

Content Includes:

Opportunities and Barriers in the Alternative UCITS Market

Ian Swallow from **Man** looks at the rising use of the UCITS structure for hedge funds, as well as new regulatory developments.

UCITS-Compliant Hedge Funds: An Alternative for Institutional Investors

We examine the make-up of investors in UCITS funds and which strategies they are targeting over the next 12 months.

UCITS: Liquidity and Transparency for Investors in Hedge Funds

We take a closer look at UCITS fund launches, as well as fund domiciles and key strategies utilized by UCITS-compliant funds.

Performance of UCITS Funds

We analyze the typical performance and volatility of UCITS funds compared to non-UCITS funds and the S&P 500, as well as looking at performance by strategy and top performing funds.

Preqin Special Report: UCITS Hedge Funds Growing in Prominence

June 2013





Foreword

It has been over a decade since the third iteration of the UCITS (Undertakings for Collective Investment in Transferable Securities) directive came into effect and made way for alternative investment funds to be formed under the European regulated structure. UCITS III broadened the eligible assets under the scheme to include the use of options and futures (among others) which would allow hedge fund managers to mimic existing hedge fund strategies under a liquid, transparent, regulated format.

Today, in 2013, investment in UCITS-structured hedge funds is widespread across Europe, with banks, assets managers and funds of hedge funds all utilizing these funds in large numbers. In countries such as France and Spain, the UCITS structure is favoured by over half of all hedge funds investors based in each country. The industry has taken some time to be adopted by such a large number of investors and it was the events and fall-out of 2008 that spurred both investors to seek alternatives to the “traditional” offshore pooled model for hedge fund investment and fund managers to launch new vehicles guided by the directive. Since 2008, the size of the UCITS sector in the hedge fund industry has grown by 260% in terms of the number of fund offerings wrapped in the structure. In 2008, the need for regulation, following Madoff, as well as increased liquidity and transparency, following gating, within the hedge fund industry was abruptly brought to the attention of investors, and managers have been quick to respond by launching new funds.

The UCITS directive is now into its fourth iteration with UCITS V soon to follow. With the sixth version of the scheme in the planning stages, it appears the European-regulated structure for hedge funds is here to stay. Hedge fund managers are increasingly adopting the structure to launch both new funds and to re-launch existing strategies, and investors are increasingly looking to make new investments under the regime despite any differences in performance to the offshore model.

In this report we present an overview of the UCITS sector within the hedge fund industry as it stands today drawing on data from Preqin’s online hedge fund services, which provide a complete 360 degree view of all aspects of the industry. We look at investor appetite for UCITS funds, with a particular focus on European investors, fund launches and the UCITS strategy breakdown, as well as recent performance of these UCITS vehicles. We are also pleased to include an article on Opportunities and Barriers in the Alternative UCITS Market by Ian Swallow, Head of UCITS Management at Man.

We hope you find this report useful, and we welcome any feedback you may have. For more information visit www.preqin.com or contact info@preqin.com.

Key Findings

- 86% of investors in UCITS hedge funds are based in Europe.
- Long/short equity is the most commonly sought UCITS strategy by investors in the next 12 months.
- Half of all UCITS hedge funds pursue a long/short strategy.
- 12% of UCITS funds are managed by US-based fund managers.
- UCITS hedge funds returned 2.46% in Q1 2013, compared to the wider hedge fund benchmark of 3.22%.

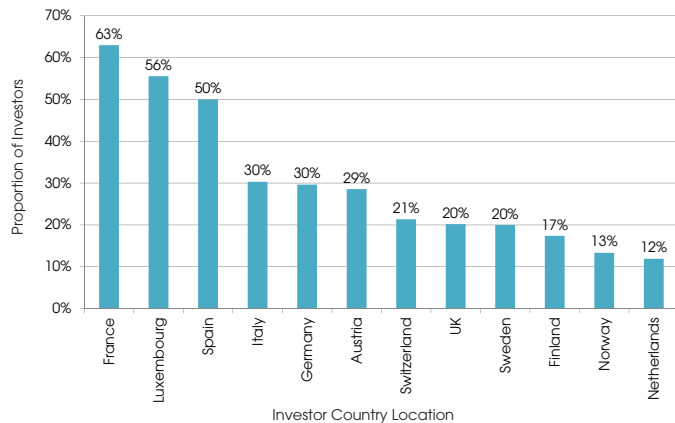
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UCITS-Compliant Hedge Funds: An Alternative for Institutional Investors

Fig. 1: Proportion of Hedge Fund Investors Based in European Countries that Invest in UCITS



Source: Preqin Hedge Fund Investor Profiles

Alternative UCITS (Undertakings for Collective Investment in Transferable Securities) funds appeal to institutional investors because they provide access to hedge fund strategies in a more regulated, transparent and liquid format than traditional hedge fund structures. The structure has adapted to the latest UCITS IV directive and there are plans for UCITS V to be introduced in 2014, with each version providing more opportunities for investors in UCITS-compliant funds.

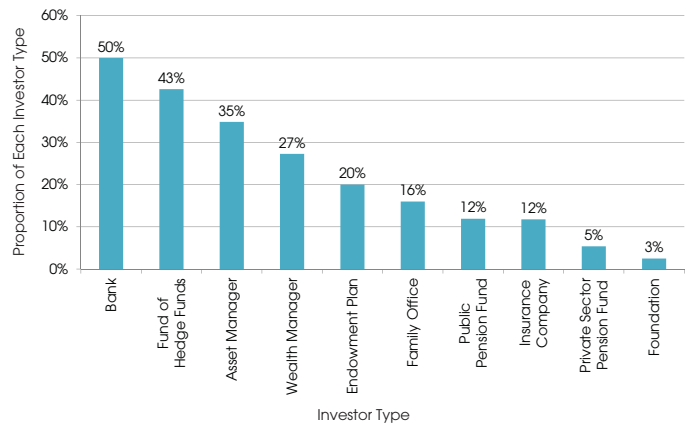
Who Invests in UCITS-Compliant Hedge Funds?

As UCITS is a European regulation, it is unsurprising that the vast majority of institutional investors in UCITS-compliant hedge funds are based in Europe, with the region representing approximately 86% of all UCITS hedge fund investors. However, the structure is now utilized by investors in other regions worldwide, with North America and Asia-Pacific home to 8% and 5% of UCITS investors respectively.

Of all France-based hedge fund investors, 63% have an allocation to UCITS funds. The fund structure is also commonly utilized among hedge fund investors in Spain (50% of hedge fund investors based in the country utilize UCITS hedge funds), Italy (30%) and Germany (30%).

Fig. 2 shows the proportion of Europe-based hedge fund investors of each type that invest in UCITS-compliant hedge funds. Of all Europe-based banks, 50% invest in UCITS-compliant hedge funds. Banks have an increased demand for liquidity and regulation, making the UCITS structure ideal for these investors if they choose to commit to hedge funds. Switzerland-based bank Cornèr Banca has a preference for UCITS hedge funds due to their level of transparency, high level of liquidity, and low volatility. Over 40% of Europe-based fund of hedge funds managers include an allocation to UCITS-compliant hedge funds; the daily or weekly liquidity typically offered by UCITS funds is attractive to fund of hedge funds managers that have to manage the liquidity of their own funds in addition to making investments. More asset managers have begun utilizing alternative UCITS structures over the past year, with funds under

Fig. 2: Proportion of Each Europe-Based Hedge Fund Investor Type Allocating to UCITS Funds



Source: Preqin Hedge Fund Investor Profiles

the UCITS wrapper utilized by 35% today, compared to 28% in July 2012.

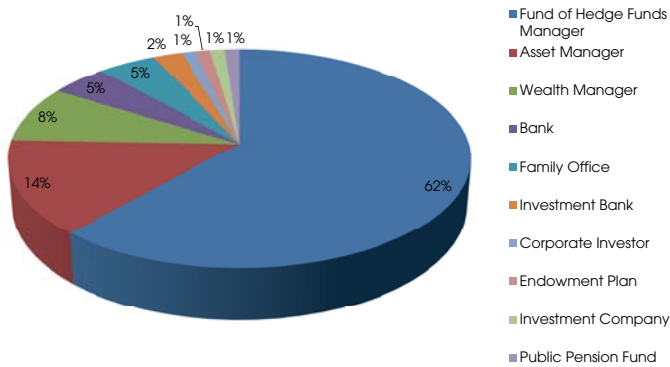
UCITS-compliant hedge funds are less commonly used by pension funds, with the structure utilized by just 12% and 5% of Europe-based public and private sector pension funds respectively. These investors typically have larger ticket sizes and so the size restrictions associated with UCITS funds can be prohibitive. Despite this, the proportion of Europe-based public pension funds investing in hedge funds under the UCITS wrapper has increased from 8% in 2011 and 10% in 2012, to 12% in 2013.

Why Are Investors Investing in UCITS Funds?

Hedge funds structured under the UCITS wrapper are attractive to institutional investors for a number of reasons, including the increased transparency and disclosure of investments, limited leverage and attractive liquidity terms. A Preqin study in June 2012 indicated that liquidity was the most common reason for investing in UCITS-compliant funds, with 63% of investors stating this as a key factor in investing in the structure. Traditionally, most hedge funds were only available through offshore structures with assets locked up for a fixed period; UCITS funds are an attractive alternative to this as they provide at least fortnightly liquidity. Other important factors highlighted by investors in the study were the opportunity to invest in regulated vehicles (44% of investors indicated this as a key reason for investing in UCITS funds) and the increased transparency associated with UCITS structures (38%). UCITS funds can also be particularly attractive to smaller investors due to the more retail nature of the structure and smaller minimum investment sizes

Despite the positives, alternative UCITS funds are not favoured by all hedge fund investors. Overall, they still represent a fairly small proportion of the overall hedge fund universe. UCITS-compliant funds are not always suited to sophisticated investors due to the level of investment constraints on the UCITS manager and may not be favoured by larger investors due to their smaller asset base. UCITS funds often have dampened returns when

Fig. 3: Breakdown of Investors Targeting UCITS Funds in the Next 12 Months by Investor Type (As at May 2013)



Source: Preqin Hedge Fund Investor Profiles

compared to offshore hedge funds due to a combination of reduced investment options, restricted leverage and other regulatory requirements. Additionally, there is a limited universe of UCITS funds compared to the overall hedge fund universe, which can lead to reduced strategy diversification for investors.

Which Investors Are Targeting UCITS Over the Coming 12 Months?

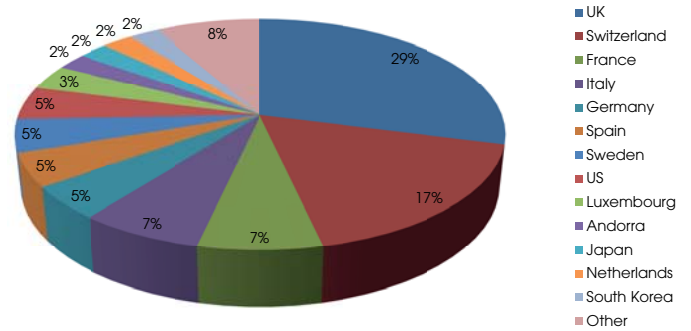
Just under a quarter of all mandates issued by Europe-based hedge fund investors looking for new investments in the next 12 months include alternative UCITS funds. The majority (62%) of investors seeking to add new UCITS investments over the coming 12 months are fund of hedge funds managers. Fourteen percent of asset managers and 8% of wealth managers are targeting UCITS-compliant hedge funds over the next 12 months and banks and family offices both represent 5% of the total. Appetite for UCITS hedge funds is lower among all other investor groups, suggesting that it is mainly firms that are managing money on behalf of clients, particularly those with high-net-worth or retail clients, that are targeting UCITS funds over the coming 12 months. The two most prominent countries in terms of investors looking for new UCITS investments are the UK and Switzerland, with the two combined representing almost half of the total.

Long/short equity is being targeted by half of all investors seeking new UCITS hedge fund investments over the coming 12 months. Long/short equity is typically a liquid strategy that works well within the UCITS framework, providing an alternative to investors committing to traditional long/short hedge funds. Fund of hedge funds manager Kairos Partners is an example of an investor currently focusing on investments in UCITS long/short equity.

Outlook

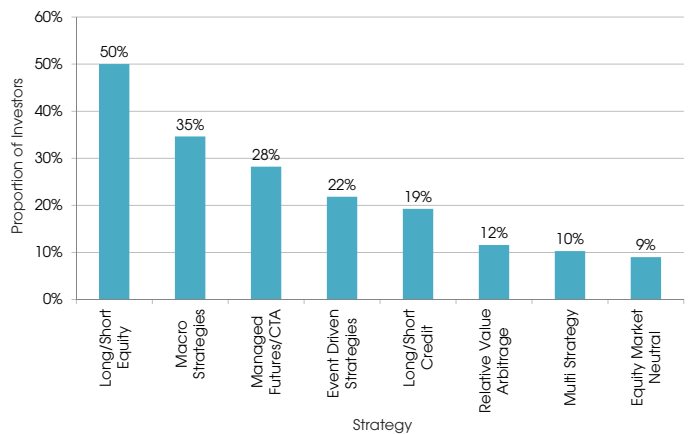
Investors have shown increasing appetite for alternative UCITS funds in recent years due to their ability to provide access to hedge fund strategies in a regulated, transparent and liquid format. The use of the UCITS structure could grow further in the coming years as investors look for alternatives to traditional hedge funds and the larger investors, such as public pension

Fig. 4: Breakdown of Investors Targeting UCITS Funds in the Next 12 Months by Investor Location (As at May 2013)



Source: Preqin Hedge Fund Investor Profiles

Fig. 5: Strategies Targeted by UCITS Investors in the Next 12 Months (As at May 2013)



Source: Preqin Hedge Fund Investor Profiles

funds, increase their exposure to UCITS funds. The outlook is positive for this alternative fund structure, although the limited universe, lower returns and smaller size of such funds mean that it will not be suitable for all hedge fund investors. These concerns may need to be addressed along with improved performance in order to convince the majority of the hedge fund universe of the benefits of UCITS hedge fund structures.

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Overview of UCITS Hedge Fund Universe

The use of the European-regulated UCITS structure as a wrapper for hedge funds became possible in 2001 with the third iteration of the directive. This widened the use of financial instruments permitted under the regulations and allowed fund managers to hedge their holdings. Since this time, the use of UCITS as a wrapper for hedge fund strategies has grown rapidly. In 2002, eight hedge funds were launched which complied with UCITS regulations; Preqin's Hedge Fund Analyst now tracks over 550 active UCITS vehicles.

Fig. 6 shows the growth of the UCITS structure through examining the number of fund launches each year and the proportion of total hedge fund launches UCITS vehicles have represented each year. Alternative UCITS funds offer investors increased liquidity, with the median redemption frequency of a UCITS vehicle being one day, with a notice period of two days. Following the market events of 2008, investors saw UCITS-compliant funds as vehicles that could satisfy their liquidity needs in an uncertain market. Alongside this, UCITS funds can offer both greater transparency on the underlying investments of the fund and regulatory oversight, which are attractive features to investors in the post-Madoff era.

In 2009, the proportion of fund launches represented by UCITS funds doubled to 12%, and in 2010 this increased even further to 16% of all launches. UCITS funds also hit their peak of fund launches in 2010, with 108 UCITS funds launched in the year. In 2011, UCITS launches remained strong, representing 13% of all hedge funds launched that year, with 94 new UCITS fund launches. However, in 2012 alternative UCITS launches made up a much smaller proportion (7%) of all fund launches. Many managers in the UCITS sector decided to focus their attention on growing and consolidating existing products rather than launching new vehicles following the implementation of new rules with the fourth UCITS directive. In 2013 so far, alternative UCITS fund launches have remained at a similar level to 2012, representing 8% of all hedge funds launches in 2013 to date.

Headquarter Locations and Domiciles of UCITS Funds

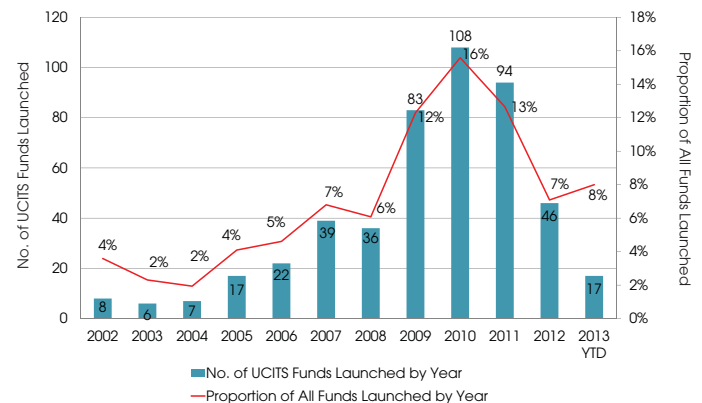
Forty-four percent of UCITS hedge funds are run by managers headquartered in the UK (Fig. 7). France is the second most common location for UCITS-compliant funds, with 13% managed by firms based in the country. Interestingly, the US is the next most common base for UCITS funds, with 12% of all hedge funds regulated under the European UCITS directive managed by US-headquartered firms.

Fig. 8 shows a breakdown of all UCITS funds by domicile. Although almost two-thirds of UCITS-compliant hedge funds are domiciled in Luxembourg, only 5% of fund managers managing a UCITS fund are based in Luxembourg.

Strategies Employed by UCITS Funds

Half of all UCITS funds follow a long/short investment strategy. Macro and relative value strategies are also commonly employed by UCITS funds, with 26% and 15% of UCITS funds utilizing these strategies respectively. Unlike the wider hedge fund universe

Fig. 6: UCITS Fund Launches Each Year as a Proportion of Total Fund Launches (As at May 2013)



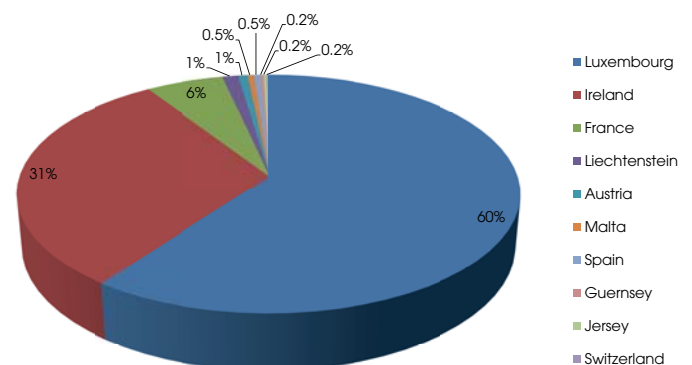
Source: Preqin Hedge Fund Analyst

Fig. 7: Top Five Countries for UCITS Funds by Location of Firm Headquarters

Location of Firm Headquarters	Proportion of All Firms Managing UCITS Funds
UK	44%
France	13%
US	12%
Switzerland	10%
Luxembourg	5%

Source: Preqin Hedge Fund Analyst

Fig. 8: Breakdown of UCITS Funds by Domicile



Source: Preqin Hedge Fund Analyst

however, event driven, multi-strategy and other strategy vehicles are not yet as established in the UCITS universe. The long-term, illiquid nature of many event driven and other strategy funds, such as asset-backed lending, do not easily lend themselves to the enforced liquidity requirements of the UCITS regulations and therefore uptake of UCITS by managers of these strategies has been low.

Fig. 9 shows a breakdown of UCITS launches each year by strategy. Following the upturn in the number of alternative UCITS launches in 2009, strategy breakdowns have remained comparatively stable in terms of launches each year. The

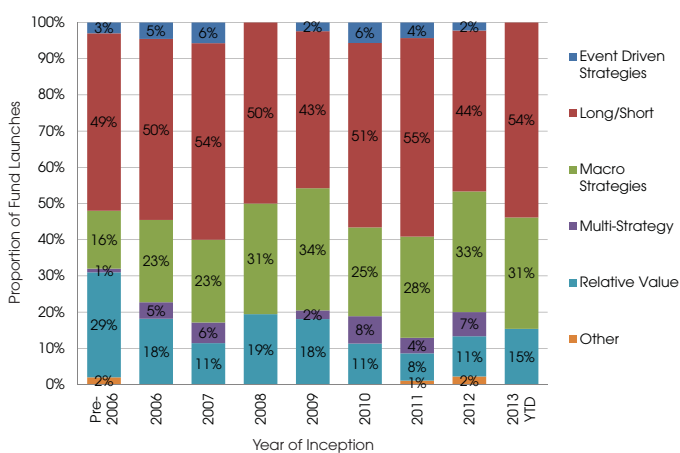
proportion of all UCITS fund launches represented by long/short vehicles decreased from 51% in 2010 to 44% in 2012. However, with equity markets rallying in 2012 and Q1 2013, the start of 2013 has seen a boom in the number of alternative UCITS funds that follow a long/short strategy, with 54% of UCITS fund launches following a long/short strategy. Relative value launches have increased in 2013 to 15%, following three years of relatively low numbers of UCITS fund launches.

Outlook

UCITS-compliant hedge funds continue to rise in prominence, with a significant increase in the number of launches in the space following the global market events of 2008. This led to investors calling for increased liquidity and greater transparency on the underlying investments of hedge funds, as well as for funds that employ lower levels of leverage. Investors saw the UCITS framework as a way to satisfy these needs; as a result, the number of UCITS funds in the industry has grown by 260% since 2008. The three main strategies utilized by alternative UCITS funds are long/short, macro and relative value. These three strategies better lend themselves to the liquidity constraints of the UCITS framework than other strategies, such as event driven, that have a much longer investment horizon.

Although alternative UCITS funds remain a niche part of the industry, representing around 7% of all hedge funds in the market today, they are an increasingly important part of the hedge fund landscape as we move into an era of regulation in the alternatives space. The latest iteration of the UCITS directive (UCITS IV) has had several improvements, including those to aid with the marketing of these vehicles. This includes the fund manager passport and improved disclosure documents, as well as cutting the cost of running UCITS vehicles by allowing fund mergers, the potential for master-feeder structures and allowing fund managers to move to more tax-favourable jurisdictions. These factors are proving attractive for fund managers considering

Fig. 9: Breakdown of UCITS Fund Launches by Year of Inception and Strategy (As at May 2013)



Source: Preqin Hedge Fund Analyst

alternative structures to the offshore commingled proposition when launching a new hedge fund.

Source New Investment Opportunities

Preqin's **Hedge Fund Analyst** currently tracks over 550 UCITS-compliant funds currently open for investment. Access detailed information on these vehicles, including investment strategy and preferences, performance, terms and conditions, key contact details, and more.

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Fig 10: Top 10 Largest UCITS Funds Open to New Investment

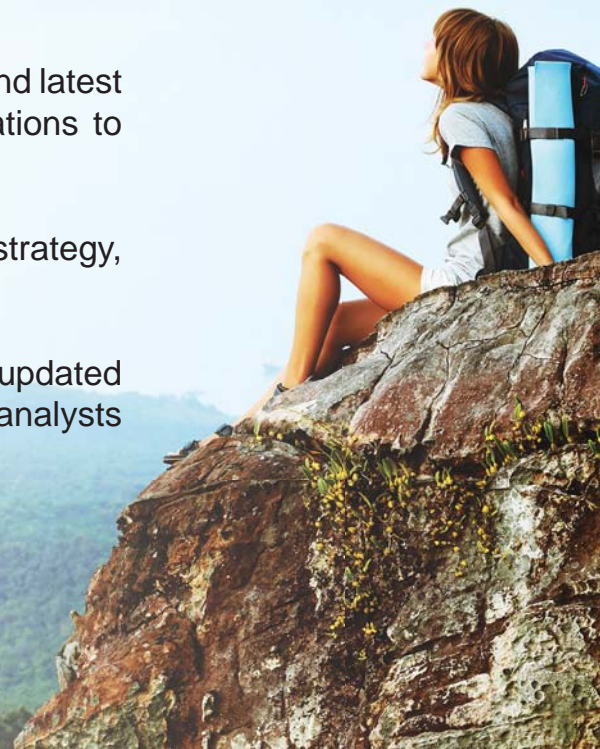
Fund	Firm	Core Strategies	Fund AUM (\$mn)	AUM Date
Standard Life Global Absolute Return Strategies Fund	Standard Life Investments	Multi Strategy	25,694	Mar-13
JPMIF Income Opportunity Fund	JP Morgan Asset Management	Fixed Income	7,667	Mar-13
Amundi Funds Absolute Volatility Euro Equities	Amundi Alternative Investments	Statistical Arbitrage	3,060	Mar-13
Amundi Funds Absolute Volatility World Equities	Amundi Alternative Investments	Statistical Arbitrage	2,586	Mar-13
GAM Star Global Rates	GAM	Macro	1,541	Mar-13
Schroder GAIA Egerton Equity	Egerton Capital	Long/Short Equity	1,519	Feb-13
Henderson Horizon Euro Corporate Bond Fund	Henderson Global Investors	Fixed Income	1,410	Mar-13
Dexia Index Arbitrage	Dexia Asset Management	Relative Value Arbitrage	1,233	Mar-13
AC - Risk Parity 7 Fund	Aquila Capital	Macro	1,022	Feb-13
ZEST Global Strategy Fund	Zest Asset Management	Macro	868	Mar-13

Source: Preqin Hedge Fund Analyst

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Opportunities and Barriers in the Alternative UCITS Market

- Ian Swallow,
Head of UCITS Management, Man

The Rise of Alternative UCITS Funds

Despite periods of strong returns, a great example of which is the 10-month period following Mario Draghi's commitment to do 'whatever it takes' to support the euro, the aggregate performance of equity markets since the turn of the millennium has been hugely disappointing, especially for European investors. While Wall Street traders happily sported Dow 15,000 caps in early May this year, both the DAX and FTSE 100 indices began the month languishing below the levels established at the height of the technology boom in the first quarter of 2000. As such, it is not surprising that we have seen a rising appetite for hedge funds in recent years, as an increasing number of investors have sought to complement the traditional assets within their portfolios with hedge fund investments that aim to provide both diversification and risk mitigation.

However, particularly post 2008, the key issue for many investors has been how to access hedge funds within a format that they are familiar with and one which fits their requirements for highly regulated, liquid, risk-controlled investments. Typically, hedge funds are offered in an offshore format with limited regulatory oversight, monthly (or less frequent) liquidity and high minimum investments.

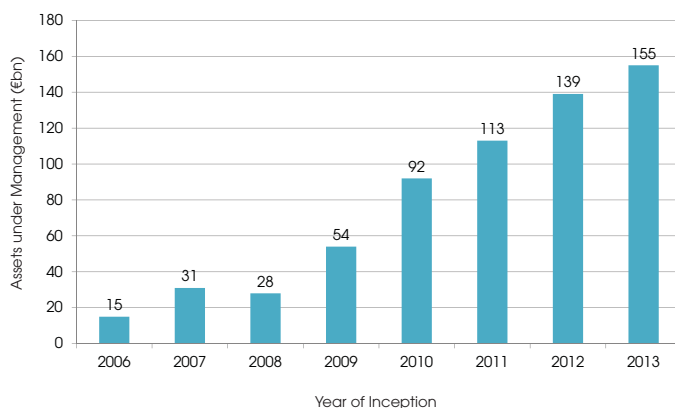
The process of bringing alternative investment strategies into the mainstream began a decade ago when the scope of eligible assets was significantly broadened with the introduction of the UCITS III framework which permitted, among other things, investments in financial instruments such as futures and options. This opened up the possibility for alternative investment managers to offer mainstream investors access to their investment strategies within the liquid, frequently priced, highly regulated, onshore UCITS format.

Consequently, alternative UCITS products have become extremely popular since the peak of the credit crisis in 2008 and assets under management have grown to €155bn¹. While this is a sizeable absolute number, it constitutes only a small proportion of the broad UCITS industry which manages assets of around €6.7tn². As such, alternative asset managers with strong track records and the ability to package their successful offshore investment strategies within a UCITS wrapper have a huge opportunity to attract assets.

A Huge Opportunity... But Only For Scale Players

While there is clearly an opportunity for alternative investment managers to capitalize on the UCITS market, the barriers to entry can be high and these restrict the ability of smaller players to offer quality alternative UCITS funds. Given the administrative complexities of UCITS regulations, considerable resources and expertise are required to structure hedge funds in a way that does not compromise the ability of the fund manager to harness alpha.

Rise in Assets under Management of Alternative UCITS Funds



Source: UCITS Alternative Index/Alix Capital

The key obstacles for alternative UCITS providers to consider are compliance with the Eligible Assets Directive (EAD) and other limitations relating to liquidity, diversification and leverage.

Eligible Assets

Introduced in 2007, EAD sought to provide greater clarification as to which assets could potentially be included in the portfolio of a UCITS product. EAD also determined that each instrument a fund manager invests in must be utilized in a cost-effective way either to mitigate risk or to generate additional returns at a level of risk consistent with the UCITS principles. For example, EAD reiterated the requirement that the potential losses relating to any asset or instrument within a UCITS structure must be limited to the amount paid for it. The guidelines in relation to eligible assets are designed to prevent irresponsible managers offering a product that is not suitable for mainstream investors.

Liquidity

The UCITS guidelines state that funds must provide at least bi-monthly liquidity, although in practice most offer weekly or more frequent redemptions. Given the additional requirement that fund managers must be able to redeem 10% of the net asset value of their portfolios on each dealing day, managers wishing to adhere to UCITS requirements inherently need to run highly liquid strategies.

Diversification

The 5/10/40 rule that applies to UCITS funds is designed to protect investors from high concentration in single securities, or issuers. In general we welcome this as a positive risk spreading rule. However, for some portfolios, where the manager has a high conviction in a certain security, this can dilute potential returns

¹ Source: UCITS Alternative Index/Alix Capital. As at 31 March 2013.

² Source: European Fund and Asset Management Association. As at 31 March 2013.

³ As at 31 March 2013.

when compared to a non-UCITS fund. As such, this needs to be taken into consideration prior to launching a UCITS fund.

Leverage

One area where the UCITS guidelines are slightly unclear, and a high degree of co-ordination with the regulatory authorities is necessary, is with regards to leverage limits. Typically, regulators will analyze the gross exposure of the portfolio without taking into account offsetting trades. As such, it is easy to quickly gain (what appears to be) a significant level of leverage in the portfolio and regulators unfamiliar with alternative investment strategies may decline approval for the portfolio when it is taken at face value. Where this is the case, it is important to have a strong dialogue with the regulatory authorities in order to fully explain the nature of the portfolio. Such discussions should include an explanation of how the risk management process ensures that high exposure is not actually detrimental to investors, but seeks to ensure that they receive enhanced risk-adjusted returns.

As such, to be able to offer successful alternative investment strategies within a UCITS framework, providers need scale, significant product structuring resources and regular dialogue with regulators.

Going Forward

There are several upcoming developments within the UCITS space which providers of alternative investment strategies need to consider.

1. ESMA: The ESMA guidelines on ETFs and other UCITS issues came into force in February this year (there is however a one year grandfathering period for some of the guidelines, specifically those relating to index-tracking UCITS funds). In short, these guidelines stipulate that investment managers provide clearer descriptions of the indices that the fund is tracking, more transparency on index calculation/the component parts and a slower re-balancing speed. This is expected to result in a number of funds, particularly ones running managed futures programmes, experiencing some difficulty in executing their strategies. Potential solutions include more complex structures that enable funds to trade the same strategy or alternatively narrowing the field of investments in order to allow the funds to continue trading.

2. UCITS V: The upcoming UCITS V changes will be primarily aimed at fund governance with three main areas being addressed:

- 1 - The depositary/custodian function will be harmonized to ensure consistency across all EU states.

- 2 - The introduction of manager compensation rules.
- 3 - Harmonization of the sanctions for breach of the main investor protection sanctions.

While these changes will need to be carefully considered by providers, they are not expected to have a huge impact on the types of funds that managers are able to be run within a UCITS framework and should provide investors with additional protection.

3. UCITS VI: There are still several unanswered questions surrounding the exact form of UCITS VI. Eight main topics have been raised for discussion so far and it is likely that they will have far reaching consequences for providers of alternative UCITS funds. Our assumption is that these changes will impact provisions around the list of eligible assets, how efficient portfolio management techniques are employed, OTC derivatives, liquidity management and the use of long-term investments. Consequently, we are already considering potential impacts on new fund launches.

Conclusion

The ongoing broadening of the UCITS framework that began in earnest in 2003 constitutes a tremendous leap forward in terms of both diversification and choice. However, it also provides some well-intentioned challenges that investment managers must overcome in order to comply with the series of directives. There is little doubt that genuine appetite for alternative products exists and that many investors are fully cognizant of the importance of diversifying their investment portfolios in the aftermath of the 2008 crisis and the broader 'lost decade' for equities. While there is considerable scope to capture assets, the UCITS framework acts as a form of quality control and only the larger-scale players are likely to have the capabilities necessary to satisfy the complexities associated with this opportunity.

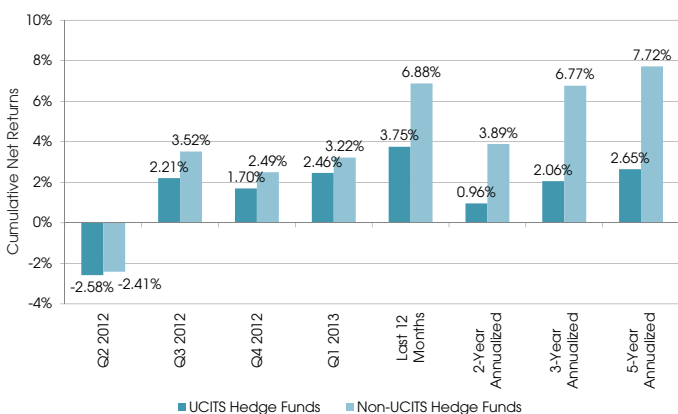
Man

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www.man.com

Performance of UCITS Hedge Funds

Fig. 11: Performance of UCITS Hedge Funds (As at March 2013)



Source: Preqin Hedge Fund Investor Profiles

Performance of UCITS Hedge Funds

UCITS funds combine the risk-reducing strategies of the hedge fund asset class with a level of investor liquidity more traditionally associated with mutual funds. The high degree of liquidity, coupled with restrictions on the level of leverage and the instruments traded, inevitably results in a dampening of UCITS fund returns when compared to hedge funds that do not adhere to the directive. However, despite these constraining factors, UCITS hedge funds have demonstrated a capacity to deliver absolute returns over the long term while maintaining a low risk profile relative to equity markets.

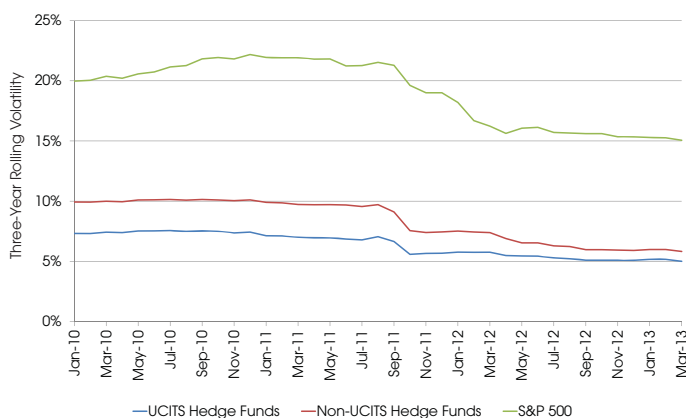
Fund Returns

Fig. 1 shows the net returns generated by UCITS hedge funds over various time periods. It provides an illustration of the subdued nature of returns delivered by UCITS funds relative to non-UCITS vehicles. The data from Preqin's Hedge Fund Analyst online service shows that in each of the quarters between April 2012 and March 2013, the returns posted by UCITS hedge funds slightly trailed those of non-UCITS funds. However, Fig. 11 also demonstrates that UCITS funds have offered capital preservation over the long term, with positive returns posted over the two-, three- and five-year periods. This was achieved amid turbulent and, in some cases, declining markets in 2008 and 2011.

The Risk Profile of UCITS Hedge Funds

The use of hedging strategies by UCITS funds has allowed these vehicles to capture the same risk-reducing qualities that attract investors to hedge funds. Fig. 12 plots the three-year rolling volatility of UCITS fund returns compared to the S&P 500 since January 2010. The volatility of UCITS fund returns was in the range 5-8% during this period while the S&P 500's level was significantly higher, ranging from 15% to 22%. This serves to demonstrate the capacity for UCITS funds, as part of a diversified portfolio, to deliver asset protection in various market environments.

Fig. 12: Volatility of UCITS Hedge Funds, January 2010 - March 2013



Source: Preqin Hedge Fund Investor Profiles

The standards required of UCITS funds represent an incentive for investors seeking to add hedge fund strategies with an even lower risk profile to their portfolios. As a result of the conditions of the UCITS directive, compliant funds not only compare favourably to fluctuating stocks but are also generally less volatile than their non-UCITS-compliant hedge fund counterparts. Although a narrowing of the gap was seen in 2012, the volatility of returns posted by UCITS hedge funds has consistently been lower than the 6-10% level of non-UCITS vehicles (see Fig. 12).

The scale of drawdowns experienced by UCITS hedge funds in recent years has been of a similar magnitude to those suffered by non-UCITS vehicles. Both fund structures saw a maximum decline of approximately 3.30% in 2010 and the 7.49% loss posted by UCITS funds in 2011 was only marginally inferior to the 7.40% fall seen by traditional hedge funds. UCITS funds fared slightly less well in the uncertainty of 2012, declining by 3.30% compared to the hedge fund loss of 2.70%.

Due to typically smaller upside returns, UCITS hedge funds tend to take longer to return to profit following a period of loss than non-compliant funds. For example, the decline of more than 7% in 2011 was followed by a 16-month recovery period, outstripping

Fig. 13: Top Performing UCITS Hedge Funds by Annualized Net Return Since Inception (As at December 2012)

Fund	Annualized Return
Skyline UCITS Fund - USD Institutional	20.10%
Absolute Insight Credit Fund - Class B1p Sterling Shares	19.10%
DB Platinum Omega Fund - I2C-U	17.93%
Global Navigator Fund - GBP B	17.51%
Silk African Lions Fund - R Class EUR	16.78%
Vitruvius Emerging Markets Portfolio - B (USD)	14.19%
MS Perella Weinberg Partners Tokum L/S Healthcare UCITS Fund - Share S (USD)	12.69%
GAM Star Global Selector - GBP	12.43%
Bond Global Select Fund	11.72%
AC - Risk Parity 12 Fund - USD A	11.57%

Source: Preqin Hedge Fund Analyst

Fig. 14: Top Performing UCITS Hedge Funds by Net Returns in 2012

Fund	2012 Return
DB Platinum Tosca Mid Cap Equity Fund - I1C	37.45%
Renaissance Ottoman Fund - Class A	36.26%
Vitruvius Greater China Equity Portfolio - B (USD)	32.12%
LFP JKC China Value Fund	28.12%
Vitruvius Asian Equity Portfolio - B (USD)	26.81%
Dueemme SICAV Euro Investments Plus	26.36%
LFP JKC Asia Value	25.95%
GAM Star Global Selector - USD	25.44%
Skyline UCITS Fund - USD Institutional	25.00%
World Invest Eurostar Equities - C EUR	24.00%

Source: Preqin Hedge Fund Analyst

the 12 months non-UCITS hedge funds took to return to black. This serves as a reminder to investors that the enhanced liquidity of UCITS funds can be restrictive for managers, that are themselves mindful that prolonged lossmaking periods may be met with redemption requests.

Fund Selection

As with most investment funds, UCITS fund investments are not without risk and the skill of managers and the returns posted varies greatly. It can be difficult for investors to identify the most successful vehicles but, reassuringly, most funds generate positive performance over the long term. More than 70% of UCITS hedge funds made gains over the three-year period to the end of December 2012 and more than half of these posted net returns exceeding 10%. Fig. 13 lists the top performing UCITS hedge funds by annualized return since inception. It shows that some managers have found considerable success replicating hedge fund strategies and generating outsized returns within a UCITS wrapper.

A large number of UCITS funds posted close to neutral returns in 2012, with one-fifth generating returns for the year in the range of -2% to +2%. However, a significant proportion enjoyed success and 40% of funds were up by more than 5% over the course of the 12 months, while a select number (8%) delivered returns exceeding 15%. Fig. 14 shows the very top performing UCITS hedge funds in 2012.

Strategy Selection

The liquidity requirements within the UCITS directive mean that the fund structure does not lend itself to all strategies. The illiquid and long-term nature of event driven and distressed strategies, for instance, has resulted in few UCITS funds operating in this space. However, funds employing long/short strategies are particularly common among UCITS funds and it is this type of vehicle that has enjoyed the largest returns in recent years.

Long/short UCITS funds posted gains of more than 8% in the three years to the end of 2012 and, as Fig. 15 shows, they benefited from equity market rallies in early 2013 to maintain a strong run of performance. The UCITS hedge fund league

tables are dominated by long/short vehicles, emphasizing their prominence both in the medium term and the long term. Relative value and macro UCITS funds delivered similar levels of returns over the last three years, posting 5.08% and 5.24% respectively between January 2010 and December 2012.

Although relative value and macro funds have not delivered the same level of returns as long/short funds, these vehicles have generated less volatile returns than their long/short counterparts. Relative value funds in particular have been less prone to significant fluctuations, with the level of volatility over the last three years standing at just 2.1% compared to long/short volatility of 6.9%. On the whole, relative value UCITS funds have made incremental gains and avoided sizeable drawdowns, providing investors with steady value growth in the long term.

Macro UCITS funds – though more volatile and with greater drawdowns than relative value vehicles – have avoided the scale of fluctuating returns generated by long/short funds. Three-year returns volatility for macro funds stands at 4.3%, placing it in the middle of the three UCITS fund strategies. The returns posted by macro funds have also generally fallen between the other two strategies, but a disappointing 2012 left macro funds struggling to recover losses and the long-term returns of these funds were surpassed by those of relative value funds in early 2013.

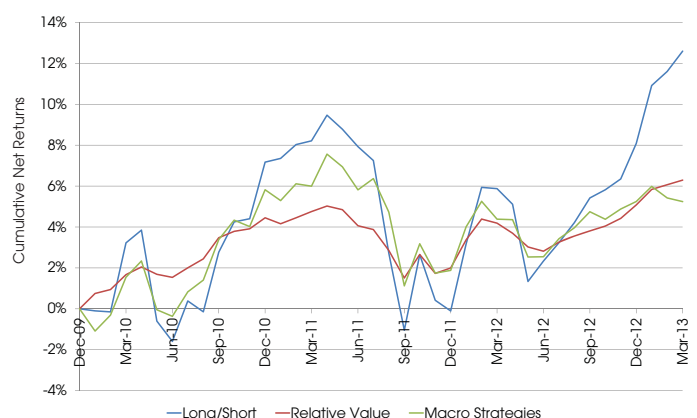
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Fig. 15: Performance of UCITS Hedge Funds by Strategy, January 2010 - March 2013



Source: Preqin Hedge Fund Investor Profiles

Preqin Special Report: UCITS Hedge Funds June 2013

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