

UCITS FoHF Survey

December 2009

ABSTRACT

This paper summarizes the results of a survey conducted among 30 of the largest Fund of Hedge Fund managers.

Among its conclusions, it shows that a most of them intend to enter the UCITS space over the next year.

Despite the fact that the survey participants generally expect UCITS Hedge funds to underperform their equivalent offshore funds, the “fund of UCITS” appears to be the preferred way to structure such offering for a UCITS investor base.

The survey highlights that there is substantial demand for fund of hedge fund strategies offered as UCITS from different types of investors. It also shows that the current investment universe is considered not deep enough and its quality not necessarily high enough to satisfy adequately these requests, which issue needs to be solved.

Survey participants recognize that Delta One Notes and Closed End funds may constitute the way to significantly improve the risk-return properties of such funds of UCITS.



Introduction

Over the past year, a significant number of hedge fund heavyweights have repackaged some of their Hedge Fund offshore offerings into UCITS in the search for a wider audience. At the same time, traditional long-only managers have also started to roll out their own vehicles using alternative investment strategies.

Given the rapid growth of this new fund universe, and because of the widely accepted assumption that there is substantial demand for regulated (“onshore”) fund of hedge fund profiles, many industry participants are now considering the launch of “UCITS fund of funds”

In December 2009, we conducted a survey among a **representative sample of 30 established fund of hedge funds managers**, along with some interviews, in order to get a better understanding of what their vision of the opportunity is, and how they intend to get positioned.

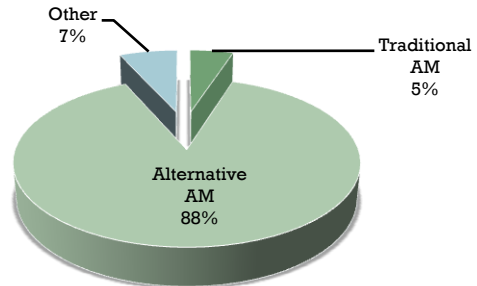
The results of this survey, combined with numerous feedback and experiences on UCITS related projects have been summarised in this paper, which main objective is to provide for some sort of an update and to highlight strengths and weaknesses of the different known approaches to deliver a fund of hedge funds profile in a UCITS.

Part I: Information about the Survey Participants:

What is the core business of your company?

Respondents : 30
Skipped Question : 0

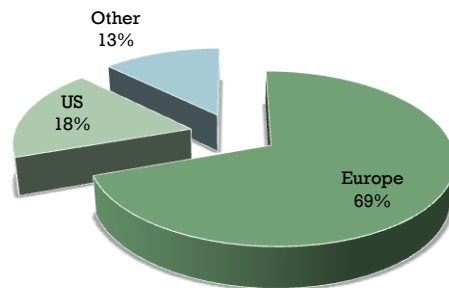
Core Business of respondents



Where does the bulk of your assets under management come from?

Respondents : 30
Skipped Question : 1

Origin of the Assets of the Respondents



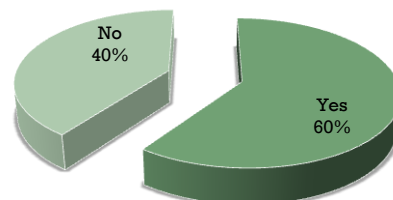
All the participants to the survey are established Fund of Hedge Fund managers.

The sample is deemed to be representative of the fund of hedge fund manager universe who have a main focus on EU distribution.

Do you have a fund distribution channel in Europe (private/retail banking network)?

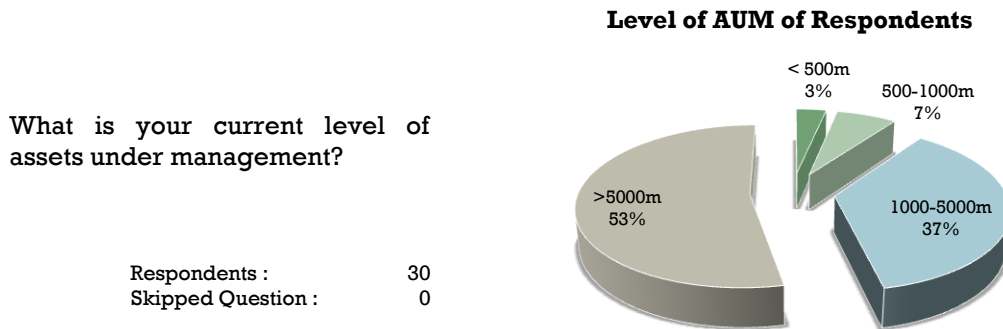
Respondents : 30
Skipped Question : 0

Owns EU Distribution

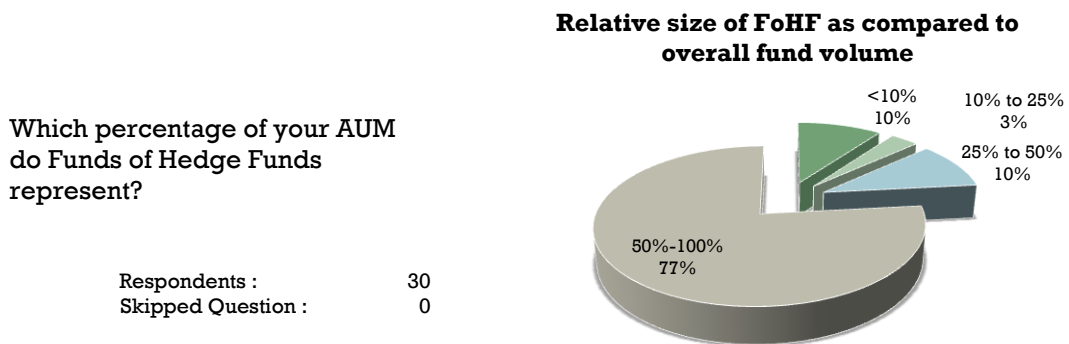


A majority of the respondents has a more or less ,captive' EU-based distribution channel.

This is likely to have a significant influence on their decisions with respect to the potential launch of such fund. Indeed, many respondents have confessed that their strategy will widely depend on the requirements outlined by their distribution channels.



90 % of the participants have assets under management in excess of USD 1 Billion. More than half of the respondents are large, “mature” fund of hedge fund managers, with assets in excess of USD 5 billion.

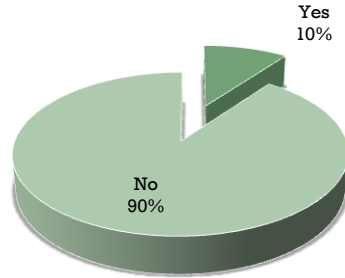


Hedge Fund multi-management represents the main business for the majority of the survey participants.

Has the respondent already launched a UCITS FoHF

Have you already launched a "UCITS" Fund of Hedge Funds?

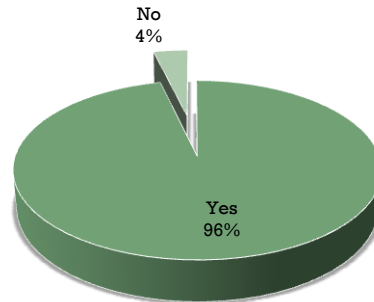
Respondents : 30
Skipped Question : 0



Has the Respondent investigated the possibility to launch of a UCITS

Have you already investigated the possibility to launch a UCITS?

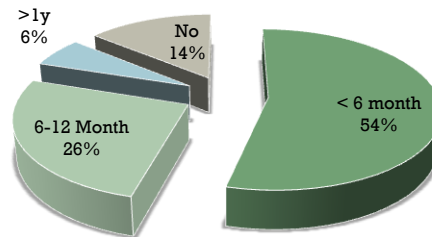
Respondents : 30
Skipped Question : 3



Expected Timeframe to launch a UCITS FoHF

Do you plan to launch a UCITS?

Respondents : 30
Skipped Question : 5

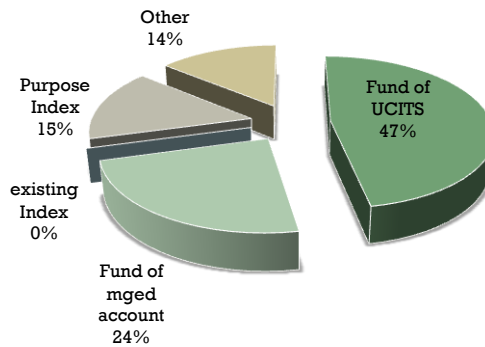


80% of the survey participants intend to launch a UCITS Fund of Hedge Funds in the next year!

If this is the case, which approach have you opted for?

Respondents : 30
Skipped Question : 9

Expected Structure of UCITS FoHF



We found this outcome quite surprising. We expected the managed account solution to be the more favoured solution, in particular if you consider the investments made by numerous fund of hedge funds managers in managed account platforms / solutions.

Highlights of Section I

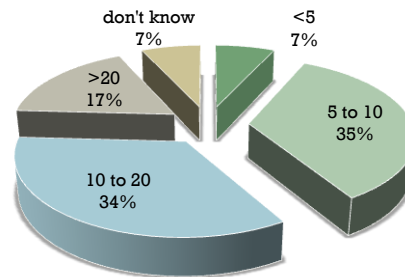
- **Almost all interrogated Fund of Hedge Fund Managers have investigated the UCITS opportunity**
- **A significant number of UCITS fund of hedge funds will be launched in 2010**
- **Funds of UCITS or Funds of managed accounts are the most popular approaches**

Part II: Hedge funds and UCITS

How many UCITS Funds of Hedge Funds do you think are already on the market?

Respondents : 30
Skipped Question : 1

Perception: how many UCITS FoHF are on the market



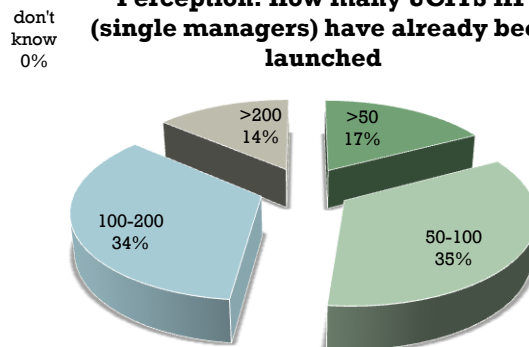
To date, we have identified 16 UCITS which performance depicts the combined performances of different alternative asset manager (fund of funds).

It is interesting to note that from these 16 funds, 6 are what could be named “UCITS of UCITS”; that is, funds investing directly in other UCITS (and other UCITS eligible assets). The ten others are so-called „Index constructions“, i.e. funds that get exposed to a fund of hedge fund strategy structured as a financial index through a total return swap.

How many UCITS Hedge Funds (single strategy) do you think have already been launched by Hedge Fund managers?

Respondents : 30
Skipped Question : 1

Perception: How many UCITS HF (single managers) have already been launched



According to most sources, there are between 400 and 600 “alternative investment strategy UCITS” available in the market. These include the so-called absolute return bond funds and other 130/30 funds. We have isolated about 125 “hedge fund UCITS” funds that pursue a hedge fund like investment strategy.

It is also worthwhile pointing out that structured products providers have recently developed indices, which are designed to replicate the performances of specific alternative investment strategies or in some cases to mimic the performance of the asset class as a whole.

Such strategies are known as alternative Beta or hedge fund replicators and have in general been constructed in such way that they would comply with UCITS eligibility requirements for financial indices. We have identified about ten UCITS tracking such indices.

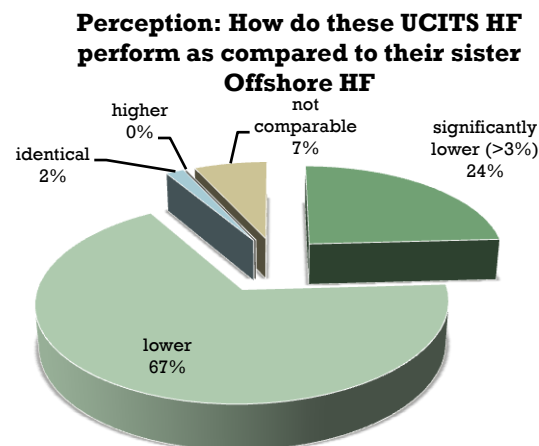
Performance: UCITS rules have been designed firstly for long only investments. A number of instruments or techniques used by alternative investment managers are not compatible with the UCITS restrictions.

Applying UCITS' Investment rules to alternative strategies may have a significant impact on their performances if done without using adapted investment solutions. This view seems to be shared by a majority of the respondents.

Actually, they think that the implementation of the same investment strategy in a UCITS impacts the performance negatively, reducing the potential for return as compared to the same strategy delivered in an offshore fund. The order of magnitude of this difference is even expected to be significant (in excess of 3% p.a.) by approximately a quarter of the survey participants.

How do you expect the performance of a UCITS Hedge Fund (single manager) to compare to its equivalent offshore fund?

Respondents : 30
Skipped Question : 1



The main challenges for the delivery of hedge fund performance in a UCITS are:

- Prohibition on direct investment in commodities and on physical shorting. This may limit a hedge fund manager to deliver its investment strategy in full.
- Leverage: A UCITS is not allowed to borrow for investment purposes. It can only obtain (limited) leverage through derivatives.
- Liquidity: the maximum redemption period for a UCITS is fourteen days and redemptions must be made in principle at the fund's net asset value. Therefore, the

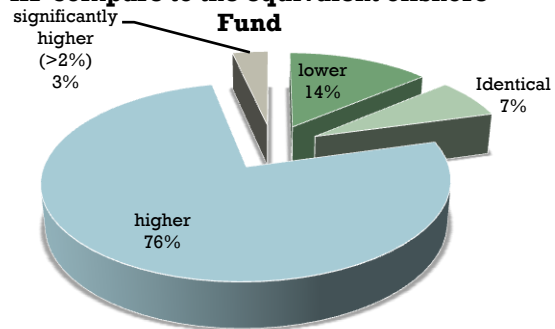
ability of managers to take positions in illiquid assets or illiquid strategies may be limited, restricting again the manager’s ability to deliver its investment strategy in full.

The performance impact of UCITS restrictions on any strategy is difficult to quantify. To our knowledge, there are too few offshore funds that have a UCITS equivalent and their track records are too short to produce evidence on the magnitude of this difference.

How do you expect the Total Expense Ratio (TER) of UCITS Hedge Funds (single manager) to be as compared to their equivalent offshore funds?

Respondents : 30
Skipped Question : 1

Perception: How does the TER of UCITS HF compare to the equivalent offshore Fund



About 80% of the participants assume the costs associated with running a Hedge Fund Strategy within a UCITS will be higher than the costs charged to the offshore equivalent fund. Another interpretation here consists in assuming that the manager is not incentivised to reduce management fees as the UCITS value proposal should be higher to the investor...

The fee structure of the “Newcits” recently launched tends to confirm this view. 2/20 is usually the headline figure and one should in addition, take administration and custody costs into account.

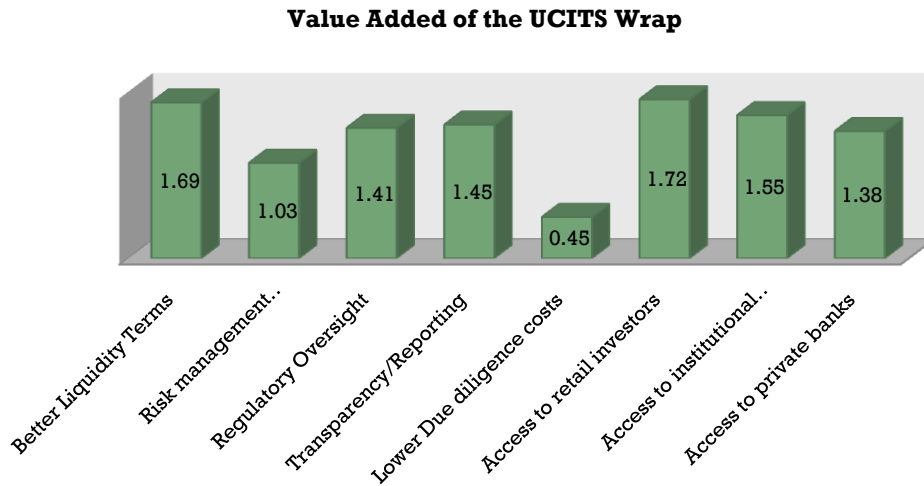
The higher costs / lower performance potential of UCITS as compared to their offshore equivalent is supposedly offset by a certain number of advantages.

If we believe the press, one of the main reasons alternative investment managers are setting up UCITS is related to the uncertainty surrounding the Alternative Investment Fund Managers Directive. Whereas this may play a role, we actually believe it is more demand driven, and that the move is mainly motivated by the ambition to gather more assets from sources that are not or no longer accessible through offshore funds or managed accounts.

We have asked the respondents where they think the value add is the greatest:

Where do you see the value added of UCITS as compared to offshore funds?

Respondents : 30
Skipped Question : 1



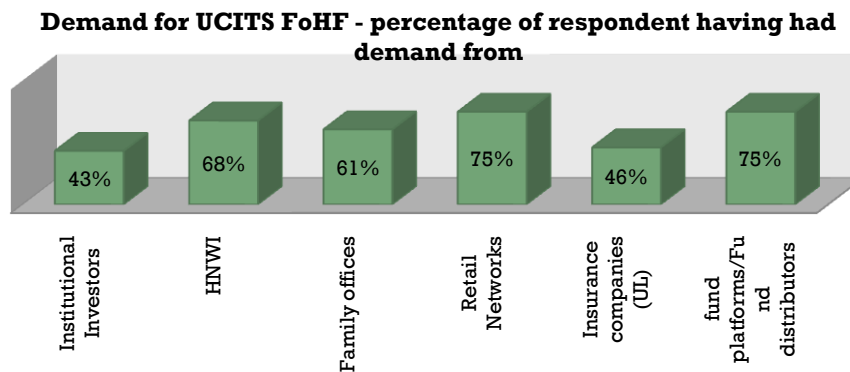
The above table has been computed on the basis of all the responses given, making the average of 0 for „no benefit“ (or N/A), 1 for „marginal benefit“, and 2 for „strong benefit“

In terms of distribution, **access to retail is seen as the major advantage a UCITS offers**. The respondents also recognise the value of the wrap with other investor classes, such as institutional investors.

When it comes to other advantages of UCITS, mainly related to its regulatory framework, the survey respondents consider enhanced liquidity and transparency as the most valuable attributes.

Have you had demand for UCITS Funds of Hedge Funds?

Respondents : 30
Skipped Question : 0



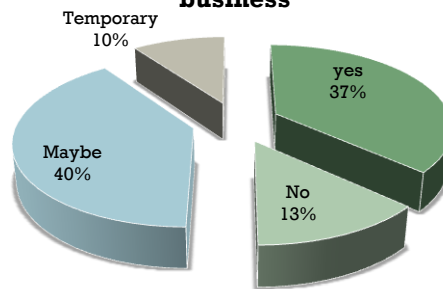
Three quarter of the respondents confirmed there is demand from retail networks and fund platforms or fund distributors. Interestingly, more than two third also had demand coming directly or indirectly from high net worth individuals, which is significantly more than the demand coming from institutional investors.

This is consistent with our experience, namely that the demand from private banking networks for regulated (UCITS) funds of hedge funds solutions is increasing significantly.

Do you see UCITS Funds of Hedge Funds as a significant development area for your Funds of Funds business?

Respondents : 30
Skipped Question : 0

Does the respondents expect UCITS to become an important proportion of his business



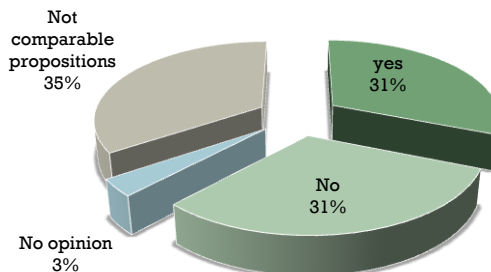
At this stage, **it is unclear as to whether UCITS will constitute a significant portion of the Funds of Hedge Funds total business in the future.**

Our opinion is that there is an increase in demand for sure, the question remains, however, as to who will be best placed to satisfy this demand: traditional Fund of hedge Fund managers or new entrants?

Do you consider UCITS to better address investor concerns than managed accounts?

Respondents : 30
Skipped Question : 1

Do UCITS address investors concerns in a better way than Managed Accounts?



Since the crisis of 2008, the „need“ for more liquidity and tighter regulation certainly brought UCITS firmly into the spotlight. Following the wake of gates, suspensions, losses, regulators and investors started to look towards more regulation.

UCITS, however, is not necessarily considered by the respondents as a better response than managed accounts to the investor demands/requirements, which is probably a fair statement.

Highlights of Section II

- **There is a general scepticism on the capacity of UCITS Hedge Funds to deliver performance**
- **Respondents see the main value of UCITS in the access the wrap provides to a certain client base**

Part III: Structuring a UCITS Fund of Hedge Funds

A UCITS cannot invest directly in (unregulated) Hedge Funds. It can, however, get an exposure to this “asset class” through:

-1- ‘Eligible’ Funds / Accounts

UCITS can invest into other UCITS, ‘supervised’ Hedge Funds (up to 30%), closed-end funds (if certain conditions are met), or managed accounts, provided that they invest in eligible assets only and that their ‘consolidation’ on the UCITS level (full transparency) satisfies all regulatory requirements (diversification, no excessive leverage, no physical short positions, etc.).

-2- Hedge Fund Indices

UCITS can invest into approved Hedge Fund indices. To be approved, the index has to comply with specific characteristics such as:

- It is sufficiently diversified;
- It is considered to be an adequate benchmark;
- It is published in an appropriate manner;
- It follows predetermined rules and objective criteria for the selection and rebalancing of the index components;
- There are no payments from index components;
- There is no backfilling;

In addition, an appropriate due diligence must be carried out by the UCITS;

-3- Delta One Notes

UCITS can invest in delta one notes linked to the performance of Hedge Funds as long as these securities fulfil the following conditions:

- They are liquid;
- The associated potential loss limited to the amount paid;
- There is accurate, reliable and regular pricing;
- There is regular, accurate and comprehensive information available;
- They are negotiable;
- Holding them is consistent with the investment objective;
- They embed no derivative (1 for 1 certificate).

We have noted that in practice, the eligible index rules restrict the underlying funds to be managed accounts only.

Also, delta one notes would be broadly used for the creation of Fund of Hedge Funds if the UCITS diversification guidelines would not make it practically impossible to replicate a Fund of

Hedge Fund: It requires a minimum of 16 different issuers to implement the strategy. In addition, a UCITS cannot hold more than 10% of the total debt issued by any issuer, which rules out a solution where these Delta notes would be issued from a segregated SPV.

For the sake of this survey, we distinguished three methods to deliver a multi-manager hedge fund performance in a UCITS:

1) Direct Investment approach

Plain vanilla approach, the UCITS invests directly in

- UCITS, and eventually
- Closed-End Hedge Funds or regulated non-UCITS Hedge Funds,
- Delta One Notes linked to hedge Funds, or
- Managed Accounts (investing exclusively in eligible assets)

2) Index approach:

The exposure to offshore funds/strategies is obtained through a Hedge Fund index. For this to be UCITS compliant, such index has to satisfy all the characteristics enumerated above.

The exposure to such Index is obtained through a performance swap (or Total Return Swap).

3) Structured approach

The UCITS enters into a derivative transaction (structured swap), which provides him with indirect exposure to a portfolio of offshore hedge funds. Such approach allows for obtaining one-to-one exposure to an offshore fund of Hedge Fund.

The exposure to the fund of hedge fund is obtained through a performance swap transaction.

We asked the respondents to provide for their input with respect to their perception of these different approaches in terms of marketability, implementation/ operational aspects, and performance expectations.

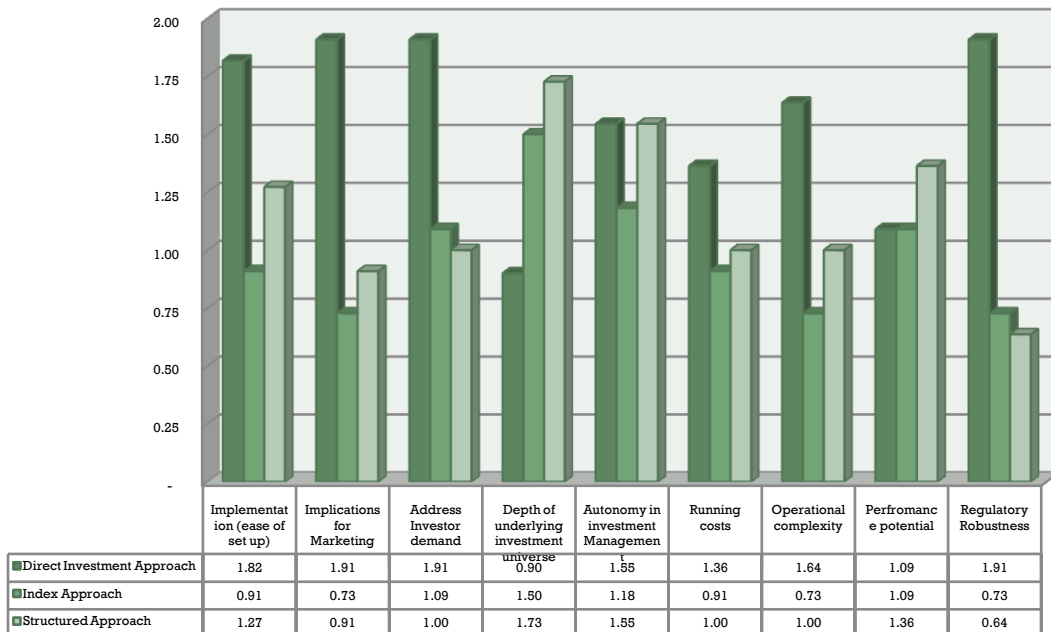
The table below provides for an average of the responses to each question:

- 2 means the approach is deemed suitable,
- 1 that it may raise some concerns but generally acceptable, and
- 0 means that the approach is considered as inadequate

Rate the different approaches with respect to?

Respondents : 30
Skipped Question : 19

Appraisal of the different Structures



- i) **Ease of implementation:** Setting up and managing a UCITS of UCITS is straight forward and much easier to implement than a UCITS tracking a Hedge Fund index or even than a structured fund replicating the performance of a Fund of Hedge Funds.
These two approaches provide the UCITS with an 'indirect exposure' to Hedge Fund performance, meaning the fund manager has to purchase transferable securities and enter into derivative transactions to obtain the desired economic exposure.
- ii) **Implications for Marketing:** **The simplicity of the direct investment approach is the main differentiation factor compared to the index and structured approaches.** Liquidity issues and (perceived) counterparty risk are negatives for the index approach and the structured approach, making it more challenging to promote.
- iii) **Investor Demand:** It is widely accepted that investors are looking for a regulated Fund of Hedge Fund exposure. It is debatable whether the fact that the investment

vehicle is regulated matters more to the investor than the nature of the economic exposure.

- iv) Depth of Investment Universe: **This is by far the main negative for the implementation of the direct approach.** Most of the (single manager) UCITS have been launched recently and their underlying strategies are not very diverse (mainly long-short equity, global macro). Industry experts claim there are currently about 200 Hedge Fund UCITS (approximately 500 if we take the 130/30 and absolute return bond funds into account). **This universe is very small as compared to the estimated 7000 available offshore Hedge Funds...**
- v) Autonomy in Investment Management: A UCITS of UCITS will be subject to a certain number of investment rules. These guidelines are not too restrictive if it wasn't for **the lack of depth of the investment universe.**
- The requirements imposed to a Hedge Fund index to be eligible make it in our view **almost impossible** to replicate the performance of a real Fund of Hedge Fund.
- The structured approach is the **most efficient** as, with exception for more stringent liquidity requirements, it does not impose additional restrictions on portfolio management.
- vi) Running costs: Participants view the running costs of the direct investment approach as the lowest.
- Some respondents told us they were quoted between 150 and 300 basis points per annum by investment banks for an index solution.
- The "KDK" structured approach would only cost approximately 100 basis points per annum in addition to the traditional Fund of Hedge Funds costs.
- vii) Operational complexity: Swap based UCITS are very common, especially in the ETF space. Therefore, we would relativize the operational complexity of the index or the structured approaches. We agree, however, that a series of direct investments in 'UCITS eligible assets' remains the operational least intensive approach.
- viii) Performance potential: The participants to the survey rightly pointed out that Hedge Fund UCITS will most likely **underperform** their equivalent offshore fund. In addition to that, investment restrictions combined with a smaller investment universe will have a **negative impact on investment performance.** As far as the index approach is concerned, diversification requirements and financial index specific limitations (rules based approach), combined with higher costs will also

reduce significantly the potential for performance. **Therefore, we agree with the majority of the respondents that the structured approach will probably deliver the better performances.**

- ix) Regulatory robustness: There is no question that as long as the underlying Hedge Fund UCITS remain unchallenged, the direct investment approach is the most robust from a regulatory perspective.

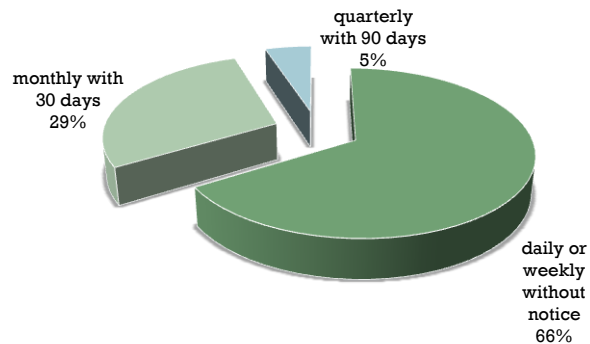
We believe, however, that the index approach and the structured approach are equally robust. Let's not forget that these approaches have been developed on the basis of directives, position papers and guidelines issued by the regulators and have already been largely used by the traditional UCITS managers.

Liquidity: We have asked the respondents, regardless of the structure chosen, what portfolio they would consider as appropriate from a liquidity perspective to satisfy UCITS liquidity requirements (fund open for subscription/redemption twice a month).

What do you consider as appropriate portfolio liquidity structure to meet the minimum bi-monthly UCITS liquidity requirement

Respondents : 30
Skipped Question : 8

Optimal Portfolio Structure (Average of respondents)

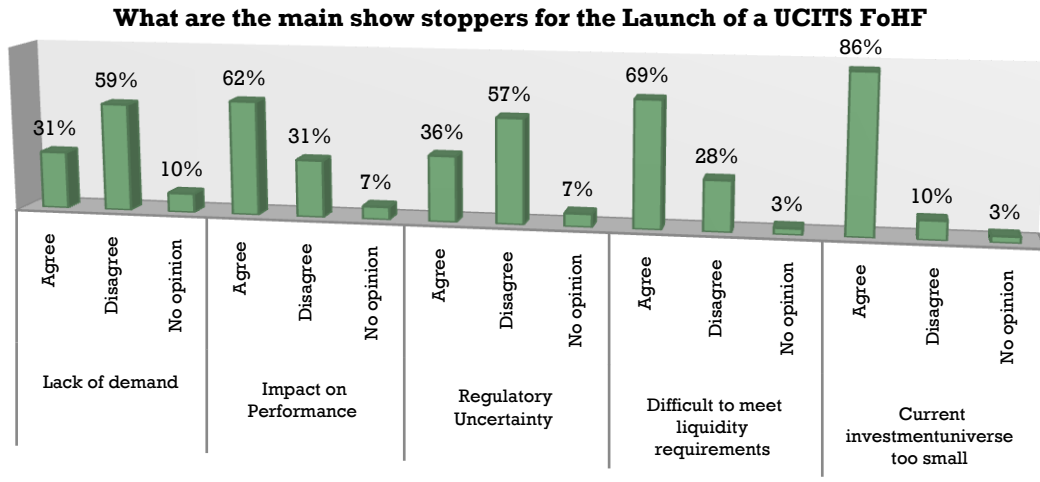


The survey participants consider that holding a minimum of **two thirds of the portfolio in liquid funds** would be sufficient.

We then asked the Survey Participants what could currently refrain them from launching a UCITS:

What are the main show-stoppers (if any) for the creation of a UCITS Fund of Hedge Funds?

Respondents : 30
Skipped Question : 1



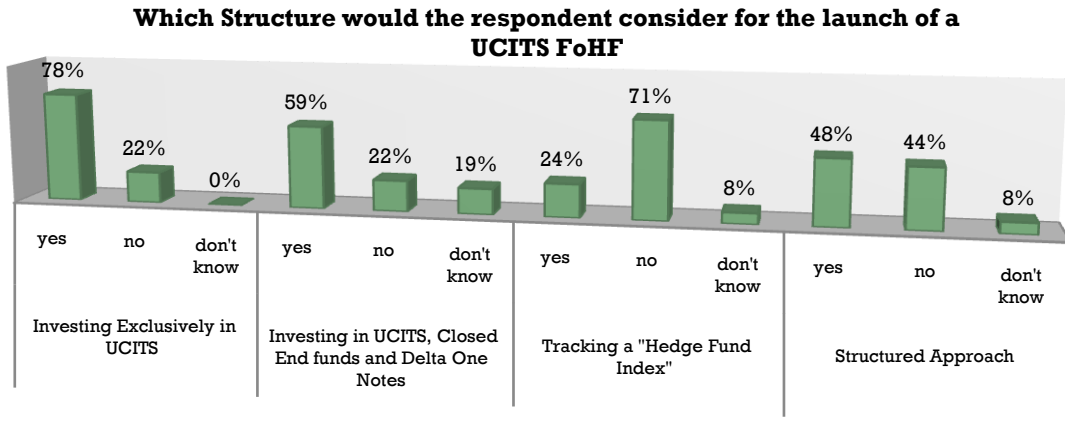
Once again, the fact that the current investment universe is too small is considered as the main negative.

Difficulties to meet the UCITS liquidity requirements or the fact that the performance may be adversely impacted to a large extent are also considered as reasons to delay or not to launch a UCITS.

Only 31% consider that the demand may not be strong enough to justify the launch of a UCITS Fund of Hedge Fund. The regulatory uncertainty, also, is not considered as show stopper by a majority of respondents.

Which structure would you consider to launch your own UCITS of Hedge Fund

Respondents : 30
Skipped Question : 3



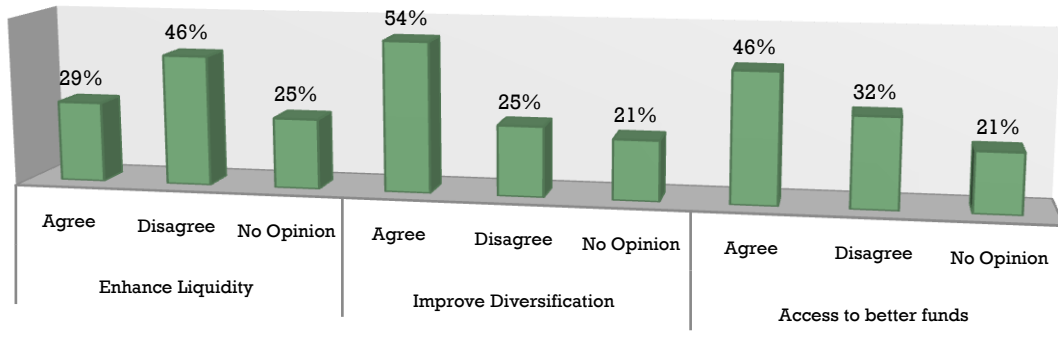
It comes to no surprise that the direct investment approach (investing exclusively in UCITS) is considered as a possible structure by the largest number of the respondents. Only about half of the survey participants would consider a structured approach whereas more than seventy percent **are ruling out** the Index approach.

It is worthwhile highlighting the fact that at least three quarters of the respondents considering the direct investment approach, would also favour an approach where the UCITS would invest directly in UCITS and in closed-end funds and Delta One notes. **It seems thus that closed-end funds and Delta-One Notes constitute a good solution to (partially) solve the issue related to the limited size of the investment universe...**

In the context of the direct investment approach, would you consider the access to closed-end hedge funds, or Delta One Notes linked to Hedge Funds (UCITS eligible assets) as essential to

Respondents : 30
Skipped Question : 2

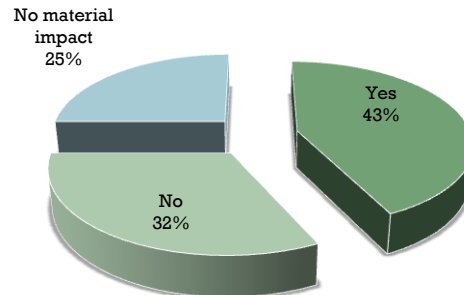
In a fund of UCITS, Access to Closed End Funds and Delta One Notes is essential to



Closed-end Hedge funds or Delta One Notes are seen as adequate instruments to increase the size of the investment universe for such funds of UCITS. Indeed, the majority of the respondents consider that they allow for an improved diversification and provide access to better funds. The Survey participants (probably rightly) consider that such vehicles do not contribute to an improvement of the liquidity terms (although one could argue that the more a portfolio is diversified, the more liquid it should be...)

Does such addition weaken the product proposal, in the sense that it reduces its marketability (no longer a fund that invests exclusively in UCITS)

In a fund of UCITS, investing in Closed End Funds and Delta One Notes weakens the investment proposal



Respondents : 30
Skipped Question : 2

The additional access is however seen as a potential negative in terms of marketing. Our view is that it should not have a material impact as it is clearly laid down in the UCITS directives and related guidelines that these are eligible assets...

Highlights of Section III

- **There is a strong preference for the most simple and straight forward solution**
- **There is a clear need for an expansion of the investment universe; Delta One Notes and Closed End funds have the potential to satisfy this need**

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