Jefferies Prime Services Quarterly

3Q2020

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Lessons learned from COVID, and predictions for the year ahead

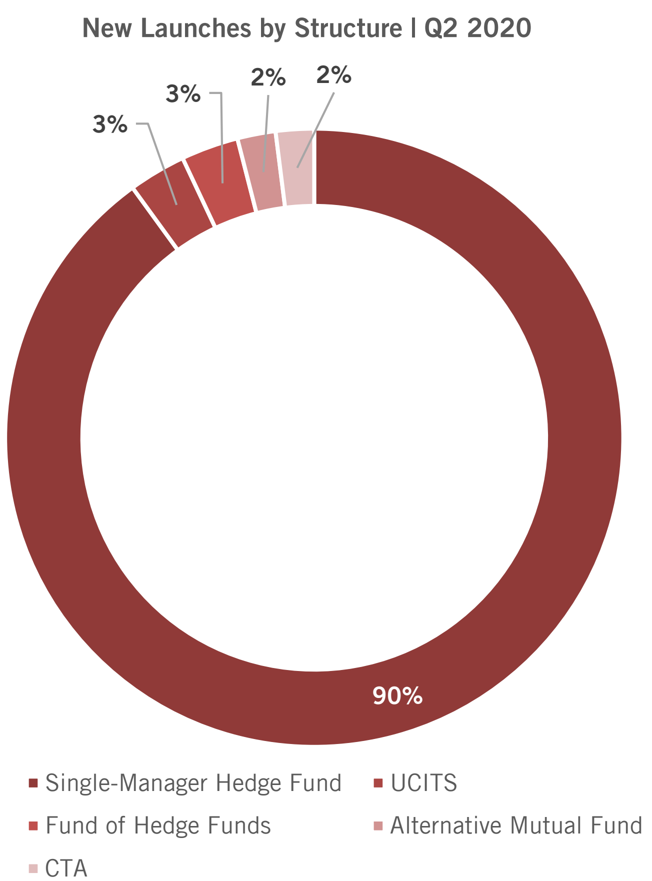
New and Emerging Managers‘ appetite to come to market in challenging conditions… unchanged

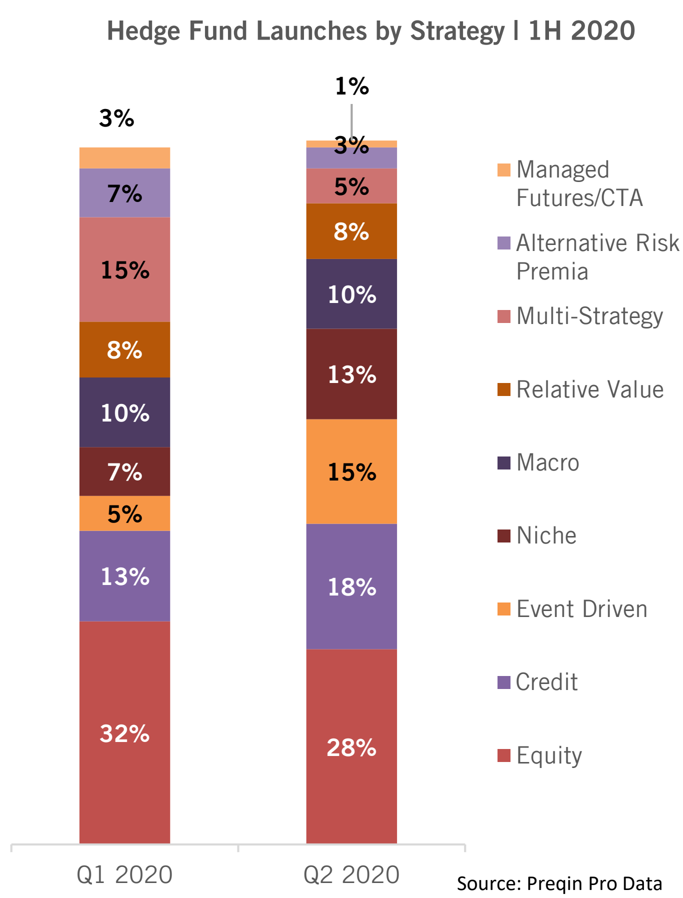
One of the most relevant barometers of an industry's strength is the willingness of new entrants to launch… one of 2020's silver linings has proven to be that the volatility and dislocation in the marketplace didn't stop many fund managers from **launching hedge fund vehicles throughout the year**. Jefferies Prime Services continues to see a healthy new launch environment, evident anecdotally through industry conversations, and **supported by the data** when viewing the number of emerging managers who have launched a fund on Jefferies platform in 2020 YTD.

The willingness of well-pedigreed managers to go out and launch funds at this time is an **indicator of the hedge fund industry's enduring strength and resilience.** Heading into Q4 with catalysts such as ongoing COVID vaccine developments, and the US election as market disruptors, one might expect this resilience to continue, and emerging managers appetite to launch unphased. Hedge fund structures can allow **active managers to take advantage of continued alpha-generating opportunities in the marketplace**, and Jefferies Prime Services sees a healthy pipeline of emerging managers extending through 2021.

Studies from eVestment[1] support the trend Jefferies Prime Services predicts for 2021; the number of **emerging managers launching products tends to spike in the wake of economic crises.** In 2009, over 300 new asset management firms launched, after the Great Financial crisis. **This was the highest number of single-year new launches recorded since 1954.** Even earlier, after the Dot Com Bubble burst in 2001, just over 200 funds launched.

Some believe that **funds which launch in periods of disruptive markets tend to perform better over time**. We'll be keeping an eye on our 2020 new launch performance through 2021; in the meantime it's interesting to take a look at which fund strategies came to market this year. According to Preqin data, 90% of new launch structures in 2020 were single-manager hedge fund vehicles, of which, **Event Driven and Credit strategies** were 15% and 18% of, respectively. As industries see increased market volatility and disruption, the number of **active managers focused on distressed situations and recapitalizations** has increased.





Source: Preqin Pro Data

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Lessons learned from COVID, and predictions for the year ahead

Nimble and Sustainable Organizations

The global pandemic has prompted organizations to completely **re-evaluate the operational components** of their businesses. Businesses have gone beyond ensuring Continuity Plans, or 'BCPs' are in place, to **reassessing basic assumptions about talent, team structures, productivity, and efficiency.** Managers, investors, and Service Providers alike are transitioning away from the short-term decisions made for an overnight distributed workforce 6 months ago, and are **applying lessons learned to develop a long-term plan** to keep their organizations agile and successful for years to come.

Hiring processes are cautiously moving forward again, and as companies consider the road ahead, they are weighing the potential benefits of employing a self-directed workforce, which might include:

- **Fewer inefficiencies** from commuting to/from work and to/from meetings – freeing up, on average, nearly an entire other work day per week
- **Greater productivity of workforce**: different time zones, for example, can facilitate a more seamless "around the world" or "across the country" model
- **More robust talent pools**: as employers can cast a geographically wider net for the right person
- **Lower costs of employment**: as employers look beyond higher cost metro areas to fill roles

Companies are always looking to cut costs where they can, but being **a lean organization is as important in 2020 as ever**. Jefferies Prime Services has seen across the spectrum, from new launches to established managers, the majority of funds migrating to remote set-ups, and **leveraging outsourced services and solutions for support through this transition.**

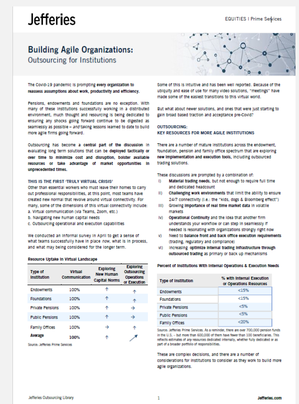
Jefferies Prime Services has seen a growing trend of new launches choosing to **outsource their trading function** at launch.

- In 2017, 30% of new launches outsourced their trading. **in 2020, 85% of new launches choose to outsource their trading**

Continuity Possible Through Outsourcing

The idea that another firm could understand your workflow and step in seamlessly in case of emergency is resonating with organizations strongly right now. Continuity of **material security execution capabilities**, has been a newly identified challenge managers are figuring out how to handle during COVID. **Outsourcing various trading responsibilities** has become a quick fix operational decision makers are turning to as a stop gap to when we can interview and vet potential coworkers in person, and **configure the legitimate need for a full-time trading team**.

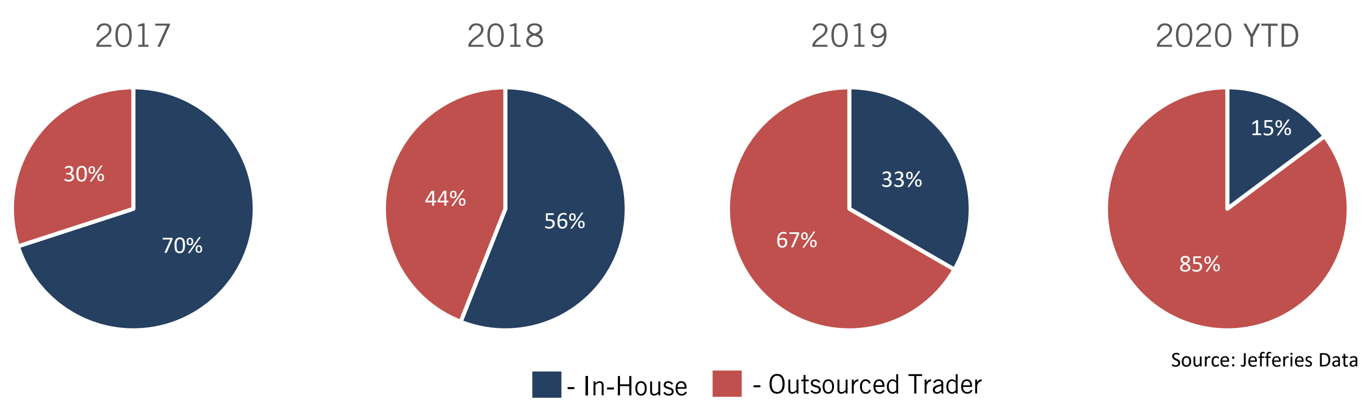
We have fielded a considerable number of new inquiries from **institutions wishing to explore many opportunities, questions and challenges COVID has presented** – whether on the **outsourced trading and operations front, or around talent and human capital questions.** We recently put together a piece which dives a bit deeper into some of the themes we're seeing around firms working to build a strong structure for the decade ahead:



Building Agile Organizations: *Outsourcing for Institutions.*

However, it's not just start-up hedge funds leveraging outsourced solutions. Established Firms and investors use outsourced solutions to **back-up their own execution needs, and further bolster operational policies.**

Type of Institution	% with Internal Execution or Operations Resources
Endowments	<15%
Foundations	<15%
Private Pensions	<5%
Public Pensions	<5%
Family Offices	<20%



Source: Jefferies Data

Adjusting to the 'New Normal' – Investors Allocating in 2020

What's top of mind for allocators going into year-end

COVID-19 has forced professionals into a remote work environment… potentially *indefinitely*. This is an obvious but necessary to mention catalyst which has caused investors to **completely reassess their portfolios**, and determine how they will go about allocating/conducting due diligence in a virtual world.

a. **On Technology –** Other than Zoom, there doesn't seem to be a clear standout collaboration software that has emerged victorious quite yet… i.e. you could find yourself using Google Meet, Microsoft Teams, Slack, and Webex *all in one day.*

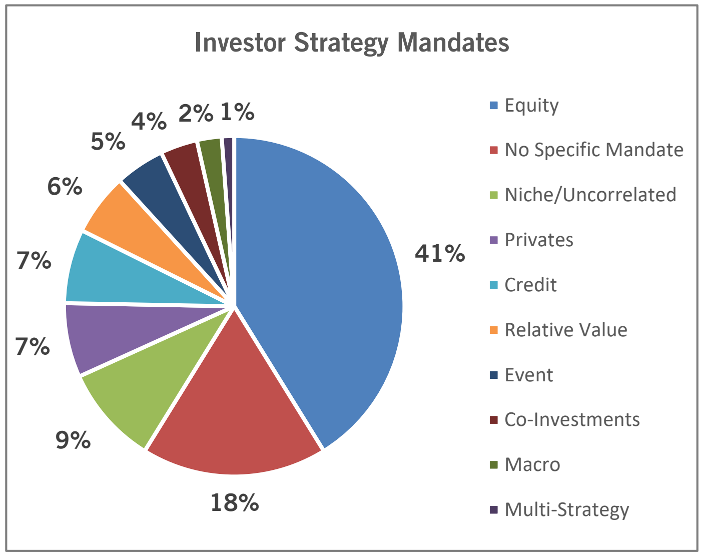
b. **On Allocations *to existing funds*** – There has been a lot of commentary on investors either reupping with existing managers in their portfolios, or investing in established managers who have reopened to outside capital.

c. **On Allocations *to new managers* –** While it has proven difficult to diligence someone in a remote environment, it's not *impossible.* Some investors have made fully remote investments during COVID. This is in a nascent stage, given the challenges with evaluating people *virtually,* but we've noticed more and more groups who have made investments, or are in the process of making one. Note – this pertains *to other asset classes* as well.
   1. **Increased reference checks** have served as a work-around by focusing on speaking with high quality investors who have physically met with the PM/team and visited the office space
   2. **Smaller allocations** are being used to test the waters until the investors can meet with the PM
   3. **Virtual investing may stick,** as younger generations take on investment decision making roles… these folks are used to developing connections via the internet. If you can find love virtually, can you find a hedge fund 'match' online too?

d. **It's Not "D&I" - It's Redefining Talent –** While women & minority managers were on the radar pre-COVID, the social justice movements and political environment seems to have highlighted this as a focus area for investors, prompting some allocators to wonder if the homogeneity among money managers means there could be a talent arbitrage with diverse managers outperforming or bringing an additional level of diversification to a portfolio.

e. **On ESG** – Similar to HF investors thoughts on Diversity & Inclusion, ESG interest continues to grow, and the demand is there for products to be created in the alternative investment industry

f. **On Office Space** – You're not the only one rethinking your real estate. Even though working remotely has proven to be effective, it sounds like investors would still like to see the future prospect of an investment team together in one office again, if possible.



Source: Jefferies Data

Many investors performed an initial asset allocation review in Spring 2020, after they had a chance to breathe post-market downturn. Throughout the year, the focus has been **on sourcing alpha-generating, asymmetrical trading opportunities, geared towards market and asset class dislocations**. While liquidity remains important to investors during these uncertain times, it seems invested capital is being trusted with **active management**. With 2020 proving to be one of the most *unprecedented* and volatile years in recent memory, with likely choppy waters ahead, investors are looking to capture **non-correlated performance with active managers**, whether markets rise or fall.

Equities – Many investors saw 1H2020 as an opportunity to redeploy to concentrated equities already in their books, and **took advantage of the dip** to buy products in a longer-biased yard sale. There is continued **demand for Healthcare and Technology** across market caps. Although allocators have concerns around the solvency and quality of balance sheets of Smid-cap companies, with an uncertain economy and political environment going into 2021. Regional Specialists are of interest, although a **US focus seems to be favored** due to the current market opportunity set and regulatory familiarity. Lower net strategies have been of interest recently given the belief that **markets will continue to see volatility**, On the other side of the coin, we so see some long-only demand, as it seems investors are either **all-in directionally, or hedging with something lower net**.

Co-investments – A number of groups, outside of the traditional investors interested in the co-investment space, are starting to focus more on working with their existing managers on these vehicles.

Performance – Returns continue to drive investor interest. Many allocators experienced turbulence in 1H 2020, so as an emerging manager, **considerable outperformance is likely to illicit looks from investors**.

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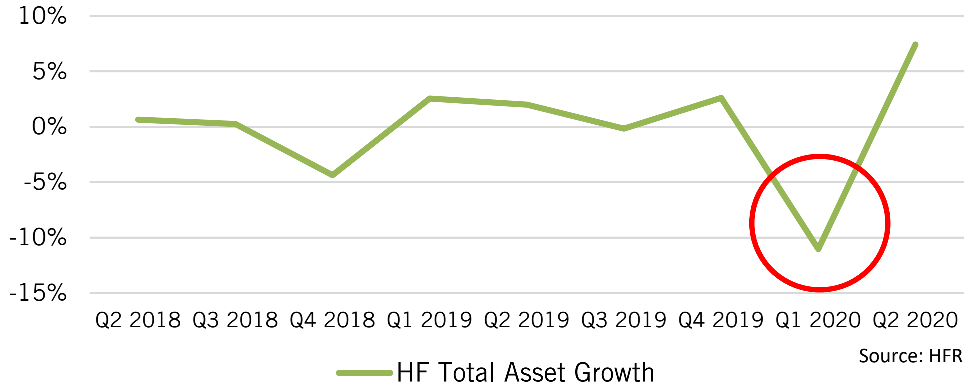
A V-Shaped recovery story for Hedge Fund Assets?

Q2 2020 saw the highest quarterly HF asset growth rate since 2010

HF assets **dropped over $3Bn** between Q4 2019 and Q1 2020…however, hedge fund assets then saw a bounce back, **as the industry asset growth rate jumped to 7% between Q1 and Q2 2020.**

Hedge Fund Industry Total Asset Growth (%)
Q2 2018 - Q2 2020

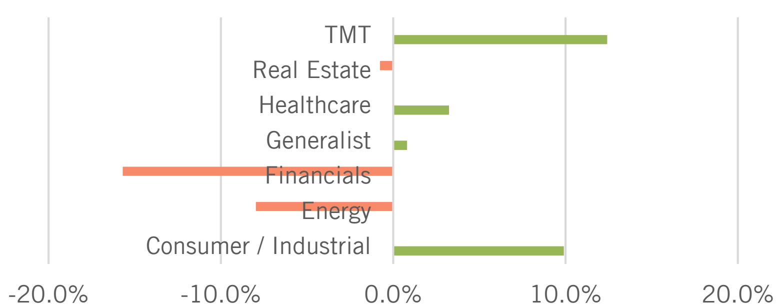


Source: HFR

But not all boats are rising with the tide…

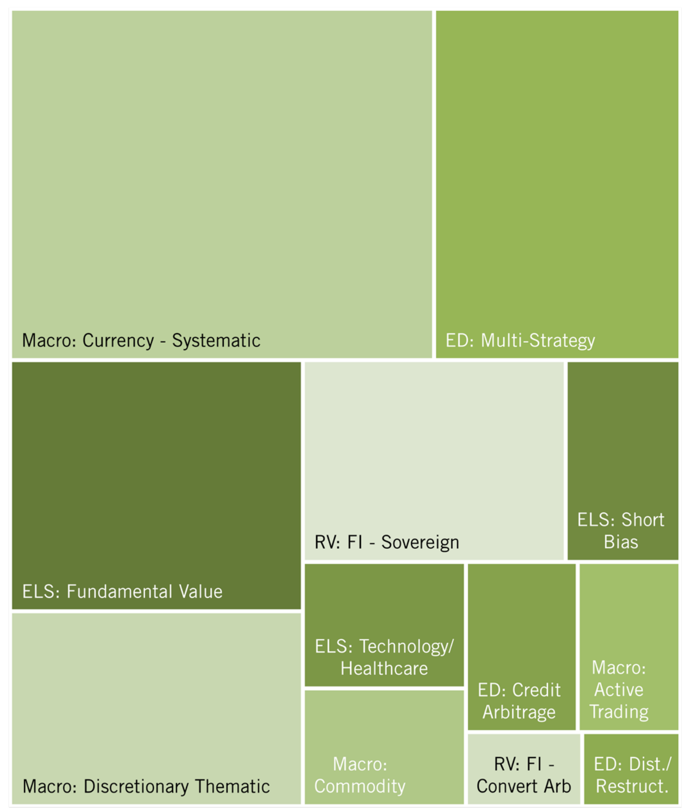
At least 12 hedge fund sub-strategies welcomed net inflows in Q2 2020
The HFRI Fund Weighted Composite Index® (FWC) saw the highest quarterly performance since Q2 2009, however, there was clearly large **dispersion in the gains among funds**, viewing the Equity Hedge (Total) Index's **13.3% surge**, versus the Macro (Total) Index's **gain of 0.8%.** Within Equity strategies, there's further dispersion of return streams based on **sector specialist and sub-strategy focus areas**:

Equity Long Short Strategies YTD I Q2 2020



Source: Jefferies Data

HFR Indices With Net inflows in Q2 2020



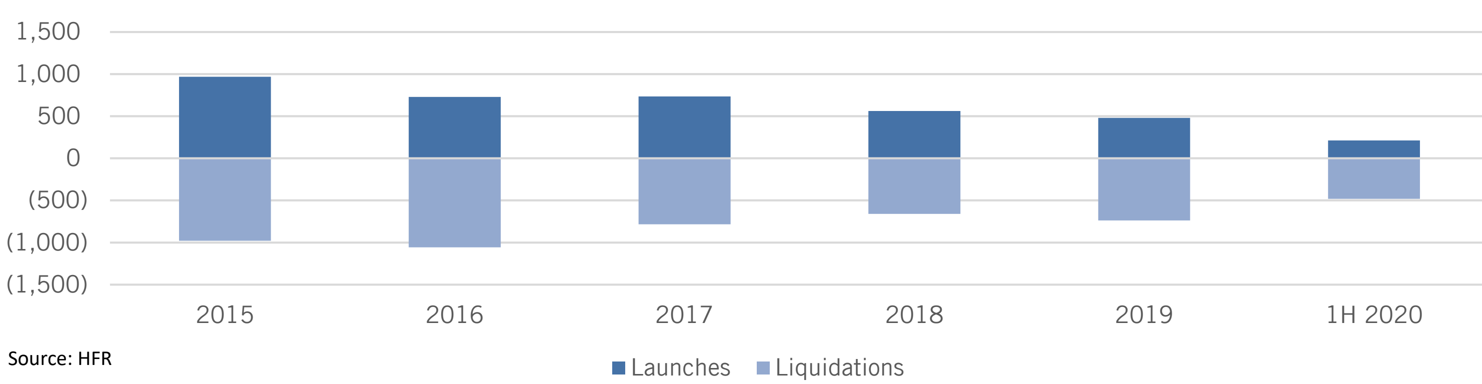
Source: HFR

… And these assets are being shared by a smaller number of players

While we see a healthy number of **quality, emerging managers launching products**, HFR data indicates that the amount of HF liquidations are offsetting the total number of funds in the marketplace.

As of Q2 2020, there were approximately 7,978 hedge funds in existence, managing over $3 Trillion in assets.

Annual Hedge Fund Launches and Closures
2015 - 1H 2020



Source: HFR

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Clients are asking: What's Happening around 13Fs?

Changes from the SEC

The Securities and Exchange Commission announced in July that it had **proposed to amend some requirements around Form 13F**, which requires larger investment managers to report on their investing activities and holdings. The proposal suggested a number of targeted changes, including an update to the **reporting threshold for institutional investment managers,** which is currently set at $100mm, to rise to $3.5Bn in Assets under Management.

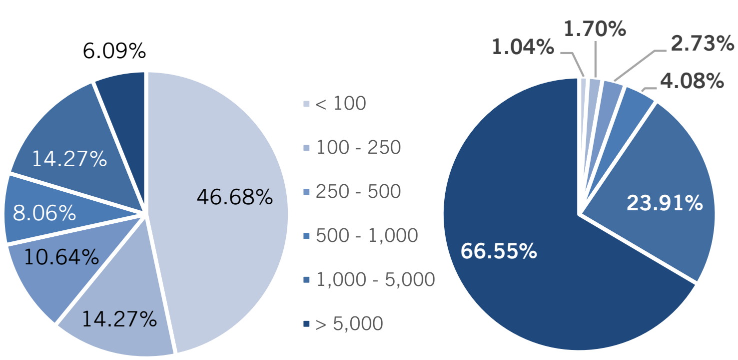
This threshold **has not been adjusted since the Commission adopted Form 13F over 40 years ago,** and since then, the value of U.S. public corporate equities has grown over 30 times (from $1.1 trillion to $35.6 trillion).[2]

Therefore, the relative value of **managing $100mm in AuM isn't what it was in 1980…** but where ***does*** managing $100mm versus $3.5Bn fall in the 2020 hedge fund landscape ?

- According to HFR data, somewhere between **6% and 14%** of all hedge funds are managing over $3.5Bn…
- …However, those small number of firms account for nearly **90% of the market value of all assets** managed by hedge funds
- Note that the 60-day comment period for this proposed amendment ended this month, and we will likely hear a formal decision on the threshold change in Q4 2020

Distribution of HF Assets by # of Firms Q2 2020

Distribution of HF Assets by Firm AUM Tier (mm) Q2 2020



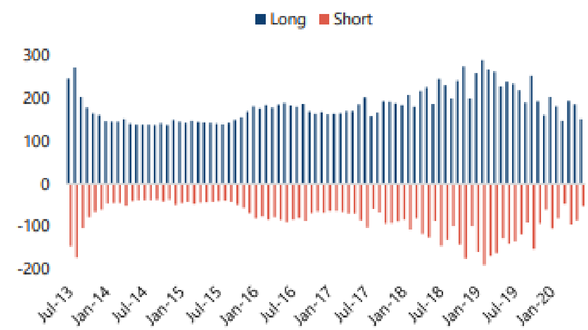
Source: HFR

Jefferies Insights on Q2 2020 13F Filings

Recent 13F Filings and MSCI data allow the Jefferies Prime Services team to conduct an analysis of what **sectors and securities hedge funds are most active in as on a quarterly basis.** Additionally, JEF **SMID Cap Equity Research team compiles a report looking at crowding, turnover, liquidity, directional shifts, and net weights of hedge fund holdings** Findings from Q2 2020 included…

1. **Across the industry, Hedge Funds came into the summer with the lowest equity exposure since Oct '15.** Hedge Funds seemed to avoid aggression and pulled in their equity risk exposure after Q1 2020. In fact, at 152%, average gross exposure was well below the historical average, and at its lowest since October 2015. This could be one of the many drivers behind the historic rise in the S&P 500 in August.

Chart 1 - Hedge funds headed into summer with below average equity exposure



Source: FactSet; MSCI; Jefferies

2. **Moves from Net Short to Net Long were seen in Consumer Staples, and there seems to be a continued 'love affair' between Hedge Funds and Comm. Serv. and Discretionary.** On top of taking down risk exposure, Hedge Funds added defense to their portfolios with Staples moving from a Net Short position to Net Long. The group is still massively underweight but it's the change that counts. Hedge Funds brought down their exposure to Comm Services and Discretionary, however, they are still overweight these groups by 4.9% and 4.8%, respectively. For Discretionary, the long-term average overweight stands at 8.7%.

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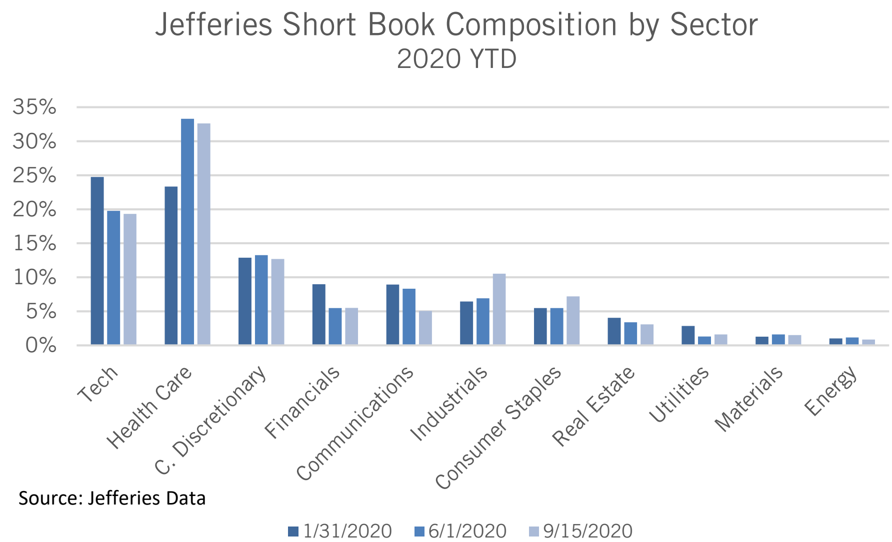
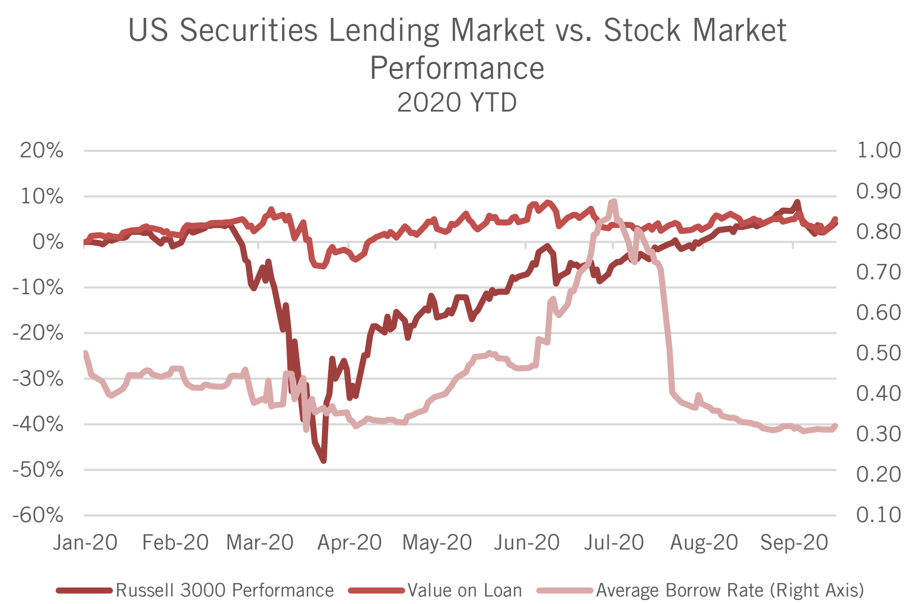
Views from Jefferies Securities Finance

Taking a Look at Short Book Composition and Flows



Source: Jefferies Data



Source: Jefferies Data

The Jefferies Securities Finance team has been able to gauge investor short interest sentiment by taking a look at our short book composition, broken out by sector for 2020 YTD. Since COVID-19 first came into our lives, we've seen a **considerable increase in shorting activity within the healthcare industry (+9.3% YTD)**. As tech valuations continue to rise in a remote environment, **shorting in tech has declined by 5.4% through 2020**. Other notable rotations in Jefferies short **book since the pre-COVID era** include; -3.5% in Financials and -1.2% in Utilities.

From Q2 to Q3 2020, the team has gathered **that cyclicals, and industrials specifically, appear to be a short book favorite** (+3.6% share in Industrials and +1.7% share in Consumer Staples). As WFH doesn't seem to be going anywhere, *even with a potential vaccine on the horizon,* we've seen a **drop in short activity within Communications (-3.3%) and Healthcare (-0.7%).**

Through the initial market downturn in March, the total market value of shares on loan had a much more muted pullback – indicating a **decrease in internalization and rising short interest**. Through the summer recovery, value on loan was fairly rangebound but notably the **average borrow rate in the borrow market tightened through July,** but has since pulled back to lower levels than we saw at the start of the year, as **supply has generally increased.**

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Top 20 Russell 3000 Short Names

Ticker	Company	Sub-Industry	Mkt Cap ($mm)	Last Exchange Reported SI (8/31/20)	Reported SI % of Float	Est. SI (9/15/20)	Est. SI % of Float	MoM Change in Est. SI (8/1/20)	QoQ Change in Est. SI (7/1/2020)	MoM Change Est. SI% of Float	QoQ Change Est. SI% of float (7/1/2020)	Utilization	Days to Cover	14D RSI
GME	GAMESTOP CORP-A	Computer & Electronics Retail	688.1	57,860,937	107.7%	42,661,615	79.4%	(11,862,917)	(11,897,994)	-20.2%	-20.7%	89.8%	4.7	68.6
FIZZ	NATL BEVERAGE	Soft Drinks	3,386.0	6,667,894	57.3%	6,637,260	57.0%	786,625	691,762	6.7%	5.9%	66.0%	20.0	49.7
BBBY	BED BATH &BEYOND	Homefurnishing Retail	1,770.8	69,349,959	58.0%	69,551,168	58.2%	(148,848)	505,829	-0.5%	0.4%	61.6%	10.4	52.4
LGND	LIGAND PHARM	Biotechnology	1,440.0	9,014,888	58.7%	8,979,249	58.4%	436,933	(15,795)	3.0%	0.2%	66.4%	37.9	23.5
MAC	MACERICH CO	Retail REITs	1,016.4	76,610,116	55.7%	76,340,814	55.5%	9,286,537	7,695,760	7.7%	6.5%	73.1%	14.6	41.7
AXDX	ACCELERATE DIAGN	Health Care Equipment	628.4	14,849,785	53.5%	15,321,713	55.2%	(398,377)	(1,981,125)	-1.0%	-6.6%	87.1%	40.7	25.4
MNK	MALLINCKRODT	Pharmaceuticals	97.3	42,049,323	50.4%	40,255,239	48.2%	(9,288,417)	28,314	-11.2%	0.0%	93.6%	9.5	29.5
GOGO	GOGO INC	Wireless Telecommunication Ser	816.6	20,395,808	50.7%	20,507,961	51.0%	1,408,717	(1,394,626)	14.2%	8.9%	90.6%	1.9	79.8
DDS	DILLARDS INC-A	Department Stores	705.6	6,819,586	112.1%	7,040,739	115.7%	286,084	153,281	70.2%	69.4%	95.0%	11.7	86.6
SKT	TANGER FACTORY	Retail REITs	566.4	45,754,578	50.5%	46,002,172	50.7%	696,267	(4,418,263)	0.9%	-4.7%	72.7%	17.8	56.3
PLCE	CHILDREN'S PLACE	Apparel Retail	424.5	6,352,550	46.5%	6,376,059	46.6%	792,448	771,346	5.9%	5.6%	35.7%	3.5	85.3
SRG	SERITAGE GROWT-A	Retail REITs	526.7	15,671,380	46.5%	15,918,868	47.3%	252,032	208,877	1.5%	1.4%	73.4%	17.7	68.0
M	MACY'S INC	Department Stores	1,945.2	135,040,404	43.6%	140,108,067	45.2%	5,050,663	(18,519,519)	1.2%	-6.4%	67.8%	5.1	56.6
ESPR	ESPERION THERAPE	Biotechnology	1,040.9	11,565,023	42.9%	11,814,828	43.8%	932,711	1,687,321	3.1%	5.9%	96.7%	18.2	66.0
SFIX	STITCH FIX INC-A	Internet & Direct Marketing Re	3,219.2	22,419,534	43.5%	22,695,609	44.0%	1,409,117	319,898	3.0%	0.3%	65.3%	10.3	65.3
CLVS	CLOVIS ONCOLOGY	Biotechnology	613.9	36,567,733	42.7%	37,335,142	43.6%	3,417,890	7,090,296	3.9%	8.2%	87.4%	6.5	83.0
TR	TOOTSIE ROLL IND	Packaged Foods & Meats	1,959.8	6,710,542	40.3%	6,904,329	41.5%	217,805	1,359,589	1.1%	8.0%	48.8%	37.2	26.7
IRBT	IROBOT CORP	Household Appliances	2,149.5	10,803,918	39.6%	10,927,285	40.1%	238,866	2,058,866	0.6%	7.3%	37.7%	18.2	65.4
REV	REVLON INC-A	Personal Products	352.5	2,708,763	39.7%	2,738,514	40.1%	144,544	665,775	1.8%	9.5%	88.4%	16.4	42.7
JWN	NORDSTROM INC	Department Stores	2,038.2	43,275,170	41.6%	41,762,166	40.2%	(1,895,333)	171,508	-1.2%	0.5%	60.8%	4.3	44.1

Source: Jefferies Data

2020 Content for Your Fall Commute… From the Kitchen

AUDIO

Jefferies Franchise-Wide Podcast: *Invisible Forces* is BACK with Season 2

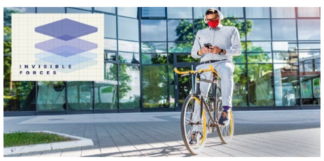
Jefferies' podcast series explores the unseen influences that are rapidly transforming our way of life and global economy. 2020 has consisted of some of the most game changing events in recent memory; in this season we look into the future at where we'll be living, how we'll be working, what we'll be buying … and why?

Each episode of this six-part series outlines important and timely themes, from the future of our supply chains, to the importance of customization across industries, and why conscious consumerism may define the next decade.

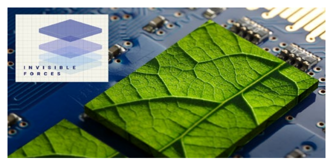
Season 2 Episodes:

S2, Episode 1:
Crying Over Spilled Milk: The Disruption Solution

S2, Episode 2:
When Tech is Your Tailor



S2, Episode 3:
The Changing Face of Urban Space



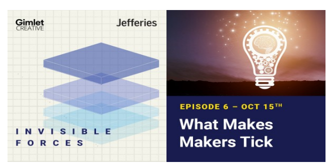
S2, Episode 4:
Lean, Mean and Green: The Future of Sustainable Businesses

S2, Episode 5:
A New Peace of Mind

S2, Episode 6:
An All-Encompassing Economy

Check out Season 1 as well…

S1, Episode 5:
A Tech Revolution for Financial Services



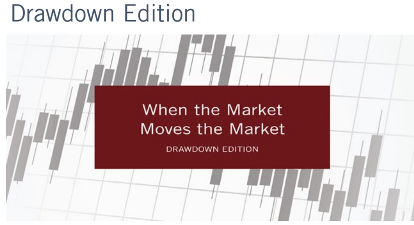
S1, Episode 6:
What Makes Makers Tick?

THEMATIC WHITE PAPERS AND PRESENTATIONS

ESG 2020: The Decade of Sustainability
Where Are We Now?

What has happened to sustainability during the first 6 months of 2020?

Market Structure Series: *When the Market Moves the Market*
Drawdown Edition

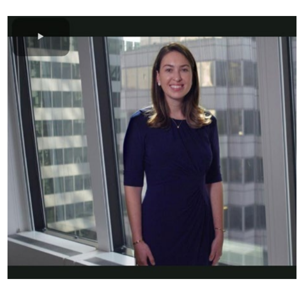


In the third installment of this series, we reflect on multiple dimensions of market structure and the capital markets landscape, and what may shape the days and months ahead.

MARKET STRUCTURE MINUTES

- When Will Then Be Now?
- Up and to the Right…*Right?*
- *The Icarus Rally*

VIDEOS



The View from Capital Intelligence:
Key Pillars of Enterprise Protection
2 key aspects of business protection that are top-of-mind for allocators and managers: vendor due diligence and monitoring critical data.

Jefferies

ENDNOTES

[1]The COVID-19 Crisis Could Launch a Wave of New Asset Managers. 2020. Available at: https://www.institutionalinvestor.com/article/b1mlkvb0hlt0mb/The-COVID-19-Crisis-Could-Launch-a-Wave-of-New-Asset-Managers

[2]SEC Proposes Amendments to Update Form 13F for Institutional Investment Managers; Amend Reporting Threshold to Reflect Today's Equities Markets. 2020. Available at: https://www.sec.gov/news/press-release/2020-152