Preqin Research Report

UCITS - The Future of Regulated Funds?

March 2010

Private Equity • Real Estate • Hedge Funds • Infrastructure

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One of the key topics in the hedge fund industry over the last year has been the growing presence of the highlyregulated onshore versions of European hedge funds known as “Undertakings for Collective Investment in Transferable Securities” or UCITS III. The rise in investor demand is evident in the increasing numbers of managers offering UCITS products and pursuing certain hedge fund strategies through UCITS vehicles. In order to better understand this shift, Preqin carried out a survey of 50 institutional investors and 60 fund of funds managers to discuss their investment preferences and views on the future of the hedge fund industry in relation to regulated hedge fund vehicles. Investor concerns about transparency, liquidity and risk management as well as future regulatory oversight through the proposed Alternative Investment Fund Manager Directive (AIFMD) are among the contributing factors for a rise in demand and numbers of UCITS-compliant funds.

Investors’ Perspective on UCITS

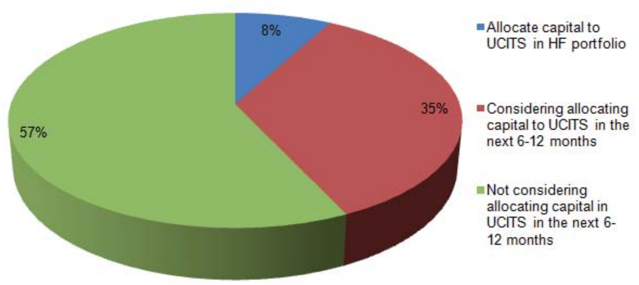
Preqin surveyed institutional investors from Europe and North America, including public sector pension funds, private sector pension funds, endowments, family offices, foundations, insurance companies, banks and asset managers. Both large and small investors were surveyed with total assets under management ranging between $40 million and $60 billion.

8% of respondents currently invest in a UCITS vehicle (Fig. 1), and all of these are European based. One requirement of the UCITS structure is that a fund must be authorized by one of the member states of the EU, however, as most North American investors are less familiar with EU regulations, many do not specifically target funds with this attribute, which is one reason why UCITS funds are not as popular with US investors as with their European counterparts. The US investors surveyed were less familiar with AIFMD, particularly as US investors must comply to a different set of rules enforced by the US Securities and Exchange Commission (SEC); for US investors, a UCITS fund must be pre-approved by the local regulatory authority. Despite this, over one-third of investors surveyed (35%) stated that they are considering investing in such a vehicle in the next 6-12 months, and this figure included two US college endowments and a US-based charitable foundation. This shows that interest in UCITS is not restricted to Europe. One Japan-based manager surveyed told Preqin that client demand for UCITS products is becoming stronger in Asia. Interest in UCITS will likely expand in the future, not only in Europe, but in other regions such as Asia, Latin America, the Middle East, and North America, especially as the calls for increased regulation of the industry continue.

At the end of 2009, Preqin surveyed institutional investors to ascertain their outlook on regulation of the hedge fund industry. In total 83% of all investors felt that the industry needed increased regulation. Enforced use of external auditors and administrators, restrictions on leverage and enforced registration with financial authorities were commonly cited by investors as possible changes to the industry. UCITS funds are

Fig. 1:

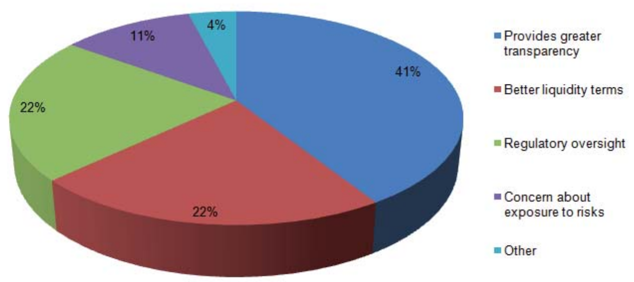
Investor Attitudes Towards UCITS



Source: *Preqin*

Fig. 2:

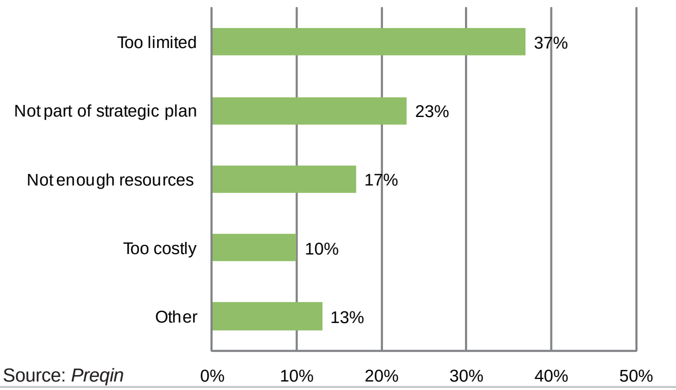
Investors’ Main Reasons for Investing in UCITS



Source: *Preqin*

Fig. 3:

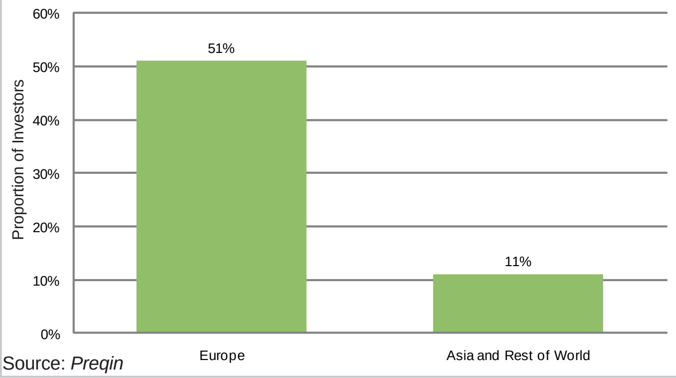
Investors' Primary Reason for Not Investing in UCITS Funds



Source: *Preqin*

Fig. 4:

Proportion of Managers Offering UCITS-Structured Funds by Region



Source: *Preqin*

increasingly being viewed as the ultimate regulatory framework within the EU. The changes brought about by the introduction of UCITS III, and the proposals for the UCITS IV structure, are increasing the number of hedge fund strategies that can be applied to this framework and as a result more UCITS vehicles are being launched. This in turn is attracting an increasing number of investors, many of which are looking for more regulated funds to add to their hedge fund portfolios.

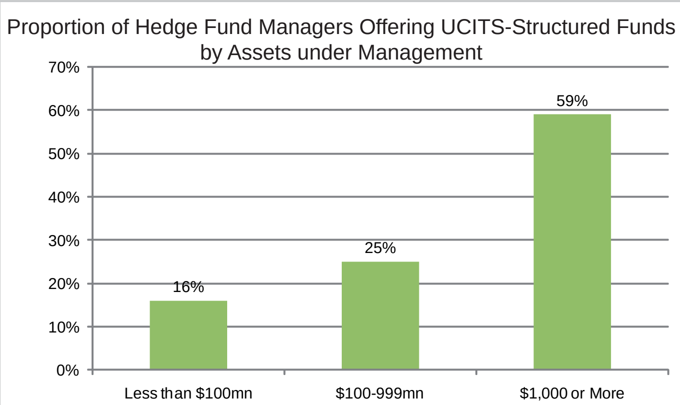
In addition to increased regulation of the industry, over half of institutional investors (53%) are seeking more liquidity and transparency in their hedge fund portfolios following the financial crisis. Furthermore, the Madoff affair and other high-profile scandals have led to many hedge fund investors becoming more cautious and conservative in their approach to investing. 41% of the investors that are currently investing or considering investing in UCITS this year stated the main reason was that UCITS provided greater transparency. 22% said the main reason was better liquidity terms, a further 22% gave regulatory oversight as the top reason, and 11% said the main factor was reducing their exposure to risk (Fig. 2). Recent market turbulence has led to some investors choosing to invest in a UCITS structure, as it serves to reduce the risk of operational losses.

The UCITS structure is not appealing to all institutions, however. As shown in Fig. 3, 37% of the investors surveyed that did not invest in UCITS reasoned that they were deterred from such an investment because the UCITS structure is too limited. Due to the limitations on the types of holdings UCITS managers are allowed to purchase and the amount of leverage that can be employed, the UCITS structure cannot be applied to all hedge fund strategies, and as a result there are fewer fund strategies available through UCITS-structured funds than through traditional hedge funds. Having a limited number of strategies available has deterred many investors from making their first investments in UCITS funds – particularly in the US, where hedge fund regulation is less prevalent. For example, a US endowment with nearly $2 billion invested in hedge funds said UCITS funds have far too many investment and borrowing limitations. Other reasons stated were that UCITS are not part of their long-term investment plans (23%), they do not have adequate resources to assess UCITS vehicles (17%), or investment in these funds is too costly (10%). UCITS III will be replaced by UCITS IV in 2011 and should incorporate modifications that benefit many investors and managers, which in turn should lead to an increased interest in UCITS funds. Despite becoming more mainstream, UCITS vehicles are unlikely to replace traditional hedge funds in the future.

Managers' Perspective on the Growth in Demand for UCITS Funds

Preqin surveyed 60 fund of funds managers from across the globe to report their views on UCITS funds. Managers from 13

Fig. 5:



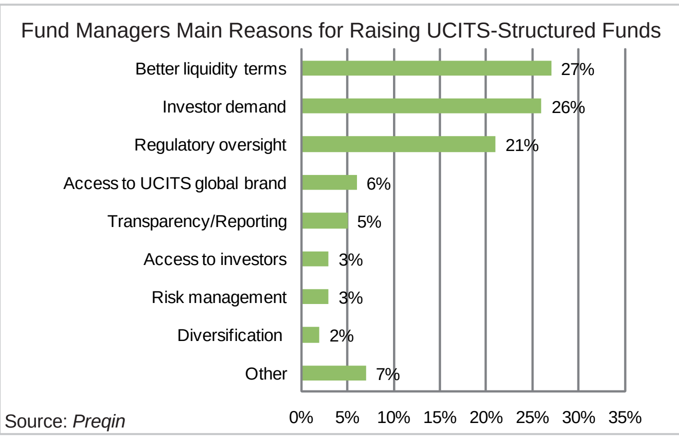
Source: *Preqin*

countries were asked about their current hedge fund offerings and future plans in terms of fund launches. Fig. 4 shows the proportion of managers in each region offering UCITS funds - none of the surveyed North American managers currently offer UCITS products. In contrast 51% of all European managers surveyed offer UCITS funds. Among the North American fund managers surveyed, five were considering launching a UCITS fund in the next 6-12 months, and two US-based managers were currently adopting a UCITS-like structure.

Generally, an investment manager of a UCITS product must be domiciled in the EU; however, a US-based manager may be allowed to manage a UCITS product from the US provided they receive local regulatory approval. Interestingly, 11% of managers from Asia and Rest of World (including Hong Kong, Singapore, Japan and Israel) offer UCITS products. As shown in Fig. 5, it is most commonly the larger managers that are offering UCITS-compliant vehicles. This suggests that UCITS is more suited to managers with large amounts of assets under management than it is for smaller managers.

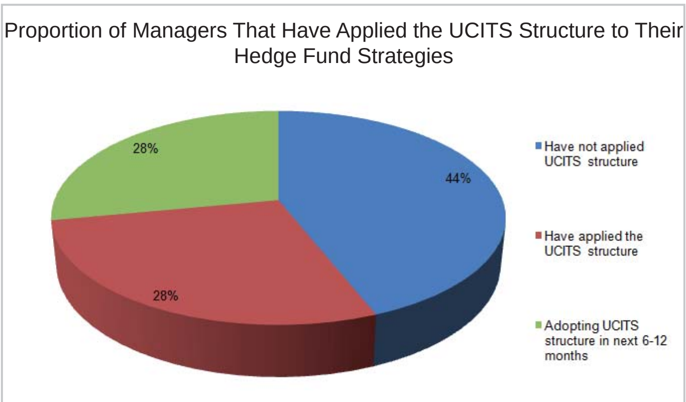
European managers are the predominant source of UCITS vehicles. Developed in Europe, the purpose of UCITS was to harmonize domestic EU markets for collective investment schemes and many hedge fund managers have noticed the value of the UCITS brand as a way to attract investors and increase distribution channels. In addition, the proposed Alternative Investment Fund Manager Directive may mean that regulations will be enforced upon fund managers, and as a result many are turning to UCITS structures to pre-empt any future changes in European fund legislation. 6% of managers named access to the UCITS global brand and EU passport as an important benefit of UCITS (Fig. 6). A large Swiss firm with approximately $44 billion in total assets opined that UCITS provides no added economic value for them, rather it was a necessary instrument to overcome regulatory issues and also for the sake of their Asian investors who were more comfortable

Fig. 6:



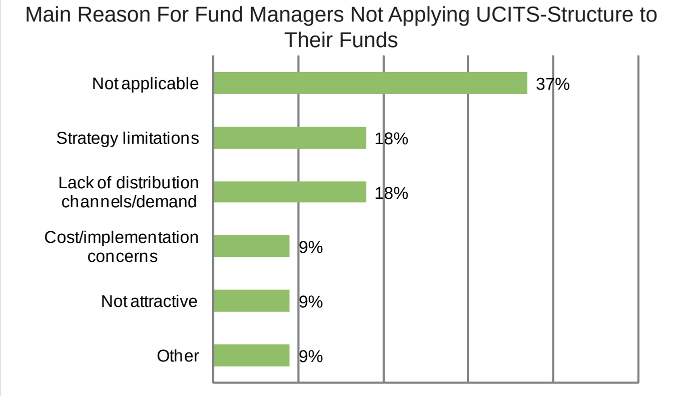
Source: *Preqin*

Fig. 7:



Source: *Preqin*

Fig. 8:



Source: *Preqin*

investing via a UCITS vehicle. However, more than a way to sidestep future regulation, managers are launching UCITS vehicles to appeal to a wider audience of investors (26%). A further 27% of managers cite better liquidity terms for investors as a significant advantage of UCITS funds. There have been some notable UCITS platforms launched recently by fund managers such as Brevan Howard Asset Management, GLG Partners, Lyxor Asset Management, 3A, Investec, Thames River Capital and Man Investments. We predict a further increase in the number of hedge fund managers offering UCITS-compliant products over the next 12-24 months.

The popularity of UCITS has historically been in the long-only space, but with UCITS III it has moved into other hedge fund strategies, such as derivatives and credit. Nevertheless the structure cannot be applied to all strategies, as confirmed by Preqin's survey results. Strategy limitations represent the second most common reason stated by managers as to why they currently do not deploy funds within the UCITS space. According to Fig. 8, 37% of managers have not applied the UCITS structure in their portfolio because they considered it inapplicable to their strategy. For example, one US manager with $4.7 billion in total assets reported that its platform was not led by liquidity, and as UCITS was dependent on liquidity, such a vehicle was not attractive. 44% of managers have not applied the UCITS structure to their hedge fund strategies (Fig. 7); however, 28% of managers are currently running a UCITS platform and a further 28% are adopting UCITS style in their hedge fund portfolio. These results reflect the growing popularity of UCITS or UCITS-like funds, with this trend likely to continue in 2010.

Conclusion

Institutional investors have expressed a growing interest in UCITS funds over the last year following concerns regarding regulation, liquidity and transparency of traditional hedge fund investments. Investor appetite for UCITS products is growing outside of Europe, where the structure was developed, in places such as Asia, Latin America, and the Middle East. UCITS vehicles are able to provide higher levels of transparency and liquidity, which is appealing to investors, although investors still need to carry out detailed due diligence.

Managers, many of which are seeking to attract new investors following drops in their assets under management over the past 18 months, are accommodating investor demands by offering UCITS products. It is more often larger managers that are able to do this, but UCITS or UCITS-like structures are also being offered by small boutiques. UCITS has become more commonplace, but managers are unlikely to replace all existing funds with UCITS-compliant funds. It is more likely they will run UCITS funds alongside their existing traditional hedge funds in order to offer a wider choice of funds to their investors. UCITS is not suited to all strategies, thus to maintain a diversified range of products managers will continue to run traditional hedge funds or use other structures to regulate their funds (such as QIFS or SIFS). Certainly, UCITS offers solutions for mitigating hedge fund risks and is designed to limit volatility. It is still an evolving product and will continue to draw new investors in the future, if it succeeds in delivering consistent returns.

About Preqin

Preqin provides hedge fund managers, marketers and others with a database of over 2,500 institutional investors in hedge funds.

Our customers can access this market intelligence in four different ways:

- Hard copy publications
- Online database services
- Consulting and research support
- Tailored data downloads

Preqin's Hedge Investor Profiles Online is a vital resource for all hedge fund managers and marketing professionals seeking backing from institutional investors. Preqin's team of dedicated analysts is constantly contacting institutional investors from around the world in order to ensure that the data we hold is up to date, reliable and complete. To register for a demo, please visit: **www.preqin.com/demo**

Preqin regularly releases research and information on fundraising and all other aspects of the hedge fund industry as both research reports, and as part of our monthly Spotlight newsletter. To register to receive more research and analysis, please visit **www.preqin.com/spotlight**

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info@preqin.com

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London:

Scotia House
33 Finsbury Square
London EC2A 1BB

Tel: +44 (0)20 7065 5100
Fax +44 (0)87 0330 5892

New York:

230 Park Avenue
10th Floor
New York
NY 10169

Fax: +1 212 808 3008
Tel: +1 440 445 9595

Email: info@preqin.com
Web: www.preqin.com

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