



Vienna, 20 September 2006

Position Statement on the Alternative Investment Group's Report to the European Commission on "Managing, Servicing and Marketing Hedge Funds in Europe"

Ladies and gentlemen,

We are pleased to send you the following position statement of the Superfund Investment Group regarding the Alternative Investment Expert Group's recent report to the European Commission on "Managing, Servicing and Marketing Hedge Funds in Europe."

Since its establishment in 1995, the Superfund Investment Group has become one of the world's leading providers of managed futures funds to individual investors, with more than 50,000 investors worldwide and approx. USD 1.5 billion of assets under management. Superfund employs a staff of more than 370 in 17 countries.

General view

Superfund welcomes the approach of the European Commission to take a comprehensive view of the development of the alternative investment sector in Europe, particularly within the hedge fund industry.

In view of the highly emotionalized character of much of the recent debate over hedge funds and the significant distortions in public opinion which this has helped to create, we greatly appreciate the objective and factual approach which both the European Commission and the Expert Group have taken regarding this topic.

The intensity with which the European Commission is reviewing the hedge fund issue is commensurate to the market relevance of these financial instruments. Over the past years, hedge funds have become a very significant component of the global capital markets.

In this context, the question of access to hedge funds by retail investors is of particularly central importance, as the demand for hedge funds by retail investors has grown enormously in recent years. It must be assumed that the strong interest from this investor segment will continue, and thus the assurance of appropriate investor protections must be given highest priority in the future.

Setting the course for the European financial markets

The future development of the European hedge fund industry will play a decisive role in determining the overall position of the European financial markets relative to the USA. Moreover, a healthy and dynamic European hedge fund industry would provide enormous macroeconomic benefits for all of Europe.

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One need only consider the burgeoning financial markets in Luxembourg and Ireland to see the benefits which the introduction of innovative and appropriate capital market instruments can yield, in terms of both domestic economic growth as well as the international positioning of their respective financial markets. Strong and highly developed capital markets are of essential macroeconomic importance in efficiently providing capital to Europe's companies. They are a basic prerequisite for sustained economic growth, innovation, and job creation.

Comprehensive European solution is needed

Considering these vital macroeconomic issues, as well as the increasing fragmentation of the European financial markets caused by divergent country-level legislation - and above all, the tremendous importance of ensuring appropriate legal protections for investors - Superfund believes that a comprehensive European solution is needed.

Only a suitable European legal framework which considers the unique structures and needs of the hedge fund industry can make Europe stronger as a center of the world financial markets, make EU members more attractive as domicile countries, and at the same time put a stop to the migration of capital to the grey market and to off-shore jurisdictions. By creating a level playing field, more international capital could be attracted to Europe, and more domestic capital could be retained within the EU member states. The quoting of fund share prices on Europe's exchanges would likewise have the effect of strengthening their position.

Hedge funds are not all the same – differentiated approach is essential

There continues to be a lack of awareness of the vast differences among individual hedge fund strategies, not only in the media and in general public perception but even in the Expert Group's report. In order to reach a sensible solution, it is absolutely essential to take a differentiated approach which examines the divergent risk parameters associated with the various hedge fund strategies.

As an example, the Superfund Investment Group follows an investment strategy of managed system trading in futures contracts and is thus keenly interested in achieving a uniform legal framework for this ever more popular category of investment instrument.

As an investment category, managed futures funds are noted for their virtually zero correlation with the full range of traditional investment instruments, as well as with other hedge fund styles. The addition of managed futures to a traditional portfolio of equities and bonds thus brings the investor a two-fold benefit: First, the managed futures component reduces the risk of the overall portfolio, and second, the addition of this component improves the total portfolio return. Beyond this basic benefit of portfolio diversification, managed futures funds trade exclusively on the world's most liquid markets, which ensures - in contrast to many other markets - that positions can be liquidated at any time, thus enabling the highly effective use of stop-loss limits. Additionally, the fully electronic trading available on most futures markets facilitates system trading on these highly transparent and strictly regulated futures exchanges.

Beyond this issue of the diversity among hedge fund styles, it is also important to have a sound understanding of hedge fund performance - particularly in terms of risk potential - compared to other investment instruments such as equities, bonds, warrants and structured certificates.

It must be recognized that managers of traditional equity funds are restricted to taking "long" positions in shares and thus can only make profits when the shares go up. When shares go down, losses are unavoidable. In contrast, hedge fund managers can profit from both rising and falling rates.

In this context, the Edhec Risk and Asset Management Research Center analyzed the risk of hedge funds by comparing investments in hedge funds with investments in equities along several dimensions. The results of the study showed that compared with both the S&P 100 and the NASDAQ 100 equity indices, a large majority of the thirteen hedge fund indices exhibited a significantly lower “value at risk” and “conditional value at risk.”

Moreover, hedge funds again showed their strengths in terms of maximum drop in value, known as “drawdowns.” During the comparison period, 73.7% of the individual equity funds suffered temporary drops in value of over 50%, while only 10.2% of the hedge funds in the study were so affected.

Finally, out of the estimated 7,000 to 10,000 hedge funds now in existence, there are just 15 failures per year on average - and in more than half of these cases, the cause stems from operational management rather than from any issues of performance or risk of the underlying investments. This risk is thus also on a manageable scale.

This study clearly shows that while risk does indeed exist in hedge funds, it is by no means any higher than traditional asset classes broadly held by retail investors, such as equity funds.

In considering these facts, the prejudices against hedge funds compared to traditional equity funds which currently exist - and the resulting difference in legal treatment - simply cannot be justified. Superfund strongly believes that the equal legal treatment of hedge funds with traditional funds is both appropriate and called for.

Regarding the report’s Recommendation #1

Minimum threshold

The addition of hedge funds and managed futures funds to investment portfolios can significantly improve risk diversification. This basic fact is proven by the portfolio theory of Harry Markowitz, who received the Nobel Prize in Economics for his work.

Hedge funds have been successfully used for many years to provide diversification to investment portfolios, not only by institutional investors and high net worth individuals but also by leading universities such as Harvard and Yale, not to mention numerous pension funds.

A balanced and diversified portfolio ideally includes a hedge fund component of between 10 and 15 percent. In this context, we find it difficult to comprehend the Group’s recommendation of a general minimum investment of EUR 50,000. In effect, this would mean that a sensible, balanced hedge fund component would be denied to retail investors with investment portfolios of less than EUR 500,000.

Or conversely, this minimum investment amount might drive some retail investors to allocate a higher proportion of their portfolio to hedge funds than is actually appropriate for them.

The recommendation of a high minimum threshold of this sort must also be considered relative to the risks of “traditional” investments such as equities and equity derivatives. There are no minimum threshold regulations for these instruments, even though the risk of total loss is often greatly underestimated by retail investors. These products are nevertheless distributed without the according mechanisms for investor protection. As a simple example, a European investor can invest 100% of his portfolio in shares of a single company.

Should the European Commission pursue the idea of introducing minimum thresholds, we would argue for these to be set at a more appropriate level.

Intermediaries and institutions who conclude sales contracts with end-investors

Superfund fully supports the recommendation of the Expert Group to establish clear requirements for the proper business conduct of intermediaries and institutions who conclude sales contracts with end-investors.

Regarding Recommendation #2

The recommendation of the majority of the Group against reopening the negotiations of key provisions of the UCITS Directive is quite understandable.

Nevertheless, in view of the continued growth in demand for hedge funds by retail investors, it is essential to ensure an adequate framework for investor protection.

For this reason, we argue that those investment vehicles - specifically including managed futures funds - which carry no greater risk than conventional UCITS investment vehicles should be deemed “eligible assets” under the UCITS Directive.

This solution would also help to level the playing field between those hedge fund strategies which fall under the UCITS Directive and those which do not.

On a final note, in considering the Expert Group’s cautious position regarding minimum thresholds in the context of strong interest from retail investors and the range of legal possibilities to structure investment instruments, we would like to draw attention to the reality that retail investors – regardless of the outcome of the present debate – will continue to have access to hedge funds with modest minimum investment amounts through structures such as certificates.

It should therefore be a matter of concern to us all that a suitable framework exists to ensure a basic level of investor protection, particularly within this segment.

Christian Baha
Founder of the Superfund Investment Group