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The Sum Also Rises:

Spain Emerges as Europe's Newest Fast-Growth Hedge Fund Market

Three years ago, there was no such thing as a Spanish hedge fund. In December 2006, the entire market had barely €1 million (\$1.6 million) assets under management. A year and a half later, it is a €2 billion (\$3.2 billion) industry.

Of course, in today's adverse global economy, that rate is likely to slow.

"This year has been very difficult," says Sophie van Staelen, CEO of Paris-based consultancy Asterias. "We might be more conservative now."

Still, there's no arguing with the nascent market's success so far. Its groundwork wasn't laid until 2003, when Spain passed a law authorizing the development of unit trusts beyond the ubiquitous mutual funds and unit trusts.

Not much happened between then and 2005 when a royal decree formalized the legal personalities of single-manager hedge funds and funds-of-funds.

Spain's first hedge fund capital began flowing in April 2006, but those first few months lacked the regulatory rigor that one associates with European Union markets. In 2007, a second royal decree established three provisions requested by the fund managers: a lockup period, a notification period and a liquidity window. They work together like this: An institution putting money into a Spanish hedge fund agrees, at the time the investment is made, that it would be a specific number of years before the money can be withdrawn. As that date approaches, the institution must notify the fund of its intention to

make that withdrawal. Then, on that date, the institution may only take out a predefined proportion of the investment, not liquidate the whole account.

In addition to protecting fund managers, these restrictions also serve Spain's national interest by encouraging capital formation, enabling larger projects to be funded.

"This allows investment in illiquid assets," says Madrid-based lawyer José Pasqual, who specializes in representing hedge funds. Still, he acknowledges that no one benefits unless there is ample return on assets. "It's in the interest of investors to let the managers manage."

By all accounts, the Iberian investment culture tends to be to the more risk-averse side of those found on in continental Europe, which in turn are more cautious than those which have been established in London or New York. This conservatism is enshrined in law and regulation.

"Institutional investors on the continent must invest in regulated funds," van Straelen says, explaining why euro-zone players would accept such restrictions on capital flows. She notes that France and Italy are also fairly new hedge fund markets, and they have grown consistently at a 20% to 25% annual clip – with the caveat that this pace may be now be slowing.

These countries have liquidity restrictions comparable to those in Spain, according to van Straelen, who notes that Spain's €50,000 (\$80,000) minimum investment in single-manager funds is among the lowest on the continent.

Spain had only four hedge funds at the start of 2007 and today has 25 single-manager funds and 38 funds-of-funds registered. The funds-of-funds appeal more to the

domestic investor, who is unlikely to be familiar and comfortable with hedge funds, according to Pasqual.

“Funds-of-funds are more diversified,” he says, “and not as risky as single-manager hedge funds.”

These fund families include such global players as Deutsche Bank, UBS, Cygnus and Barclays, as well as such local talent as Caja Madrid, Invercaixa and of course Banco Santander. There is no minimum investment for funds-of-funds, as there are for single-manager funds. Further, funds-of-funds can be marketed to the retail trade, while single-manager funds can only be sold to qualified investors. In fact, a single-manager fund must be sold to dozens of qualified investors – it has to maintain a roster of at least 25 shareholders or risk losing its charter.

The Spanish hedge fund market may be poised for prodigious growth, but its focus on in-country resource could prove to be its biggest inhibitor. It could be many years before a sustainable depth of talent and breadth of infrastructure have been established in Madrid and, according to van Straelen, foreigners have experienced difficulty registering there as fund managers.

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