



The State of Our Union 2020

ENDURANCE AND INNOVATION FOR
THE NEXT DECADE

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Jefferies

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Endurance and Innovation

Each year, we release *The State of Our Union*, to reflect on our industry and explore what may lie ahead.

At the dawn of a new decade, it is a particularly good time to reflect on where we are – not where the headlines say we are – and what that could mean for the coming years.

The hedge fund industry is not even a full century old, but we have endured many cycles and various forms of booms and busts. But it is perhaps our endurance and innovation that best exemplifies both our history and our future.

With more than \$3 trillion of assets under management across nearly 10,000 funds – about 400 of which manage over \$1 billion – hedge funds are a meaningful part of global portfolios. The industry has matured, institutionalized and diversified to deliver cutting edge solutions and facilitate deeper market access across the globe. Despite the fact that headlines have trumpeted the industry's decline on an ongoing basis for years, a closer look under the hood reveals the same generational shifts, product evolution and emergence of new talent as any other sector.

Events that serve as a harbinger of decline for some merely mark the emergence of a new set of standard bearers and innovation for others. The closing of a handful of household name funds has opened new doors of opportunity and prompted many to renew, refresh and rethink their approach to markets. If the last decade was defined by the rise of passive management, data science and a straight up equity market, it is possible (even likely) the next will see a broader correction and resurgence in the importance of a hedged portfolio.

What will make up the innovation and endurance of the next decade?

Some nascent trends at the close of 2019 are likely to accelerate, as investors become more focused on sustainability and a closer alignment of personal and portfolio values. We expect **environmental, social and governance issues to continue their rise** – but that the three will **cease to be viewed under a single umbrella** given their diverse nature. **Product innovation and the melding of public and private investments** will continue, given the shrinking of public markets and the massive growth in private ones. And finally, the **importance of content** will truly revolutionize how funds connect with partners and counterparties.

In January 2010, it's unlikely many of us would have been able to predict a decade long equity market rally, that the U.K. would vote to leave the European Union or that tariff wars would mar headlines at the close of 2019.

What was predictable, however, is that an industry borne of innovation and vision would continue to endure. While the 2010s certainly presented some challenges, we should not be surprised that in the face of those challenges, the hedge fund industry is starting a new decade near all time asset highs, across an enduringly large number of funds – more than *twice* the number of publicly traded American companies - and with some of its brightest minds electing to set out on their own, embracing the risk of starting a new enterprise ten years into the longest equity market rally of all time.

We are excited for what the coming decade may bring and look forward to partnering with you in the days ahead.

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1. Where Are We Now? Recession. Correction. ...Crash?

Any *State of Our Union* penned at the start of 2020 would be incomplete without reflecting on the market we are bringing with us to start this new decade.

We are well over 120 months into a U.S. equity market rally – history’s longest. The prime motive of investing is turning \$1 into, well, more than that. What encompasses or accounts for that growth goes by many names: yield, return, alpha, beta, growth. If you had a crystal ball, it’s very likely you would have plunked much of your liquid net worth into the U.S. stock market on January 1, 2010 and let it grow threefold.

But all good things must come to an end and many discussions recently have centered on: what could cause this run to stop?

A few scenarios:

Recession: What we are asked about most frequently. Marked by economic slowdown – conventionally, two consecutive quarters of negative GDP growth. If strictly governed by its academic definition, recessions don’t necessarily make predictions about equity market performance, but due to the decline in economic activity across real GDP, income, employment and industrial production, among others – equity market declines are common. There have been **seven official U.S. recessions** since 1969. Yet despite an inverted yield curve in the second half of 2019 (in which the yield of the 2-year UST exceeded that of the 10-year), recession does not necessarily seem to be looming on the horizon.

Expansion periods are lengthening and contractions are...well, contracting. If we look at the last 50 years, the average expansion period (previous trough to current peak) since 1970 is nearly *more than double* that of the fifty years prior.

Recession Snapshot 1920 - 2020

	Number of recessions	Number of recessions longer than 10 months	Average Contraction	Average Expansion Length	Notes
1920 - 1970	10	6	14.8 months	35.5 months	<ul style="list-style-type: none"> • More recessions of longer duration • Shorter expansions • Recessions distributed beginning across quarters: two began in Q1, four started in Q2, three began in Q3 and one in Q4
1970 - 2020	7	4	11.8 months	78 months	<ul style="list-style-type: none"> • Fewer recessions of shorter duration • Longer expansions • Three of the longest post WWII recessions, but the three longest expansions ever

Source: NBER, Jefferies

U.S. Business Cycle Expansions and Contractions: 1920 - 1970

Peak	Trough	Contraction	Expansion	Cycle	
		<i>Peak to Trough</i>	<i>Previous trough to this peak</i>	<i>Trough from Previous Trough</i>	<i>Peak from Previous Peak</i>
January 1920	July 1921	18	10	28	17
May 1923	July 1924	14	22	36	40
October 1926	Nov. 1927	13	27	40	41
August 1929	March 1933	43	21	64	34
May 1937	June 1938	13	50	63	93
Feb. 1945	October 1945	8	80	88	93
Nov. 1948	October 1949	11	37	48	45
July 1953	May 1954	10	45	55	56
August 1957	April 1958	8	39	47	49
April 1960	February 1961	10	24	34	32
Average		14.8 months	35.5 months		

Source: NBER

U.S. Business Cycle Expansions and Contractions: 1970 - 2020

Peak	Trough	Contraction	Expansion	Cycle	
<i>Quarterly dates are in parentheses</i>		<i>Peak to Trough</i>	<i>Previous trough to this peak</i>	<i>Trough from Previous Trough</i>	<i>Peak from Previous Peak</i>
Dec. 1969	Nov. 1970	11	106	117	116
Nov. 1973	March 1975	16	36	52	47
January 1980	July 1980	6	58	64	74
July 1981	Nov. 1982	16	12	28	18
July 1990	March 1991	8	92	100	108
March 2001	Nov. 2001	8	120	128	128
Dec. 2007	June 2009	18	73	91	81
Current Expansion →			~127	TBD	
Average		11.8 months	78 months		

Source: NBER

A correction: Typically a >10% equity market decline. **Corrections are more common than recessions** (9 corrections since 2000 vs 2 recessions), and while they may coincide with or constitute a bear market, that isn't always the case. A critical distinction between recessions and market corrections is that recessions can be reflected in stock market behavior (typically, negative), and corrections *are by definition*, negative stock market periods. Corrections are often viewed as “normal” part of the evolution of global markets and can be sparked by a variety of exogenous factors that precipitate selling. Corrections can be harder to predict than recessions.

S&P 500 Corrections: 2000 - Present

StartDate	SPX Index	EndDate	SPX Index	Return	Length (Days)
3/24/2000	1527.46	10/9/2002	776.76	-49.1%	929
10/9/2007	1565.15	3/9/2009	676.53	-56.8%	517
4/23/2010	1217.28	7/2/2010	1022.58	-16.0%	70
7/22/2011	1345.02	10/3/2011	1099.23	-18.3%	73
10/28/2011	1285.09	11/25/2011	1158.67	-9.8%	28
4/2/2012	1419.04	6/1/2012	1277.78	-10.0%	60
8/17/2015	2102.44	9/28/2015	1881.77	-10.5%	42
11/3/2015	2109.79	2/11/2016	1829.08	-13.3%	100
10/3/2018	2925.51	12/24/2018	2351.1	-19.6%	82

Source: Jefferies

And finally:

Crashes: A more than 40% downturn in the equity markets. Crashes are as often driven by panic as they are broader economic performance. While crashes are associated with bear markets, they aren't necessarily coincident – as happened following the crash of 1987. The three most material crashes in the U.S. since 1920 are well known: 1929, 1987, and 2008-2009.

One additional factor that researchers are investigating as a possible signal of impending crashes is an increase in the “comovement” of stock prices.¹ In a “healthy” market – perhaps half of stocks will move up or down on a given day. But some researchers posit that increased comovement of stocks, as they argue happened before the 2008 crash, can serve as a blinking warning of an impending drawdown.

We don't take a stand as to whether 2020 starts a decade and ends one of the longest periods of economic expansion and bull markets in history. But it is important to understand that managers are revisiting their risk management processes, stress testing portfolios and exposures under various scenarios to prepare for an eventual downturn, and working with trading desks to understand how changes in market structure could influence how corrections or bear markets emerge in the future.

We have heard the most from managers trying to understand and plan for the "next recession," despite the fact a correction seems more likely to occur first, given the difference in frequency. But in looking at NBER's data, and how prolonged recent expansions have become, it is entirely possible this upward equity run will continue deep into 2020...or even beyond.

It is unclear whether we are "late cycle" or "latER cycle." As such, managers are in planning mode. They are revisiting past periods of stress to understand how each line of their portfolio may react to changes. They are convening risk and trading offsites to discuss different scenarios – and how to respond. IR and marketing professionals are dusting off their rapid-response workflows to ensure they haven't been lulled into complacency. And investment professionals are revisiting basic assumptions to ensure they aren't found flat footed when the world changes.

Prepping for the...Inevitable?



The Great Divorce: E from S from G

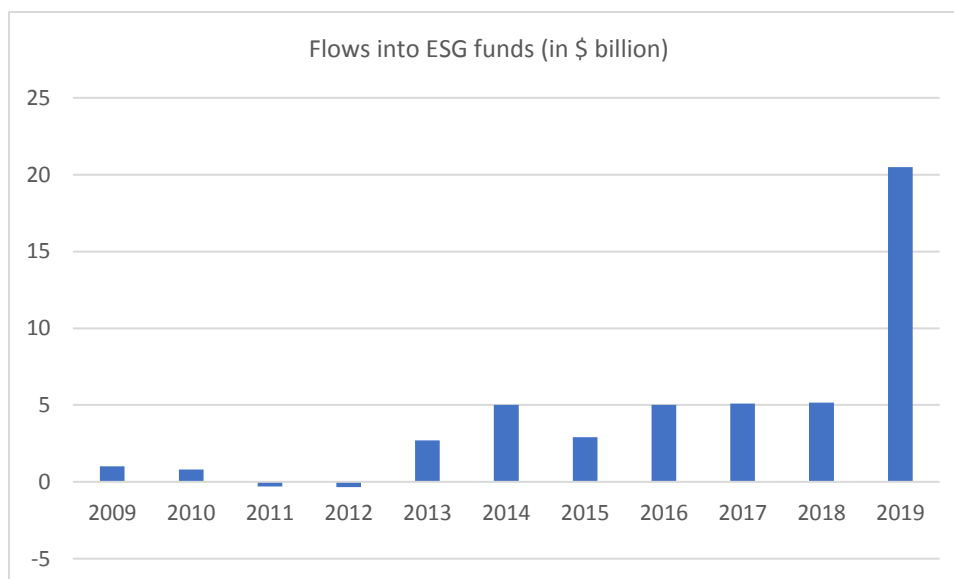
After “data,” ESG may have been the most buzzwordy phrase of 2019. For many good reasons – investors are taking a closer look inside their portfolios to align their holdings with their values or get ahead of emerging trends like decarbonization. Economists have long spoken of a somewhat false dichotomy between values like treatment of employees or proper governance with shaping a portfolio or effectively running a company. As this piece went to print, BlackRock was making headlines that put sustainability squarely in focus, and the World Economic Forum’s International Business Council (IBC) proposed a common set of metrics and recommended disclosures for companies to embrace around sustainability, contributing to the growing body of global data.²

One of the ongoing challenges to global consensus around incorporating these issues into portfolios is because in some sense “ESG” tries to be all things (or at least, many things) to all people.

ESG is an umbrella term for an *extremely diverse* set of factors – many of which can conflict with each other. Blending these diverse inputs to come up with a single “ESG” rating, score or silver bullet that triggers a buy or a sell on a company can be an extremely complex endeavor. How to analyze a company that has stellar environmental bona fides – but has meager (at best) governance? Or a firm that does right by employees and shareholders, but fails all metrics of sustainability?

To navigate this, a growing number of investors are actively seeking vehicles that allow them to align their values, but that don’t necessarily tick every “E,” “S,” and “G” investment box. We believe the next decade will, in fact be dominated by this type of investment, much like passive investing dominated the last decade – but that it will not take the form of “ESG investing” together. Investors are remaking this corner of the industry by becoming more specialized – a trend we highlighted in our **2019 State of Our Union**.

In 2019, investors poured over \$20 billion into ESG funds – *four times* that of 2018, and more than 2015-2018 combined.



Source: Morningstar

These flows are only expected to accelerate, as companies increasingly report on these issues, creating the data that has been sorely lacking. Companies may leverage SASB or the new WEF IBC metrics, among others.

One corner that may benefit the most from increases in transparency and reporting are those focused on the “E” – and addressing the global transition to decarbonization.

Former Bank of England Governor Mark Carney recently remarked millions of retirees’ livelihoods and assets could be negatively affected by climate issues. And Sir Christopher Hohn, at COP 25 in Madrid at the end of 2019, called on all companies to more robustly and transparently report their carbon emissions.

“Investing in a company that doesn’t disclose its pollution is like investing in a company that doesn’t disclose its balance sheet...If governments won’t force disclosure, then investors can force it themselves.”
- Sir Christopher Hohn, TCI³

This reflects a well worn adage: how can you manage what you do not measure? As companies increasingly report their emissions, climate impact and mitigation efforts, investors are presented with a growing body of data that will inform investment theses and research processes. Who wouldn’t want to more accurately understand if a company is at high risk of exposure to climate related changes, like some corners of insurance or financial services? Or if a fossil fuel focused firm begins to diversify its business lines to acquire renewable or utility companies? Or how pending regulation could affect various business lines and asset values?

This highlights a very true issue that may not have been on Milton Friedman’s radar – in some cases and over time, changing “values” will explicitly affect the “business,” he claimed that *IS BUSINESS*.¹

¹ “The business of business is...*business*.” Friedman was famously quoted as saying.

You don't need to be Greta Thunburg to understand climate changes pose a very real impact on asset values. Mark Carney, Repsol and Sir Hohn have recognized the outsized role climate issues will play on investment themes in the coming decade. You simply don't need to be a climate enthusiast to understand the implications of a paradigmatic shift to a *lower* carbonized world means. Repsol SA, for one, said in a first for the oil and gas industry in December 2019, "In line with its commitment to sustainability, Repsol aims to achieve net zero emissions by 2050, making it the first oil and gas company in the world to assume this ambitious goal. At the same time, it is setting a decarbonization path with intermediate targets for 2020 to 2040."⁴

Microsoft went one further, declaring its intention to go carbon *negative* by 2030.⁵ Such clear statements could certainly be a sign of things to come.

Drivers of Rise in Sustainable Investing



A Word on Generational Shifts: It has been well reported that hiring and retaining top Millennial and emerging Gen-Z talent takes more than money these days. A company's purpose, its treatment of its employees and its efforts around sustainability are increasingly important in the global war for talent.

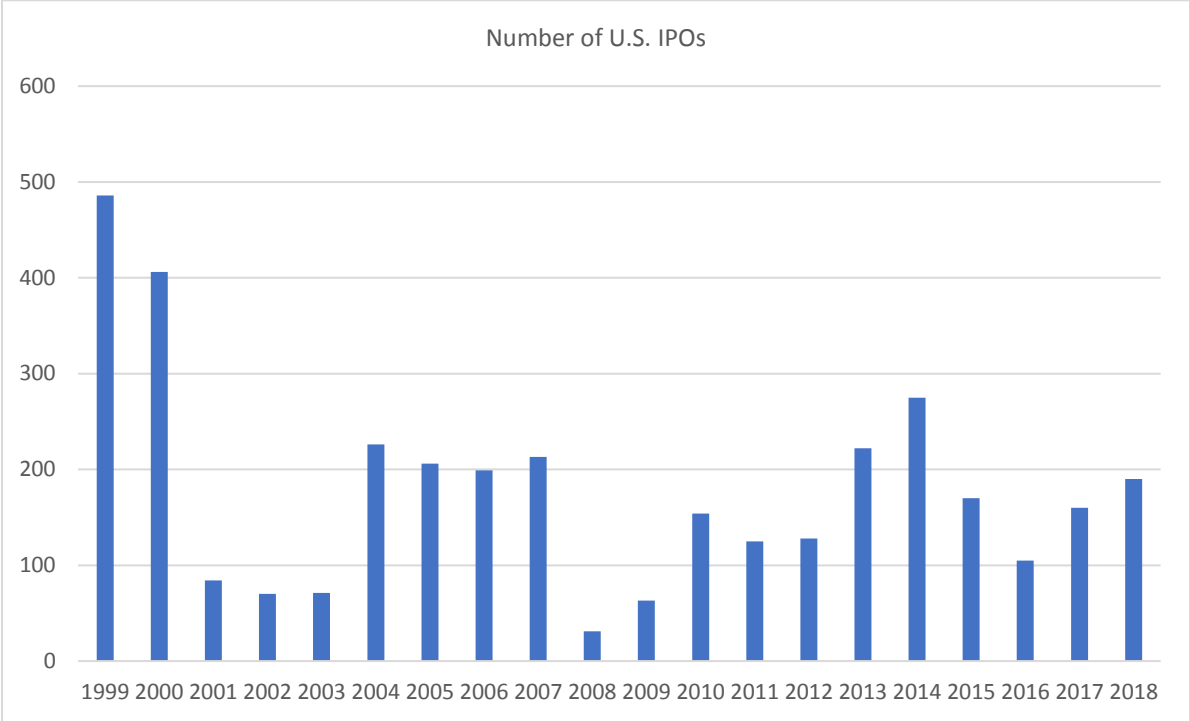
And it's not just current and future employees and customers – the rising generations are in increasingly powerful investment positions, with a new set of values. We wrote in an earlier piece, ["E is for Emissions?"](#) that even a small shift in millennials' investment preferences could result in \$1 trillion moving into ESG or sustainable defined contribution plans.

Innovation is the Lifeblood of This Industry | Shifts in Public and Private Market Vehicles

One of the least surprising but most underreported trends of the hedge fund industry in the last decade has been its evolution to serve as a major solutions provider to some of the world’s largest investors across diverse vehicle offerings. Flagship funds have given way to UCITS, 40 Act funds, funds of one, SMAs, public/private vehicles, long only carve outs, more levered vehicles, co-investment vehicles and a number of other bespoke investment solutions.

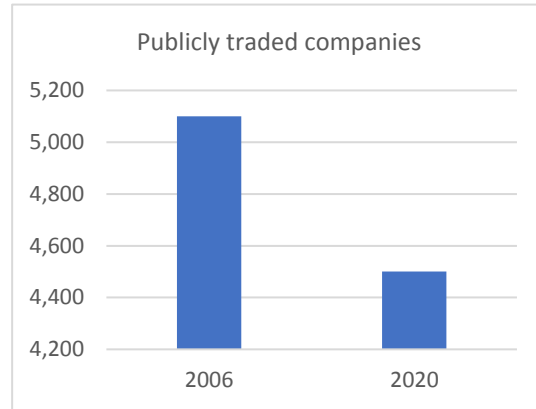
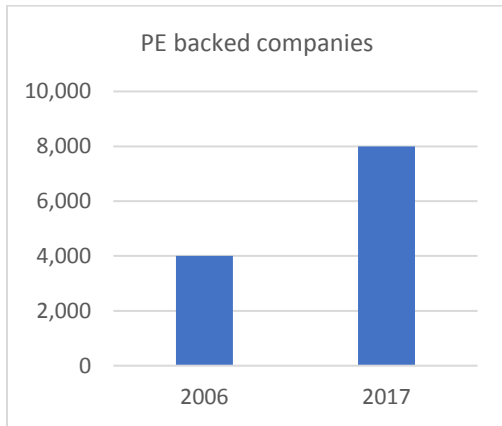
The diversification of product lines within alternatives funds has been a critical driver of the industry’s evolution from access product to solutions provider. Two decades ago, investors were keen to find an in-the-know hedge fund manager who was likely to be ahead of the trade of the decade. Today, firms are built on the success of the investment professionals’ ability to understand LPs’ needs and craft a performing solution to meet those objectives.

One of the most interesting corners of this shift has been in private market funds launching public or hybrid vehicles or co-investments, and public market funds launching private or hybrid vehicles or co-investments. As the public markets either continue to contract as measured by number of publicly traded companies – or maintain their levels, depending on who you ask – investors increasingly look to the private markets to broaden their universe.



The U.S. public market universe has remained remarkably rangebound in recent years – down from its peak in the 1990s.⁶

If we look across the last 20 years, the net asset value of private equity has grown more than sevenfold since 2002 – which McKinsey estimates is twice as fast as global public equity growth.⁷ McKinsey also estimates the number of companies backed by Private Equity grew from about 4,000 in 2006 to 8,000 in 2017, while publicly traded companies witnessed a decline from 5,100 to ~4,500.⁸



Source: McKinsey

Given the shrinking sandbox of publicly traded companies, and an enduringly high number of players *in that sandbox* (~10,000 hedge funds globally), it makes sense that investors have increasingly looked to privately held companies to grow their investible universe.

Content *Is* the New Communication | Your Administrator Has a Podcast. Do you?

Quarterly investor letters are so 2010.

How do *you* consume content in 2020? How do you learn? Where do you develop new knowledge? And given that many of us now apparently have an attention span somewhat in line with a goldfish – how do we connect and communicate with others?

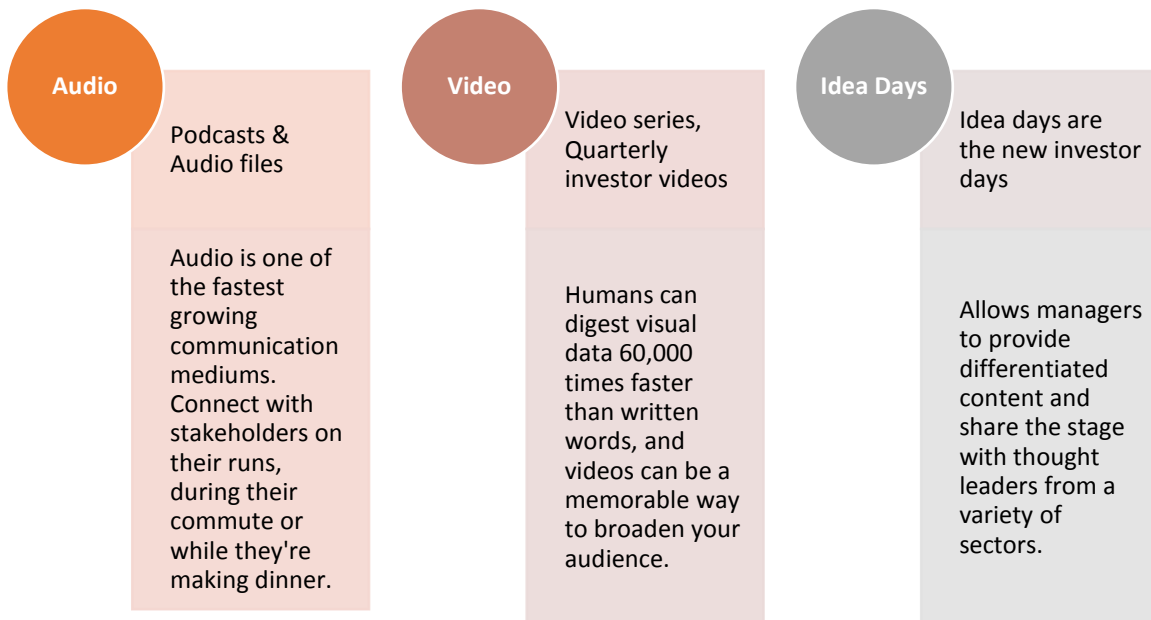
A decade after revolutionizing the media and consumer sectors, content has finally reached the shores of financial services. Actors across the financial services industry – from banks and brokers to allocators and administrators – are leveraging new delivery mechanisms to tell their story to the market and attract and engage with stakeholders.

Jefferies Capital Introductions team estimates there are thousands of hedge fund investors across the globe. Managers are increasingly realizing it can help to put a face with a firm, or a voice to a strategy. Whether videos, podcasts, webcasts, idea days or other differentiated mediums, hedge fund managers are working to more succinctly and compellingly explain their value proposition.

More than 10% of the Billion Dollar Club (those firms managing more than \$1 billion of assets) have content focused marketing efforts, and while it may be easy to say those are precisely the firms with enough resources to do so, Jefferies estimates nearly *twice that* of emerging managers are exploring various new mediums to connect with stakeholders beyond traditional PDFs and PowerPoints.⁹

Not everyone is a video – or radio – star. But a large and growing number of firms across the financial services spectrum are learning how to leverage new and revived mediums to tell their stories in concise, visual ways.

Growth of Differentiated Communication Mediums



How Jefferies Can Help

As in years past, it is our sincere hope that this *State of Our Union* piece helps to squarely identify where we are as an industry and inform how businesses can strategically plan for the days ahead.

Whether better understanding the current asset raising environment, exploring new vehicles or product launches, digesting changes in market structure or even building new content efforts, the Jefferies Capital Intelligence team has worked with clients to understand the trends and themes underneath the surface that are impacting their businesses.

While the last decade has witnessed broad expansion, managers and allocators are actively planning for shifts in that environment, while strengthening the foundations that helped them get to this point. At this point in our industry's maturity, it is important for partners and counterparties to be able to deliver differentiated insights and provide clients the answers to questions they simply can't get from elsewhere...even Google.

The Jefferies Capital Intelligence team has spent the last ten years building a differentiated, strategic and highly data driven offering to help clients run more efficient and profitable businesses. We look forward to partnering with you in the decade ahead.

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¹ The Financial Crisis and Co-Movement of Global Stock Markets – A Case of Six Major Economies. Yonghong Jiang, Memgmeng Yu and Shabir Mohsin Hashmi. <https://www.mdpi.com/2071-1050/9/2/260/pdf>

² <https://www.weforum.org/whitepapers/toward-common-metrics-and-consistent-reporting-of-sustainable-value-creation>

³ As quoted in The Financial Times, "Hedge fund TCI vows to punish directors over climate change." December 1, 2019.

<https://www.ft.com/content/dde5e4d4-140f-11ea-9ee4-11f260415385>

⁴ Repsol Investor Press Room. "Repsol will be a net zero emissions company by 2050." <https://www.repsol.com/en/press-room/press-releases/2019/repsol-will-be-a-net-zero-emissions-company-by-2050.cshmtl>

⁵ Official Microsoft Blog. <https://blogs.microsoft.com/blog/2020/01/16/microsoft-will-be-carbon-negative-by-2030/>

⁶ The World Bank

⁷ McKinsey. "Private Markets Come of Age: McKinsey Global Private Markets Review 2019."

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⁸ Ibid

⁹ Jefferies