The State of Our Union 2019

TURNING POINT:
THE FUTURE IS ALREADY HERE

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Jefferies

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TURNING POINT

The Future Is Already Here…It's Just Unevenly Distributed

William Gibson

The end of one era and start of another often blur together in ways that can be hard to untangle in the moment. Last year we laid out, for the first time, the Jefferies Capital Intelligence view of our industry, and outlook for the year ahead. In the twelve months since, many of these views have been borne out, while new questions, challenges and opportunities have come to light.

Now, one month into 2019, we can see the "alternatives fund of the future" taking root, and beginning to develop at different paces in different pockets throughout the industry. Progress isn't uniform – but it is certain. Driven by undeniable and invisible trends pushing the industry forward, these changes will only accelerate in the years ahead.

We feel strongly that 2019 marks a turning point for the alternatives industry and global economy – laying the foundation for the decade ahead. We are therefore again looking across our "union" – at the investors, allocators, experts, specialists and counterparties that create and sustain the ecosystem in which we operate and make our living. The processes and execution behind how we raise and retain capital, the products we launch, the strategies we run and the organizations we manage are all rapidly shifting beneath our feet.

Against an increasingly volatile backdrop, there are three themes in particular that are helping to shape our next chapter and define a new set of emerging leaders and innovators. First, the **acceleration of specialization** and "**variations on a theme"** business models have created a new alignment between allocators and managers, collaborating to create more precise and aligned solutions and strategies. This sometimes results in "uncaptured performance" which helps explain the durability of capital in the industry, and the willingness of allocators to continue seeking solutions from alternatives providers. Second, **next generation R&D is flourishing**, as investors go broader, dig deeper, and start to tame the deluge of information and data that has emerged. Finally, a segment from the **Jefferies Millennial Survey** looks at **what the convergence of this shift in research processes and the rise of millennial led alternatives funds means,** leveraging data from a 200+ person survey.

> **The State of Our Union 2019** *argues we are at a fundamental turning point. This inflection is the beginning of a new decade for hedged, private and alternative investors, and will be increasingly evident the years to come. The term "hedge fund industry" is itself becoming somewhat a misnomer – if not relic of the past - oversimplifying the products, performance and portfolio diversification that have created a more mature, innovative and varied set of alternative managers.*

This is the beginning of an exciting new chapter for the alternative industry – and we believe the next decade will have some of its roots in 2019. It is our hope The State of Our Union 2019 helps better understand emerging issues and explores the follow on impacts that are driving our industry forward.

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[1] The "State of the Union" clause in the U.S. Constitution may be found in Article II, Section 3. The President "shall, from time to time, give to Congress information of the state of the union, and recommend to their consideration such measures as they shall judge necessary and expedient."

PREDICTIONS FOR THE DECADE AHEAD

1 **RISE OF UNCAPTURED PERFORMANCE**

- Rapid growth of separately managed accounts, funds of one, hybrid products and other one off vehicles means a growing percentage of managers' performance may be uncaptured by publicly available indices, muddying overall understanding of returns.

2 **HEALTHCARE IS THE NEW FAANG? CONVERGENCE BETWEEN TECH & HEALTHCARE SPECIALIST FUNDS**

- A decade ago, top "tech" stocks were older economy firms like Intel, Cisco, Microsoft and IBM. The stars of the last few years - the FAANGs - represented diverse product lines that leveraged data in similar business models and rose to stardom. The next generation of "tech stars" may well be found in a crossover between the healthcare and technology spaces going forward.

3 **NEXT GENERATION R&D CREATES NEW DIVIDE BETWEEN THE HAVES AND HAVE NOTS...AND IT'S NOT JUST ALL ABOUT DATA**

- Gaining an investment edge is no longer about getting a piece of information *first* - nor is it enough to harness *the most* data. Next generation R&D has created a new generation of forward thinking investors, and this will create the next divide between winners and losers.

4 **RESURGENCE IN PERMANENT CAPITAL VEHICLES**

- Desire for differentiated capital base and longer locked capital creates resurgence in appetite to explore permanent capital vehicles

5 **SPEED OF ORGANIZATIONAL CHANGE ACCELERATES AS MILLENNIALS BECOME FOUNDERS AND DECISION MAKERS**

- The next generation of leaders build organizations that are a reflection of minds and careers shaped after the turn of the century

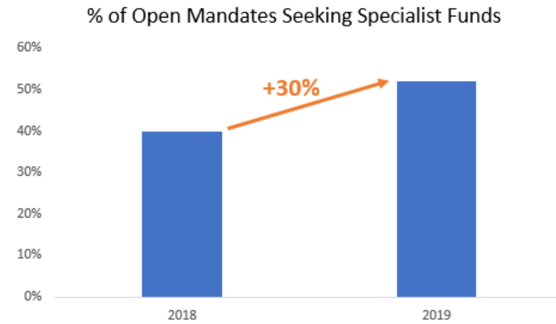
THE ALTERNATIVE FUND OF THE FUTURE...AND NOW

Many of these predictions are already in motion. Our view of the alternative fund of tomorrow encompasses the following:

I. ACCELERATION OF SPECIALIZATION AND 'VARIATIONS ON A THEME' BUSINESS MODELS

Sector, region and strategy specialists increasingly dominate the landscape. We've seen a **30% YoY increase** in specialist searches – to *half* of all open Equity mandates for allocators.

Healthcare and technology specialist funds are the only Equity sub strategy to have **welcomed seven consecutive quarters of net inflows**.



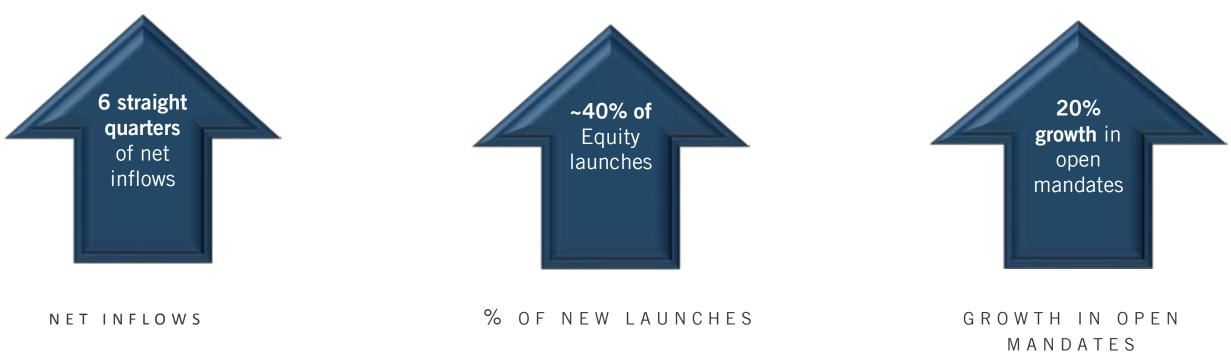
Over the last consecutive seven quarters, Equity Hedge sub strategies have bled money and witnessed outflows – except for two: healthcare/technology funds and quantitative directional ones.[1] Specialist funds are also an increasing percentage of new launches. The Jefferies Capital Intelligence team estimates that approximately 40% of new and emerging equity funds in 2017 and 2018 were of the niche or specialist type.

Perhaps these should come as no surprise, given that we noticed in 2017 for the first time – more than 40% of open mandates for Equity funds were targeting niche or specialist managers. In 2018, that number grew by 30% to over *half* of all open allocator searches.

We anticipate the appetite for and management of specialist firms to continue to accelerate in the years ahead, given the significant opportunity for funds to differentiate from competitors. The era of supermarket firms that try to be everything to everyone seems to have waned, as allocators seek a more precise match for their portfolios.

CHART 1

Robust Growth in Specialized Firms – By Number of Firms, Allocator Appetite and Net Recent Inflows



Our 2018 pieces, *Checking the Pulse: A Deep Dive on Healthcare Specialist Funds* and *Tech-Tonic Shifts: A Deep Dive on Technology Specialist Funds* individually explored the appetite for these firms. We anticipate this specialization and focus on specific core competencies to continue, as managers work to identify their precise value proposition and highlight differentiated return streams from their generalist competitors.

What does this mean for managers, allocators – and even issuers? Managers need to be more precise about their value proposition – they could fit in diverse sleeves across allocators' portfolios, and two tickets could be allocated for entirely different reasons. We identified *thirty different independent variables* impacting an allocator's decision to fund a healthcare manager. The subsequent combinations thereof are nearly endless – scientist/low net/fee agnostic to long biased/longer lock/ok with high fees.

MANAGERS

- More precisely articulate value proposition
- Align with counterparties whose core competencies match managers'
- Launch diverse products reflecting tailored variations on specific specialty

ALLOCATORS

- Closely identify specific exposures across managers and portfolio
- Ensure performance attribution is optimized - are you getting most of your exposure from generalists or specialists, and is performance in line with expectation and allocation?

ISSUERS

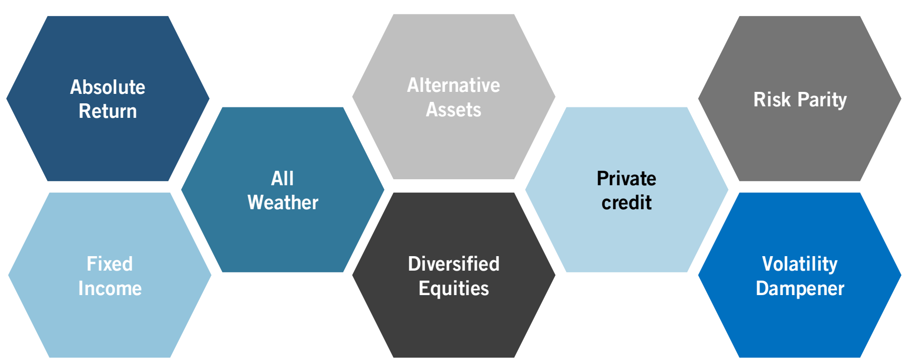
- Understand the growing importance of sector specialists
- Strategically engage with sector or specialist investors

Variations on a Theme: "Multi-product" is the new Multi-strat

We live in an era of hyper customization. Whether having nearly a dozen different milk options to go in your coffee (or nitro), to identifying a more precise allocation for market exposure in your portfolio, everyone from retail customers to allocators are seeking individualized service and solutions for their needs.

The master/feeder structure is the backbone on which the hedge fund industry has grown and evolved. And while it is a necessary feature of many firms, it is increasingly one piece of a much broader and more diverse offering. The Jefferies Capital Intelligence team is in the late stages of conducting a portfolio construction survey – and interviews with allocators to date report that more than 70% of them classify hedge funds in multiple buckets across their portfolios.

CHART 2
Location of Hedge Funds in Current Asset Allocation Models[2]



With over 9,000 hedge funds in operation – nearly double the number of U.S. listed companies (~4,300) – it seems obvious that allocators *already* have a wide variety of options to gain market exposure or express an investment thesis. But many of our managers report ongoing discussions and requests with LPs to create and launch ever more vehicles tailored to the LP's specific net exposure, transparency or even liquidity needs.

Despite the fact there are more than 9,000 hedge fund products in the world, more than half of funds fielded requests for a modified version of their offering in the last 24 months.[3]

Why does this matter? From an industry and organizational expansion perspective, pre-existing LPs have long served as the best source of incremental capital. But allocators are increasingly approaching alternatives managers *first* when seeking to fill a specific gap in their portfolio – particularly on the back of a strategic asset allocation review. This is the convergence of traditional portfolio allocation with the current environment that fosters individualized solutions, to more precisely align a vehicle's return stream with the asset allocation model of their particular portfolio.

In return, **managers are working in conjunction with allocators to offer "variations on a theme"** – vehicles based on their core competencies, but that have more precise alignment of liquidity terms, transparency, volatility or gross/net exposures with allocators own needs. The same portfolio can then reflect precise needs of allocators' portfolios from a risk, volatility or target return perspective.

Instead of launching multiple products that are diverse in strategy or work across the capital structure, the current variations on a theme more likely see a manager offering: a master/feeder, a longer biased/long only product, a longer locked version of the master feeder, a higher or lower vol product or a product with enhanced leverage. Separately Managed Accounts (SMAs), Funds of One (FoO), co-investments, and other customized vehicles have increased to the extent that it is now more common for funds to *have* them, than not.

In fact, Jefferies Capital Intelligence estimates that nearly two-thirds of managers have fielded inquiries about bespoke or alternative versions of a pre-existing product in the last 24 months. While significantly fewer are believed to actually have launched one (again, we estimate about 20% of those who received inquiries), this represents a material growth in the reverse inquiries surrounding the launch of new products.

CHART 3

Potential Benefits to the 'Variation on a Theme' Business Model

Potential Benefits	Potential Challenges
New and diversified revenue streams	Mission creep
Diversify capital base	Cannibalize products
Deepen LP relationships	Increased operational complexity
Take advantage of idiosyncratic investment opportunities	Heavier lift for IR/marketing professionals
Help attract and retain talent	Increased reporting and bookkeeping complexity

Last year we talked about how alternatives managers and their LPs have entered a "Partnership Era," that requires more constant and sophisticated communication between stakeholders. A direct outcropping of this increase in transparency and communication is the "variation on a theme" business model. It explicitly differs from a multi-strategy business model. While the multi-product model *may* evolve into a multi-strategy firm over time, it is intentionally not multi-strategy at conception.

> Allocators and managers engage regularly, with increasing transparency on both sides across their respective portfolios and regarding market intelligence. Customization plays a considerable role in the partnership era – as allocators continue to seek specific best ideas (nearly as frequently as more general strategies or vehicles), individual co-investments top the list of many active searches.
> *State of Our Union 2018: Too Much Information, Not Enough Intelligence*

As managers vet these strategic opportunities, they typically embark on a five step process to field, consider, launch, and evaluate them to ensure they don't result in mission creep, existing product cannibalization or too onerous a burden for operational and marketing/IR professionals.

CHART 4

Evolution of the Multi-product Model: From One Core Competency, Many Products

II. NEXT GENERATION RESEARCH & DEVELOPMENT: A NEW DIVIDE

The research process, like everything else, has been considerably disrupted – and in some cases, research *about* research is top of mind for leading investors. Multiple factors are driving firms to revisit their own research processes and inputs from front-to-back, including:

1. **Growth of data** and anticipated acceleration of available data
2. **Increasing cross asset correlation**
3. **Shift in invisible forces** impacting and creating new investment opportunities
4. Crossover and **convergence of themes across sectors** impacting business models and
5. **Revisiting alignment with (and core competencies of) counterparties**

Funds have revisited and rededicated their efforts to internal "R&D" to constantly stay current with emerging themes and tools to improve investment processes. In some cases, this has led to development of more robust data science initiatives, incorporating new data across investment teams – in others, investors have sharpened their focus on information and content that crosses sectors, providing a pan-market perspective and complementing macro and traditional equity research.

Managers in the know increasingly comment that if they are only considering the impact of an idea on one company, one subsector, or even one GICS vertical, they are likely missing a profound insight. This is in part the result of technology shaping every industry, and is having far reaching implications for hiring, talent retention, training and the broader research ecosystem.

> We live in a world where "Uber Technologies" plans to IPO in both name and GICS sector as a software company - but it will count amongst its competitors Tesla and Ford, two vehicles providers in the Consumer Discretionary sector.[4] These days, we can't talk about Domino's Pizza without discussing their data science infrastructure. We cannot discuss Apple's technologies without reimagining the future of healthcare.
>
> As a result, thematic pan-sector data and research is as important as more traditional forms of research that focus on macro or equity verticals.

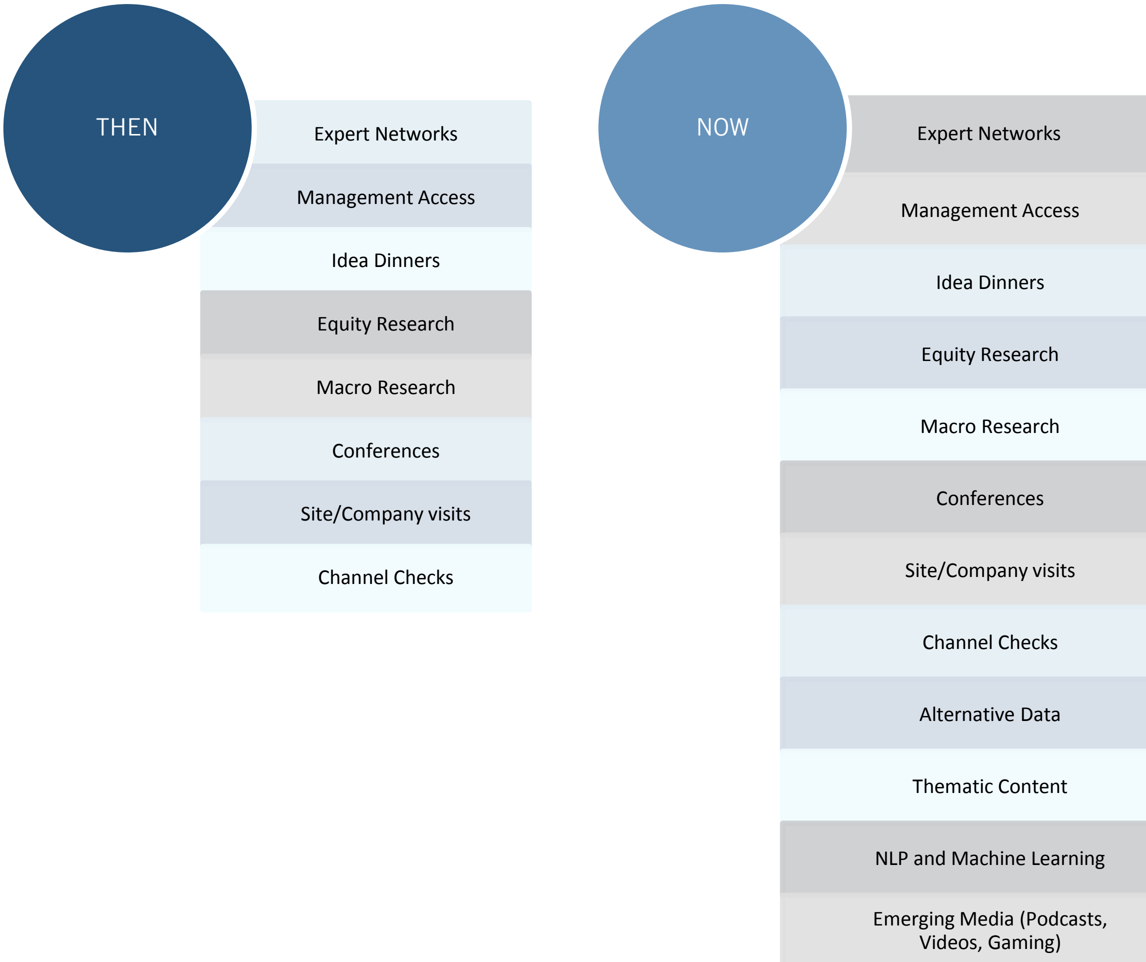
Allocators are increasingly asking about firms' internal "R&D" efforts, working to understand research efforts to ensure that managers maintain an edge in today's market. We are witnessing funds devote resources to building out internal R&D projects that source, collect, and analyze big data with fast-growing sophistication. At the same time, managers are repurposing broker votes to best capture expenditures and measurement of the inputs they receive, and better align needs with counterparty core competencies.

It's not hard to see why counterparty relationships are shifting in the wake of these changes – who delivers cutting edge and differentiated data, content and insights *in addition to* more traditionally valued macro, fixed income or equity research? Substituting new forms of alternative data for expert networks are one shift – but as we explore in the next section, the research process has become a 24/7 pursuit.

As clients hunger for more *intelligence* in an era of ubiquitous information, the way they consume it is continuing to change – rapidly and materially. We have seen a shift in how our partners prefer to consume their content, be it via traditional media like two-pagers and white papers or through multimedia channels such as podcasts and videos.

CHART 4

Next Generation Research & Development



III. MILLENNIALS RISING: A NEW GENERATION OF DECISION MAKERS REPORT A 24 / 7 RESEARCH PROCESS

As these industry wide shifts are occurring, a new guard of founders and decision makers is also beginning to assume leadership roles – that headline grabbing favorite - the millennial generation. This has considerable implications for both how the research and investment process evolve, and how leaders run these businesses. In February, the Jefferies Capital Intelligence team conducted its inaugural tranche of the **Jefferies Millennial Survey**, of nearly 250 focusing on content consumption and social media.

Not only are we living in an age of informational ubiquity, the next generation of decision makers *sources* data from new mediums at all hours of the day. Investors increasingly report that podcasts, videos, idea summits and conferences provide accretive and incremental data points from sources they were less likely to come across in the past. The decision-makers of the future no longer prefer to source ideas and input solely from expert networks, traditional data sets, idea dinners, or even a morning phone call.

These millennial minds were shaped after the turn of the century, and their careers were formed in a post-global financial crisis culture. This means that the hedge funds of the future—and every company they invest in—will be led by a cohort that is vastly different from the current cadre of leaders, and among the biggest difference is in how they seek and consume information versus their predecessors. Moreover, as millennials increasingly enter the upper ranks of our industry, businesses shift - and the speed of change itself quickens.

One of the fastest changing aspects – and partial driver of the disruption in the research process – is the rise of audio as potential data input. The **Jefferies Millennial Survey** reveals that millennials are nearly twice as likely to listen to podcasts as those born prior to 1981, but the *universe* of podcasts consumed is *four times as large*, on an individual basis. The average millennial reports listening to 4 podcasts regularly – and of particular note, these podcasts are almost unanimously across an extremely diverse group of topics.

CHART 5

Universe of Millennial Podcasts Consumed by Topic

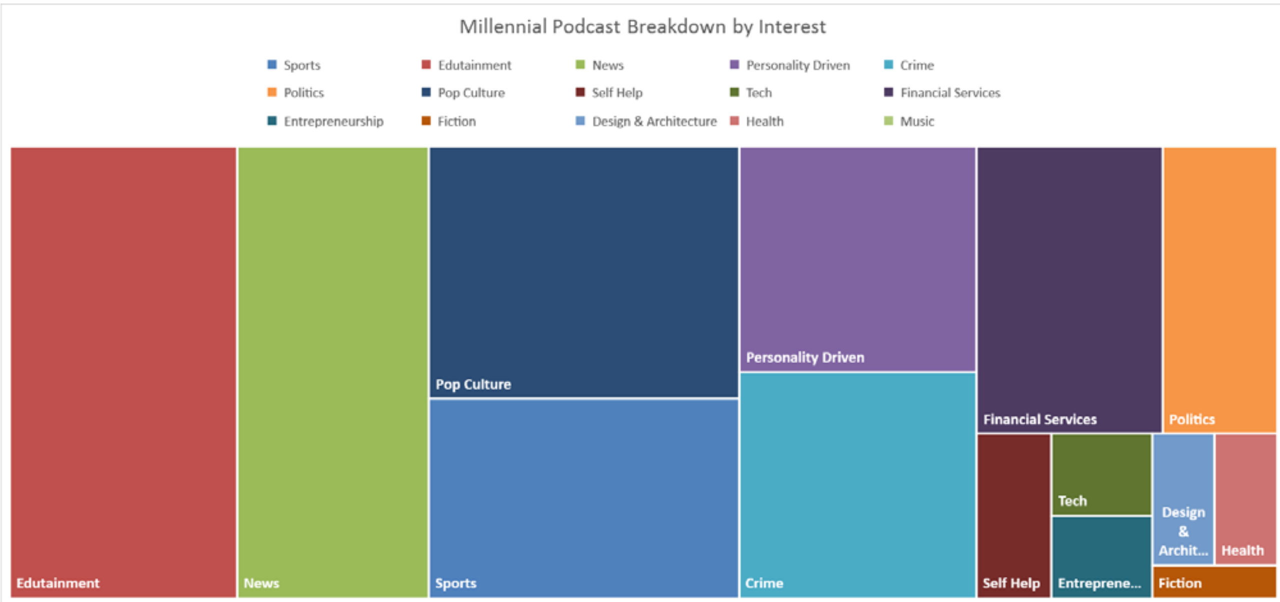
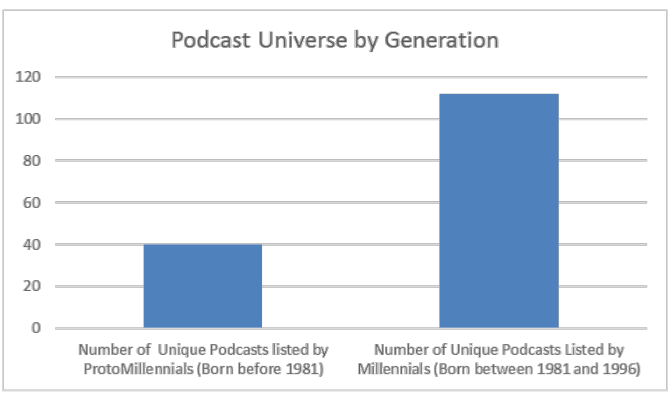


CHART 6

Podcast Universe by Generation – Millennials Reported Tuning Into More Than One Hundred Unique Podcasts in the Last Month



The research process now happens during a workout, on a commute or while they're watching their kids soccer games' – but *not via pdf or powerpoint.* Audio now regularly comes up in conversations, as investors listen to *Equity, Capital Allocators The Curious Investor,* or *Recode Decode* as part of keeping up with the industry.

An investor active in the private market reports one of his best sources is a "well curated Twitter feed." Rising millennials report they are just as likely to source a new piece of data point from an emerging form of media, whether a podcast, video – or even gaming system. We have entered the age the 24-hour research cycle, from checking Twitter before you get out of bed, to falling asleep to an industry insider's podcast, and the next fleet of leaders are ushering us into it.

Before anyone claims print is dead – millennials report reading an average of two newsletter/round ups per day – but again, that's half the number of podcasts they're tuning into on a regular basis. Part of the future will nearly certainly belong to audio and other forms of media. For the first time in 2018, more than half a dozen of Jefferies' alternatives clients report *launching their own podcasts or videos* to complement traditional investor letters.

How Jefferies Can Help

As we wrote last year, given the changing needs of both managers and allocators, Jefferies has built a Capital Intelligence team predicated on delivering relevant, timely and accurate introductions and knowledge to both groups, to help arm each with the wisdom needed to make decisions more likely to result in the Partnerships both are seeking. This is even more important as we move towards 2020 and navigate this turning point.

1. **Relentless focus on specialists.** With more than half our open mandates focused on specialists, the Capital Intelligence team has focused on honing its data to assist sector and regional specialists. We conducted two deep dive surveys and white papers, *Checking the Pulse: A Deep Dive on Healthcare Specialist Funds* and *Tech-Tonic Shifts: A Deep Dive on Technology Specialist Funds,* checking in with more than 100 individual allocators to understand the motivations that drove them to move from interest to allocation.

2. **Thematic, pan sector content**. We are increasingly conducting bespoke research engagements for clients on topics ranging from market structure to ESG or shifts in the structure of alternatives vehicles. Investors' hunger and curiosity to understand the emerging invisible forces that are driving change in the broader economy is strong, and they're working for all possible data points to build a better investing mosaic.

3. **Staying ahead of rising relevance of new products.** Whether SPACs, 144A or Investment Company products, Jefferies continues to innovate and assist clients in tapping capital markets in a variety of ways. We have seen a resurgence of and growing interest in these types of products and look forward to collaborating with clients in this area in the years ahead.

If you have any questions on the above, or if we may be of assistance as you work through questions around specialization, the shifting state of the research process, or how to navigate the emerging crop of millennial leaders, please don't hesitate to let us know.

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[1] HFR

[2] From upcoming Jefferies Capital Intelligence Portfolio Construction and Asset Allocation survey (1H2019)

[3] Jefferies Capital Intelligence

[4] FactSet

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