

ESMA report highlights liquidity concerns for Alternative Investment Funds

The main risks faced by the sector relate to a mismatch between the potential liquidity of the assets, and the redemption timeframe offered to investors. This is particularly the case for real estate funds and funds of funds. For hedge funds, the issue of leverage is key at more than 900%, in a sector valued at EUR 354bn in net asset value (NAV), including EUR 269bn for hedge funds with UK AIFMs.

The AIF sector was heavily impacted by the COVID-19 related market stress during the first quarter of 2020, and while outside the reporting period, a snapshot of the main event is included in the report.

Main findings:

- **The size of the EU AIF universe** continued to expand to reach EUR 6.8tn in NAV at the end of 2019, a 15% increase from 5.9trn in 2018. The growth of the EU AIF market results from the launch of new AIFs in 2019 and positive valuation effects;
- **Funds of Funds (FoFs)** account for 15% of the NAV of EU AIFs, at around EUR 1tn (+22% compared with EUR 841bn in 2018). At the very short end, investors can redeem 39% of the NAV within one day, whereas only 29% of assets could be liquidated within this time frame. If large redemptions were to occur, AIFs would face challenges due to this liquidity mismatch;
- **Real Estate Funds** account for 12% of the NAV of AIFs, at EUR 802bn. They continued to grow, albeit at a more moderate pace (+9% in 2019 after +35% in 2018). Compared with 2018, the proportion of retail investors was stable (21%) but remains high compared with other AIF categories. RE funds are exposed mostly to illiquid physical assets which take time to sell, so liquidity risk in RE funds remains a concern;
- **The size of the EU Hedge Fund** sector remained stable in 2019 at EUR 354bn, or 5% of all AIFs. However, when measured by gross exposures, HFs account for 62% of AIFs since they rely heavily on derivatives. Leverage is very high at more than 900% after adjustments, and particularly so for some strategies highly reliant on derivatives;
- **Private Equity Funds** account for 7% of the NAV of all AIFs, or EUR 456bn, and experienced the largest growth in 2019 (+28% compared with +66% in 2018). They follow a range of strategies and are almost exclusively sold to professional investors;
- **Other AIFs** account for 60% of the NAV of EU AIFs, at around EUR 4tn (+15% compared with +6% in 2018). The category covers a range of strategies, with fixed income and equity strategies accounting for 68% of the NAV and an additional residual category amounting to 29%. Other AIFs are mainly sold to professional investors, although there is a significant retail investor presence; and

- EU Member States can allow **non-EU asset managers** to market alternative funds at national level under the National Private Placement Regime (NPPR), even though such funds cannot subsequently be passported in to other Members States. The market for such non-EU funds is comparatively large: The NAV of non-EU AIFs marketed under NPPRs' rules amounts to EUR 2.1tn, i.e. more than one-fifth of the AIF market. NPPR fund marketing is concentrated in a small number of Member States, and 98% of investors are professional investors.

ESMA will continue to report annually on its analysis.