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An Alternative Route into Hedge Fund Investment

Institutional appetite for UCITS-compliant funds and managed account structures is increasing, leading many fund managers to offer alternative structures. Amy Bensted investigates which investors are using these less traditional routes to hedge fund investment and the reasons why.

Investors that are hungry for improved transparency and liquidity, as well as greater ownership of assets, are increasingly looking at UCITS versions of hedge funds and managed accounts as they seek new routes to alpha. In Preqin's Global Investor Report: Hedge Funds, we revealed that 8% and 12% of new fund searches in the next year include UCITS and managed accounts respectively. Although this represents a relatively small proportion of total fund searches, the growing popularity of alternative structures to commingled funds has been undeniable. More UCITS funds are launched year-on-year and institutional investors continue to investigate the benefits of separately managed account structures.

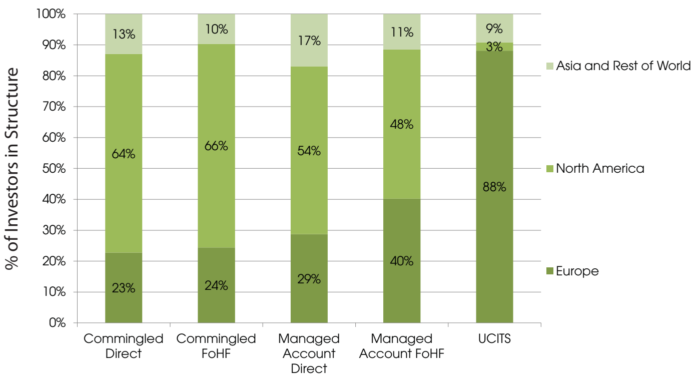
In this feature we will examine the current trends in the managed account and UCITS sectors, revealing the types of investors that are considering these structures, what options are available to them, and how recent developments in each sector have made the industry more attractive to the institutional market. We will also examine the current UCITS and managed account offerings in the marketplace to look further at the types of funds, managers and strategies that investors can choose from.

Who is Investing in UCITS Hedge Funds and Managed Accounts?

Using Preqin Hedge Fund Investor Profiles, a database of 3,700 institutional investors that are active in hedge funds, we examined investor interest in commingled funds, managed accounts and UCITS-compliant funds across different geographies. Unsurprisingly, given their importance to the hedge fund industry, North America-based institutions account for the greatest amount of interest in most structures. The notable exception is for UCITS-compliant funds, for which European investors account for nearly 90% of all investors in such funds. Given that UCITS is a European regulated fund structure, this is perhaps unsurprising. Interestingly, equal percentages of North American and European investors consider commingled fund of funds (69%), whereas a slightly smaller percentage of Asian investors (60%) would invest in such funds. When looking at commingled direct funds, however, the trend is reversed, with 70% of Asia and Rest of World interested in these structures, versus 61% and 58% of North American and European investors respectively. In general, European and Asia and Rest of World-based investors show a more diversified attitude towards hedge fund structures, with higher proportions of these investors looking beyond traditional offshore commingled funds. For instance, 9% of European investors and 7% of Asia and Rest of World investors consider managed accounts over commingled funds, while the figure for US-based investors is just 5%.

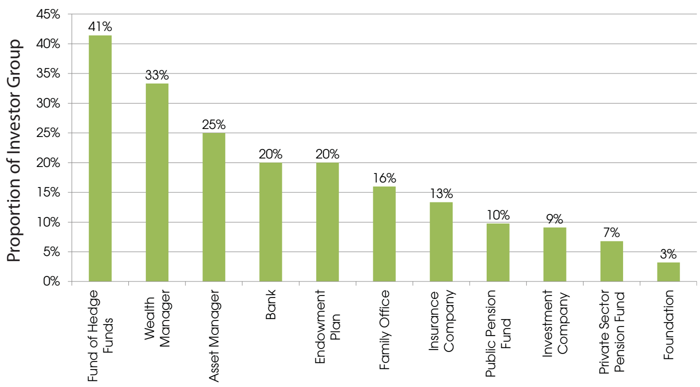
Looking at the institutional universe within Europe, it is clear that some groups of investors are allocating to UCITS in large numbers - over 40% of European funds of hedge funds consider UCITS as a structural preference when choosing investments. The reassurance of daily/weekly/biweekly liquidity offered by UCITS-compliant funds can be a big draw for funds of funds, particularly when faced with being gated in funds and then issued with investor redemptions themselves. UCITS are also of interest to the clients of wealth managers, asset managers and banks. Traditionally a long-only retail vehicle, the advent of UCITS III and now UCITS IV has allowed several different hedge fund strategies to be managed under a regulated regime. This is

Fig. 1: Breakdown of Regional Investment in Each Type of Hedge Fund Structure



Source: Preqin Hedge Fund Investor Profiles

Fig. 2: Proportional Interest of European Institutional Investors in Alternative UCITS



Source: Preqin Hedge Fund Investor Profiles

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very appealing to many smaller investors looking to make their first investments in the complex hedge fund industry. For many larger investors, however, UCITS-compliant vehicles are less attractive. For example, European pension funds show a reduced appetite for UCITS vehicles compared to their peers, with 10% of public pension funds and 7% of private sector pension funds considering such a structure. Such institutions typically have larger ticket sizes and experienced investment teams, and therefore the size restrictions of the UCITS fund industry may be prohibitive. Consequently, these investors are more likely to turn to managed account platforms as a way to manage their liquidity/transparency and ownership needs, or invest via a standard commingled structure.

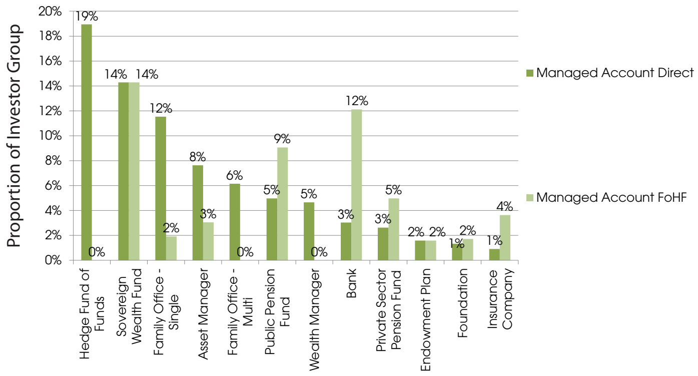
Fig. 3 shows the appetite for managed accounts across various groups of institutional investor, with appetite split by investment in single-manager funds and in managed account versions of funds of funds. Once again, fund of funds managers show the greatest interest in managed accounts, with almost one-fifth of all multi-managers interested in these structures. Managed account investment is typically favoured by those investors with the largest allocations to hedge funds. Excluding funds of funds, the typical allocation to hedge funds of all investors that choose to invest through managed accounts is $1.5bn, compared to $485mn for non-managed account investors. Sovereign wealth funds, with their significant ticket sizes and out-sized assets under management, can absorb the additional costs associated with managed accounts, both operationally and in terms of managing the daily transparency feeds these funds offer. Public pension funds, and in particular those in Europe – of which 16% consider managed account versions of funds of funds – also show a relatively strong interest in managed accounts. The average allocation to hedge funds of a public pension fund that uses managed accounts is $745mn, whereas the figure for a public pension fund that does not stands at $507mn. Despite the growing interest in alternative structures, however, it is clear the investment structure of choice for the pension fund market remains the traditional commingled fund.

Why UCITS and Managed Accounts?

It is clear that over the past four years investors have become more sophisticated towards their investments in hedge funds, and are on the whole in possession of greater risk awareness. Last month's Hedge Fund Spotlight, which focused on a study of European investors, revealed that 65% of investors are interested in UCITS-compliant vehicles because of their increased liquidity, while 44% find their regulated status appealing, and a further 38% pointed out the attraction of the increased transparency offered by such structures.

Wrapping hedge funds in UCITS structures first became a reality in 2003, when the UCITS III directive came into action. This directive widened the investment restrictions to allow the use of derivatives for investment purposes, which made a range of hedge fund-type strategies possible within the framework. The structure offers many benefits to investors, including daily to

Fig. 3: Proportional Interest of Global Institutional Investors in Managed Accounts



Source: Preqin Hedge Fund Investor Profiles

fortnightly liquidity, greater restrictions on the use of leverage, enforcement of risk management procedures, more transparency of holdings and asset valuation, and notably, regulation under the EU UCITS framework. The advent of the UCITS IV directive further widened the number of eligible hedge funds under the scheme, by allowing for master/feeder structures, allowing fund mergers, simplifying cross border marketing, and the passporting of management companies as well as funds. Additionally, the directive states that all fund managers must now produce what is known as a Key Investor Information Document (KIID) to detail the fund strategy in non-technical language, which increases levels of transparency still further.

Managed accounts have been around for many years and have been commonly used by investors to allocate to certain strategies, for example foreign exchange funds or managed futures. There are many options available to investors wishing to allocate to hedge funds via managed accounts, from investor owned separately managed accounts, platform traded managed accounts, and manager owned "funds of one". The rise of the platform fund has been notable since the credit crisis in 2008. In a platform the operational control of the fund's assets is held by the platform provider and they arrange the administrative control of the service provision for that vehicle. Investor assets are pooled, allowing the advantage of the liquidity that a platform can offer as well as the standard manner of reporting, but with less of the operational, administrative and IT burdens typically associated with managed accounts.

What Types of Funds are Offered?

Long/short equity funds are the dominant strategy in the alternative UCITS landscape. Such vehicles are able to adapt readily to the restrictions of the UCITS wrapper and adjust their existing strategy accordingly to the regulation. The strategy is also relatively transparent and easily explained to the less sophisticated investor, allowing an easy transition into compliance to UCITS regulations. Following long/short equity the global macro strategies (including CTA funds) are among the

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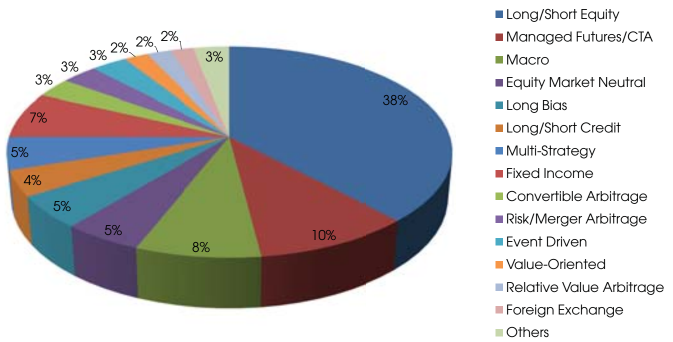
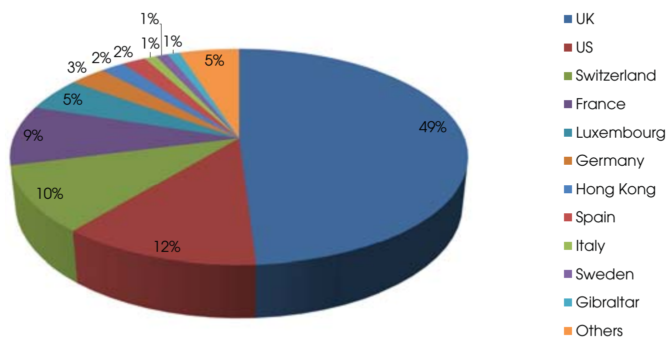
Fig. 4. Universe of Alternative UCITS Strategies (Number of Funds)



Source: Preqin Hedge Fund Investor Profiles

Fig. 5: Breakdown of Alternative UCITS Fund Managers by Location



Source: Preqin Hedge Fund Investor Profiles

most common funds in the UCITS-compliant hedge fund market today.

As managed accounts can vary significantly between ownership and structure, it is more difficult to benchmark the strategies being used in the managed account sector. Aside from managed futures funds, which account for two-thirds of the managed accounts tracked by Preqin, the strategy breakdown is evenly split between most major liquid hedge fund strategies, with long/short equity accounting for 22% of non-CTA managed accounts. Foreign exchange, global macro, market neutral, multi-strategy and statistical arbitrage strategies are also commonly used in a managed account format. Managed accounts are often viewed as a panacea to investors' requirements for increased liquidity; however, a managed account can only be as liquid as the underlying asset of the fund. Consequently, there are even some managed accounts in more illiquid strategies, although typically with some form of lock-up or notice period.

Nearly half of UCITS-compliant hedge funds are run out of the UK, the established centre of the hedge fund industry in Europe. Interestingly, 12% of the UCITS vehicles that Preqin tracks are managed from the US. Despite UCITS vehicles being of small interest to North American investors (3%, Fig. 1), US-based managers have noted the value of the structure for marketing their vehicles to the European and Asia and Rest of World markets.

Outlook

Managed accounts and UCITS-compliant hedge funds are still a niche alternative to the commingled structure in the hedge fund industry. Despite this, however, they continue to grow in popularity amongst institutional investors looking at fresh ways to access hedge fund strategies, meet their transparency and liquidity requirements, and also gain additional control over their assets. Changes in each sector – the new UCITS IV amendments and the growth of the managed account platform over the past five years – have made it not only easier for managers to launch alternative versions of their commingled funds, but also for investors looking to capitalize on these structures. Both UCITS-compliant funds and managed accounts tend to be more popular amongst managers of more liquid strategies, although managed accounts can be offered in less liquid strategies provided investors in these accounts understand their liquidity will be reduced as a result.

As institutional investors continue to increase allocations to hedge funds and diversify their portfolios both in terms of strategies and the structures they invest in, we can expect the alternative UCITS and managed accounts sectors to grow in size over the next few years. Given the continuing uncertainty and volatility experienced in global financial markets, investor appetite for liquidity and transparency shows little sign of abating. UCITS and managed accounts can offer an easy way for institutional investors to tap into this highly sought liquidity and transparency while investing in managers that are able to diversify risk and provide much needed alpha.

Data Source:

This month's feature article features data taken from Preqin's Hedge Fund Investor Profiles online database, the hedge fund industry's leading source of intelligence on institutional investors and their future intentions.

This powerful online product offers users access to regularly updated profiles of over 3,700 institutional investors in hedge funds worldwide, featuring investment plans, preferences and key contact details.

Interested in finding out more? For full details on how Hedge Fund Investor Profiles can help you, please visit:

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