



Growing diversity in the European hedge fund market

By: Sophie van Straelen | Managing Director of Asterias Limited

The European hedge fund industry was once concentrated in just two markets: England and Switzerland. Today, other markets such as France, Italy, Sweden and Spain have emerged as common locations for hedge fund managers. This relatively new trend, which really began in 2000, can be explained by the recent development of onshore markets for European hedge funds.

This article reviews the burgeoning hedge fund industry from the supply side perspective and analyses its main characteristics in terms of type of strategies, risk profiles and investment culture. As we are still at the early stage of growth in hedge funds in Europe, this is an initial exercise to provide an overview of recent trends and patterns in an increasingly diverse market place.

Europe at a glance

Here are the highlights of the current European hedge fund landscape:

Table 1 | Highlights of supply & demand

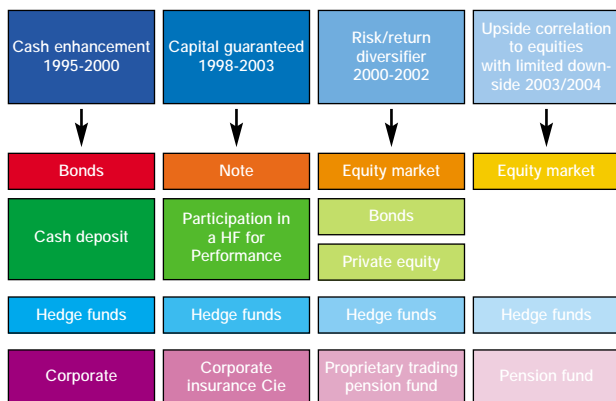
The Supply side (managers)	The demand side (investors)
Relatively short history	Spectacular growth since 2000
Mainly concentrated in Switzerland and the UK	Mainly in funds of hedge funds
Dominated by Equity strategies in the UK and Fixed Income strategies in the Continent	Mainly concentrated in the Continent
concentrated	Demand for transparency and liquidity
Relative small asset bases	Emphasis on capital preservation
Strong institutional involvements	Emergence of local regulation
	Development of retail products

Source: EuroHedge

The history of supply in hedge fund capacity in Europe is relatively short and has seen significant growth since only approx. 10 years. With some rare exceptions¹, most of the management capability in hedge funds has been developed since the mid 1990s, mainly in response to the demand for assets capable of outperforming the risk free rate, which at the time of the formation of the European Union sharply decreased due to the rate convergence process in Europe. The supply was triggered by the demand, mainly of institutional nature. Some US based global macro funds were quite successful raising capital in Europe in the 1990s,

¹ Such as Banque Privée Edmond Rothschild in Geneva and Georges Karlweiss, who started one of the first funds of hedge funds in 1969; or houses such as HDF Finance in France who did so back in 1986.

Graph 1 | Evolution



Source: Asterias Ltd

stemming mainly from high net worth individuals or funds of funds. At that time, Arpad Busson, chairman of EIM, was one of the pioneers in introducing big US macro managers to European investors.

However, the demand until very recently (2000) remained concentrated in Switzerland in general, and high net worth individuals in particular. Supply progressively grew in London for single managers, and in Switzerland for funds of hedge funds. London has always been a strong financial centre with a deep entrepreneurial culture, capable of attracting managers to set up their new hedge fund operation.

The evolution of the institutional demand

Graph 1 shows the evolution of demand in Europe by investor category. This is a broad representation of the main trends that we have seen emerging in the last 10 years. The first boxes represent the traditional portfolio by type of investors and how they have increased hedge fund investments and through what type of vehicle. For example, cash enhanced products emerged in France to respond to the demand from corporate investors (who are in general invested in bonds or cash) for returns above the risk free rate. Capital guaranteed products responded to the demand for preservation of capital with an exposure to the risk/ returns of hedge funds. That chart shows how various types of hedge fund vehicles can respond to the specific needs of various investor types. It is difficult to compare institutional investments in hedge funds in Europe to the US. The type of investors is in general broader in the US and mainly includes endowments, universities or charity organisations. Each of these displays very different investment cultures and a more relaxed attitude towards risk taking. In general, European investors

are more risk adverse, frequently approaching hedge fund investment with «a mutual fund mentality», and often preferring similar product characteristics when investing in hedge funds. That explains the more pronounced demand for transparency (or access to the portfolio and its positions) and liquidity. These specific demands explain why European managers are rarely able to get away with long lock-up periods, such as their peers in the US do.

In response to the more risk-averse investor approach as observed in Europe, capital guaranteed products have been a popular means for investors to gain access to the asset class. In some European countries, these are the only appropriate vehicle an investment in hedge funds.

In response to the rising appetite for hedge funds since 2000, most regulatory bodies have now started to design legal frameworks facilitating the emergence of an on-shore hedge funds industry. Given the absence of regulatory experience in Europe, some regulators however have chosen some very narrow definitions of what a hedge fund is, and should be allowed to do. Germany or Spain are examples of such restrictive legislations.

Still an opaque market

For most decision makers and analysts in the asset management industry, it is still a challenge to garner accurate data and meaningful analysis on hedge funds. This particularly applies to Europe. Well-established data sources such as HFR provide limited information on the European market in terms of supply and demand. Their analysis of data by location of managers categorises European funds under the heading «other location», which in the third quarter of 2004 comprises a market share of 11% compared with 29% in Delaware and 50% in the Cayman Islands, British Virgin Islands, Bermuda and the Bahamas. Clearly, Europe still represents a small universe, difficult for most databases to access. Another, relatively accurate, source of European data is Hedge Fund Intelligence, an English publication which provides a biannual overview of the evolution of European managers. This article makes use of their data, as well as our own data for specific markets such as Italy and France where we collect information directly from local managers. There is definitely a gap in the information available and in the way that information is analysed. This was not such an issue when the market was concentrated in only two locations, but now asset allocators are have to deal with multiple market places in their quest to secure capacity and identify niche players. With this in mind, there is a demand to

access local qualitative information delivered in a standard, non-local, industry format.

Assets in Europe

Eurohedge has published a figure of USD216b for hedge fund assets managed in Europe as of June 2004, which represents 24% of the total assets registered in the HFR global database (USD890b at the end of Q3 2004). According to Eurohedge, 71% of assets were managed out of United Kingdom, with 62% of managers also located there. France is second in the geographic line-up with 6% market share (USD 12.4b) by assets and 7.4% by manager (22 managers). The Spanish market share is biased with one global macro player located in Spain representing all the assets managed in Spain and therefore this number does not represent a universe of hedge fund managers. There is a significant gap between France and England reflecting the fact that the vast majority of hedge fund managers are still located in England. Our own data at the end of June 2004 shows USD23b managed in hedge funds in France (excluding cash enhanced products) by a total of 25 managers.

Geographic breakdown of hedge fund managers in Europe – June 2004.

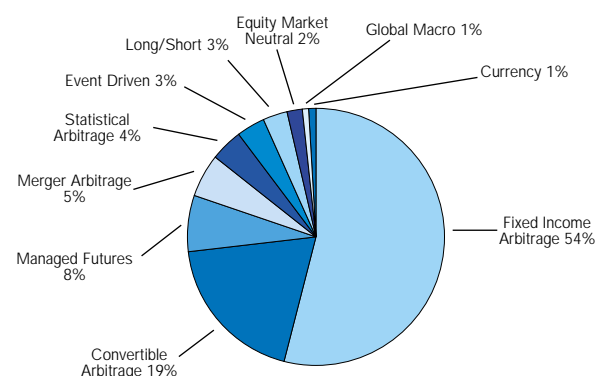
Table 2 | Hedge fund domiciles in Europe

Location	Market share by AUM
U.K.	71 %
France	6%
Spain	6%
Sweden	3%

Source: UBS AIS Report - EuroHedge April 2004

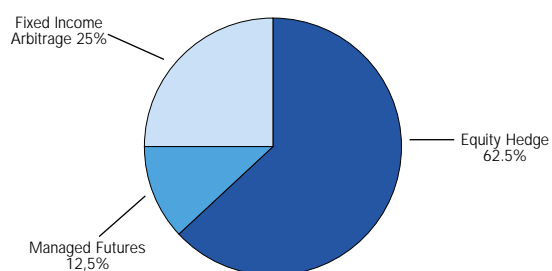
Due to the fragmentation of the market and the recent history of European hedge fund databases, these numbers are only estimates. The development of onshore regulation across Europe compels new registered products to be listed by the regulatory bodies and more public information will gradually become available. In Italy, for example, the local asset management association now publishes the assets managed in SGR Speculativi (local hedge fund products) on a monthly basis. However, 90% of the products listed are funds of hedge funds and are therefore not representative of local management capability. Since 2003, five Italian firms have registered eight single managers (at the end of June 2004) accounting for USD265m in assets, still a very small proportion (2.65%) of the total USD10b managed locally.

Graph 4 | Hedge fund strategies in France



Source: Asterias Ltd.

Graph 5 | Hedge fund strategies in Italy



Source: MondoHedge

Product distinctions

As locally registered products are launched, the differences between markets in terms of investment culture (driven by local demand) and the specific skills of local managers become clearer. For example, the equity investment and management culture in the U.K. is reflected in the fact that European Long/Short Equity managers represent 36% of the total strategies managed from the U.K.² However according to Eurohedge, «Fixed Income strategies showed the fastest growth with assets more than doubling over the past year, boosted by the emergence of new funds with a credit rating focus», representing 23% of hedge fund European assets. On the Continent, in France for example, Long/Short Equity managers represent only 8% by number and 3% in assets and fixed income arbitrage represent 54%.³ There is a clear distinction between on the one hand U.K., Scandinavian, Italian and Dutch investment cultures which

² Source: Eurohedge June 2004

³ Source: Asterias Ltd.

are mainly equity driven, and on the other hand the rest of Continental Europe (France, Germany, Spain) cultures which are more risk adverse and oriented towards fixed income. With these distinctions in mind, one can draw a map of Europe where certain types of products are more in demand than others. This analysis is pertinent when a manager wishes to distribute its products across Europe.

Local management skills matching local demand

Skills: In England, most managers have a strong background in equity analysis and hedge fund managers have therefore diverted their long only expertise into the hedge fund sector. French managers have a strong fixed income and derivatives background, which explains why, according to our latest market study, 85% of French hedge fund managers are in fixed income, managed futures and convertible arbitrage. In Sweden, one hedge fund manager who is an equity manager dominates the market; other strategies include managed futures and fixed income arbitrage.

Product range: These local skills have in some instances resulted in the creation of specific types of hedge fund products designed to meet particular local institutional requirements. Thus, capital guaranteed products have been very successful in certain European markets such as Spain, Germany and France, where institutional investors were unable to invest directly in hedge funds. Likewise, French managers have used the only legal route they had until recently for the distribution of hedge fund products by creating enhanced cash products with 90% of the capital invested in cash and the remaining 10% in hedge funds to generate extra returns over the EURIBOR rate. More recently, particular requirements for transparency and liquidity have had a large impact on demand for managed accounts: Lyxor (SG group) is a good example displaying demand for such products. Having developed the concept of an integrated managed account platform in 2000, Lyxor

has experienced spectacular growth in the last four years, today managing more than EUR20b in their managed account platform.

Proximity: The concept of proximity is becoming more important today as we see qualitative managers opting to set up their new fund locally as opposed to in London. Retaining local talent has become one of the key concerns of regulatory bodies. At the same time, it is becoming more difficult for non-European managers to analyse local institutional demands and to distribute their funds to end investors. With this in mind, the model of finding a local distribution partner is quite an attractive option in most European market places.

Conclusion

The emergence of a European hedge fund industry is one of the most important developments in the asset management industry over the last five years. Europe has become a source of recognised market skills as well as a source of capacity for international funds of funds. The biggest of these firms have opened London offices with dedicated European research teams, which is reflective of their growing interest in European managers. While London, Geneva and Zurich used to be the three centres for hedge fund managers, since 2002 we have seen other locations in France or Italy gain popularity as managers that used to concentrate on their local market are now open to outside investors. The European market offers a wide range of talented managers with relatively short track records on the one hand but liquid products and capacity on the other. As an example, firms like Kairos in Italy or ADI in France are now in the eligible universe of the large funds of funds. We are at the earliest stages of these developments and there is still much to be done in terms of analysing the European market at the local level.

www.harcourt.ch

www.harcourt.ch

For previous issues of the swissHEDGE and people & services of Harcourt Investment Consulting AG.