Jefferies Prime Services Monthly

OUTLOOK 2018

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*****The Jefferies fiscal year runs through November 30th, so December 1st is our 'new year.' We hope this piece – while a bit early – prompts some reflection on the year to date and stimulates conversation as to what may lie ahead. Thank you to all of our clients and partners for a productive and successful 2017, and…'Happy New Year.'*****

Jefferies

2017 YEAR IN REVIEW

Our inaugural Prime monthly quoted Jimmy Iovine: **Everything we know could be wrong already**. It's no less true now than at mid-year.

Here's some of what we learned was wrong in 2017:

1. **Something would derail this equity rally.** While 2016 was notable for being unpredictable, 2017 may be remembered as the year when the markets seemed to stop responding to the unpredictable**.** The enduring equity market rally refused to blink in response to numerous macro events. Trump tweets, North Korean sabre rattling, and multiple elections across Europe failed to prompt material or long-lasting market moves.
2. **We had heard the last of: 'Data,' 'A.I.,' 'MiFID II' and 'Fidget spinners.'** All vying for the most pervasive buzzwords of 2017.
3. **We had finally gotten our collective cybersecurity acts together.** After the headline Equifax and SEC cyber breaches, concerns have only escalated - electronic threats are existential threats. Et tu, Uber?
4. **Anything would get done in Washington**. There's still a few weeks to go – but legislative reform has seemed out of reach for the 2017 Congress so far.
5. **Global politics would get a little more predictable after a crazy 2016.** From the UK's snap elections in June to Germany's recent inability to form a coalition government and risk new elections shows the only certain thing in politics remains uncertainty.

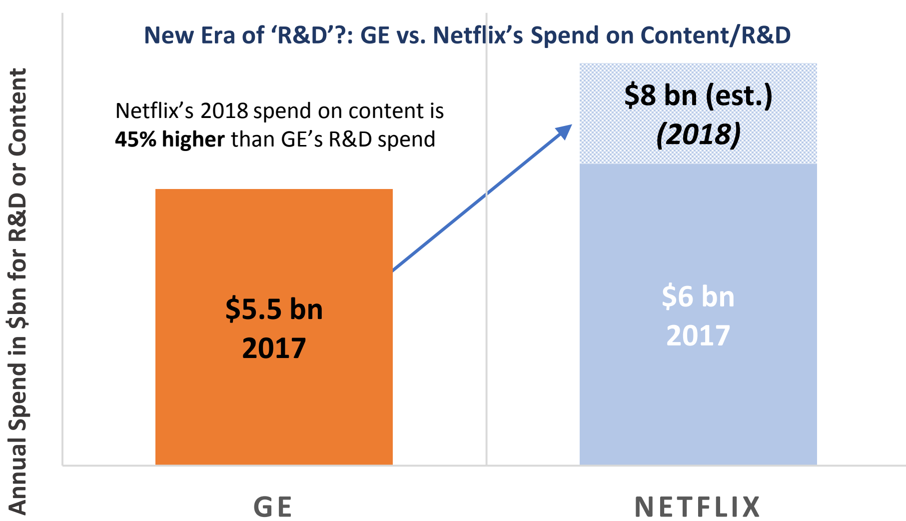
Biggest cliffhangers heading into 2018:

- Do hedge funds have a shot at ending the year up double digits for the first time since 2010?
- Which city will win the contract for Amazon's HQ2?
- And finally….AT&T/TWC – happily ever after or never after?

WORD TO THE WISE

Market bubbles and manias exhibit the same pattern of investors acting 'colorblind in a sea of red flags,' followed by a crash."

Roland Benabou, Princeton University
Groupthink: Collective Delusions in Organizations and Markets



Source: GE Annual Report 2016; Netflix 3Q 2017 Earnings Call

TOP PREDICTIONS FOR 2018

Return to Our Roots. After years of 'institutionalization,' managers and investors have increasing appetite for smaller, more nimble or niche hedge funds – many of whom report higher volatility.

Cryptocorruption. Feelings on cryptocurrencies seem completely binary: tulip-awaiting-crash or 'The Future.' Given the explosion in crypto products, it's likely there will be at least **one** big flame out.

Talent acquisition and recruiting becomes even more cutthroat – particularly for data focused professionals or engineers – as firms elevate business development .

Sector spinoffs continue to gain steam. More than 36% of emerging Equity Long/Short start ups in 2017 reported a specific sector focus. We expect that percentage to grow, given demand.

Macro events prompt rise in oil prices. The simmering macro and political issues across the Middle East or in Venezuela heat up and start to drive oil materially higher.

Cybersecurity fails trigger the first headline casualties. Rise of A.I. driven cyber means 2018 may be the first time a sizeable and public breach challenges a firm's ability to weather losses.

Regulatory divergence continues to cause confusion. Whether MiFID II itself or the multiple rules that try to address its loopholes, ongoing altering of trading landscape will be costly and confusing.

Re-insurance related products continue to attract interest. We started to hear from a growing number of allocators and managers focused on the product.

Rate of ICO growth outpaces IPO growth. The rate of Initial Coin Offerings (ICOs) has exploded with more than 100 in 2017, and that pace will only continue to accelerate.

INVEST TO GROW: CONTENT & THE FUTURE OF 'R&D'

Comparing GE and Netflix may be like comparing apples to french fries, but it was notable to us that Netflix's anticipated 2018 content spend is **~45% higher than GE's entire R&D spend this year**.

Netflix is a single purpose company – it delivers content for consumption – while GE is (still) a diversified conglomerate. But an estimated $8 billion in content spend is a **lot** of *Orange is the New Black*. We suppose Stranger Things have happened…but as diverse companies increasingly view original content and innovation as integral to their company branding, R&D spend remains a space to watch. Those who can build their own increasingly will, and those who can't – will look to buy.

2017 PERFORMANCE: CRYSTAL BALLS AND CRYPTOCURRENCIES

Performance 2017: Cautiously Optimistic

We have 11 months of 2017 under our belts – and barring an acute market move in December, it's possible hedge funds will **post their best showing in five years**, up around +8% on average through November (based on early estimates).[1]

Hedge funds overall ***have only posted one down month over the last 21*** (October 2016, when they were down 59 bps). Equity L/S funds are performing particularly well this year, up around 11% YTD (+10.69% through October, with initial estimates of slightly less than 1% for November). It's too early to be sure of how the year will end, but there's considerable cause to think 2017 will be a reversal in the last two years' more muted showings.

[1] Jefferies and HFRI

LEADERS	LAGGARDS
BITCOIN +850% YTD	**CBOE Volatility -29.70% YTD**

BITCOIN PRIMER

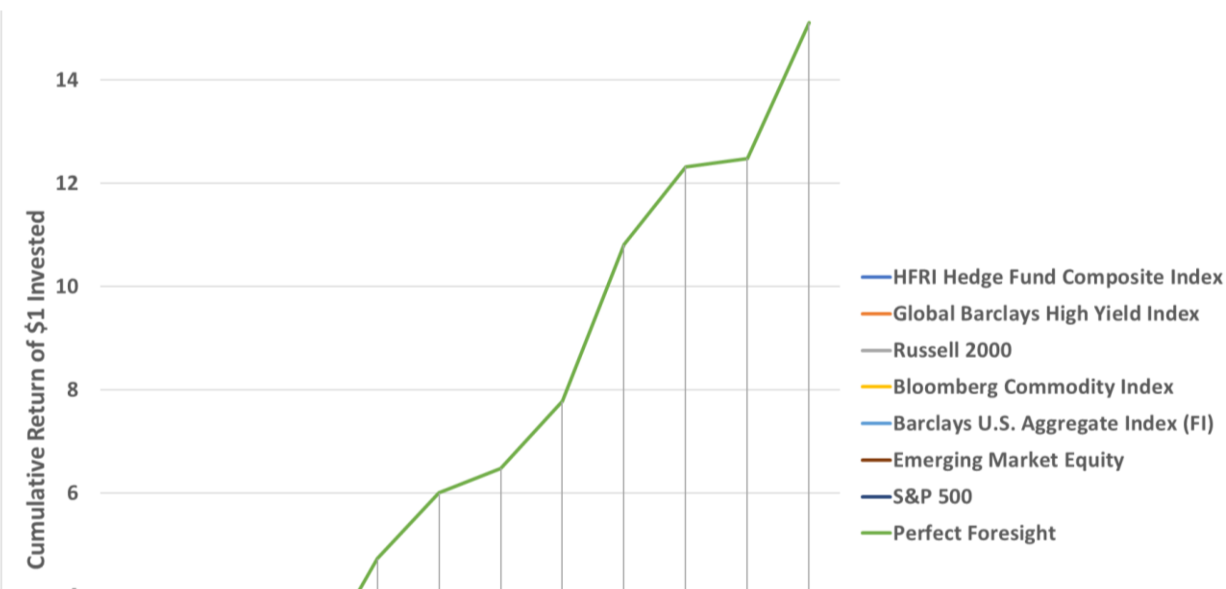
We can't talk about performance without addressing one of this year's highest flyers: cryptocurrencies. Few topics provoke as polar reactions as crypto. As of November 1st, **there were more than 1,000 available cryptocurrencies**, and more than 100 funds dedicated to the strategy. Some frequently asked questions below.

1. **What *IS* a cryptocurrency?** Cryptocurrencies are a digital store of value that uses decentralized cryptography to secure transactions and exchange. The oldest and most well known example is Bitcoin. All bitcoins are cryptocurrencies but *not all cryptocurrencies are Bitcoins*.
2. **Are cryptocurrencies "securities," "commodities" or "currencies?"** Unclear. Each crypto token has different attributes, meaning the SEC and the CFTC *may* regulate various tokens in the future if they are determined to be securities or currencies, but they have largely been silent on the issue to date. The SEC issued an investor bulletin on Initial Coin Offerings in July – making it an important space to watch for the year ahead, particularly as the CME's new futures market for Bitcoin takes off.
3. **Why are they so valuable**? Depends on who you ask – and when you ask them. Bitcoin has witnessed considerable volatility, and some precipitous drawdowns before launching its current upward march. Current market cap of crypto currencies? $200 billion.
4. **What is an ICO**? An ICO (or 'initial coin offering) is when a new cryptocurrency token is offered for sale to the public. Dozens of companies have raised more than $1.5 billion in ICOs in 2017.
5. **Tulip or 'The Future?'** Our crystal ball is fuzzy on this one.

JEFFERIES GRAPH OF PERFECT FORESIGHT

Since Sports Illustrated can apparently predict a Houston Astros World Series victory three years out….we've been inspired to see what would have happened if our crystal balls picked the best performing asset class annually between 2005 and 2016.

What becomes quite obvious - given most of us *don't* have crystal balls in our offices – is that winners change. And while headlines will trumpet the success or failure of a given asset class from year to year – what's clear the only "sure winner" over time relies on being able to see the future.



The graph of perfect foresight takes the highest performing asset class of those listed above for each year and calculates cumulative return of $1 invested starting January 1, 2005 through December 31, 2016.

JEFFERIES CAPITAL CONSULTING YEAR IN REVIEW: REGIONS

The **Jefferies Capital Consulting team traveled to more than 40 cities** in 2017, meeting with investors across diverse verticals including: hospital systems, insurance companies, family offices, endowments, foundations, consultants, and pensions, among others. With **many managers reporting a 2018 focus on building relationships with investors in less heavily trafficked cities**, we are well positioned to help.

A snapshot of selected regional takeaways is below, and we broke out our trailing twelve month searches by region to the right. Please contact us with any questions or for a deeper dive on any cities or regions below.

MIDWEST

Home Of: A large allocator community that includes several of the country's largest fund of hedge funds, family offices, and institutional hedge fund investors

Known For: Particular historic receptivity to event driven strategies given local familiarity, but more recent activity around sector focused managers or others poised to take advantage of specific market dislocations in niche or other strategies

In 2018: Given the consolidation of the intermediaries landscape, the bar for an investment is set very high in many cases for new investment unless there is a specific gap the allocator is looking to fill

MID-ATLANTIC

Home Of: Mature, diverse allocator communities with active endowments, family offices and RIA/wealth management platforms. Less engagement overall with consultants.

Known For: Interest in "old school" hedge funds – more comfortable with smaller, more volatile managers than some other allocator communities, but still have extremely high bar to invest.

In 2018: Continued interest in "letting hedge funds be hedge funds" and finding managers who make concentrated bets, as well as niche or off the run strategies.

NORTHEAST

Home Of: Considerable endowment and RIA/wealth manager community; some allocators have undergone leadership changes that impact allocation approach.

Known For: Heightened appetite for long biased, generalist Equity L/S managers; less interest in smaller, sector focused managers.

In 2018: Continue to selectively allocate on a 1 in-1 out basis across portfolio; maintain focus on niche and Equity L/S strategies and investing for the long term

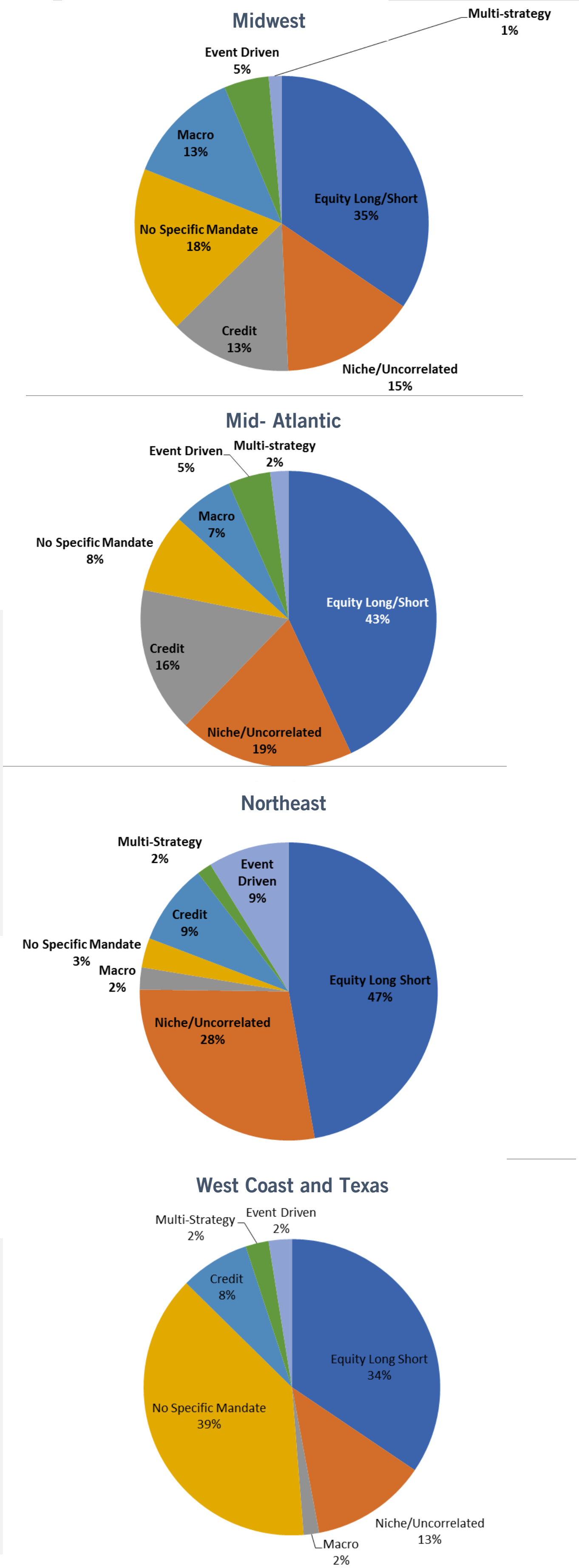
SOUTHWEST & WEST COAST

Home Of: Diverse, active investors across alternatives space; cities typically have distinct and tightly knit allocator communities (i.e. – family offices vs pensions vs. RIAs/Wealth Management platforms, etc.)

Known For: Active event calendar that draws managers and allocators throughout the year, particularly in Texas. Many allocators in the region conduct their own diligence processes without relying on consultants.

In 2018: Continued heightened activity, but generally West Coast investors take their time diligencing and monitoring managers, so total time to allocation may be longer on average.

Trailing Twelve Month (TTM) Searches by Region



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THE 2018 EMERGING MANAGER HANDBOOK

We are ringing in the new year with resoundingly positive sentiment around the new and emerging manager space – a trend we expect to continue through 2018.

The Talent Acquisition Model: Finders Keepers. There is a new wave of talent entering the emerging manager community; among this fresh talent, investors are looking for diversity of thought and a utilization – if not concentration on - new investment approaches.

Outsourcing is *A Thing* – and Grows in 2018. The Outsourced COO/CFO model has become much more widely accepted for emerging managers, allowing COO/CFO functions to be done by experienced teams while keeping personnel costs low. Outsourced trading also continues to gain traction, with about one-third of new managers selected an outsourced trading model in 2017.

Alignment of Interests: All The Buzz. Allocators are looking for new managers that align with all aspects of the allocator's portfolio – this is ***not all*** about fees (although it's *a lot* about fees). Allocators want to have an open dialogue about a manager's term and fee structures, including conversations around seed capital and the associated fee discounts, lock up periods, and redemptions.

The Investor Due Diligence Process: *It's Personal.* Investors are deep-diving into the emerging manager's past professional career, but now regularly widen the scope of who is reviewed and how wide to cast the background check net. In trying to build the most accurate mosaic of an organization's character as possible – diligence now includes studying employees' social media presence, both past and current.

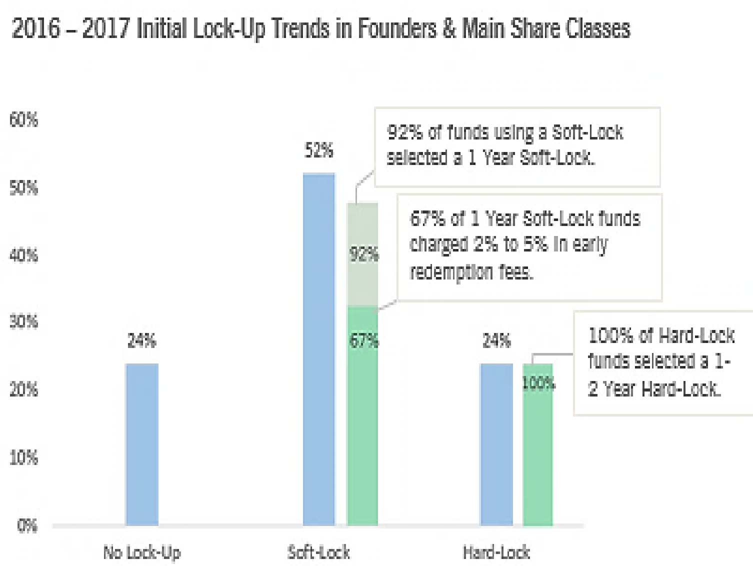
Performance Matters Most. Emerging Managers have the advantage of a clean performance slate **but** the first three years are critical for the Manager to prove that the investment process that he or she has promised is strictly followed, sustainable, and alpha generating.

Transparency is Key. Into 2018, allocators are seeking the partner for the long term – and like any good relationship, they recognize the base of an enduring relationship is transparency and trust. Emerging managers should be upfront and open about all aspects of the business they are launching: strengths, weaknesses, opportunities and challenges.

All About the Balance. Allocators are in search of Emerging Managers that have found the balance of running a hedge fund as if they had more money under management, and the performance and determination to build an institutional business.

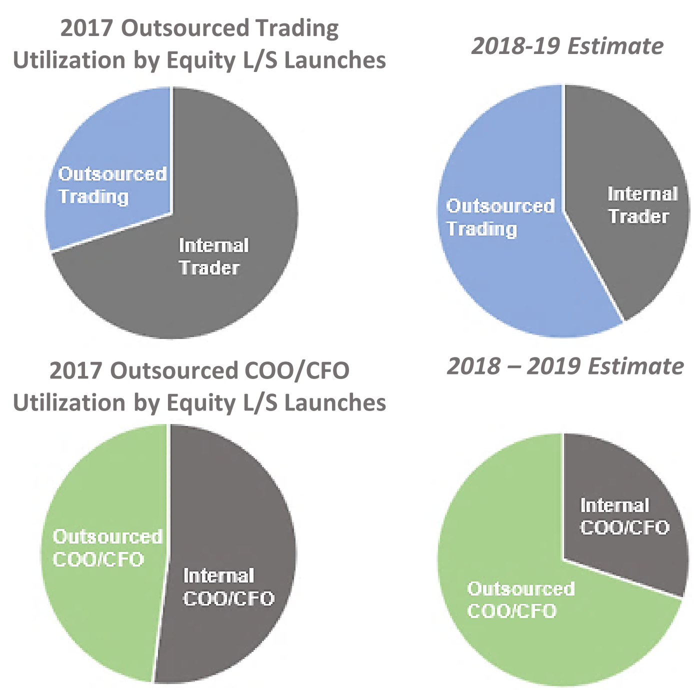
LOOKING AHEAD

Emerging Managers and allocators are seeking long term partnerships, as evidenced in the **one to two year lockup periods in exchange for lower fees**. The longer lock up period started to gain steam in 2017, and we anticipate this trend to continue into 2018 and beyond.



Source: Jefferies Capital Consulting

The outsourced trading model has become a more utilized resource for Emerging Managers to allow more focus on the investment process. In 2017, **about one third** of the **Long Short Equity new launches** were interested in partnering with an **outsourced trader** and **about one half** were exploring the **outsourced COO/CFO model**. We predict outsourcing uptake to continue to grow.



EVENT DRIVEN INVESTING: GUIDING PRINCIPLES FOR 2018

Dan Stratemeier and our Event Driven team put out excellent content – their upcoming year end note is no exception. We wanted to offer a refresh of some of their guiding principles as they reflect on 2017 and think about what excites them for the year ahead. **The full note will be distributed in early December, so watch your inbox.**

The market trades what is right in front of its face – this has been the case since 2009. The most obvious "in front of your face" today trade clearly is tax reform. We believe the market reaction could mirror what we saw post last year's election. We are still working on the best names but CMCSA, UPS/FDX, ILG, ADP/FISC, WM come to mind.

Spins & SOTP stories work - DLPH. LW. MFGP. DXC. Enough said. For some reason the super smart Harvard folks always find reasons to NOT own spins, while we find reason TO own them.

Merger Arbitrage/ buyer votes don't fail - EQT & ESV are this year's examples of our strongest arb theme- shareholders vote with their feet and not their shares. Additionally - deals that are supposed to happen, eventually do. We still don't trust Chinese buyers, lets all forever now de-risk in November, and life is just to short to pay attention to the vast majority of these reported for sale situations (look at the last week alone…JNPR & AXTA).

The Rainbows – Kroculick's rainbow redux got off to a tough start (BATS, CTL) but has roared back. If we exclude CTL (clearly ranked way too high originally), the redux basket has outperformed the S&P by 500bps with a number of fantastic out performers (all highly ranked- FMC, TSN, DXC). In addition, many of the original rainbow securities continued to generate significant alpha this year (ATVI, XPO, HRS, AVGO…). And that is the crux of why we do these rainbow analysis, There are always exceptional winners here but many fundamental investors simply ignore the strategic and financial benefits of mergers and indiscriminately sell these stocks.

We back winners because winners win – Brad Jacobs. Mike Lawrie. Ed Breen. Hock. Chris Hsu. Pat Riley. Bill Parcells. Phil Jackson. Coach K. It is pretty simple, proven winners tend to win again and again. Despite the clear and obvious success of these career CEOs many find reasons to continually not believe in their genius. We respect game, especially when there is real ownership in the C-suite.

Own stocks you get hung up on pitching - last year it was VMW (my forever love- 20% short interest!). This year it was ADP (Bill has lost it), LW (was so silly I forgot it) and XPO (list too long). The smack we heard on each strengthened our resolve. There is nothing better than an idea we love that everyone else hates. Embrace the hate.

Activists don't have to "win" to "win" - I really learned this in 2017. Jana won in EQT as ISS put the company on notice for a break up; handsome Bill won in ADP because Carlos has been exposed for what he is and shareholders have been promised change; Third Point is winning in Nestle (just run the buyback math). The narrative and actions matters much more than the "vote score." Oh, and on that point – ISS matters….a lot. Vanguard and Blackrock each own 5-10% of virtually every stock these days so any great activist idea must pass the "three ways to win" and "ISS test" to get our attention.

"Everybody Lies" – There were many investors that continued to own HPE because they simply believed Meg when she said she was not interviewing away and she wasn't going to leave. The reporting (and her Hillary hugs last year) told a very different story that just didn't feel right to us. Thankfully, we already had read the book and understood that even good people lie. So, I'm a positive guy and therefore won't write much more but thankfully we moved on from HPE in time and feel we have become a better investors ever since I read that book.

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GLOBAL ASSET ALLOCATION: FANGs, BATs and COUNT DRACULA

Overly concentrated ownership of blue-chip stocks appears to be more the risk for equity markets in the short term rather than weak economic data. The narrow group of 'super-performers' is entirely consistent with their high ROIC versus the market. But their tight correlation to each other and changing technical conditions suggest that their performance as a group might be challenged going into 2018.

in Monopolies, Oligopolies and Technology (V) we posited that 'In our view, labeling the technology sector as a 'bubble' is quite far from the truth. Just because the index is broaching new highs does not mean the sector is over-valued. On most conventional measures, the sector is not excessively expensive. In our view, many of the constituents have either joined an oligopoly (semiconductors) or have achieved monopolistic models that allow for 'increasing returns to scale' (internet/media).'

We still hold this view. However, this is not the time to own all of them. **The market appears to have moved to excessively owning a 'few winners' entering year end without necessarily remembering the adage about 'the winner's curse**'. The analyst has always felt that the existing business model of these companies being both 'asset light' with high market share would allow them to produce 'infinite returns' to scale. The difficulty for the companies or 'the winner's curse' would be that they would find it hard to 'reinvest' their profits at the same rate of return in future ventures. Equally, their oligopolistic models would eventually attract the interest of regulators. The best analogy we would offer is Microsoft as it grew through the 1990s.

There are some pertinent facts that investors should consider that have little to do with their core underlying profitability but the manner in which the market has discounted it. Firstly, the companies' market cap as a % of total market cap of their respective indices or comparable ones has become disproportionately large (see RHS charts). Of course, this is due to the 'price' nature of many weighted indices but this in itself cannot carry on forever otherwise the markets would be discounting 'infinite profits' even during recessions! Returns to scale work both ways – accelerating profits in expansions but sharp decelerations during slowdowns.

Secondly, the companies appear to be inversely correlated to the VIX - despite their market caps becoming increasingly large as % of total market cap (see chart opposite). Thirdly, after a long period in which the stocks were inversely correlated to the ten year bond yield, they have begun to be more correlated. This is occurring as short rates have moved sharply over the past six months and as inflation pressures gather.

Lastly, we would ask investors to keep a close eye on the rolling correlation between the best and worst stocks. **With investors attempting to own 'all the winners' correlations will naturally narrow but if there is a panic, the risk is the sell-off could be quite violent.**

We switch from FANG and BATs both into MSCI Energy. Full note available here.

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Jefferies

Top Jefferies Research Reads in recent weeks

Leaders of the Pack:

- Jefferies 2017 Energy Conference Preview
- JEF Macro Weekly: A December to Remember?
- FDA Updated Guidance on Gene/Cell Therapy – Positive Tailwind for Industry
- ROG SW: Blue Sky Scenario for Roche: Impower 150 & HAVEN 3 Beat Expectations
- Seattle Tour – When Increasing Clouds is a Good Thing

Other Notable Reads

- Jefferies 2017 UK Global Healthcare Conference Takeaways
- Conference Call on Tax Reform and the Impact on Multinationals – Brief Recap

Global Fund Flows*

- Over the past week (16 to 22 Nov), all asset classes recorded net inflows. Global equity funds experienced a broad-based net inflow of US$8.7bn thereby extending the streak of inflow to 8 weeks. Equity inflows into Japan, Korea, global financials and IT were particularly sharp. Within global bonds, net inflows (latest: US$7.4bn) resumed. Last week, significant interest was seen among corporate/government bonds and inflation-protected bonds. In contrast, sizable withdrawals from high yield bonds continued. Energy and the US led inflows into commodities and money markets respectively.
- Equity Trade Ideas. We remain 1) long Japanese banks relative to the market, 2) long Eurozone equities relative to UK equities, 3) long US energy (equities) relative to the overall market
- Full note available here: Equity Strategy Global Asset Fundflow Tracker

*Source: Bloomberg, EPFR, Jefferies. All references to mutual funds and ETFs

Jefferies Equity Strategy:
China – Watching the Long End of the Bond Market

The recent sell-off in China government and corporate bonds is not too surprising given the latent inflation pressures, stronger growth and tightening of bond margin/collateral requirements. The Chinese yield curve is shifting upwards. This should induce a much needed rotation within the equity markets given the poor market breadth during the recent rally. The authorities appear likely to continue on their easy-tightening bi-polar world through 2018. We have argued that by forcing the closure of capacity and cutting of capex alongside an expansion of the PBOC balance sheet, the Chinese economy has moved out of deflation into inflation. Although some macro measures have begun to cool this is not too surprising given the difficult base effect as well as the fact that the economy has been growing above trend. Full note available here.

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Seattle Tour: When Increasing Clouds is a Good Thing

The Jefferies Internet team hosted multiple company and expert meetings across Seattle in November, which reinforced their view Amazon AWS is running away with a major lead in cloud and can help support a $750bn-$1trillion market cap by '22. While AWS is ~8x larger than Google Cloud, we continue to find encouraging partner/customer data points supporting our view that Google is no doubt the up and comer to watch. Both Amazon and Google remain top large cap picks.

Cloud Wars. We heard from multiple perspectives around the battle for the public cloud including customers, partners, and industry experts. While there is no question that this is a massive market opportunity (est. $72Bn IaaS market within a nearly $200Bn total cloud opportunity), how many players are needed to support this market and the role each ultimately plays is still up for debate. AWS remains the unquestionable leader in the space, a point we heard reinforced multiple times both as part of our Seattle meetings and throughout the Jefferies AI Summit last week in Boston.

How Can Google Catch Up? Google Cloud remains the up and comer and has increasingly become a talking point in our cloud conversations, with signs more and more customers are now willing to give GCP a serious look as part of a competitive head to head vs. AWS and Azure. Many of the experts we have spoken with agree that GCP has a lot to offer from a technology perspective (inc. strengths in AI, analytics, and containerization/Kubernetes) with the company also showing willingness to remain aggressive on price. The big pushback vs. broader GCP adoption continues to be around perceived weaknesses in sales and services, which Google is actively working to combat, investing heavily in cloud headcount growth. In our view, the company is putting dollars to work in the right areas and needs to provide additional signs of customer referenceability while also leveraging the partner channel to more effectively compete with the two leading vendors in the space.

We also met with EXPE's new CFO. While the travel industry has undergone some recent turbulence, Expedia reiterated their long term confidence in a market that is growing double digits and also highlighted room for operational improvement. Although competition remains tough, Expedia has not seen any meaningful impact from direct hotel bookings or Airbnb. The overall market is still a >$1 trillion opportunity, with offline travel growing single digits, online growing double digits, and leaders able to grow 15%+ with plenty of room for multiple winners. To support that view, EXPE's room night growth has been at ~17% YTD. In our view, moving their own infrastructure to the public cloud with Amazon AWS (away from internal DC) can help make EXPE more efficient in multiple ways, yielding operational improvements and also providing a more holistic view of the customer which can effectively reinforce customer loyalty and top-line growth. We believe EXPE's stock is attractively priced at 11x CY18 EBITDA vs Internet peers at 15-20x.

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According to Steve…

In October, SMID Strategist Steve de Sanctis published: **JEF's SMID-Cap Strategy – 25+ Fascinating and Fun Charts on SMID, According to Me.**"

We include some of his most interesting charts and observations here:

A sneak peek at some of Steve's top views for the coming year:

1. **Small is way too expensive** even if you include all of the benefits from tax reform.
2. **Earnings growth has been weak** on both an absolute as well as relative basis.
3. **Volatility and high yield spreads should move higher** at some point in our lifetimes, and that hurts the SMID Caps.
4. **Positioning stays the same** - growth beats value, higher cap, higher quality, and better balance sheets are the way to go. Overseas better than foreign inside of small.
5. **Still really like** Tech, Materials, and Financials. Underweight bond proxies of Real Estate and Utilities. Marketweight everything else.

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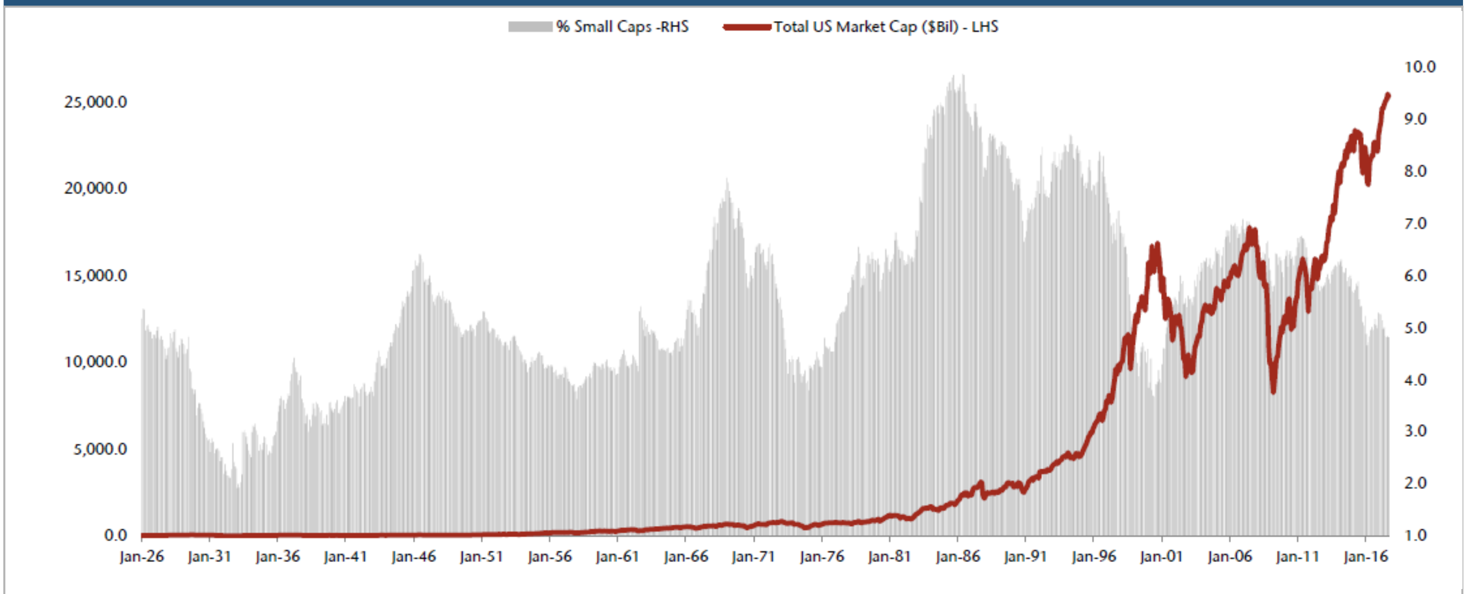
1. Small caps are not as big of the overall market as they have been in the past



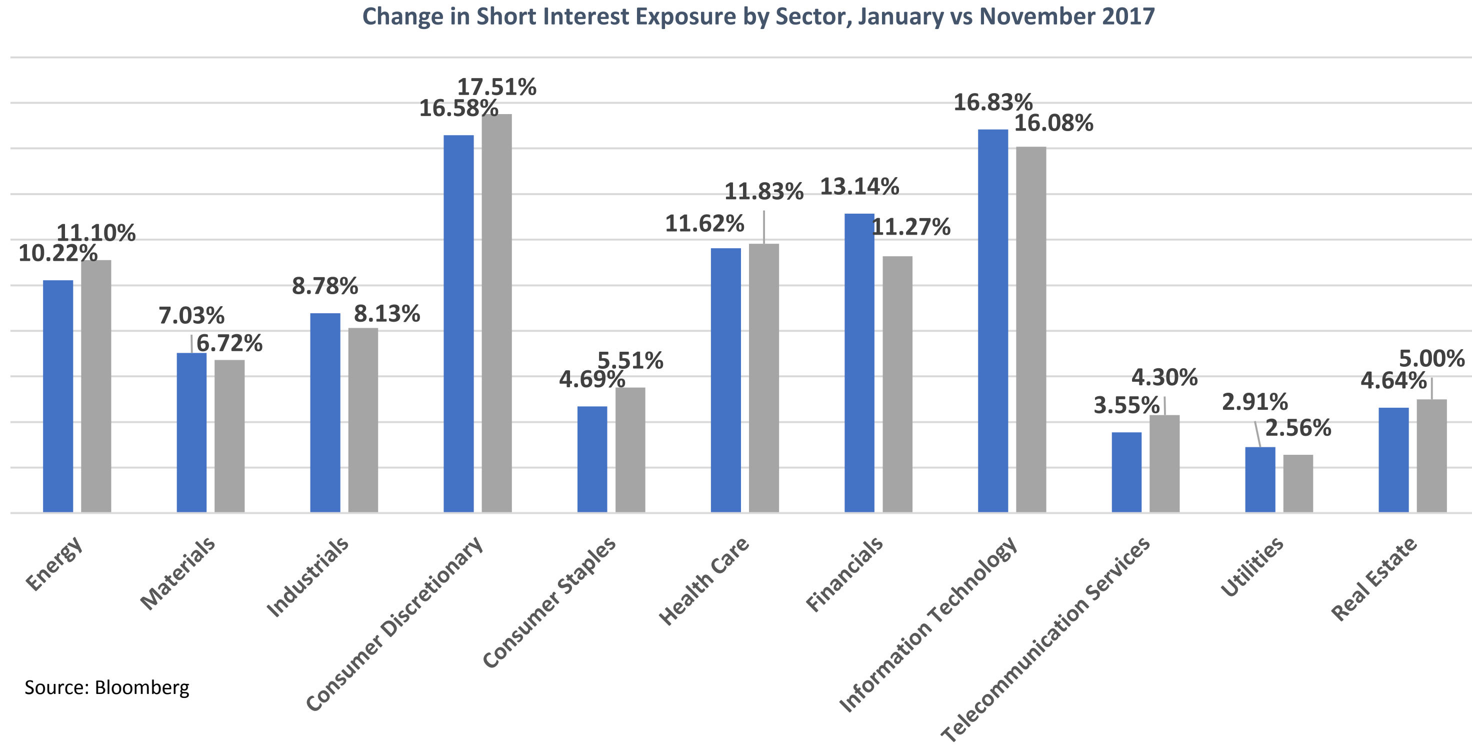
Source: Center for Research in Security Prices, the University of Chicago Booth School of Business, Jefferies

2. In the Event of Tax Reform…At a 20% tax rate and no stipulations, small cap earnings growth jumps over 50%

	Under various corporate tax rates						
	Earnings Growth (In %)			P/E Ratios			
Benchmark/GICS	**Current**	**25%**	**20%**	**Current**	**25%**	**20%**	**Long-Term Avg.**
SmallCap	**22.3**	**43.1**	**51.4**	**21.4**	**18.3**	**17.3**	**15.8**
Discretionary	20.1	38.9	47.6	17.9	15.5	14.6	16.1
Staples	26.2	49.5	59.5	23.6	19.9	18.7	17.9
Energy	41.7	66.5	75.9	20.6	17.5	16.6	17.3
Fin'ls	16.5	39.4	47.7	18.3	15.3	14.4	14.6
Health Care	35.3	71.0	81.1	24.6	19.5	18.4	20.2
Industrials	24.2	43.1	52.4	21.3	18.5	17.4	16.8
Info Tech	18.9	34.3	39.8	22.3	19.7	18.9	20.8
Materials	40.5	56.4	65.0	19.9	17.9	17.0	15.8
Utilities	2.2	20.7	28.7	24.5	20.7	19.4	16.8

JEFFERIES SECURITIES FINANCE: 2017 – A SHORT LOOK BACK

As we look at short interest exposures by sector from the beginning of the year to present, increase in short sentiment has shifted most materially in the Consumer and Energy sectors, whereas the largest reduction in short exposure was in Financials.



On a notional and volume basis, we have had an upward trend in shorts from the beginning of the year as the market rose, but have recently started to see new activity in shorts (by volume) start to lag. This graph reflects short volumes vs. SPX performance in yellow, which suggests there are less new shorts coming onto the books as we go into the end of the year.

LOOKING AHEAD

- **Increase in term borrow demand to smooth borrow costs over the year**. On the short side, accounts seek smooth volatility of borrow costs and minimize recall potential, while long holders want to lock in and maximize outperformance – especially for long term core holdings. Jefferies is highly active on both sides on the term market.
- **Further exploration of short exposure through options vs. traditional physical borrow.** As the borrow market has tightened for some hard to borrow securities, some have explored expressing shorts via options.
- **Continued increase in lending longs that have hard to borrow value**. Volume of clients willing to lend their long positions has increased steadily. Historically, this optimization fell to larger funds with a treasurer (often with an equity finance background), but the types of clients exploring this opportunity has expanded steadily over 2017. The fully paid for and synthetic outperformance markets have become much more fluid with ease of operations and borrow fee being key.
- **Pre and Post trade optimization for efficiency**. While industry balance sheet limitations have eased in the past 12 months, there is still a focus on broader balance sheet efficiency, particularly in a current tight wallet environment. Optimizing financing and margin positions is an additional way to more precisely engage with counterparties. While these transfers and optimizations were historically done manually, counterparties and third party vendors are exploring the ability to have this optimization at point of trade, which will bring some of the traditional back office functionality to the front office/trading function.

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JEFFERIES SECURITIES FINANCE: 2017 – A SHORT LOOK BACK

WHEN ASSESSING SHORTS – LIKE NAPOLEON, CONTEXT IS KING

- When assessing short interest – context is king
- For example: T has recently made headlines as a top short - but the read through to **pure bearishness should be taken with a grain of salt**.
- T shorts are largely driven by MergerArb community **hedging out TWX long** exposure (85-90% of total SI by our estimates)
- In a deal close there is no technical effect, but as we've seen this year in large event/arb shorts (cap structure, Merger Arb, Event) **gamma has not been friendly in scenarios where the trade breaks down**.
- TWX downside is the focus, but don't ignore an unwind of 220mm+ shares of T in the event of a deal break.
- Some other notable crowded shorts with uncomfortable outcomes:
    - MBI (credit/cap structure) +28% post earnings
    - HLF (Event/Arb) +12% post tender
    - ETM (Event/Arb) +11% post merger close
    - HTZ (credit) +100% since June
    - RH (fundamental BUT) +44% and +25% 1 day moves in the last 2 months
- Takeaway – **in a relatively low vol, low Arb return, crowded environment, tails are cheap for both protection and as pure alpha**
- This holiday season, both gamma and too much eggnog at the holiday party could be your worst enemies. Plan accordingly.

One final observation: **we have seen a reduction in the number of securities that trade at hard to borrow fee levels**. The borrows that continue to trade at non-GC levels tend to be more crowded and have a higher volatility in borrow fees than a year ago, indicating more activity in a smaller pool of names.

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