Jefferies Prime Services Quarterly

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Talent is Hitting a Target It's Hard for Others to Hit. *Genius* Is Hitting a Target It's Hard for Others to *See*.

There are many talented investors – but some are able to identify invisible emerging trends *early* that we may come to take for granted as obvious in the future.

Here are some of the early stage trends we have been hearing more frequently from forward thinking alternatives managers. As the world evolves and the pace of change accelerates, it's possible :

1. **Ethical consumption trends s p r e a d across multiple sectors**. As demand for more ethically and sustainably sourced products grows – from protein to diamonds to everything in between – and technology allows supply to catch up, it's possible consumers of nearly all products will come to expect their purchases be more in line with sustainable lifestyles. The world doesn't need to fully "go vegan," in order for subtle changes in preferences to have considerable impact. This could particularly affect:
   i. Paper and packaging – does it look good on social media and is it sustainable?
   ii. Food and beverages – what's in your protein?
   iii. Carbon – looking far beyond carbon footprints to carbon ecosystems. What is the all around impact?
2. **Wealth transfer begins in earnest, changing consumption and investment norms**. About 10% of total global wealth - $30 trillion – is expected to move between Baby Boomers and their younger counterparts in the coming decades. This doesn't include wealth already *owned* by millennials – estimated at around $20 trillion. The needs, desires and norms of the largest generation – and among the first digitally native ones – will have considerable repercussions. See here for our Millennial Habit Survey Series: Phase 1 | Phase 2.
3. **Moving from a disease treatment system to a true *health care* one.** As data collection explodes, and novel approaches to processing disparate forms of health information continue to evolve, the health care industry as we know it is pivoting and expanding to include all aspects of life from sleep and exercise, to gene therapy or consumption habits and everything in between.

2019 Hedge Fund Performance Review I HFRI		
Strategy	**April 2019**	**YTD**
HFRI Event Driven	1.61%	5.80%
HFRI Macro	1.37%	3.74%
HFRI Relative Value	0.77%	4.65%
HFRI Equity Hedge	1.75%	9.52%
HFRI Fund Weighted Composite Index	**1.49%**	**7.08%**

Source: HFRI as of 5.24.19

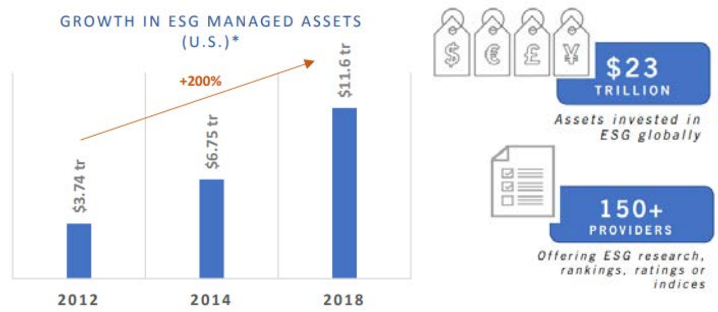
Why is ESG Everywhere?

Environmental, social and governance investing (ESG) – has hit an inflection point. **ESG invested assets in the U.S. have more than tripled since 2012**, and now hover around $23 trillion globally.

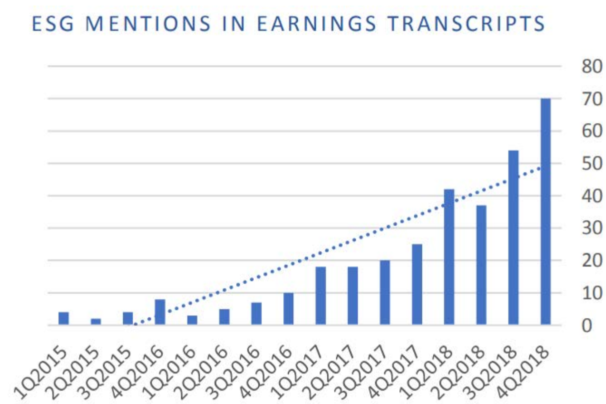
In March of this year, BlackRock launched one of the most successful exchange traded funds *ever* – the iShares ESG MSCI USA Leaders ETF raised more than $850 million at its debut.

And Consultants increasingly boast ESG Leads to respond to client inquiries about bespoke sustainable or impact investing solutions.

Redefining Value: An Advanced ESG Primer explores why the momentum behind sustainable investing has turned a corner, with allocators, asset owners, investors and issuers alike revisiting their focus on the space.



*In trillions USD; Source: Forum for Sustainable and Responsible Investment



Source: Jefferies, AlphaSense

Some of what's driving this?

- **$30 trillion in expected wealth transfer** between Baby Boomers to Gen Xers and Millennials in the coming years
  - Rising generations of investors are much more concerned with issues around sustainability and corporate governance
- **Data availability has exploded**. While a standard lexicon hasn't emerged *yet*, the days of Company Says…Non-Profit/NGOs Say…. are behind us. Third parties are now triangulating with hundreds of thousands of data points to measure company sustainability.
- **Increase in product customization**. Demand *and* supply for more bespoke products is on the rise – among them, those focused on sustainable themes, screens or other various inputs.

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3Q2019 Portfolio Pre--Cap

We've been keeping our finger on the pulse of the biggest—or most unusual –issues that have shaped portfolios in the second quarter and will continue to do so in the coming weeks and months. Among them are:

Voice. Just over half of the next generation of leaders already have a smart home device. As we watch the adoption time for tech innovations plummet, we're wondering how long it will take for Alexa's 80,000 skills, to reach a million. Jefferies analyst Brent Thill recently reported that voice was a major emerging theme at the Shoptalk ecommerce conference convening companies like Google, Amazon, Microsoft, and Apple.

The next frontier of cloud will be *gaming*. What do cloud providers and your 9 year old have in common? They both want to stream video games on the cloud. Google and Microsoft are close to achieving this—and the streaming speed, power, and location continuity it requires. We wonder if this round-the-clock gaming access might have implications for the potential convergence of gaming and healthcare, or even other sectors too.

The Unicorns and FAANGs of the Future. The UK's Prince George wasn't the only famous birth of 2013. It was also the year both "FAANG" and "unicorn" were coined. Since then, the FAANG stocks have dominated public market commentary, and unicorns, private market discussions. We are focused on identifying the potential FAANGs of the Future and the next crop of unicorns. Our best guess? **The convergence of healthcare and technology**.

The current FAANGs are **unified by their use of data, which enables everything from content creation, to selling iPhones, to selling *everything***. While these brought together tech and consumer discretionary, the "FAANGS of the Future" may marry tech and healthcare. Are VR headsets that help stroke patients "tech" firms or medical devices? Where does 23&Me's data sale to Glaxo SmithKline fit? Will our apple a day come from Tim Cook or Granny Smith? **-- Shannon Murphy & Lily Calcagnini**

Seeding & Acceleration Landscape: Current Themes

Anchor (No Economics)

- Anchor investments (without economics) typically made by 'friendlier' parties and driven by prior relationships. Seen most frequently in the new launch space where firms are backed by family offices or family capital

Separately Managed Accounts

- **25% of client base reports running at least one SMA** supporting the well publicized trend of increased investor demand for customization and transparency

First Loss Capital

- Hedge Funds, of varying stages in their lifecycles, continue to entertain conversations with providers of first loss capital
- Have seen a handful of new launches take first loss capital day one

Spotlight on Outsourcing

The trend of hedge fund managers outsourcing their trading infrastructure to prime brokers via Outsourced Trading Desks (OTDs) continues to accelerate. Increasingly, those laser-focused on generating alpha acknowledge that trading may "not [be] a good use of resources and time," as John Laub explained to Bloomberg reporters. Meanwhile, LPs have come to view outsourced trading as a shrewd decision in certain circumstances.

- Shift back towards institutional seeders versus unique, one-off deals
- 2018 saw a noticeable uptick in seed and acceleration deals compared to 2017 & 2016 where the number of deals appeared consistent year over year
- **Strategy**: Hedge Fund seed & acceleration deals in 2018 **spanned strategies with noticeable preference towards equity long short and macro**, the remaining deals split across Special Sits & ED, Credit, and Quantitative firms
    - Within the equity deals, **an overwhelming amount of seeded funds have a sector or geographic tilt**
- Current strategy preferences towards equity and macro is likely due to **greater capacity and scalability of the strategies** compared to others
- **Increased focus on liquidity** – allows seeder flexibility to exit relationship without compromising the integrity of fund asset composition
- **Capacity** is typically at least **8x the seed investment**
- Increased incidence of seeders providing **working capital support** – most are non-distortive of economics; finding interesting ways to structure this that minimize tax drag
- Increased tolerance for seeders to not have **overtly preferential liquidity**
- **Recent activity from groups like**: Blackstone, Clocktower, Forrester Capital, HS Group, Inception Point, Tages, Titan

Millennials (born 1981-1996) are **increasingly senior decision makers, leaders, and founders of alternatives funds**.

The Jefferies Capital Intelligence team has launched a series of surveys to understand **generational differences in how information is created, consumed, and *valued.***

The responses revealed stunning differences between how the "old guard" and new guard of business leaders and decision makers think about **valuation, monetization, and commercialization of the newest assets of the modern economy—content and data.** The implications for our industry and most others are profound.

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Millennial Survey Series: Methodology

Phase I: *Social Media and Content Habits*

Phase I explored several key questions about **how content is consumed** vis-à-vis **social media, news, apps, and devices**. We wanted to understand:

1. What are the **differences in social media usage** between "protomillennials" (those born before 1981) and millennials (born in or after 1981)?
2. Do these differences impact ***how* information is consumed and valued**?
   a. Do these difference impact **when information is consumed and valued**?
3. What are the **emerging forms of media most leveraged** by each group, and how frequently?
4. What does this tell us about who will be the **winners and losers of next-generation content creation and dissemination for alternatives funds?**

Phase II: *Commercializing Existence: Who among us cares when companies sell our data?*

Phase II dug into the behaviors and standards of acceptability around **key issues for the next decade: personal data, its valuation**, and its **monetized**. We wanted to know:

1. What are the **differences in assumptions about privacy** between "protomillennials" and millennials?
2. How do these differences **translate into professional, consumer, and social behaviors?**
3. How do these differences impact ***expectations for the future* of personal data privacy** and the related rights?
4. How does this determine the **winners and losers of next generation alternatives funds and the companies they invest in?**
5. What conclusions can be drawn about future ownership, valuing, valuation, and commercialization of data—the "new oil" of the modern economy?

Millennial Survey Series: Key Takeaways

Millennials think in pictures, with more than 75% of them checking Instagram at least once per day

They **hunger for information and news**, out-consuming older generations in virtually every media source except live TV.

Millennials have a **growing interest in podcasts**, which makes the research process a 24/7 endeavor.

About half of respondents **use technology to enhance their health or fitness regimes**, *regardless of age cohort*.

Email is the great generational equalizer. No matter their age, respondents treat their inboxes the same—**less than half read all their emails.**

Millennials are **30% likelier to rest easy knowing a company is commercializing their data**—and they **don't feel entitled to compensation**.

Much of the working-age population **are still forming an opinion on key issues surrounding data and privacy.** The terms of the debate are still being defined.

Dual Reality. Protomillennials and millennials hold **entirely different baseline assumptions** about **what counts as personal data, if they're entitled to privacy**, and **who "owns"** this information.

Compared to older generations, **millennials generate *more* data** and have ***more* interest in seeing it** but care ***less* about how it is repurposed** by third parties.

Top Reads in Equities Research

A few examples:

- Amazon (AMZN) – Deep Dive - Still Room to Run (Thill, Apr. 3) – Brent sees a road map to $3,000/sh for AMZN over the medium term even with what he believes are conservative growth estimates. AWS, advertising and 3P are all expected to grow faster than retail, and are accretive to margins. New businesses including healthcare would be generally incremental to our forecasted growth.

- Interactive Entertainment – Game Changer: A Deep Dive on Free-to-Play Console Games like Fortnite (O'Shea, Mar. 8) – While the "free to play" video game model will likely expand the market, it also presents uncertainty. Fortnite generated $2.4B in '18 revs (est), showing FTP can produce superior results, particularly as Tim estimates Fortnite's EBIT margin could be 2,000bps better than ATVI or EA. Tim believes the largest franchises like Apex (EA), COD (ATVI), and GTA (TTWO) are best positioned.

- Medical Supplies & Devices – Alcon Deep Dive: Survey Work Points To Attractive Large Cap Opportunity (Petrone, Apr. 4) – Ahead of Alcon's spin from Novartis, Anthony completed doctor and consumer surveys. Based on his findings, Anthony sees 200bps of incremental share in AT-IOLs on launch of PanOptix and a $450-$600M revenue uplift from PRECISION1. He thinks these drivers could help push topline growth over the initial LRP.

- Expedia (EXPE) – Deep Dive into Expedia's Core (Thill, Apr. 22) – Brent analyzed EXPE's major growth drivers and margin levers, which he believes will drive the stock in the next 2-3Y. Intense competition has weighed on EXPE's rev growth and margin profile, but Brent believes newer initiatives can help double OM from 7.6% in '18 to 15%+ in '23E. Shares trade at just 8.6x '20 EBITDA, the lowest multiple in Brent's large/mid cap group.

- Healthcare Services – Upgrading DGX & LH: UNH PLN To Help Growth from 2020 Onward, Valuations Are Low (Tanquilut, Apr. 2) – Brian upgraded shares of DGX and LH to Buy following analysis of the upcoming roll-out of the UNH's preferred lab network (PLN). DGX and LH combined have only about $1B of UNH's $8B lab spend, so their inclusion in the PLN should drive meaningful share gains. Brian sees EPS boosts of >2% for both DGX and LH and beginning in ‘20.

- Starbucks (SBUX) – "Third Wave" Coffee Not Impacting SSS; SBUX Growth Model Intact, Raising PT (Barish, Apr. 18) – Andy conducted an overlap analysis for SBUX and select "third-wave" competitors. Even in the most bullish third-wave growth scenario, the SSS impact on SBUX is limited to ~40bps by F22. Andy expects 3-4% SSS growth in the US.

Equity Strategy: Global Asset Allocation: From Trade Wars to Digital Wars

Access full piece here

Global equity markets continue to under-estimate the relentless expansion of the US-China trade dispute. The US Department of Commerce yesterday announced that it would put Huawei and its 70 affiliates onto its entity list. As an effective export ban, it holds back the development of 5G (the largest global capex project) and the growth of Internet of Things. It also completely disrupts the global tech supply chain. The macro and micro implications are immense.

No sooner than the US tariffs were hiked to 25% from 10% on US$200bn of Chinese imports last Friday (see Global Asset Allocation: Trade Deadlines (II)) than the US DoC decided to put Huawei and its 70 affiliates into its Entity List, thereby requiring them to obtain a US government license when they buy any components from US companies. ZTE was put onto the same list last year when it was subject to the US export ban. In effect, a broad trade war between US and China on rebalancing the trade deficit, IP and foreign technology transfer issues has coalesced into curbing China’s competitive advantages in 5G. The 5G technology will effectively provide countries with almost unlimited bandwidth at unimaginably fast speeds whilst allowing the parallel world of Internet of Things (IoT) to develop. As a source of services’ competitiveness for countries 5G provides a huge advantage once it is installed – everything from the use of autonomous vehicles to AI eco-systems. It should be pointed out that aside from the huge investment in the roll-out of 5G, enormous amounts of money are required to install fiber-optic systems and operating systems including base stations.

China has been leading the race in 5G technology and many DM and EM countries had announced plans to start procuring gear from Huawei. The Achilles heel for the Chinese telecom equipment makers is that they rely on US semiconductors and components which cannot be readily substituted (baseband chipsets for handsets (**Qualcomm and Intel**), semi-conductor for base stations (**FPGA from Xilinx**), RF/power amplifier chipsets (**Skyworks, Quorvo, Avago and Macom**), and optical components (**Lumentum/Finisar**)).

The bottom line is that investor’s are under-estimating the evolution of the US-China trade dispute. The progression from tariffs to direct actions against single Chinese companies and their inter-linked supply chains has a wide-ranging impact on profitability that investors will find difficult to quantify. We have highlighted the issues of the mispricing of systematic and unsystematic risk **(see Global Asset Allocation: BRICS, FAANG and GIPS). See Implications from US Placing Huawei on Trade Blacklist for details.**

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JEFFERIES UPCOMING EVENTS

Upcoming Conferences & Events		
May 29-30	NEW YORK	Jefferies 4th Annual Japan IT & Service Summit
June 2-5	TEL AVIV	Jefferies Israel Tech Trek 2019
June 4-7	NEW YORK	Jefferies Healthcare Conference 2019
June 13	LONDON	NASDAQ in Association with Jefferies 40th Investor Program
June 17	NEW YORK	Jefferies Annual Steel & Metals Industry Summit
June 18-19	NANTUCKET	Jefferies Consumer Conference 2019
June 19-20	NEW YORK	BattleFin New York – Alternative Data Discovery Day
August 6-8	NEW YORK	Jefferies 2019 Industrials Conference
August 26-28	CHICAGO	Jefferies 2019 Semiconductor, Hardware, and Communications Infrastructure Summit