuM	Average Start-Up Size	Average Current AuM
2005	79	188	60	135	56	130	38	110
2006	63	134	41	99	41	92	29	74
2007	66	112	38	89	33	72	30	56
2008	85	111	30	97	27	96	19	38
2009	34	81	39	55	53	58	20	33
2010	49	47	31	28	34	36	20	17

Note: All figures are in US$ million.

[1] For more information on UCITS III hedge funds, please refer to the Eurekahedge Overview of 2009 Key Trends in UCITS III Hedge Funds report published in March 2010.

Figure 6: Launches and Liquidations across European Hedge Funds



Source: Eurekahedge

The UCITS phenomenon is also partially responsible for the high number of launches seen in Europe – about 280 hedge funds were launched in the first six months of 2010. As such, Europe accounts for more than half of the launches seen so far globally and this launch activity is the strongest on record.

Fees

While the management fees of European hedge funds have remained around 1.6%, the average performance fees have seen some changes over the years. Hedge funds launched so far in 2010 have an average performance fee of 16.35%, a further reduction from the average in 2009 and 2008. The decrease in performance fees indicates that some new managers have launched funds with lower fee structures in order to attract capital; however, most savvy hedge fund investors are still happy to pay 2/20 for funds that perform consistently well over time and in all market conditions. Table 3 gives the trend of average hedge fund fees since 2004.

Table 3: Fee Structure of European Hedge Funds

Year	Average Performance Fees (%) of Launches	Average Management Fees (%) of Launches
2004	19.41	1.59
2005	19.99	1.56
2006	18.60	1.61
2007	18.32	1.64
2008	17.58	1.59
2009	17.16	1.61
June 2010	16.35	1.62

Prime Brokers and Administrators

Tables 4a-4d showcase the changes in the service provider landscape of European hedge funds. The key trend here is the decrease in the share of prime brokers and administrators listed as "Others". We interpret this as a move towards quality service providers in the wake of the financial crisis and the subsequent demands for greater transparency and risk management by investors.

Tables 4a-4d: European Hedge Fund Service Providers

2010	
Prime Broker	**Market Share**
Morgan Stanley	18.73%
Goldman Sachs	17.09%
JP Morgan	10.80%
UBS	9.60%
Credit Suisse	9.09%
Deutsche Bank	9.07%
Barclays	7.15%
Citigroup	4.25%
Newedge Financial	3.17%
Bank of America (Merrill Lynch)	2.78%
Others	8.26%

2008	
Prime Broker	**Market Share**
Morgan Stanley	19.63%
Goldman Sachs	11.86%
JP Morgan	5.91%
Lehman Brothers	5.78%
Deutsche Bank	5.46%
UBS	5.11%
Newedge Financial	4.43%
Credit Suisse	3.65%
Bank of America (Merrill Lynch)	3.30%
Barclays	2.98%
Others	31.89%

2010	
Administrator	**Market Share**
CITCO	14.67%
Citibank	9.91%
GlobeOp	9.36%
HSBC	8.86%
BNP Paribas Fortis	4.46%
State Street	4.12%
JP Morgan	3.91%
PNC Global Investment Servicing	3.77%
Northern Trust	2.98%
Daiwa	2.94%
Others	35.01%

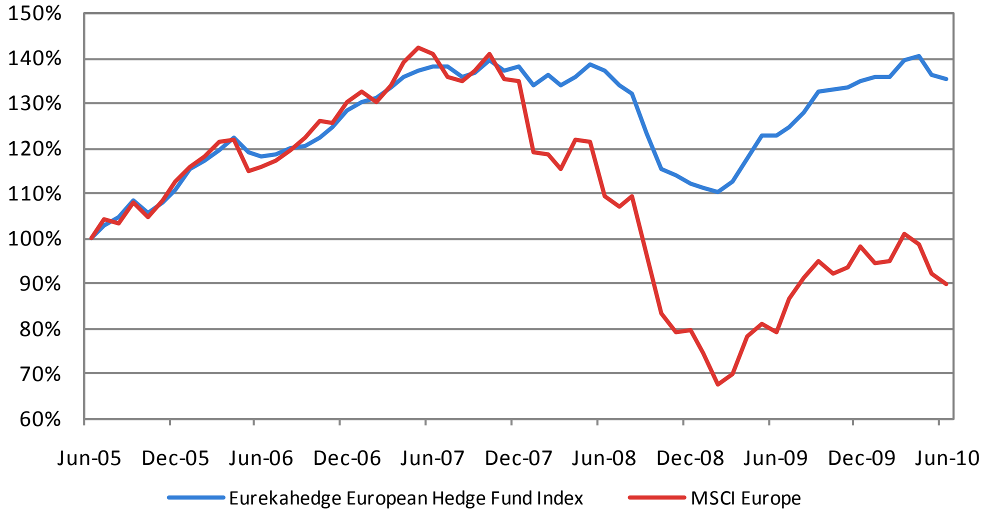
2008	
Administrator	**Market Share**
CITCO	14.36%
HSBC	14.16%
Citibank	10.87%
Northern Trust	5.66%
JP Morgan	5.21%
PNC Global Investment Servicing	4.77%
Morgan Stanley	4.21%
Custom House	3.73%
State Street	3.08%
Management International	2.81%
Others	31.15%

Note: The figures in Tables 4a-4b are based on data reported to the Eurekahedge databases by hedge funds themselves and not by prime brokers / administrators.

Performance Review

In this section, we discuss the performance of European hedge funds over the past few years, breaking it down in terms of different strategies employed and regional mandates of the funds. Figure 7 shows the performance of the Eurekahedge European Hedge Fund Index and the MSCI Europe Index over the last five years.

Figure 7: Performance of Eurekahedge European Hedge Fund Index vs MSCI Europe



Sources: Eurekahedge and MSCI

European hedge funds have not only outperformed the underlying markets over the last five years, but they also provided greater stability of returns. Since June 2005, the Eurekahedge European Hedge Fund Index is up 35.29% with an annualised volatility of 7.82% while MSCI Europe Index is down 10.13% with an annualised volatility of 17.11%. In the shorter term, over the last three years, European hedge funds delivered annualised returns of -0.76% while European stocks saw negative returns of -13.97%, signifying that hedge funds outperformed the underlying markets by 13.21% every year on average.

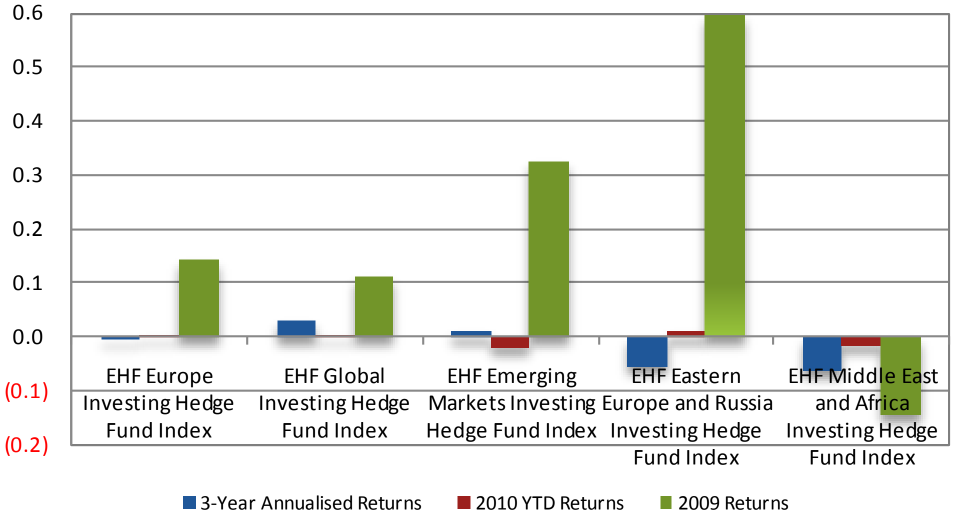
After delivering record returns in 2009, when the Eurekahedge European Hedge Fund Index gained 20.39%, the 2010 returns have been more muted, with the June YTD returns currently standing at 0.26%. However, against the backdrop of highly volatile markets, this once again represents an outperformance of more than 8% June YTD.

Table 5: Fee Structure of European Hedge Funds

	Eurekahedge European Hedge Fund Index	MSCI Europe
12-Month Returns	10.26%	13.27%
5-Year Annualised Returns	6.23%	-2.11%
5-Year Annualised Standard Deviation	7.82%	17.11%
Maximum Drawdown (5 Years)	-21.01%	-52.53%
2010 YTD Returns	0.26%	-8.57%
2009 Returns	20.39%	23.39%

Geographical Mandates Performance

Figure 8: Performance across Regional Mandates



Source: Eurekahedge

In terms of geographical mandates, European hedge funds allocating to Eastern Europe and Russia have delivered the best returns in 2010 with gains of 1.14% June YTD. The 2010 returns represent significant outperformance for the managers as the Eastern Europe markets are down 7.73% on average for the year[2]. Furthermore, the strong returns in 2009 (59.69%) and the 12-month rolling returns of 27.8% suggest that most managers focusing on the region are above their high-water marks which serves to prevent unnecessary risk-taking and as such, protect investor capital through the current market volatility.

Additionally, managers investing in the European markets also remain in positive territory June YTD. Despite the euro devaluation and the negative market sentiment due to the sovereign debt concerns, the performance of Europe-investing hedge funds has been very commendable. Their 2010 returns of 0.31% are ahead of the global hedge fund average of +0.01% as well as the underlying markets.

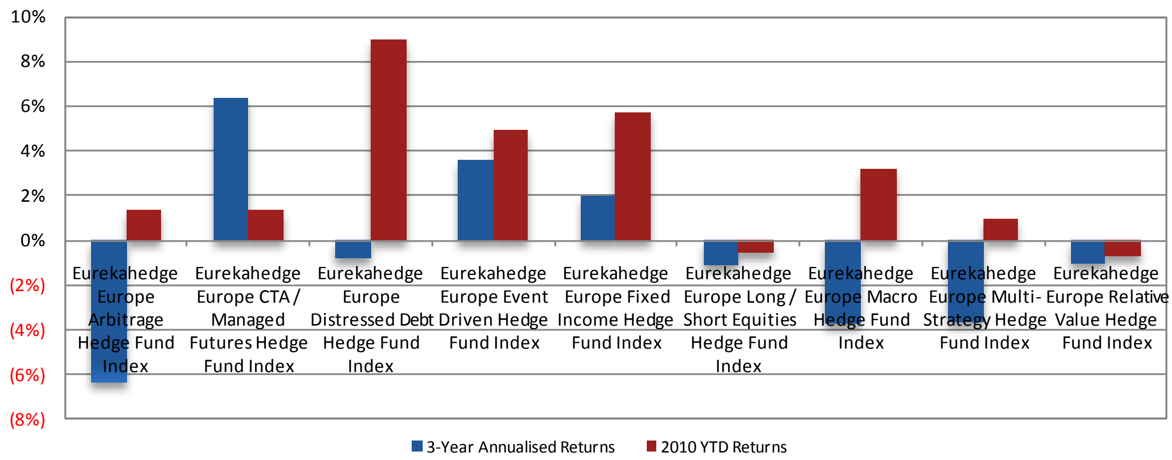
Table 6: Performance of European Hedge Funds by Regional Mandates

	Europe	Global	Emerging Markets	Eastern Europe and Russia	Middle East and Africa
12-Month Returns	7.65%	5.15%	10.13%	27.83%	-20.55%
3-Year Annualised Returns	-0.32%	2.85%	0.93%	-5.74%	-6.17%
Maximum Drawdown (3 Years)	-14.06%	-9.43%	-29.64%	-58.55%	-29.34%
2010 YTD Returns	0.31%	0.24%	-1.99%	1.14%	-1.65%
2009 Returns	14.26%	10.99%	32.54%	59.69%	-14.65%

[2] MSCI Eastern Europe and Russia Index

Strategic Mandates Performance

Figure 10: Performance across Strategic Mandates



Source: Eurekahedge

Most strategic mandates have delivered positive returns in the May 2010 YTD measure. Managers employing strategies in the fixed income sector have posted the best returns – the Eurekahedge Europe Distressed Debt Hedge Fund Index advanced 8.98% May YTD while the Eurekahedge Europe Fixed Income Hedge Funds Index rose 5.76%. Distressed debt managers have had a dream run since March 2009, delivering massive returns of 60.91% in the last 14 months. Throughout the last year, distressed debt managers found excellent opportunities to purchase the debt of high-quality corporate at discounted prices. Furthermore, their plays in emerging market sovereign issues were also highly profitable.

In the three-year annualised returns measure, CTA hedge funds have posted the best returns of 6.38%. Additionally, CTA managers have also been the most consistent over the last three years, with a Sharpe ratio of 0.41. The recent volatile environment in European markets has once again resulted in a favourable climate for CTA/managed futures funds as investors look for the diversification provided by broad mandated funds to ride out uncertain markets.

Table 7: Performance across Strategic Mandates

	Arbitrage	CTA/ Managed Futures	Distressed Debt	Event Driven	Fixed Income	Long/ Short Equities	Macro	Multi-Strategy	Relative Value
12-Month Returns	21.71%	0.35%	60.91%	21.05%	28.79%	19.97%	19.64%	17.67%	2.24%
3-Year Annualised Returns	-6.35%	6.38%	-0.81%	3.60%	1.98%	-1.12%	-3.69%	-3.66%	-1.00%
3-Year Annualised Standard Deviation	9.12%	5.81%	15.59%	8.60%	10.40%	8.94%	35.30%	11.84%	4.93%
Maximum Drawdown (3 Years)	-31.97%	-3.83%	-39.64%	-15.02%	-25.87%	-21.69%	-55.65%	-31.44%	-9.08%
2010 YTD Returns	1.34%	1.36%	8.98%	4.91%	5.76%	-0.55%	3.15%	0.99%	-0.72%
2009 Returns	11.31%	7.43%	33.61%	24.02%	28.56%	20.73%	61.49%	17.74%	0.77%