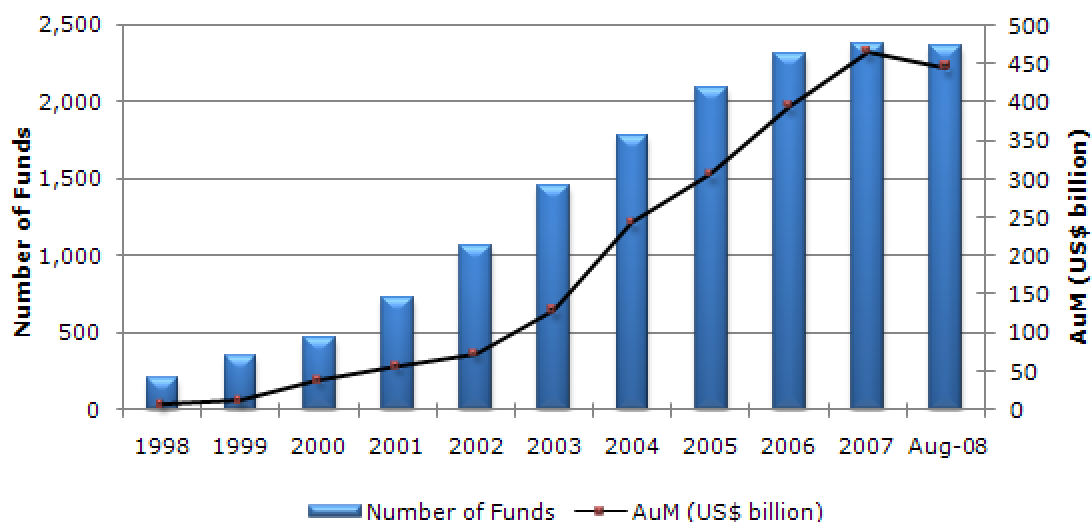
2008 Key Trends in European Hedge Funds

Eurekahedge

Introduction

The European hedge fund industry has grown at a rapid pace over the past decade, with an 11-fold increase in the number of funds and a handsome 60-fold increase in assets. Based on the information of 3,150[1] funds in the Eurekahedge European Hedge Fund Database, we estimate 2,361 operational hedge funds within the region's hedge fund space, managing assets to the tune of US$445 billion. The following graph charts the growth of the industry over the past decade.

Figure 1: Industry Growth over the Years



Source: Eurekahedge

A glance at Figure 1 shows a marginal decline in both the number of funds and assets within the region's hedge fund space during the first eight months of this year. Most, if not all of this decline can be explained by the recent movements in the underlying markets – high volatility across most asset classes, sharp drawdowns in the regions' equity markets, a severe dearth of liquidity over recent months and the near-collapse of several, large financial institutions, during the period.

This report aims to look into the current structure of the European hedge fund space, and analyse some of the structural changes that the industry has seen over the recent past. It also includes a comparative analysis of the performance of European hedge funds – both against their global peers as well as against other Europe-centric investment vehicles.

Industry Make-up and Growth Trends

Age and size

Among the first questions that crop up when discussing the structure and growth trends in the hedge fund industry, is about how the age and the size of a fund affect its performance. Do larger funds fare better than their smaller-sized counterparts? And, do older funds fare better than newer ones that have been launched relatively recently?

[1] Including 289 long-only absolute return funds and 729 obsolete funds.

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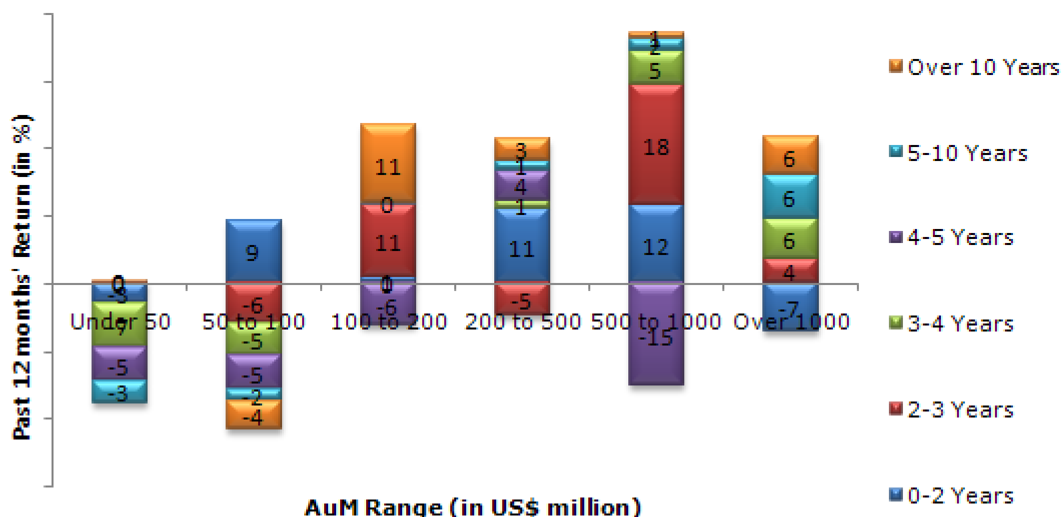
While the answers to such questions may vary from time to time, based on the movements in the underlying markets, among other factors, we will try and answer them based on the performance of European managers over the last 12-month period. The reason we are looking at their performance over the last 12 months, instead of, say, just this year-to-date or a two-year period, is because the 12 months would capture the performance of managers soon after the US subprime crises broke out.

Figure 2 illustrates the 12-month returns of European managers by age and size. The idea behind plotting both the variables on the same graph is not only to analyse the interdependence of the two factors, but also to be able to analyse the performance based on one factor, keeping the other constant. It is also important to note that each section in each vertical bar represents the average returns of that particular set of funds, and that the returns stated on the bars are not cumulative.

Figure 2: Last 12 months' Returns by Age and Size



Source: Eurekahedge

Having clarified all of that, we will look at some of the interesting observations that Figure 2 throws up. First of all, it shows that medium- to large-sized funds (AuM over US$100 million) have fared significantly better than their smaller-sized counterparts. This is partly because large funds have been in a better position to cater to redemption requests seen during the year, than smaller funds which often had to sell their holdings at their current market prices in order to raise cash for redemption payouts.

Secondly, many of the older, large-sized funds (over US$1 billion), which tend to be managed by experienced managers with proven track records, have considerably outperformed their newer, large-sized counterparts. This can be explained by the simple fact that experienced managers managing large sums of money are generally more cautious than younger managers, who often tend to take more aggressive calls on the markets and paying a heavy price for them.

However, some newer funds with US$50 million to US$1 billion in assets have posted healthy gains over the past 12 months. In some cases, these newer funds are managed by old, experienced managers who liquidate their over-sized, over-aged funds to start newer, smaller ones. In some other cases, some new funds tend to be conservative in their approach during volatile and uncertain times in the markets, and hence keep a significant portion of their capital in cash – (a) to minimise capital erosion, if at all; and (b) in order to meet redemption request, should there be any, without having to liquidate their positions to raise cash.

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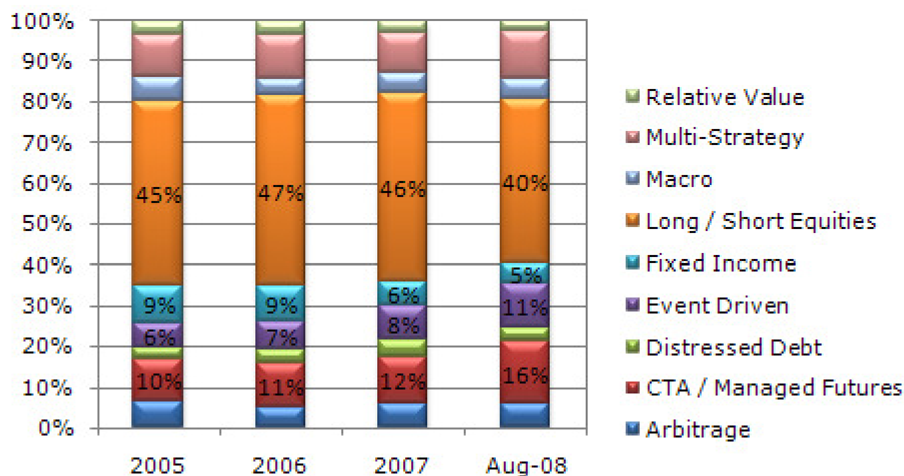
Investment style

In this section we look at changes in the market shares (in terms of AuM) of the investment strategies employed by European hedge funds, over the past three years. Figure 3 clearly shows that the composition of the industry has changed more during the first eight months of this year, than over the previous two years.

In terms of strategic mandates, many like arbitrage, relative value and distressed debt, among some others, have seen little or no change in their market shares over the 3-year period in question. This suggests that managers employing those strategies have seen their assets increase at a pace similar to that of the European hedge fund industry. However, some other strategies like long/short equities, CTA/managed futures, event driven and fixed income have seen a marked change in their market shares over the period under consideration.

CTAs have seen the largest change – an increase of 6% – in their share in percentage terms, since end-2005. Clearly, most of this change has taken place in 2008 on the back of both healthy returns (the Eurekahedge CTA/Managed Futures Hedge Fund Index[2] is up 9.8%) and net inflows into the strategy year-to-date. Likewise, event-driven managers in the region saw an increase in their share this year, on the back of decent performance during the first half of 2008. The Eurekahedge European Event Driven Hedge Fund Index, although negative for the year-to-August, returned 1.9% for 1H2008, and was up 5.7% between February 2008 and June 2008; events such as the confirmation of a takeover bid for Alltracel (a European drug/healthcare firm), among some others, afforded managers with decent opportunities during the period.

Figure 3: Change in the Strategic Mix of European Hedge Funds



Source: Eurekahedge

Long/short managers, on the other hand, saw a notable decline of 6% in their share in just eight months. This can be explained by the high volatility and sharp downturns in equities across the region, a slowing economy, a weak financial sector, a spike in inflation, among other factors, which took a toll on the performance of equity-investing managers in the region; the MSCI (All Countries) Europe Index shed 20.8% year-to-date, against which the Eurekahedge Europe Long/Short Equities Hedge Fund Index lost 5.7%.

Fixed income managers saw a drop of 4% in their share since end-2005, as rallying equity markets (particularly in 2006) and hence superior returns across long/short funds in 2006 and across CTAs from 2007 till-date, saw investors reallocate assets to higher yielding strategies during the period.

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[2] Referred to the Eurekahedge (Global) CTA/Managed Futures Hedge Fund Index since most CTAs allocating to Europe employ a 'Global' geographical mandate.

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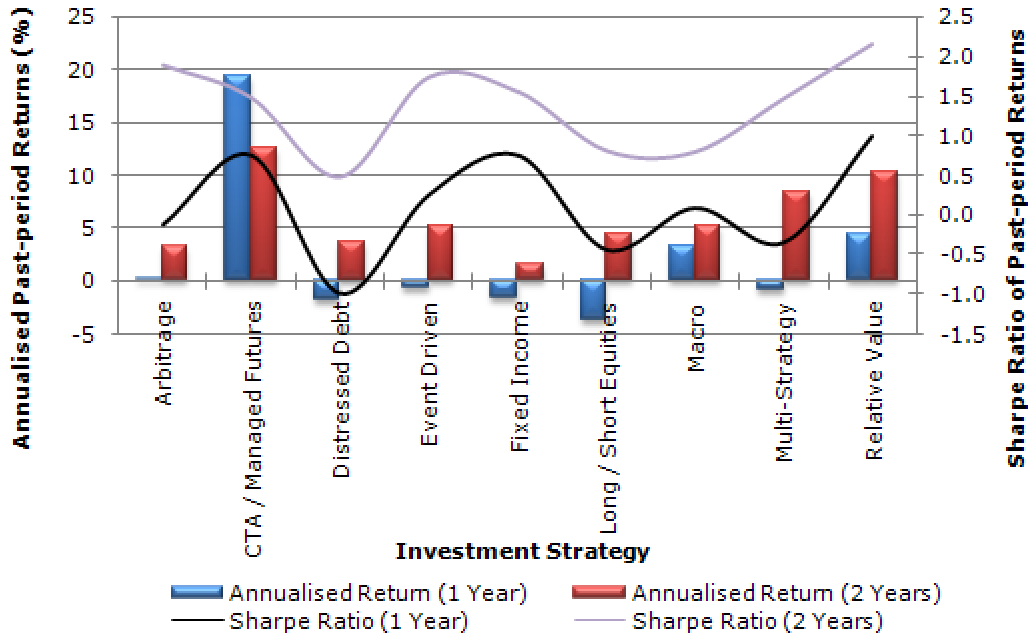
While this section of the review is mainly intended to cover the current structure and structural trends within the industry, we shall take a quick look at the strategy-wise performance of European managers, merely to further substantiate the aforementioned changes in the strategic mix of the industry.

Figure 4, below, clearly shows that long/short managers have seen negative returns over the last 12 months, while CTAs have recorded double-digit annualised returns both over a 12- and 24-month period.

Figure 4: Performance of Europe-Investing Funds by Strategic Mandate



Geographic mandate and head office location

What follows, is a similar comparison of the changes in the market shares of each of the geographic mandates employed by managers with exposure to Europe. In that context, Figure 4 throws up some interesting observations such as an increase in the market shares of broader mandates like Global and Emerging Markets, and a decrease in the shares of mandates with a relatively narrower geographic focus.

Global managers have seen a solid 5% increase in their share across the European hedge fund space over the past eight months, while pure Europe-investing funds saw their share of the pie fall by 5% during the same period. This marked change can be explained by the reallocation of investor capital from funds with narrow-focus mandates to those with broader mandates, in order to minimise risks associated with over-concentrating their investments across one (or relatively fewer) geographies, particularly during times of high volatility and uncertainty in the underlying markets.

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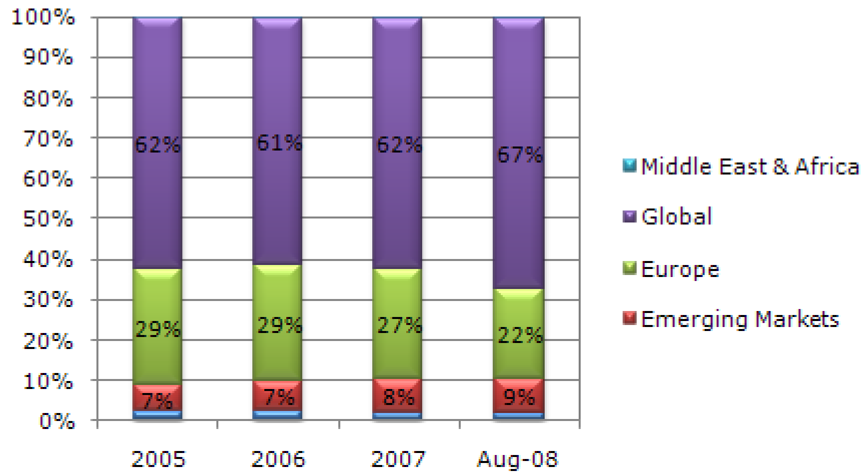
Figure 5: Change in the Geographic Mix of European Hedge Funds

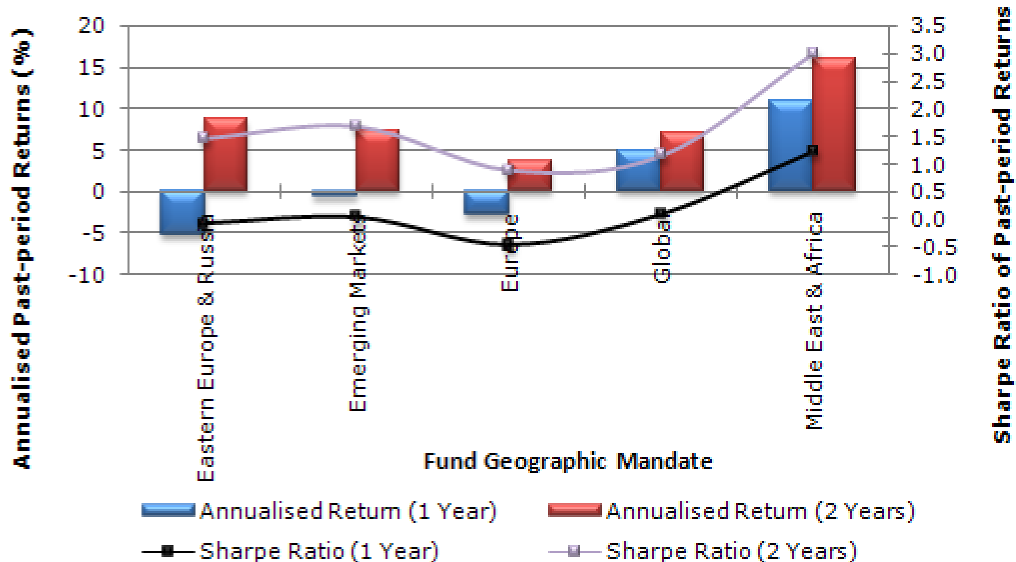


Source: Eurekahedge

Similarly, managers investing solely across Eastern Europe and Russia, who already make up a small fraction of the European hedge fund industry, lost a portion of their existing market share to funds that allocate to global emerging markets. On the whole, the first eight months of the year saw large amounts of fresh inflows of capital into global managers, as opposed to emerging market managers, since emerging markets across the board have taken a hit due to the sharp increases in energy prices (through 1H2008) coupled with slowing exports (particularly to Europe and North America).

These changes in the market shares of geographic mandates are also mirrored in the returns of managers employing each of these mandates. Figure 6 shows that emerging market managers have considerably outperformed those investing solely in Eastern Europe & Russia over the past one year, while global managers have outperformed pure Europe-investing funds both on a 12- and 24-month basis.

Figure 6: Performance of Europe-Investing Funds by Geographic Mandate



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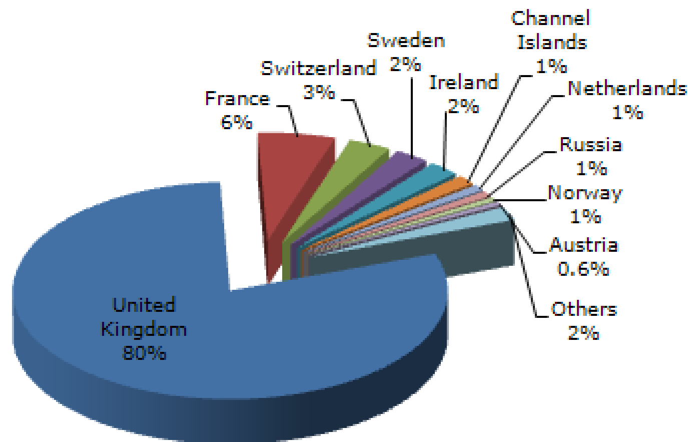
While we have seen significant changes in the composition of the European hedge fund space in terms of regional and strategic mandates, the industry compositions in terms of European head office locations has remained more or less unchanged. Figure 7 illustrates that the UK, similar to the case in our previous reports, continues to account for over three-quarters of the AuM of Europe-located, Europe-investing funds, with France being a distant second, accounting for 6%.

Figure 7: Breakdown of European Hedge Funds by European Head Office Locations



Source: Eurekahedge

Service Providers

This section provides a quick snapshot of the composition of service providers in the European hedge fund space. Figure 8 shows current breakdown of the administrators (by assets under administrations) of European hedge funds, and Figure 9 shows a similar breakdown for prime brokers (by assets under management) of funds that allocate to the region.

Figure 8: Market Shares of the Top 10 Administrators of European Hedge Funds

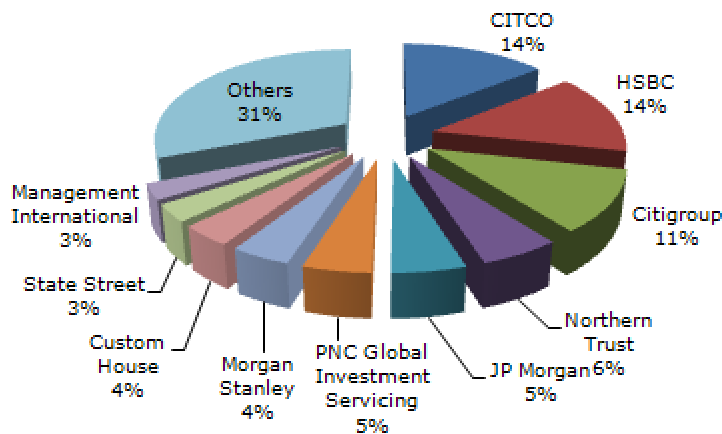


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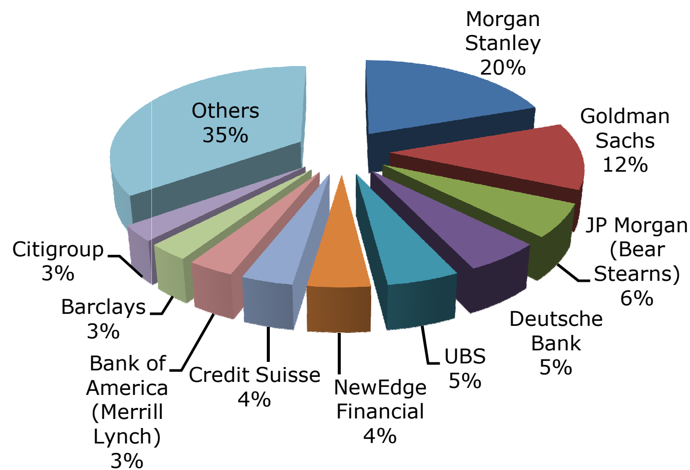
Figure 9: Market Shares of the Top 10 Prime Brokers of European Hedge Funds



Source: Eurekahedge

Performance Review

Having illustrated the 12- and 24-month returns across geographic and strategic mandates, we will compare the returns of European hedge funds versus those of funds investing across other regions in this section, and draw a comparison between the performances of different types of investment vehicles allocating to Europe. To this end, we have taken into account 36-month returns of hedge funds and other investment vehicles, so as to analyse their performance over a period that has seen both bull runs and bear phases in the underlying markets.

As a preface, we compared the performance of the Eurekahedge European Long/Short Equities Hedge Fund Index against that of an appropriate European equity market benchmark – the MSCI Europe index – over the period since the inception of the Eurekahedge index in December 1999 (Figure 10). While this does not quite account for the diversity of strategies and underlying asset classes among hedge fund allocations, it is still fairly representative, considering that equity-focused strategies currently make up close to 40% of the funds and assets allocating to Europe. As is evident from Figure 10, European hedge funds have seen very stable returns in sharply downward trending markets (December 1999 to April 2003), whereas in bullish markets, they have risen in step with, if not in excess of, underlying equities.

However, in 2008, hedge funds have fallen in tandem with the underlying markets, owing to the poor trading conditions – the slowing of economic growth, a dearth of liquidity, heightened inflationary pressures, high volatility in the equity markets, etc, all of which negatively impacted the performance of hedge fund managers.

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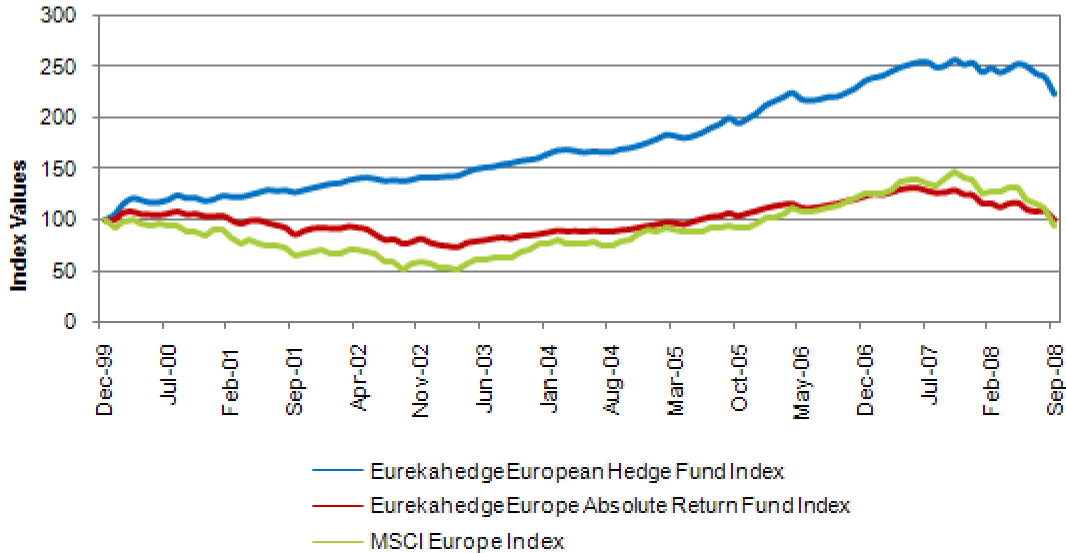
Figure 10: Index Performance Comparison

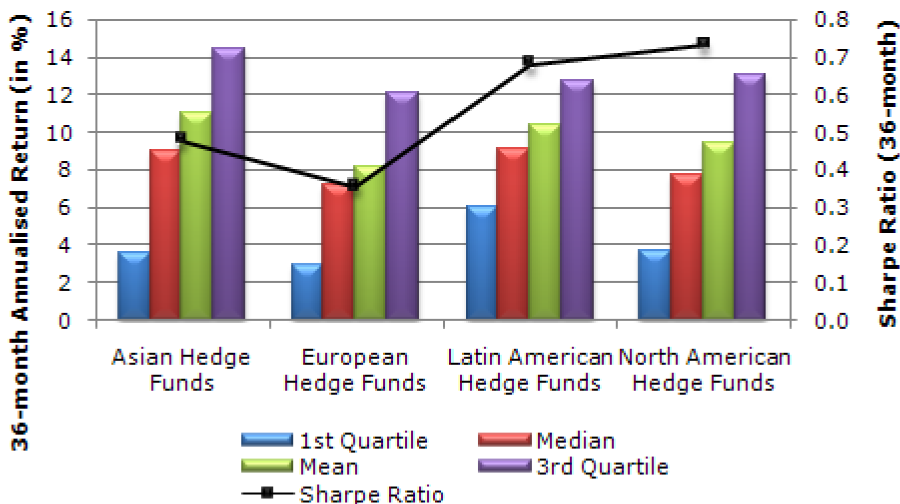


Source: Eurekahedge

Europe vs rest of the world

We have seen in previous sections of this write-up, how age, size and investment style can affect returns among European hedge funds. But were an investor to contemplate building a portfolio that comprises only hedge funds, would European funds be preferable to their counterparts in North America, Asia or Latin America? To answer this question, we compared the average returns (risk-adjusted and otherwise) as well as the quartile dispersion of returns, for each of the regional hedge fund spaces[3] over the past 12 months. It must be noted, though, that we have excluded onshore Latin American funds from this comparison, since most of them show highly inflated returns due to the strengthening of domestic currencies (in which they are denominated), during the period in question.

Figure 11: Mean and Quartile Returns across Regional Hedge Funds



Source: Eurekahedge

[3] In a survey of 619 Asian, 847 European, 111 Latin American and 1,302 North American hedge funds.

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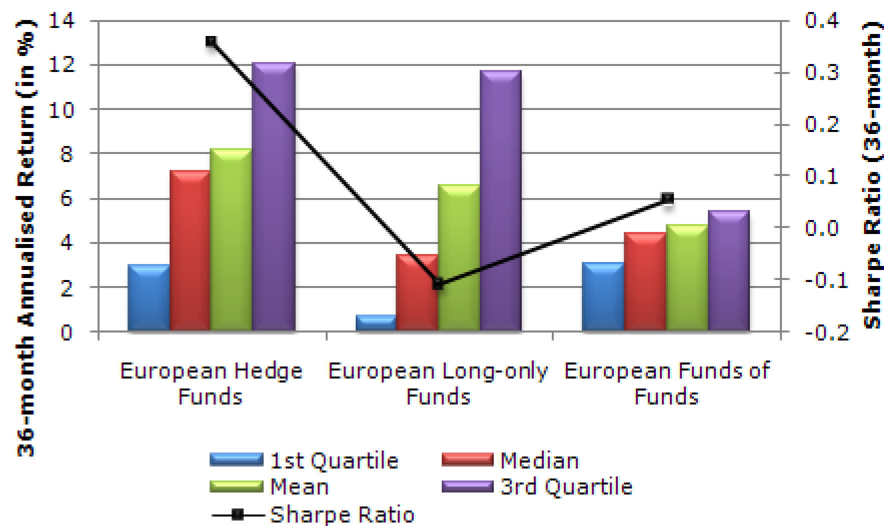
Figure 11 suggests that European hedge funds have underperformed their global peers on the basis of their 36-month annualised returns. This, to some extent, can be explained by the poor year-to-August returns of European funds, which have been further dragged down by managers allocating to Emerging Europe (the Eurekahedge Eastern Europe & Russia Hedge Fund Index has lost over 13% for the first eight months of the year). Furthermore, below-average returns in Europe through 2007, as the credit crisis that originated in the US spread into Europe, negatively impacting hedge fund performance also proved to be a drag on the 36-month returns for managers allocating to the region.

While Asian and Latin American managers have also taken a hit this year, owing to sharp drawdowns across their respective equity markets, among other things, impressive double-digit gains over the previous two years helped keep their 36-month annualised performance healthy. North American managers, on the other hand, had an exceptionally good eight months this year (being flat, over the period), despite a continuous flow of negative data and distress in the financial sector in the US, as regional hedge funds exploited currency and commodity trends within the region. This, coupled with consistent, double-digit returns in recent years helped them maintain a healthy 36-month average.

Hedge funds vs other alternatives

Although European hedge funds did not particularly stand out against their global peers, their performance is surely worthy of praise when contrasted against that of other Europe-focused investment vehicles.

Figure 12: Mean and Quartile Returns across European Alternative Investment Vehicles



Source: Eurekahedge

Figure 12 reveals that among Europe-focused investment vehicles, hedge funds have recorded the highest mean and median returns over the last 36 months, clearly highlighting their alpha generating potential. They also recorded a higher Sharpe ratio than both their long-only counterparts and funds of funds, implying higher (albeit marginally) returns realised relative to their volatility.

Funds of funds, on the other hand, recorded the least average returns (4.8%) on a 36-month annualised basis. While a portion of their underperformance can be attributed to the fact that a number of hedge funds themselves were negatively impacted by difficult trading conditions in the underlying markets, particularly over the last 12 months, some attribution can also be made to the fees they charge. The fees charged by funds of funds (which also include the fees charged by hedge funds they invest in), make up a larger portion of their returns than in the case of hedge funds or long-only absolute return funds. However, funds of funds have recorded a higher Sharpe ratio than long-only managers, suggesting the investment vehicle have generated marginally higher returns per unit of risk, over the 3-year period.

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Long-only managers returned 6.7% (annualised) over the 3-year period, but with a large difference between their mean and median return. This, coupled with wide inter-quartile ranges, suggests high dispersion in their returns, and that their mean returns have been positively skewed by a few managers that recorded strong returns. Furthermore, the lower average returns for long-only managers as compared to hedge funds, can be explained by the fact that they provide higher beta, which brings down their performance during times of downward market movements; the MSCI Europe Index lost over 20% year-to-date, bringing its 3-year annualised returns to a modest 6%.

Of course, in practice, the choice of investment vehicle boils down to their accessibility (especially the better-performing ones) to investors. This section is merely an exercise in enquiring the quality of returns for each fund type.

In Closing

The European hedge fund space has grown at a robust pace over recent years until mid-2007, after which the US subprime crisis broke out and spread across other regions and asset classes. This took a toll not only on the global financial sector but also on most market participants, the world over. However, we do anticipate the aforementioned growth to resume soon after the dust from the financial storm settles.

After an eventful month in September, which saw several centuries-old financial institutions collapsing, being taken over or bailed out, followed by an unprecedented ban on shorting financial stocks across some developed countries, markets continue to remain volatile in October. Most major equity markets are currently trading at oversold levels, against the backdrop of slowing economic growth, a dearth of liquidity and recessionary fears across some developed markets that have not declared an official recession yet. Furthermore, the slightest boost in investor confidence result in sharp, short-term upturns in the markets, while the smallest bit of negative data more than reverse those gains, thereby resulting in high volatility.

We are also currently seeing central banks and governments across the board, injecting funds into their respective economies, besides setting aside enormous sums of money to prevent other financial institutions from collapsing. This comes across as a clear and firm measure to control and gradually undo the damage that the global financial sector has seen over the past year. Although these measures do not particularly come across as a direct, permanent fix to the underlying problem, we do expect them to stabilise market movements over the near- to medium-term and in turn strengthen investor confidence, which would have a healthy, positive impact on the broader markets.

As such, we do see some pockets of profitable opportunities for hedge funds in the current market scenario. For instance, we expect the high volatility across the equity markets to work in favour of managers employing short-term trading strategies. Furthermore, continuous appreciation in the US dollar against the euro, among other currencies, affords currency-investing funds with lucrative opportunities. And finally, the oversold equity markets make for good buying opportunities for long-term equity-focused, value-investing managers. Based on these factors, among others, we continue to be fairly optimistic about hedge fund performance over the medium term.

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