Jefferies Annual State of Our Union 2022

JEFFERIES PRIME SERVICES WHITE PAPER | 2022

Jefferies

The State of Our Union 2022

A Pivotal Year for Decisionmakers

From 2019 – 2021, **hedge funds posted their first three consecutive double digit returns since the 1990s**, delivering cumulative returns for that period of ~40%.[1] They also had the best asset raising year in 2021 since 2015, welcoming more than $15 billion in net inflows, while continuing to jump headfirst into private investing.[2] In fact, private investing has increased so substantially, **a snap Jefferies survey of 41 hedge funds with public market flagship products revealed 66 *other* share classes for private market exposures.**[3]

And the competitive landscape is rapidly changing.

Traders and investors are navigating markets amid uncertainty about Fed action (or actions) this year, a challenging energy landscape in Europe, the steepest inflation in decades, a drawdown for digital assets, and the reminder that volatility can reappear when you least expect it.

Everyone is trying to prepare for the unknowns ahead, while building institutions that endure and thrive across cycles.

There are no predictions in this year's piece. Instead, we take stock of the many changes the industry and global markets have endured in the last decade and dig into the critical questions facing decision makers in 2022. Leaders are redefining the competitive landscape, identifying new business opportunities, and taking their organizations to the next level.

You can't manage what you don't measure and building firms with greater enterprise values starts with asking the right questions. "Management" is the word driving this decade – across risk management, portfolio management and organizational management. Performance is a necessary driver of profitability, but there are many other factors like diverse revenue streams and overall strength and agility of an organization that are required for next generation business models.

So much has changed in the last 15 years, it's hard to talk about "the" hedge fund industry as a monolith. The movement of public investors deeper into private markets, and the diversification of private market investors into public markets has created a global alternatives industry that now tops $10 trillion.[4]

The funds of today – even those with 20 or 30 year track records – bear little resemblance to their earlier incarnations. We hope this year's *State of Our Union* sheds light on the endurance and agility that has brough us here, and the innovations that may lead the way to what's next.

Shannon Murphy
Head of Strategic Content
+1.212.336.1139

Leor Shapiro
Head of Capital Intelligence
+1.212.336.6260

Erin Shea
Business Consulting
+1.212.323.3337

Annette Rubin
Strategic Content
+1.212.778.8361

TOP THEMES FACING ALTERNATIVES DECISION MAKERS in 2022

- Elevated Volatility
- Return of Stock Picking Environment
- Acceleration of Private Market Activity
- Inflationary Pressures
- Changes in Market Structure

TOP QUESTIONS FACING ALTERNATIVES DECISION MAKERS in 2022

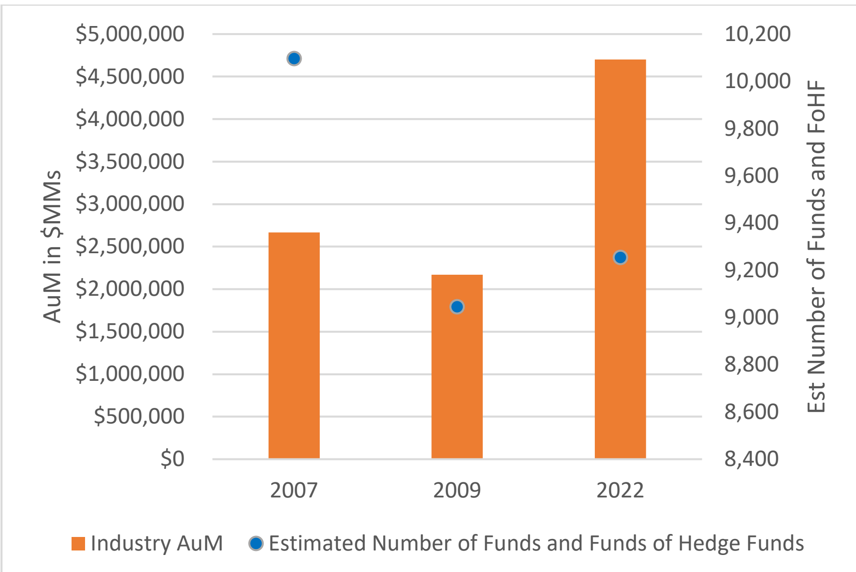
1	**Who** is managing **what**, **how much are they managing,** and **why does this matter?** The “competitive landscape” question
2	How have alternatives’ funds **enterprise values** been effected by **structuring new share classes?** The “valuation” question
3	What is the **current opportunity set** among new or expanding asset classes? The “upside” question
4	How do **themes in the private market affect public investments**…and vice versa? The “adjacencies” question
5	How has the **market structure of various asset classes** changed? The “risk management” question
6	Why is **capital raising now a horizontal effort**, rather than a linear and progressive one? The “partnership” question
7	Are **sector multi-strats** increasingly in demand? The “diversification” question
8	How have **expense ratios changed** given shifts in fixed and variable expenses? The “opex” question
9	What are the new **“table stakes” for content and communication?** The “engagement” question
10	What are the **organizational innovations** underway that build the institutions of tomorrow? The “business management” question

What, How and How Much – And Why Does It Matter

The makeup of the hedge fund and fund of hedge fund industry has shifted considerably in the last 15 years, redefining the competitive landscape. Diversification, institutionalization and innovation have created an entirely new reality for those looking to successfully manage a fund and compete over market cycles.

The industry first topped 10,000 funds in 2007, but the composition of funds and strategies that dominate has shifted, as firms are managing *twice the assets* they were 15 years ago. On a more granular level, longstanding institutions have found new competition from all corners – from new and emerging funds, traditional private investors and even new asset classes.

Industry Makeup | Estimated Number and AuM of Hedge Funds and Funds of Hedge Funds in 2007, '09 and '21



Source: HFR, Jefferies

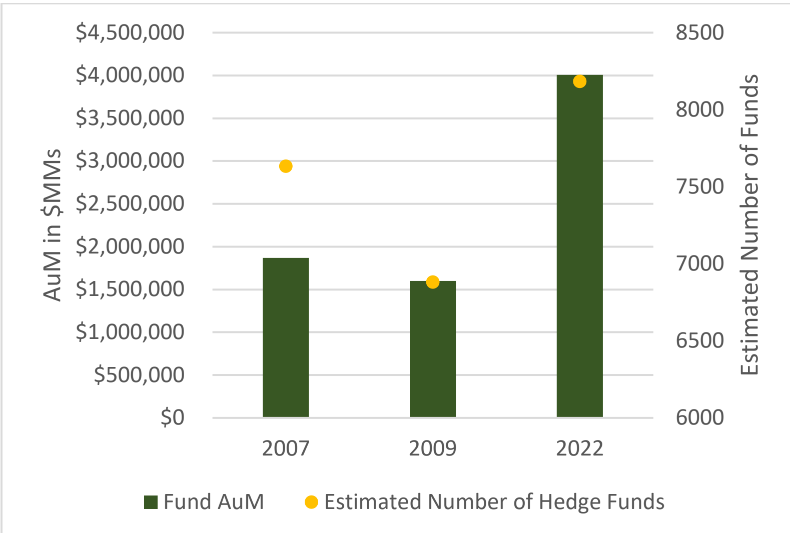
Industry Makeup | Funds of Hedge Funds and Hedge Funds as % of Total, 2007 & 2021

Source: HFR

The composition of funds has changed. As the number of funds of funds declined and firms consolidated, hedge funds grew as a percentage of total and now comprise 90% of the industry by number of funds.[5]

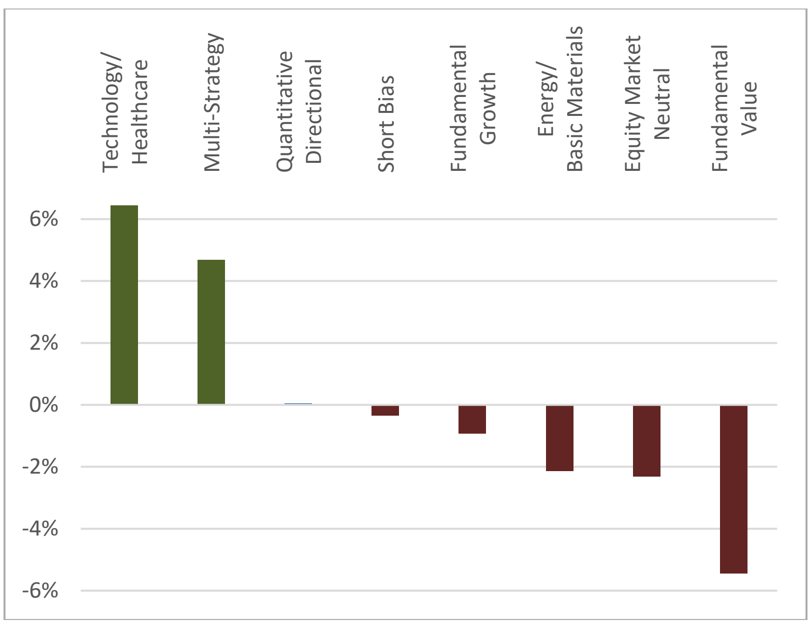
The *strategies* that make up total industry AuM have shifted as well, reflecting shifts in allocator appetite. Equity Long/Short (ELS) firms now represent more than 30% of industry assets.[6] Together with Event Driven strategies, they make up nearly 60% of the total. By substrategies within this largest Equity bucket, **healthcare and tech sector funds have been the biggest beneficiaries of growth in the last decade** growing from 4% of ELS assets to 11%.[7]

Industry Makeup | Estimated Number and AuM of Hedge Funds Only (Excl. FoHF)



Source: HFR, Jefferies

Industry Makeup | Change in % of Total Equity Long/Short AuM by Sub-strategy, 2007 vs. 2021



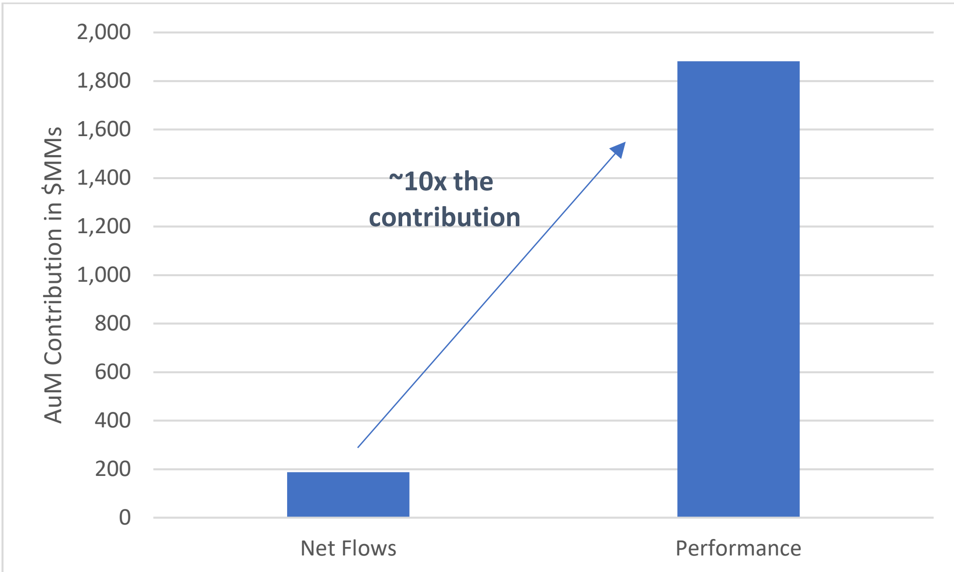
Source: HFR, Jefferies

The Changing Competitive Landscape*

- There are **7% more hedge funds in 2021 than there were in 2007**
- These funds are **competing for twice the assets**, with AuM at all time highs of $4.1 trillion
- In many ways, this is good news, with more dollars to go around, however, **scale is your friend**
- The biggest **funds** managing $5 billion or more account for 11% of the industry's number of funds – but they are responsible for managing around more than **80% of the industry's assets**. By contrast, those **managing less than $100 million account for 67% of all funds, but manage less than 5% of industry assets.**
- At the **firm** level – firms managing more than $5 billion in assets account for ~6% of the number of firms, but about two-thirds of industry assets.
- As assets have grown, **Equity Long/Short strategies have witnessed the steepest growth**, now overseeing >30% of total assets, followed by Event Driven strategies which oversee another 28%.
- Within ELS, **healthcare and technology sector specialists** have grown as the greatest percentage of total AuM, from 4% of ELS assets to more than 11% of ELS assets.
- Sector specialists have **ridden a wave of popularity in recent years, and are now diversifying into sector multi-strategy funds**

*All data is from HFR and Jefferies Capital Intelligence

Growth in Industry AuM By Flows and Performance 2010 - 2021



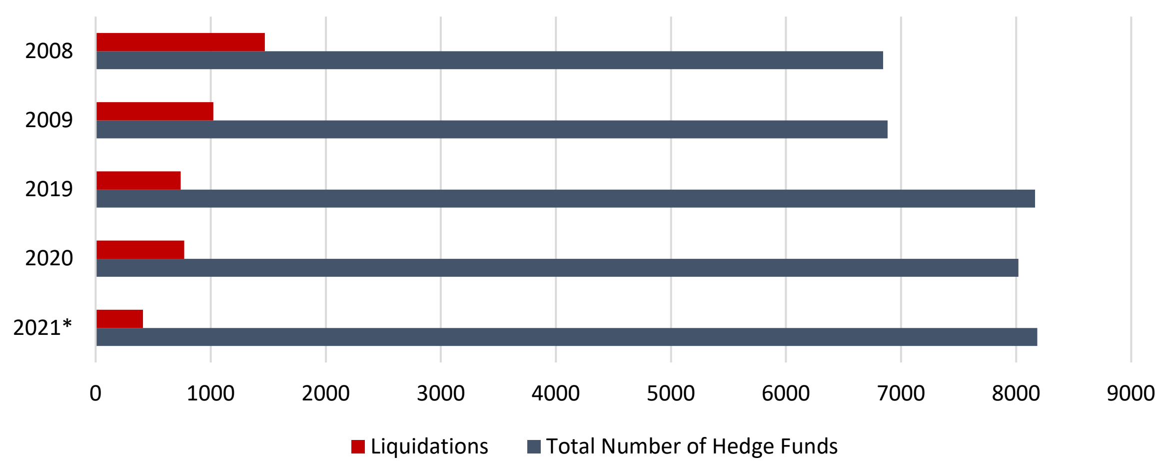
Source: HFR, Jefferies

The value proposition for investing in many funds appears quite different than writing a ticket 15 years ago. Allocators are more likely to seek diverse asset exposure from managers already in their stable and approved. And managers are more likely to start incubating new strategies early on with internal capital to prove out investment theses and processes.

Those choosing to come to market in 2022 are launching in an entirely different ecosystem than in the past. The service provider community is fully institutionalized across outsourced offerings – whether outsourced COO/CFO, trading or compliance – which allows new launches to shift fixed to variable expenses.

And liquidations? Closures as a percentage of total number of funds are near decade lows.

Liquidations as a Percentage of Total Number of Hedge Funds: 20008-09 and 2019-21



**Through Q3 2021 Source: HFR, Jefferies*
Source: HFR, Jefferies

GROWING ASSETS IS NOT GATHERING ASSETS

Organizational growth can be eyed suspiciously if done too rapidly and without thought to durability and resourcing of a vehicle.

But the dozens, if not hundreds of firms who have built multi-billion dollar platforms offering numerous $5 billion+ products should serve as proof asset growing is not the same as asset *gathering*. Why does this matter?

Given the trajectory of firm growth to asset growth on the hedge fund side, **we anticipate the appetite for these large products to grow.**

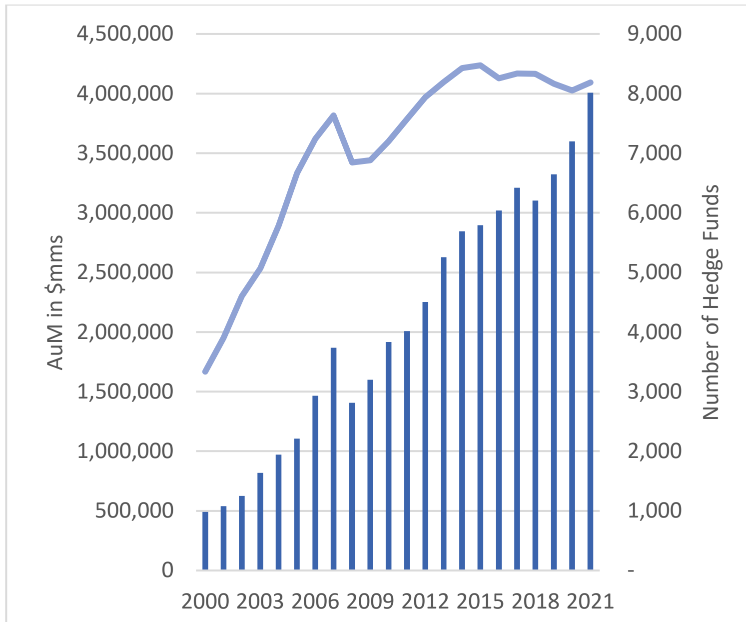
This creates considerable opportunity for those who are scaling firms now to grow exponentially in the coming years. Strategic build outs and measured growth can offer additional benefits to both managers and LPs from both an optionality and stability perspective.

In many ways, one of the biggest headlines of the last decade should be how successful many of the biggest funds have been in getting even bigger. Yes, some household names closed, but closures in any industry organically occur over the years.

In the last decade, allocators were sensitive to perceived "asset gathering" – believing some funds were focused on asset accumulation without regard to capacity constraints in order to grow fees.Growing a business at the expense of performance or firm durability is clearly counterproductive. In all industries, measured and strategic growth is the vanguard of long term successful firms.

But appetite for and ongoing expansion of some of the most institutional firms is indicative of additional paths forward for many of today's emerging and scaling managers. **In many ways, one of the quiet stories of the last five years is how successful the "big" funds have been at getting even bigger.**

Industry Makeup | Growth in Hedge Fund AuM vs. Number of Funds



Source: HFR, Jefferies

Product and share class diversification, when developed appropriately, can vary revenue streams, dampen return volatility over market cycles, and assist in data and information gathering for investment and risk processes.

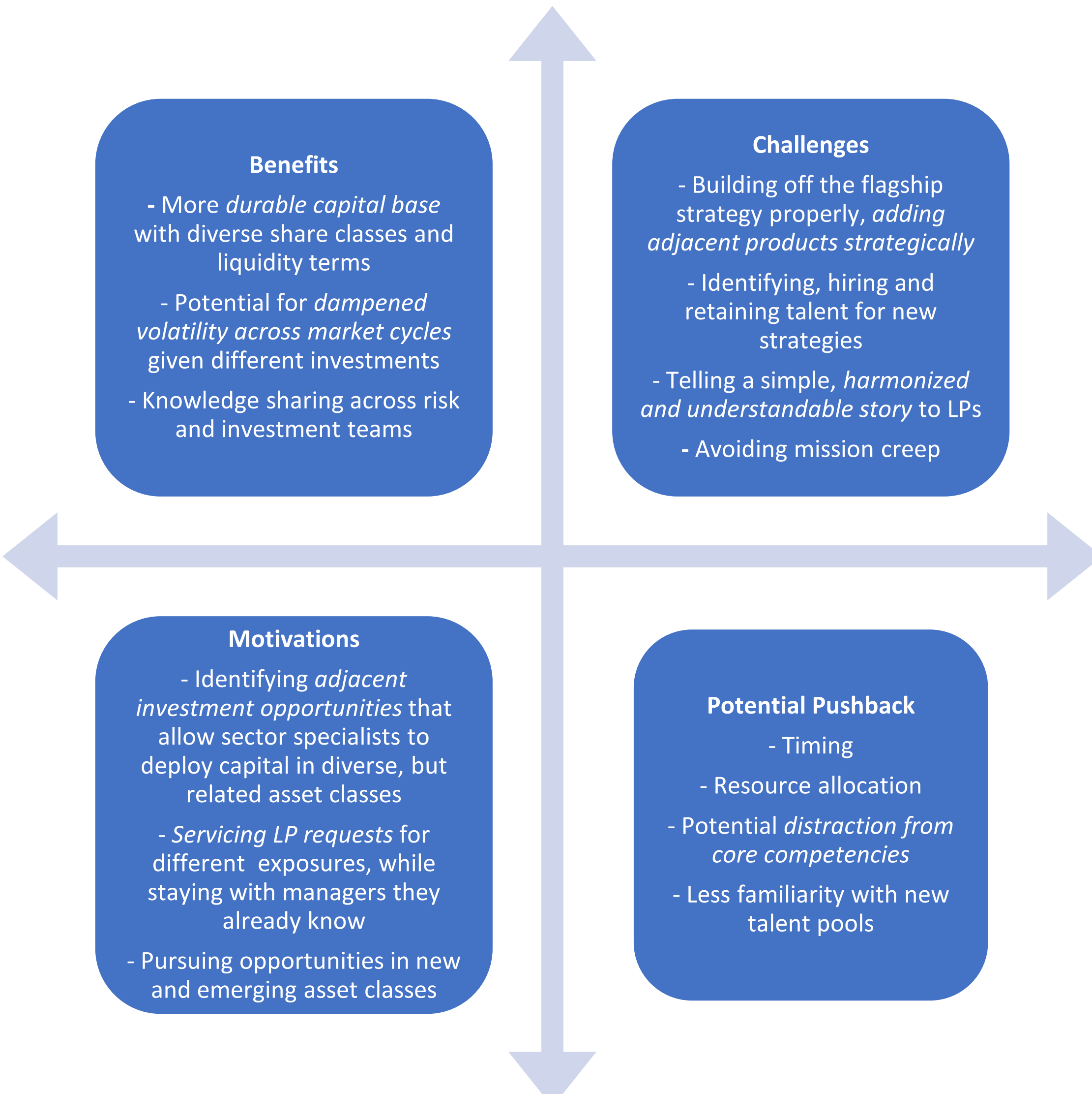
MANAGED GROWTH

Structuring Share Classes, Enterprise Value and a New Generation of "Multi-Strategy" Funds: Sector Focused Multi-Strats

One of the other industry shifts that is gathering steam is around structuring new share classes to diversify revenue streams and smooth volatility. One version of this is a new generation of multi-strategy managers. This time, however, they are building out expertise across asset classes *within* one industry or sector.

Every decade, hedge funds evolve to structure new vehicles and products to take advantage of emerging or changing opportunity sets. More recently, managers are re-examining core competencies and are exploring adjacencies to build new teams, products, vehicles and share classes. Creating a **new generation of sector multi-strats to better weather market cycles, smooth revenue streams, and take advantage of operating synergies.**

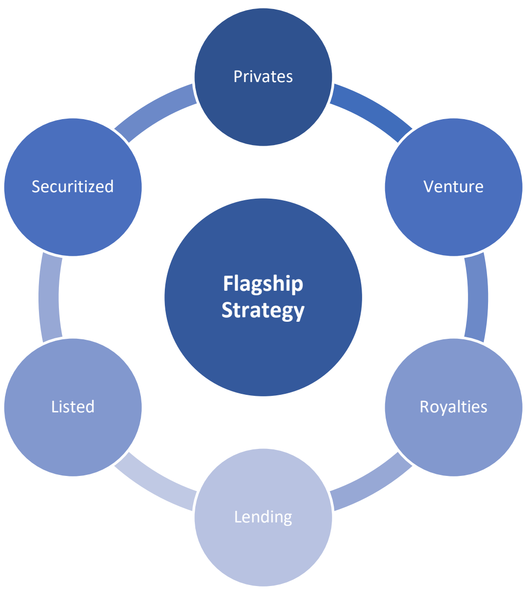
Drivers of Growth and Diversification for Sector Multi-strats



When 'Hard Closed' Means Strategically Open and 'Soft' Closed Means Open: Share Class Construction to Optimize Enterprise Value

The enterprise value of a hedged or alternatives fund is largely grounded in its expected cash flows of fund management and incentive fees. As such, taking advantage of adjacencies and opportunities to leverage core expertise and competencies in new vehicles can lead to lowered business risk and higher enterprise value if they are strategically structured and managed. Because different asset classes and markets often require different term and fee structures, diverse vehicles can smooth management company revenue streams.

Sector focused firms have a particular ability to explore synergies with their industry knowledge and expressing it through various asset classes. A growing number of firms are expanding their vehicle offerings to pursue full life cycle investment for certain products, companies and themes. In fact, a survey of 41 traditional public hedge funds revealed *66 private vehicle share classes.*



Three main themes that have emerged in **share class construction** in recent years include:

1. **Share class diversification:** A growing number of managers are diversifying beyond the traditional flagship and/or SMA products by leveraging a diverse and growing catalogue of share classes.
2. **Diversification happening *earlier* in the life cycle:** Emerging managers are more comfortable with structuring an additional share class to give them greater agility – even if it's a smaller or initial step as a one-off co-invest or SPV.
3. **Considerable growth in longer locked vehicles**: A small but growing number of firms are rolling their more liquid share classes into longer locked vehicles *and* are launching dedicated private vehicles that are even longer duration. Whether migrating gated one year to gated three year, or gated two year to gated four year, shifts to longer locked capital are happening and LPs are taking advantage.

Sample Estimated Terms and Fees by Product 2022

Fee & Liquidity Terms by Product							
	Flagship Long/Short	Long Biased	Long Only	Co-Invests	Hybrid/ Crossover	Private	Venture
Fees	1.50% MF 17.50% IF	1.6% MF 20% IF	1.2% MF 16% IF	0% MF 10% IF	1.9% MF 20% IF	1.8 MF 20.5% IF	2.0% MF 20% IF
Lock Up	1Y*	1Y	1Y	Varies but 1Y most common	1 – 10 Y	3-10 Y	3-10 Y
Liquidity Terms	Monthly - Quarterly	Monthly - Quarterly	Quarterly	Variable	Quarterly	N/A	

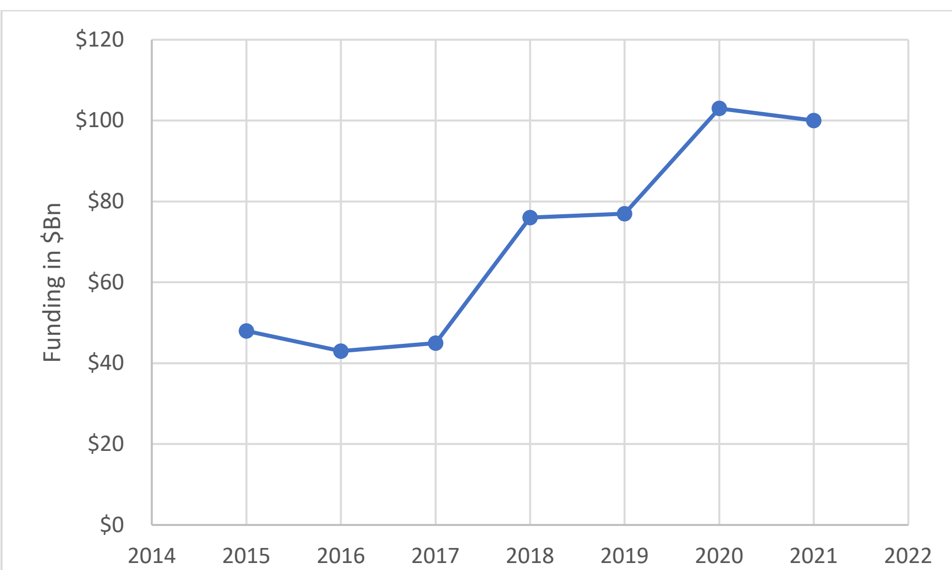
Source: Jefferies **1Y varies between hard and soft lock*

Share class construction has re-emerged as a strategic priority for a number of funds – particularly those who are diversifying strategies and asset classes. A first step is often a one-off co-investment or SPV, allowing the manager to establish an additional track record without having to fully launch an entirely new strategy or vehicle.

For firms looking to expand to investment across a company's entire lifecycle, building out additional share classes and products can take advantage of different return streams. As the private market continues to balloon, a growing number of firms are becoming more active in the space.

In fact, U.S. start up financial deals with funding from firms who are *not* traditional venture capital has grown by slightly less than 50% since 2018.[8]

Growth in U.S. Startup Financing Deals with Non-traditional Early Stage Investors*



*Source: PitchBook, WSJ. *The WSJ defines "nontraditional investors" as "financial institutions that aren't traditional venture-capital firms."*

Shifts in Market Structure Facilitating New Opportunities and Headwinds

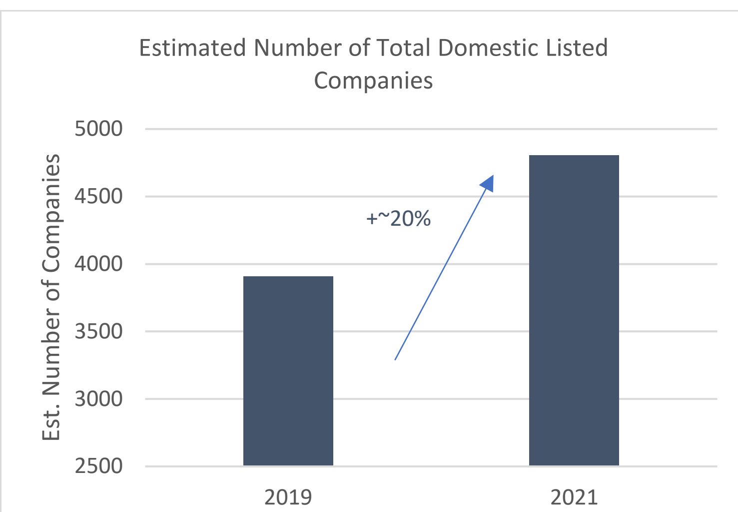
2021 was a notable year for many corners of global capital markets. After a record breaking 2020 for SPACs, 2021's pace only accelerated, with more than twice the number of deals and nearly twice the volume of the year prior. Private equity deal making was as high as its been in years, with more than 1,000 deals – a nearly 50% increase over the prior year.[9]

The number of public companies **continued to grow – rising above 4,800**, a number still **dwarfed by the millions of private companies in the U.S. economy,** but ~20% higher than 2019, **and the highest number since 2002.**[10] Equity volatility was the 2nd highest in a decade, lower than 2020's record year since 2009, but still elevated at around 19.7, despite the fact most equity markets closed the year much higher.

2021 Market Performance Snapshot

Primary Markets	FY 21	FY 20	Y/Y
Total Equity Issuance ($bn)	435.8	390.4	11.60%
Total IPO Value ($bn)	153.1	85.4	79.20%
# of IPOs	393	209	88%
Small Cap as % of Total IPOs	**66%**	**73%**	**-7.40%**
Private Equity Deal Value ($bn)	**1035.7**	**689.6**	**50.20%**
Secondary Markets			
Equity ADV (Bn)	11.4	10.9	4.40%
ETF ADV (Bn)	1.7	2	-15.10%
ETF as % of Equity ADV	14.80%	18.20%	-3.40%
Market Performance			
S&P 500	32.80%		
DJIA	26.60%		
Nasdaq	40.90%		
Russell 2000	47.20%		

Source: SIFMA



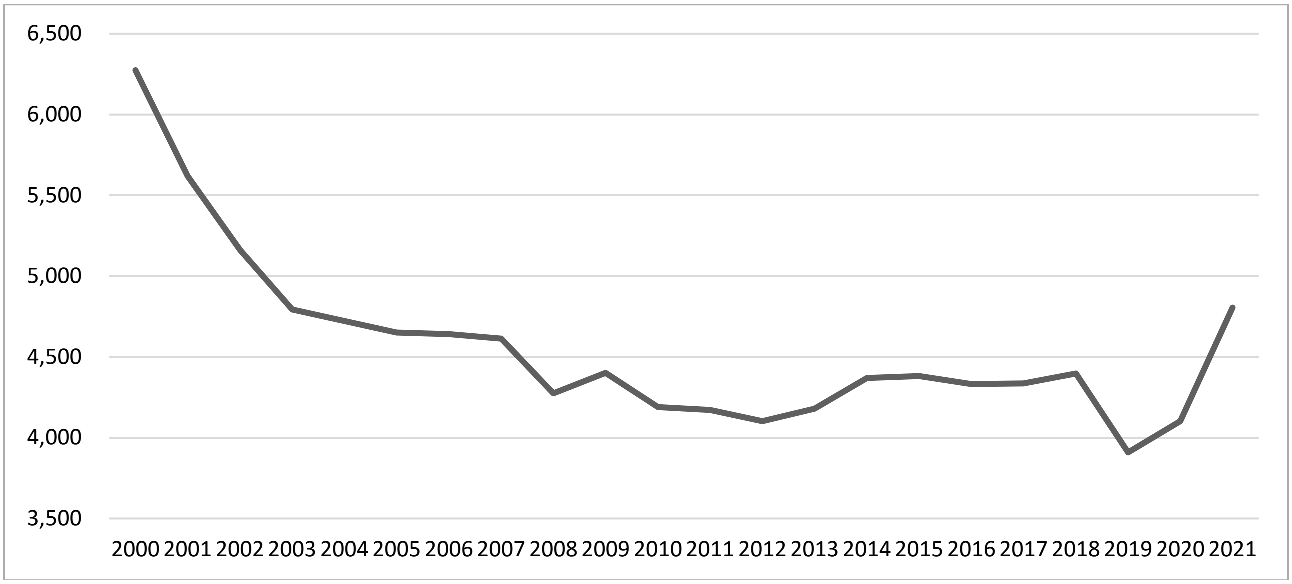
Source: SIFMA

A Growing – But Shifting – Opportunity Set*

- The number of **public companies is as high as it's been in 20 years** – expanding the opportunity set and giving stock pickers a much larger sandbox to play in
- This growth, on the back of a decade long plus bull market, has risen expectations for **a decade of dispersion** and a market ripe for stock picking and robust research processes
- At the same time, equity ADV remains elevated (though not at 2020 levels), and **ETFs are making up a lower % of total ADV**
- There are almost **600 SPACs searching for an acquisition target** as of January 2022 month end
- These statistics do not reflect BDCs or SPACs, which would expand the publicly traded investible universe more
- M&A, for its part, was strong across nearly all sectors in 2021, but **healthcare specifically generated $325 billion in aggregate M&A in the U.S., compared with $1.95 billion in 2020**

Source: SIFMA

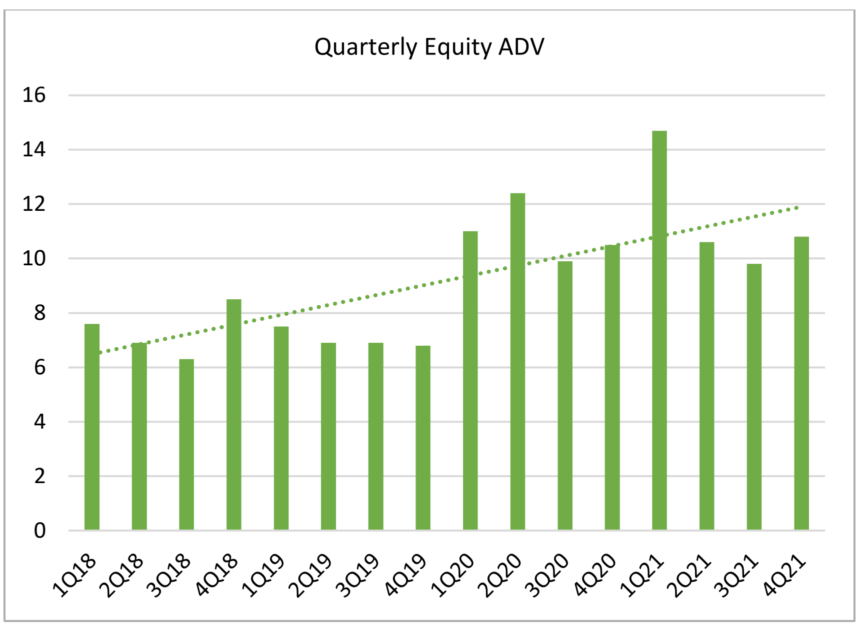
Change in Estimated Domestic Listed Companies U.S. 2000 - 2021



Source: Dealogic, World Federation of Exchanges, SIFMA estimates

This growth back to 2002's estimated number of publicly traded companies (ex-SPACs and BDCs), has been coupled with heightened trading volumes. While the first and second quarters of 2020 are often remembered as extremely high volume periods – they *were,* but peak volume in the last few years is actually 1Q21. **Volumes remain elevated, with ETFs comprising a smaller percentage of these heightened trading days.**

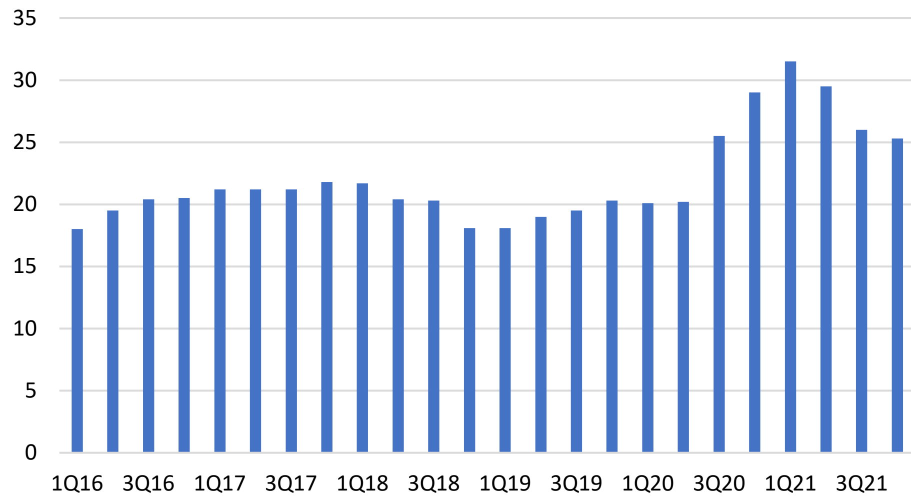
Averaged Daily Volumes, Equity, 2018 - 2021



Source: CBOE Global Markets, SIFMA estimates

And while P/E ratios for the S&P 500 remain higher than average over the last 5 years, they have declined from their 1Q21 peak.

S&P 500 Average P/E Ratios



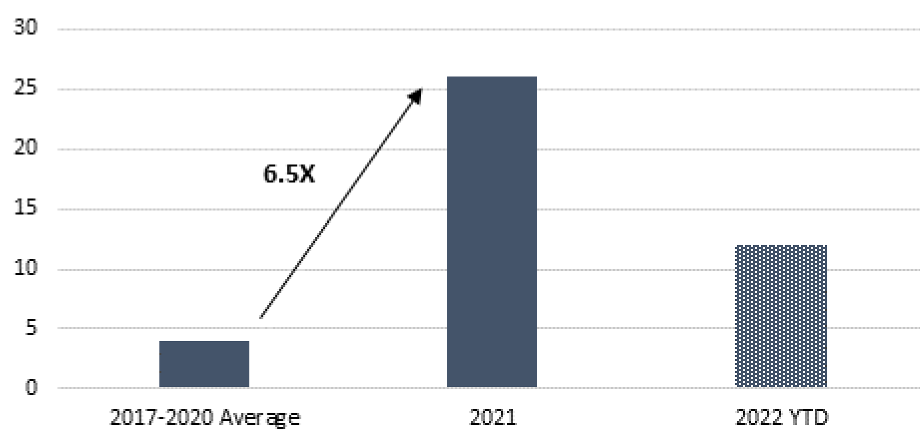
Source: SIFMA Estimates

Notes on Digital Assets and Crypto

One of the areas where inquiry has exploded has been around digital assets. The Jefferies Capital Intelligence team has seen a 6 fold growth in questions and potential open mandates in the space over the last three years.

Importantly, **more than 90% of these focus *not on trading the currencies or assets themselves*, but how to play the private opportunities in the space.** Much of these investments and funds are focused on one step removed exposure, seeking to invest in the ecosystem *around* these assets, but less frequently the currencies themselves.

Open Crypto and Digital Asset Mandates

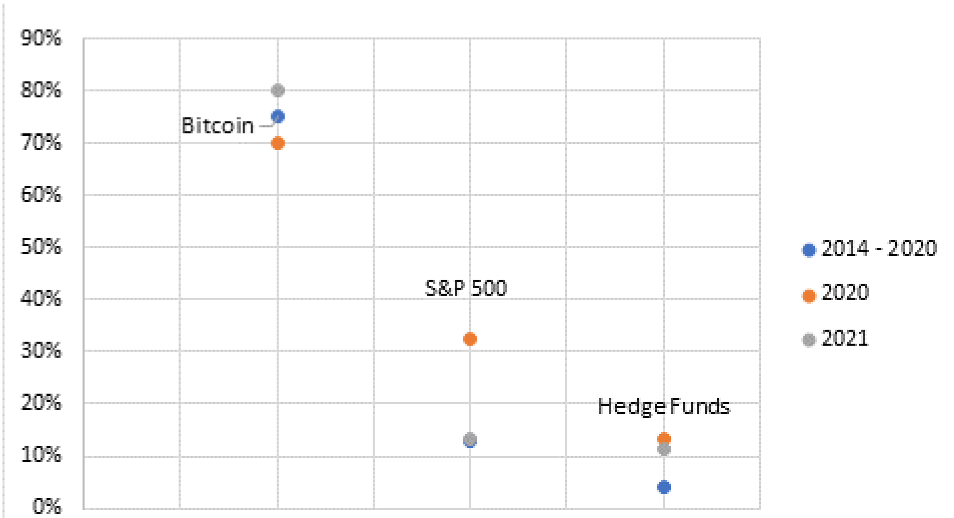


Source: Jefferies Capital Intelligence

This preference for private exposure to cryptocurrencies, rather than the currencies themselves, may allow investors to gain exposure to the asset class, but with less volatility over time. With literally hundreds of currencies, the most liquid (Bitcoin) still has exponentially more volatility than both the S&P 500 or hedge funds.

But with a multi-trillion dollar market cap, and hundreds of publicly traded companies (and even more private ones), focused on the space, the fear of missing out is driving many institutions to determine how to invest in the industry without investing in the currencies.

Annualized Vol for BTC vs. S&P 500 vs. Hedge Funds 2014 - Present



Source: FactSet, HFR, CoinGecko, Jefferies

How the 'Hedge Fund' Industry Is Positioned For the Next Decade

After three years of solid performance and asset raising, the continued diversification and structure of share classes (and potential enhancements to enterprise value), the hedge fund industry is well positioned to navigate its next chapter. Many anecdotally report assets raised in recent years are "higher quality" than the past – with LPs less likely to redeem over short time horizons or in periods of stress, and in fact, are more likely to "top up" during a drawdown than in the past. One need only look at the difference in assets raised vs. assets grown organically to help understand why.

Jefferies Health of the Hedge Fund Industry Dashboard 2022

INDUSTRY ASSETS	# OF HEDGE FUNDS	ASSET FLOWS	RATIO OF LIQUIDATIONS TO TOTAL # OF FUNDS	NUMBER OF NEW AND EMERGING FUNDS	BAROMETER OF OPEN MANDATES
↑	↔	↑	↓	↗	↑
All-time highs	Persistent	Reversal of 3 years of outflows	Near decade lows	Heightened in the face of broader headwinds	Diverse, increasing
$4 Trillion	~9,000	+$15 Billion (2021)	~5%	Over 1,000 (2020-2021)	Focused on specialists and customization

How Jefferies Can Help

We make thousands of choices each day. For the decisionmakers in our industry, that number can be much higher, under pressure-filled conditions. At Jefferies, we've made it our mission to partner with our clients, share timely insights, and help narrow down and prioritize those decisions by drowning out the noise.

This is our fifth State of Our Union. The experience we've gathered analyzing the industry from a 10,000-ft view allows us to deliver the most relevant and groundbreaking information in the Alternatives space.

In the wake of the pandemic, mangers and investors alike proved resilient – allocating capital, generating alpha, and maintaining operational agility. In 2022 we're seeing a new playing field with a redefined competitive landscape, changing market structure, and emerging asset classes, and we're here to help you navigate this new reality on the ground.

The Jefferies' platform has developed and institutionalized over the years, and we are delighted to continue offering our clients access to Global Prime Brokerage, Securities Lending, and Swaps products. Find further support through our Global Outsourced Trading business, robust Capital Markets offering, and best in class Client Service, Trading, and Execution capabilities. We look forward to tackling the ever-evolving markets with you in the decade ahead.

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[1] HFR
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[3] Jefferies Capital Intelligence
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[7] HFR, Jefferies Capital Intelligence
[8] PitchBook, WSJ
[9] SIFMA
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