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EUROPEAN MARKET COMMENT

EUROPE-BASED HEDGE FUNDS— DOES IT PAY TO PLAY?

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Interest in hedge funds has surged in recent years, but nowhere has the growth been as dramatic as in Europe. According to Eurohedge, by the middle of 2004, the assets of nearly 900 Europe-based hedge funds (including commodity trading advisors [CTAs]) increased by over 70% from the same point in 2003 and over 25% from the beginning of 2004. Stripping out CTA assets, Europe-based hedge funds manage just under $200 billion, or over 20% of estimated worldwide hedge fund assets, with London-based firms controlling roughly 75% of Europe's share of assets. Europe offers a diverse range of strategies, with long/short equity hedge funds accounting for the majority of assets (35%, with 70% of these assets invested solely in European equities), followed by convertible bond arbitrage and global macro, each of which account for roughly 10% of assets. The fastest growth has been in global macro and fixed income arbitrage in recent years.

While hedge funds have been popular in Europe since the inception of alternative investing, the characteristics of the market have changed dramatically in recent years. For decades the market was dominated by the now notorious Switzerland-based fund-of-funds (FoFs), which charged high fees, offered poor transparency, and predominantly served a high net worth client base. These FoFs soon earned a reputation as hot-money pariahs with the potential to destabilize unwitting hedge fund managers hungry for investor capital. There were very few actual direct hedge funds until the early 1990s, and for most of that decade the European market was determined to be in its "infancy" and attracted little investor interest. In recent years this classification has been brushed aside and capital has flooded in. As hedge funds continue to attract investor interest and U.S.-based managers reach capacity limits, fears of spread compression, capital crowding, and a sustained period of low returns abound. Will global diversification be the answer to achieving meaningful returns in an increasingly "picked over" space? Is a European hedge fund allocation a "must have" for a balanced hedge fund portfolio?

While there arguably are some benefits to geographical diversification of hedge funds, the primary considerations in building a program are finding diversified and sustainable sources of return and value added. Therefore, it is necessary for investors to hold European mangers to the same standards that they require of their U.S.-based managers, as the value added solely from geographical diversification is likely limited. The following are key characteristics of European hedge funds and how they differ from those in the United States.

Manager Structure

In contrast to hedge funds in the United States, independent management companies are in the minority in Europe. Many managers note that they prefer to focus solely on the investment process, and therefore, the majority of managers work for asset management houses that provide administrative and marketing support. The majority continues to operate either within their existing institution (i.e., run a long/short hedge fund alongside their pre-existing long-only portfolio) or within another, already established, money manager. There is also an important second tier of boutique umbrella operators, which provide similar support services, but are privately owned. Managers in both types of organizations are paid a salary, with all of the management fees going directly to the institutions for which they work. The investment team may receive as much as half of the performance-based fee and may have an equity stake in the firm, but this is by no means standard. Finally, there are some stand-alone operators, similar to those in the United States, who value the independence and financial incentives of this model. As the industry matures, the stand-alone model is likely to become more popular.

Fees

On average, management fees are 1.5% and performance-based fees, 20%, although 2% and 20% is becoming increasingly common. However, as the U.S. operators continue to increase their fees (from the standard 1% and 20%) in response to market conditions, European hedge fund fees no longer appear as an outlier.

Investor Base

The bulk of assets in European hedge funds continue to be FoF capital, which makes up 60% to 75% of managers' investor base. In contrast to the United States, there are very few large university endowments, foundations, or charities with the assets or the in-house experience to invest directly in hedge funds. Furthermore, pension funds also primarily utilize FoFs, as they have only turned to hedge funds in recent years. In the short term, we expect FoFs to continue to be the vehicle of choice. However, European hedge fund managers have experienced small, but increasing investments from large family offices that have been active in the area for some time and are somewhat more fee-sensitive than institutions.

Liquidity Terms

European hedge funds tend to have more liquid terms than those of the United States. While some European funds offer weekly liquidity, in response to FoF clients, monthly liquidity is the norm. Lock-ups are uncommon and tend to be for only one year with provisions for early redemption if a penalty is paid. This facilitates access for FoFs or other institutions that may be precluded from investing with a hard lock-up. Increasingly, in recognition that overly generous liquidity terms can be both restrictive and destabilizing, managers are moving toward more stringent liquidity terms and a more stable investor base.

Key Strategy Differences

Equity long/short includes both pan-European and U.K.-only funds. The U.K. equity market is the broadest and most liquid in Europe, which facilitates the execution of a long/short or "market-neutral" strategy. In contrast to U.S. funds, fundamental stock analysis is relatively uncommon, although gaining in popularity. Many managers rely on the brokerage community for idea generation, which can result in significant overlap in the top holdings of large hedge funds. A number of managers focus more on sector rotation than stock selection, which is the traditional long-only management style in the United Kingdom. Experienced short sellers are difficult to find, as the industry is relatively new in Europe, with many managers maintaining significant long biases and/or relying on indices for their sole short exposure. As most long/short managers in Europe have started up long/short products with no prior experience shorting, they have tended to learn from experience, and have since implemented tighter risk controls and better management of their short exposure. Overall, European managers have proven less adept at managing their net exposure and capturing the upside in bull markets than their U.S. peers.

Distressed and special situations investing are a relatively small part of the industry as a whole, but have attracted significant attention from the global hedge fund community. U.S.-based multi-strategy managers have considered Europe to be a hotbed of restructuring activity over recent years, and are increasingly staffing up in the area by opening offices and hiring local talent whom they expect to join with a ready-made network of contacts in the legal, regulatory, and industrial spheres. Despite the surge of interest in the area, there are reasons to question whether the European distressed will be the "free-for-all" that some expect. The distressed debt arena is exceptionally nuanced in Europe. Banks play a pivotal role due to the predominance of senior bank loans in capital structures, and the bankruptcy and restructuring process differs significantly by country. Default rates in Europe are close to all-time lows, and are in fact lower than the average default rate in the United States. Nonetheless, many U.S.-based multi-strategy arbitrage managers have successfully navigated the European restructuring landscape.

Conclusion

Many of the significant differences between the more mature U.S. hedge fund industry and that of Europe relate to its relative "youth" and the fact that many managers are still on the learning curve. In addition, fund structures are generally less entrepreneurial, which diminishes the alignment of interest between the manager and the investor. Liquidity terms tend to be more favorable to investors, although in the long run impede managers' flexibility and may give rise to a less stable investor base. The investor base itself is dominated by FoFs who may be more motivated by short-term performance than is desirable. Fees have historically been higher, and performance has been lower.

Overall, investors would be advised against regarding a significant allocation to European hedge funds as a "must have" in a hedge fund portfolio. With over 7,000 hedge funds now in the marketplace the "hit rate" for finding new managers will inevitably be low. This is particularly true now as barriers to entry remain low and seed capital is abundant. We expect the "hit rate" in Europe to be lower than average and are therefore wary of FoFs built exclusively from European managers. Investors should scrutinize European hedge fund managers to the same degree as U.S.-based managers, with attention paid to the sources of return and value added, particularly in light of what may be higher fees. They should also ascertain whether the source of return (e.g., arbitraging European cross-border transactions) is not already being exploited by a multi-strategy U.S. manager with a significant investment in Europe with perhaps better resources, a proven track record, and a more stable investor base.