The State of Our Union 2021

THE BIG BOOK OF HEDGE FUNDS: A DECADE OF DURATION

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Jefferies

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The Big Book of Hedge Funds: A Decade of Duration

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

Last January, our theme was **Endurance and Innovation**. We had no idea how critical those themes would become for us, our families, colleagues and businesses in the months to come.

After a momentous year that reshaped the globe and capital markets, we are using this *State of Our Union* **to explore and define what it means to launch, grow and manage an alternative asset firm in the wake of 2020**. Without assumptions or expectations, we conducted a deep dive to revisit the pillars of our industry – reporting on how the dust settled, what's changed and what is still uncertain.

What turned things around and what did we learn in one of the most critical years in recent memory?

After a decade of treading water with some challenges to performance, muted asset flows and questions about the long term viability of the hedge fund industry, **2020 put many of those questions to bed, and revealed why the hedge fund industry may be one of the most exciting and vital for the coming decade. This *State of Our Union* launches the Jefferies "Health of the Hedge Fund Industry" dashboard,** reflecting indicators as strong as they have been in years.

What do the lessons of 2020 mean in terms of:

- Performance, asset flows and fund formation
- The future of LP engagement and why 2020 was the year "secrecy" died
- What lies ahead for new product development
- How new efficiencies emerged, putting agility at the top of managers' to do lists, and
- What the acceleration of sustainable investing means for hedge funds

The first few months of 2021 indicate the twists and turns of last year are not behind us. But hedge funds started this year in as strong a position as they have been in a decade. *The State of Our Union 2021* explains how this came to be, and what it means for managers, investors, and the broader alternative investing ecosystem across the globe.

We also explore the acceleration of trends that pre-dated 2020, including: the growth of sustainable investing, why outsourcing has come to be a "must have" rather than a "nice to have" for many firms, why specialists have become critical to allocators' portfolios, and where some of the most innovative and exciting new launches are emerging.

We couldn't have predicted what truly lay ahead in January of 2020, whether a pandemic or murder hornets. But twelve months on, we are even more excited for what the coming decade may bring and look forward to partnering with you in the days ahead.

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Predictions for the Decade Ahead for Hedge Funds

Given the gathering tailwinds for hedge funds, following a decade where we saw innovation and endurance, but also muted enthusiasm and several challenges, we lay out predictions for what may lie ahead. In the coming decade:

1. **The number of hedge funds will reach all time highs, topping 9,000 globally**. As single manager vehicles continue to diversify their offerings, innovating and launching crossover vehicles, we may start the 2030s with an all time high number of these single manager funds.

2. **Hedge fund assets will surge, growing by more than 30% in the coming years.** Organic performance asset growth, coupled with renewed interest in the industry, we could see assets topping $4 trillion in 2024.

3. **Technological advances and shifts in work patterns will facilitate a more geographically diverse industry**. We will see an evolution from a small handful of global investment centers to a growing number of emerging hubs across the U.S. and Asia.

4. **Secrecy will be a hallmark of the past, and true transparency will be the cornerstone of all manager/LP relationships.** After decades of being described as "secretive" or flying below the radar and not seeking the limelight, managers have and will only become more and more transparent in real time with their partners.

5. **After an era of blockbuster growth, quant funds will find allocators have a more muted appetite for black box products**. With growing transparency and challenged performance in the first precipitous drawdown in over a decade, quant funds may find themselves on their back foot for the first time in years.

6. **Allocators add new dimensions of diversification to their allocation process.** Asset and strategy allocation have long been hallmarks of the portfolio construction process. But a growing desire to dampen group think and limit confirmation biases will see allocators seek more diverse managers – as individual investors, PMs, CIOs and geographically/regionally.

7. **Broader market structure changes and the ever evolving 'shape of the sandbox' (the shifts in the number of public and private companies) create new opportunities for specialists.** There has been an undeniable change in the balance between public and private companies, allowing sector specialists new tools for identifying and creating value.

8. **Cybersecurity reasserts itself as a top priority for in an environment that favors agility**. Many firms turned "virtual" overnight, and with shifts to more dispersed operating footprints, cybersecurity has taken on renewed importance.

9. **Interest in Asia focused funds – both those with "boots on the ground" or those investing in the region – accelerates.** For years, many have predicted growth in asset flows and managers focused on the region. Given the growth prior to 2020, and several broader industry trends that underpinned success of these funds, we see sustained growth here, particularly after travel returns.

10. **ESG and sustainable investing dominates discussions going forward for managers and LPs alike**. With climate on the top of many investors' minds, and a call for "heightened scrutiny" for ESG metrics in investment process and risk management – the era of ESG has arrived, and will result in new products, vehicles and heightened asset flows.

The 'What:' In the face of headwinds, the number of hedge funds is surprisingly resilient

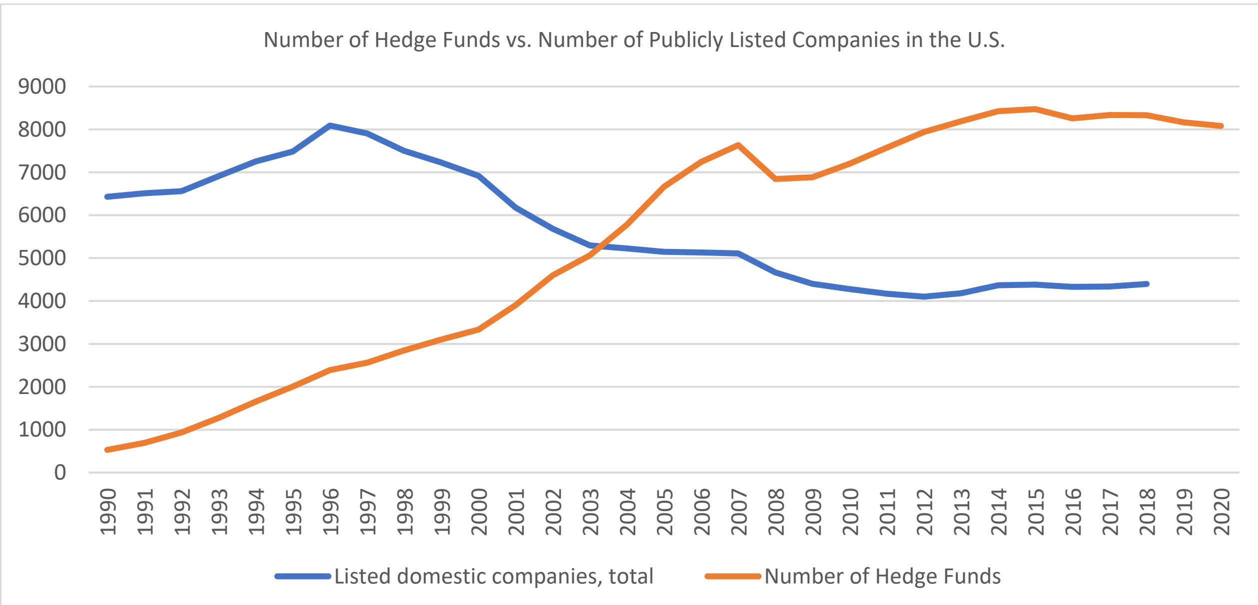
In the latter half of 2020, **there were more than 9,000 hedge funds and fund of funds globally**. More than 8,000 of these are hedge funds, and just over 1,000 are funds of funds. While this represents a very slight decline from the 2015 peak of 8,474, the number of hedge funds has **steadily remained above 8,000 since first reaching that point in 2013.**[1]

Funds of hedge funds, meanwhile, continue – but are down more than 50% from their 2007 peak of 2,462.[2]

Following a decade when many headlines saw ruin ahead for the industry because of perceived muted performance, a very real decline in fees, rising operating costs and new competitors outside the industry, it is clear that the hedge fund industry began 2020 with a strikingly stable number of firms in the face of headwinds.

Compared with many other universes, like the number of publicly traded companies in the U.S., the hedge fund industry has been extremely resilient.

Chart 1. Number of hedge funds vs. number of publicly listed companies in the U.S.



Source: The World Bank, HFR, Jefferies

The 'What:' Assets continue to reach all-time highs, grounded in performance

So, the *number* of firms has been stable. What has this looked like for assets under management?

Top line – assets have grown, and we entered **2021 at all time industry AuM highs**. One of the most interesting dimensions of the hedge fund industry, and another factor driving its endurance and resiliency, is that **the vast majority of this growth over the last decade has been on the back of organic performance.** Time and again, the expansion resulting from performance has far outstripped net inflows or outflows from allocators.

For example, in 2007, hedge funds welcomed nearly $200 billion of net inflows, making up more than 12% of total industry assets.[3] The following two years saw 8% and 9% of total industry assets flow *out* of the industry. A decade on, net in and outflows have become a much smaller percentage of industry growth or contraction. In the third quarter of 2020, while the industry welcomed net inflows of nearly $13 billion, **performance-based asset growth dwarfed this by over 9x, as hedge funds produced nearly $120 billion in assets from strong performance alone.**[4]

Table 1: Net inflows or outflows as a percentage of total hedge fund industry AuM

Year	2007	2008	2009	2018	2019	2H2020
Net Inflows or Outflows	**$195 Billion**	**($154 Billion)**	**($131 Billion)**	**($38 Billion)**	**($43 Billion)**	**$16 Billion**
Industry AuM	**$1.9 Trillion**	**$1.4 Trillion**	**$1.6 Trillion**	**$3.1 Trillion**	**$3.3 Trillion**	**$3.6 Trillion**
Inflow/Outflow as % of Total Industry AuM	**10.3%**	**-11.0%**	**-8.2%**	**-1.2%**	**-1.3%**	**0.4%**

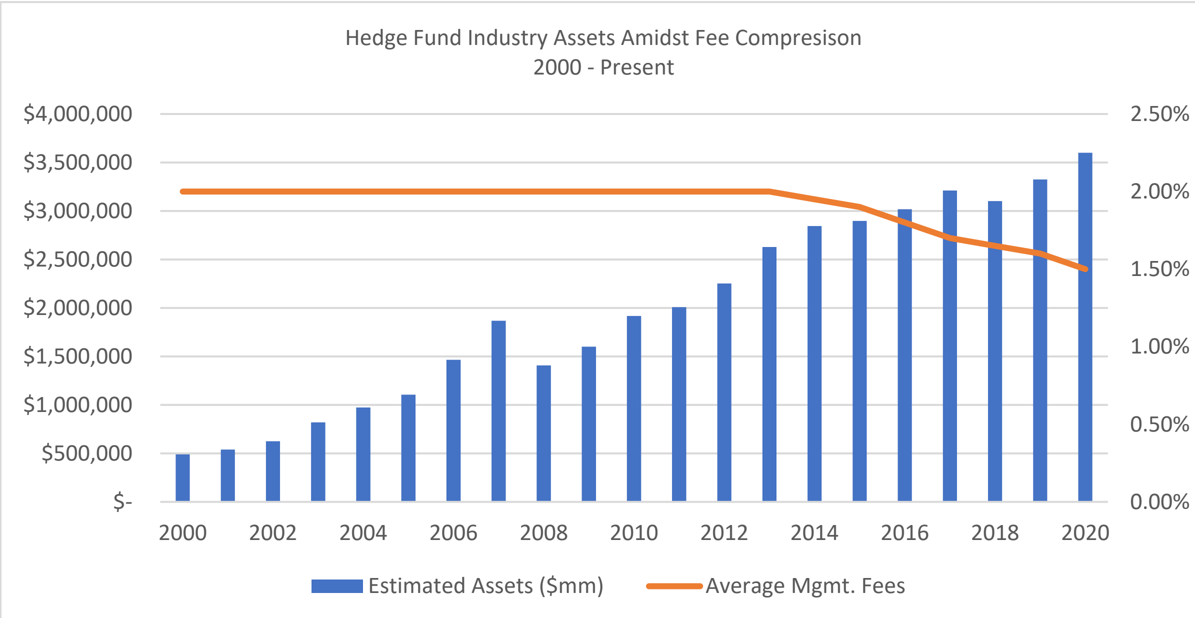
Source: HFR, Jefferies

Funds have also spent years fighting claims of "asset gathering" rather than focusing on performance.

The data simply does not bear this out, and while there may be individual examples of managers taking in more assets than they know they can effectively put to work in the market, it does not seem to be an industry wide story, as many headlines would have readers believe.

In fact, when looked at alongside the downward trend of fees over the last decade, it seems even less plausible. If hedge funds were more focused on "asset gathering" than serving as responsible fiduciaries, as average fees have declined, it's likely we would have seen funds attempting to manage as many incremental dollars as possible. Instead, the growth of total industry AuM – over a time when many large, mature, multi-billion managers returned capital to outside investors to manage only internal capital – has been driven largely by performance. Not just asset raising.

Chart 2: Hedge fund industry assets vs. average management fee over time



Source: HFR, Jefferies

While headline management fees declined over the last decade (and in some cases, incentive fees, though these experienced somewhat less of a compression), many argued the hedge fund industry would see a large number of funds returning capital and managing just friends and family money – or that fewer funds would come to market.

This does not seem to have been borne out.

While there have been some high profile wind downs, the number of firms, industry asset levels, and the number and strength of new launches indicate that the fee alignment that took hold over the last decade **did not dissuade managers from bringing new products and funds to market.**

There is an enduring number of hedge funds – especially when viewed in the context of industry headwinds, and the shrinking of other universes, like publicly traded companies – that have declined in the last two decades. Performance driven growth has vaulted assets under management to all-time highs.

This is hardly the story of a “challenged” or “hobbled” industry.

The 'What:' Asset flows reverse years' long trend, tick up in 2020

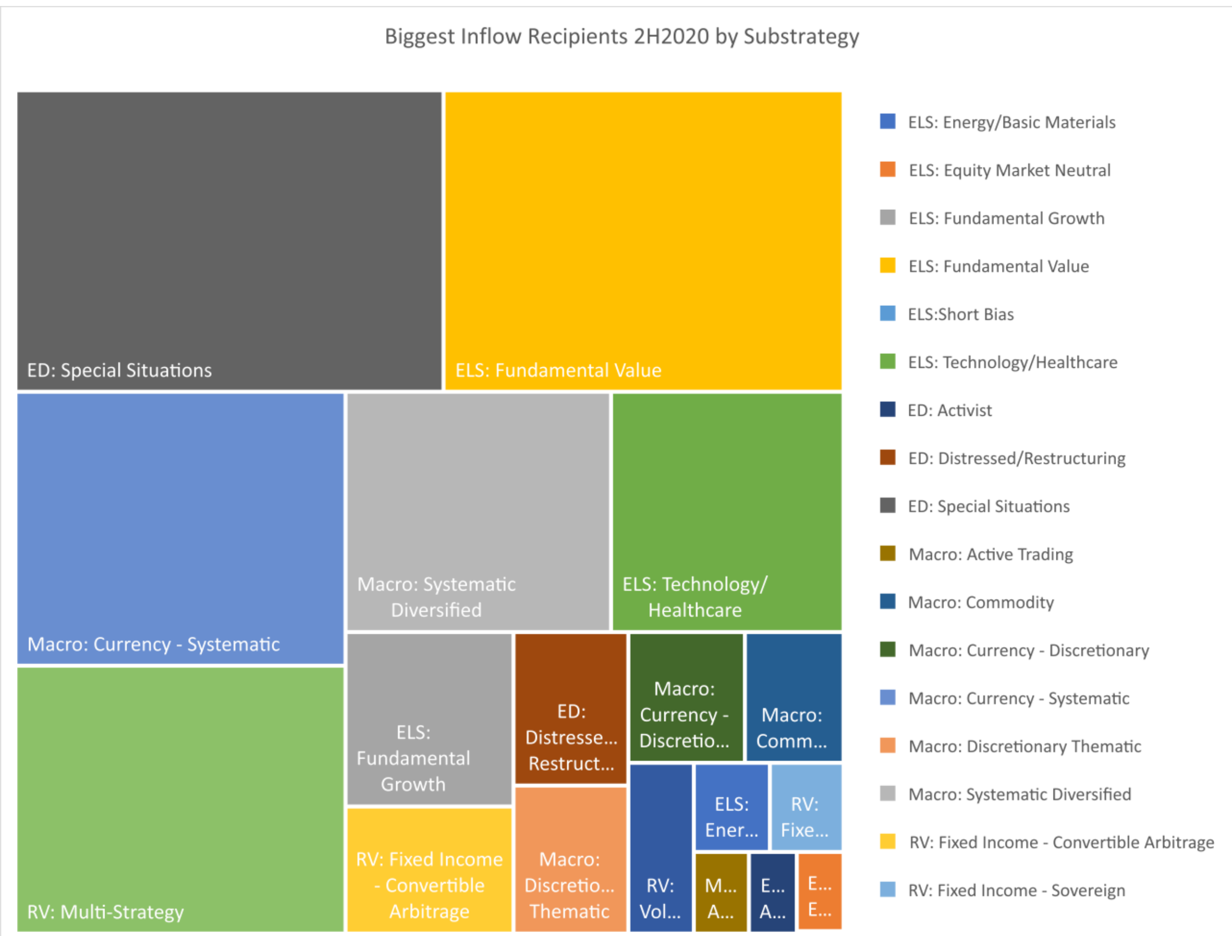
A curious thing happened in one of the most challenging, confusing and unprecedented years in recent memory: quarters-long trends of outflows or muted inflows reversed for many hedge fund substrategies.

For the first time in 10 quarters, the industry welcomed net new inflows – to the tune of nearly $13 billion in Q3 and more in Q4 to total $16 billion for the year.[5]

Of particular note:

- Equity Long/Short funds are the first sub strategy to manage more than $1 trillion
- In Q3, for the first time since 1Q2015, 6 out of 7 Macro substrategies welcomed net inflows, to the tune of $8 billion
- Six substrategies across the industry welcomed over $1 billion *each* in a single quarter for the first time since 2017 in Q3 and five did the same in Q4[6]
- Despite a completely unprecedented shift to remote working and rolling global lockdowns, allocators continued to send net new inflows to managers, and emerging managers report being able to raise capital in a virtual environment[7]

Chart 3: 2H20 Net inflows by hedge fund strategy



Source: HFR, Jefferies

And it wasn't just large, household names that were able to open the door to new capital – managers across the size and maturity spectrum report welcoming inflows from new LPs.

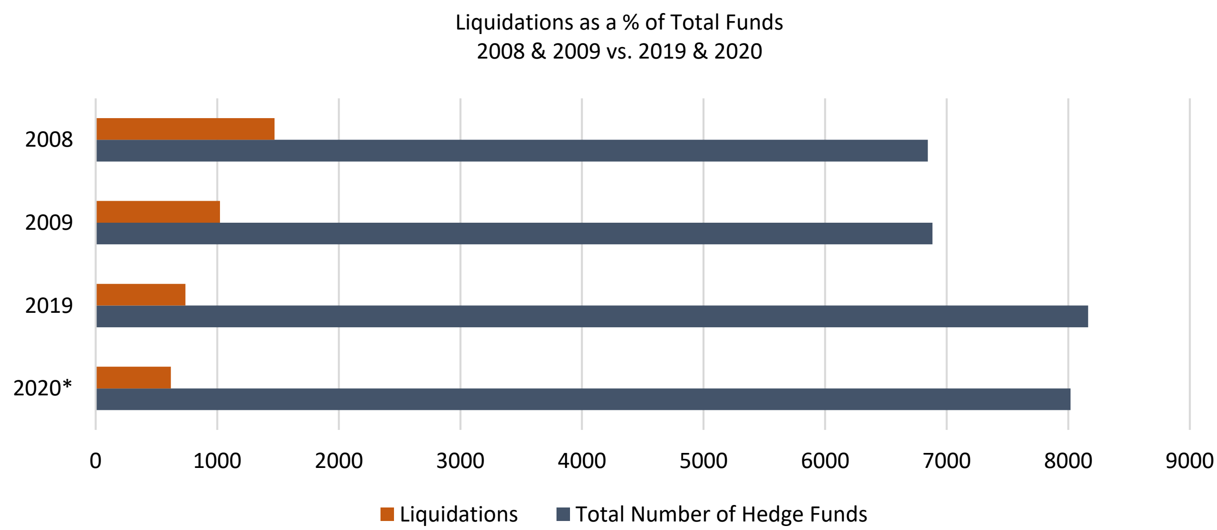
The 'What:' Emerging managers continue to thrive as liquidations are more muted

Persistent number of funds. Assets resurging to all-time highs. What does the liquidation to total fund ratio tell us about the strength of the hedge fund industry in 2021? If ever there were a tough time to maintain or bring a new firm or product to market, it was certainly in the last 12 months, with the world on rolling lock downs and many teams required to shift to a wholly remote work environment nearly overnight.

And yet.

When we explored the ratio of liquidations to total number of funds, in 2020, we saw this ratio hit a near decade low. And it wasn't just a lower percentage of closures. Last year, more than 350 new funds came to market.[8] Choosing one of the most uncertain environments in memory to hang on, or one's own shingle – at a time when agility remains at a premium is a sign of the ongoing resiliency of the industry.

Chart 4: Liquidations as a percentage of total number of hedge funds: 2008-2009 and 2019-2020



**Through Q3 2020*
Source: Jefferies, HFR

Organizational turnover is a very strong indicator of an industry's strength – whether it is the tech start up world, or shops on Main Street. **An industry's health is a balance of long term, enduring firms, with organic retirement/closure of long operating ones, the closure of those who underperform, *and* an ongoing appetite for new thinkers and new firms, products and vehicles to come to market.**

In 2019 through 3Q20 – following a challenging decade for funds and amidst one of the most unprecedented – **just under 1,000 new funds came to market globally.** By comparison, fewer than 400 private equity came to market over the same period, despite the fact that the private market continues to grow, as public markets in many markets contract.[9]

So while hedge fund industry fees are lower, new launches are back and emerging managers are firing on all cylinders. The willingness of these new entrants to come to market, with a better alignment of interests with investors, is a major sign for sustained growth for the hedge fund industry moving forward.

Table 2: Selected indicators across fees, new launches and performance

	Average Industry Fees	New Launches	Performance
Early 2000's	↑ (2% / 20%)	↑	↑
Post Global Financial Crisis	↓ (1.75% / 17%)	↓	↔
Present and Beyond	↓ (1.5% / 15%)	↗	↑

Source: Jefferies

As we reflect on the pillars of a healthy industry – the persistence in number of funds, assets continuing to march to all time highs, a reversal in outflows to multiple subsectors, an enduring number of new products and managers coming to market *and* decade lows for liquidations to total number of funds ratio – we are extremely bullish on the 2020 decade for the global hedge fund industry and its partners and broader ecosystem.

Table 3: Selected indicators across number of funds, total industry AuM and liquidations to total funds ratio

Number of Hedge Funds	Assets Under Management	Liquidations/Total Funds Ratio
Persistent	All Time Highs	Hovering Near Decade Lows
~8,000	$3.6 Trillion	~7%

Source: Jefferies, HFR, eVestment

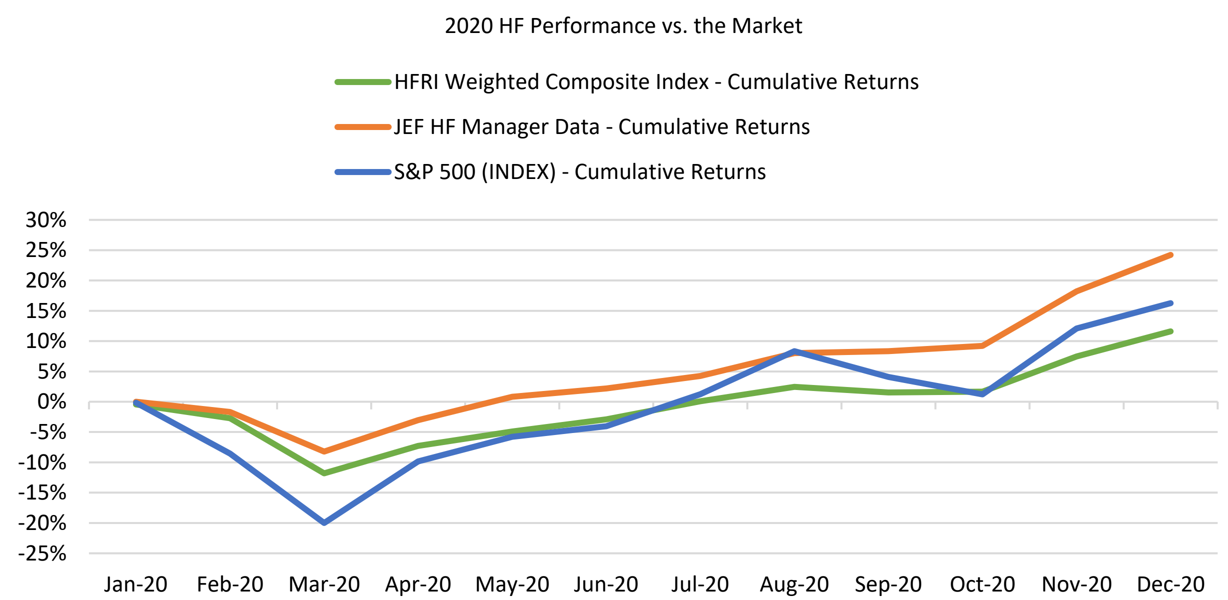
The 'Why:' Performance continues to attract interest from diverse LPs

Outperformance. One of the most obvious indicators of industry health that directly appeals to investors.

On a risk-adjusted basis, active managers have proven their worth as a product that can perform over cycles. Hedge funds aim to deliver their main objective, *to hedge,* and protect investor capital in times of drawdown. Most funds did this in the demanding March – April period in 2020, and over the course of the year, many delivered outsized performance.

2020 allowed hedge fund managers to reassert their value proposition to portfolios, following a prolonged period of an up tape for the U.S equity market.

Chart 5: Performance in 2020 of hedge funds and the S&P 500



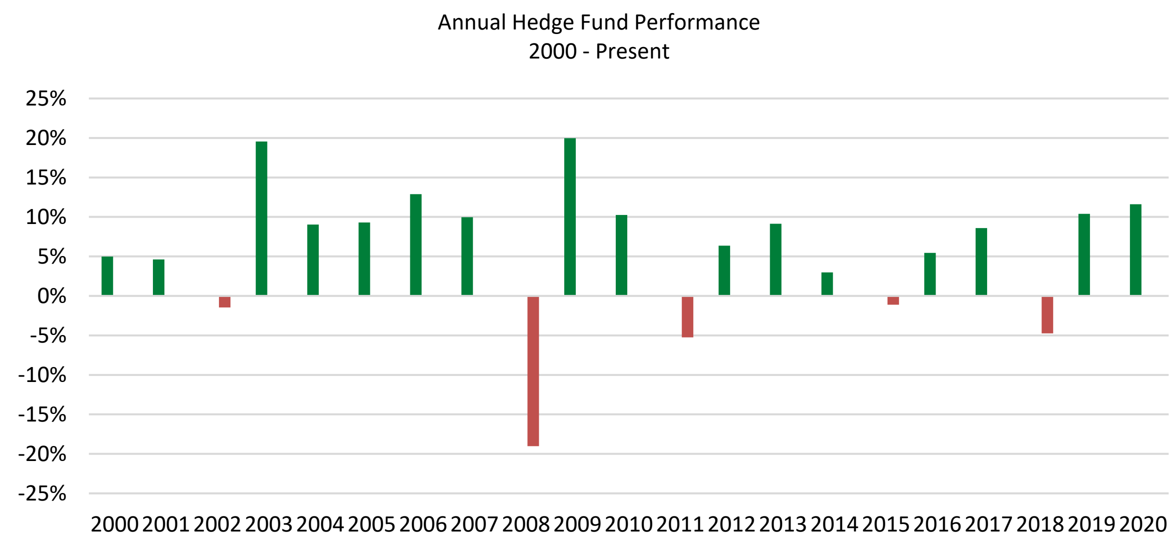
Source: HFR, Factset, Jefferies

Data shows that the longer the drawdown, the more substantial outperformance can be – regardless of the cause of the downturn.[10] As funds protected in this drawdown, they then went on to have one of the strongest five-month period in memory.

Looking at April-August 2020, the HFRI Fund Weighted Composite Index surged over 15.1%, which marks the strongest five-month gain since the period ending February 2000.[11] In the wake of the March drawdown, a time when most funds protected against the precipitous drop, these returns came when investors needed them the most. **In fact, Equity Long/Short hedge funds created more than $120 billion in new value in 2020.[12]**

The last decade has been market also by a growth of passive products, persistently low interest rates and prolonged periods of developed market easing. Hedge fund returns were more muted than they had been in prior decades, but for the most part continued to deliver positive numbers – with 2011 and 2018 being the exceptions (the latter of which was largely driven by the 4Q2018 broader equity market sell off).

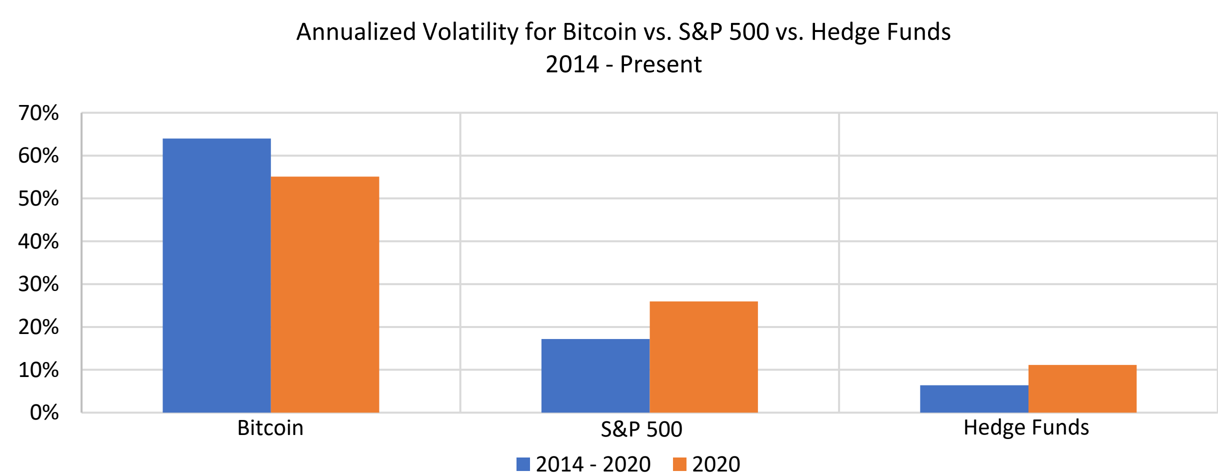
Chart 6: Hedge fund performance 2000 - 2020



Source: HFR

These products continued to offer allocators a desirable risk/return profile. Hedge fund managers achieved their 2020 returns with a volatility of 11.13% to the S&P's 25.95%, resulting in a Sharpe ratio of 1.04 to the S&P's 0.71.[13] If we look over a longer period of time – the value of hedge funds as a volatility dampener is also obvious. Over the past 6 years, hedge funds have seen a historical annualized volatility of 6.4% versus the S&P's 17.2% and a sky-high 64% from bitcoin.

Chart 7: Hedge fund, bitcoin and S&P volatility 2014 – 2020 and 2020



Source: HFR, Jefferies, Factset, WSJ

The Rise of Asia

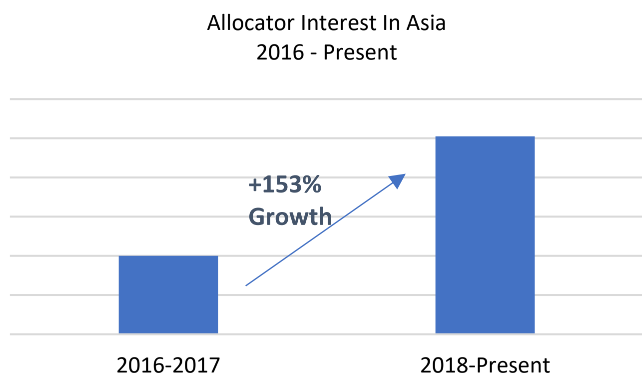
Another part of the 'why' fueling the start of a new dominant age for hedge funds – growth and innovation *across the globe*, not just originating in the United States.

One place that has witnessed considerable growth and is poised for an acceleration of interest, asset flows and potentially differentiated performance is Asia. Asia has long been considered a more nascent region for hedge fund launch and maturity, but by 2020 – it has matured to a nearly $200 billion industry that witnessed, in its own right, just under 100 new launches in a challenging year.[14]

The Jefferies Capital Intelligence team has witnessed an uptick in queries around Asia based managers in recent years. Last year, this was challenged by the inability of allocators to get on planes, host in person meetings and conduct investment and operational due diligence in person. *However*, as China continues its strong rebound post Covid, and a growing number of China companies are included in broad based indices, we continue to field a growing number of questions around the maturity of Asia based managers and access to the region. There were headlines around considerable outperformance by some funds based in the region, and after China focused funds, we saw a slight uptick in inquires focused on India as well.

We saw an uptick in Asia interest *before* 2020 – and we anticipate this to only accelerate in the decade ahead.

Chart 8: Allocator interest in Asia | 2016 - Present



Source: Jefferies Capital Intelligence

This is driven in part by the opportunity set in the region continuing to grow – as the number of publicly traded companies in the U.S. continue to decline, and the number of firms in Europe remains somewhat range bound. Managers and allocators alike are looking at new products (like SPACs), or maturing and growing markets for new opportunities as the shape of the investing sandbox evolves.

Table 4: Universe of 10,000 largest publicly listed companies by region

	% Breakdown in Market Capitalization of 10,000 biggest listed companies	% Breakdown of Number of listed companies of the 10,000 biggest listed companies	Average market capitalization of 10,000 biggest listed companies
United States	34%	6%	$41.2 bn
Advanced Asia	21%	15%	$9.13 bn
Europe	21%	35%	$4.63 bn
China	12%	16%	$5.67 bn
Emerging Asia ex-China	6%	13%	$3.45 bn
Other Advanced	4%	5%	$5.90 bn
Latin America	2%	5%	$2.8 bn
Other Emerging	1%	2%	$4.19 bn

Source: OECD

The ‘How:’ Trends that preceded pandemics laid the groundwork for overnight agility

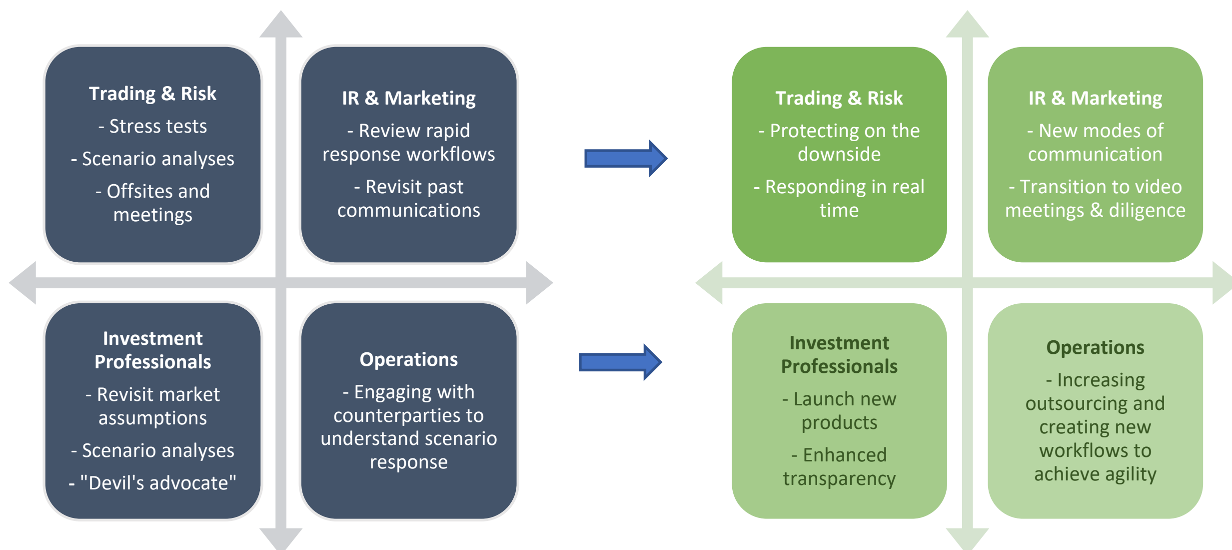
In last year’s *State of Our Union*, we remarked that after a decade long bull equity market, many managers were quietly preparing for a new decade, and a time when things would not always be going according to plan.

How right many of them were.

We highlighted across organizations – from investment teams to risk managers, from investor relations leaders and marketers, to chief operating and financial officers – plans that were underway to understand new stress tests, and build more agile and enduring organizations. This served many of them well.

Prepping for the…Inevitable?
From *The State of Our Union 2020*

This resulted in…
Stronger, more agile organizations in 2021



Source: Jefferies State of Our Union 2020

The 'How:' Institutions of the next decade – nimble and resilient

We see four major pillars of this next decade of the next era for hedge funds:

1. Outsourcing and agile partnerships
2. A new era of identifying, training and retaining talent
3. Innovative methods of investment and operational due diligence
4. Enhanced transparency that has become the bedrock of relationships between manager and LPs

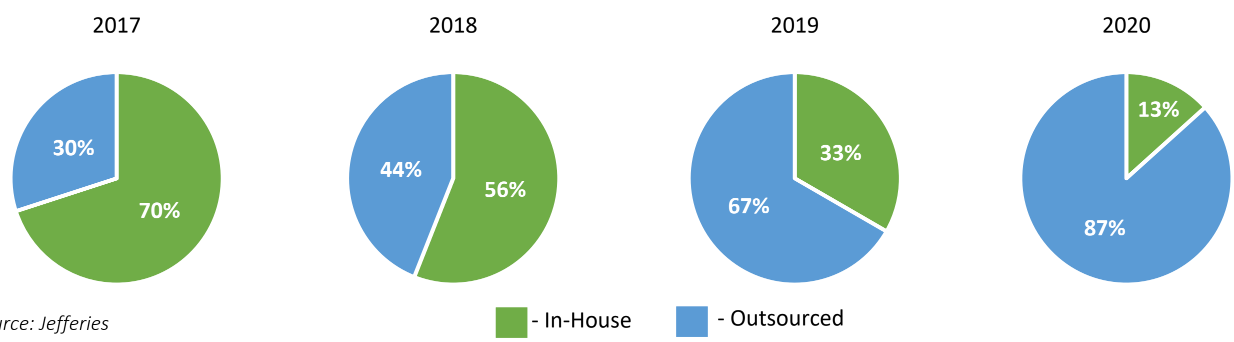
These trends were on the march prior to 2020. As often happens in periods of crisis, many were accelerated and turned into **new cornerstones that underpin a thriving industry.**

Outsourcing and agile partnerships

The pandemic highlighted the importance of "key man risk," but not in the context it has traditionally considered. The "key man" concept has broadened from typically investment professionals, to partners and providers across their operating ecosystem. Managers were forced to re-evaluate existing processes, providers, technology and team structures overnight, to ensure operational continuity. This caused an uptick in the number of managers engaging Outsourced Trading Desks and Outsourced COO/CFO firms to ensure another organization can step-in in *any* BCP situation.

In fact, compared with 2017, when 30% of new launches outsourced their trading, by last year, 85% of new launches choose to outsource their trading.[15]

Chart 9: Outsourced trading trends from Jefferies platform



Source: Jefferies

Leveraging outsourced trading desks ensures operational continuity, access to non-local markets or those in different time zones, and backup/shadow resources at all times.

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

Table 5: Outsourcing from established institutions

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

Source: Jefferies

A new generation for identifying, training and retaining talent

Many of the events of 2020 prompted leaders across the globe and among industries to revisit basic hiring assumptions that resulted in largely homogenous workforces. They are now reconsidering confirmation biases, groupthink, and whether they truly *are* identifying "the best talent" if their workforce doesn't reflect data that reflects a more heterogenous global talent pool.

The remote environment is allowing companies to access a wider and broader group of potential employees, and rethink their hiring procedures. It also shone a spotlight on professional empathy and also raised conversations about physical and mental wellness more than ever.

Rethinking Hiring Processes

Improve Definitions of Roles, Responsibilities and Interview Procedures

- Clearly state the roles and responsibilities within job specs to **ensure candidates are the right fit**.
- Talent may be more apprehensive to ask for **clarification on the details** of a position during a virtual hiring process.

Commit to Technology

- Showcase to top talent your firm focus keeping up-to-date with the latest tech strategies – increasingly important to **communicate in a remote environment**.
- **Leverage ATS – Applicant Tracking Systems** facilitate a collaborative firm hiring process, and determine how early and often to follow-up with candidates.

Structured Communication

- The formality of remote interviewing allows firms to:
  1) Dedicate focus areas for each interview session
  2) Collect talent feedback more efficiently online
- Existing employees are able to better prepare for and reflect on their conversations with candidates.

References are No Longer Just 'Checking the Box' - But Also May Not Determine Sourcing for the Role

- Firms are realizing the value in candidate references and channel checking – this helps to inform hiring managers:
  1) Whether the candidate is a fit for the role
  2) How talent learns/trains best once onboarded
- But they are also recognizing the necessity of looking beyond their own 4 walls for recommendations for new hires

Alternative funds have also had the opportunity to take a step back and reassess the competitive landscape in a virtual and increasingly changing world. The talent competition pool for financial services has extended beyond other comparable firms in the industry, and hedge funds are vying for young talent against the Facebooks and Googles of the world. Many are reassessing employee benefits and other human capital and business considerations to align with emerging industry standards.

- ✓ **Flexible working styles as a recruitment tool –** When employees have been working from anywhere, for what reason will they return to your office full-time?
- ✓ **Human capital initiatives centered around professional empathy** – focused on health and wellness, social interactions, and team culture.
- ✓ **Hybrid arrangements between flexible work, hubs and "core time"** – Finding the balance of employees conducting work in different environments, but coming together for discrete tasks like brainstorming, pitches or training

New methods of investment and operational due diligence

The forced virtual format of internal and external calls in 2020 has caused companies to reevaluate the **efficiency of historical business travel and in-person meeting schedules**. It is likely that remote ODD and IDD will be a permanent component of the diligence process moving forward.

Historically, diligence processes resulted in an initial report, with minimal follow-up after the preliminary deep dive. The current role of a diligence team has transitioned into a much more proactive, ongoing risk management and monitoring engagement.

For this reason, ODD and IDD was overdue for a fintech revamp.

Comparing travel and meeting times in 2019 with to the state of business now, it is clear where efficiencies can be found in connecting virtually versus traditional in-person meetings.

A Closer Look at *Meetings*-From-Home:

+13% **Meetings per person have increased by 12.9%.**[6] Between working hours (8am-5pm), *5-6 meetings* have turned into *7-8 virtual calls, with greater ease in rescheduling, and time saved commuting.*

+14% **Number of attendees per meeting has risen by 13.5%.**[6] Workers are more accessible while WFH, *especially on the more senior-level,* and are able to be more involved in daily workflows without *traveling to-and-from various cities.*

-20% **Length of meetings have decreased by 20.1% on average.**[6] Meeting participants have found ways to be more efficient and succinct with their time, allowing for reallocated resources to other initiatives.

Not only has the format of how we are conversing changed in the due diligence process, but the way documents are shared, and the kinds of information being disclosed has begun to shift as well.

Data Rooms 101

Data rooms became an increasingly relevant and efficient way for managers to share information as part of the IDD and ODD process in a virtual environment.

Industry wide, a mix of managers are charging this cost to the management company versus the fund

Costs range from ~3,500 to $7,500 annually and beyond, based on number of users

Access to documents typically limited to a period of 24-48 hours

Source: Jefferies

LPs are increasingly asking to see:

- ✓ Covid questionnaires
- ✓ ESG and sustainable investing policies
- ✓ Virtual counterparty portal demos
- ✓ Enhanced business continuity and agility plans
- ✓ Updated compliance manuals for virtual / remote work environments
- ✓ Workforce statistics

Enhanced transparency is now not just expected, but bedrock

Table 6: Evolution of Alignment

AGE OF THE FOUNDER	AGE OF FEE COMPRESSION	AGE OF CUSTOMIZATION	AGE OF TRANSPARENCY
1990-2008	2009-2015	2015-2020	2020 →
- **Less robust controls**, high levels of secrecy	- **More robust controls**; still considerable secrecy	- **More robust controls**, transition to more transparency	- **Robust controls**, consistent transparency
- **High fees**, little investor pushback	- Industry-wide **pushback on fee structure**, beginning of broad "re-set"; widespread **"decline" of 2 and 20**	- Adjusted **fees become "new normal"**	- **Historic lows** for management and incentive fees
- Focus on "name on the door"; **investing in individuals**, assessing personality, and values	- Increase in **creative fee structures and share classes**, including scaled management fees and loyalty share classes	- Managers proactively meeting investor demand for **customized products**, leading to the **rise of SMAs**, an increase in **co-investments, carve-outs**, etc.	- A "push, not pull" collaborative approach to sharing with LPs; **unparalleled levels of access**
			- Increase in frequency of manager/LP communications; Finding **new ways to share information**

Defining Characteristics of the Age of Transparency

- Established managers providing information to LPs where they had previously pushed back
- Emerging managers providing unparalleled levels of transparency
- Use of data rooms and screen-sharing to share confidential documents – compliance manuals, etc.
- Reference -checking and information sharing amidst the allocator community itself

+20%

Managers that recently participated in a Jefferies survey reported sharing **SEC deficiency letters via a data room in 2020**.

Highlighting a radical shift in **willingness to share sensitive information** and finding secure and efficient ways to do so.

Looking ahead: What to expect down the road?

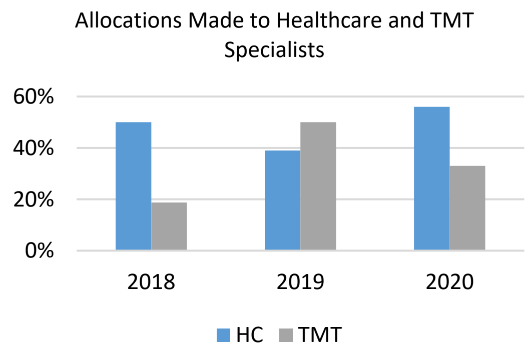
Customized and Specialist Strategies

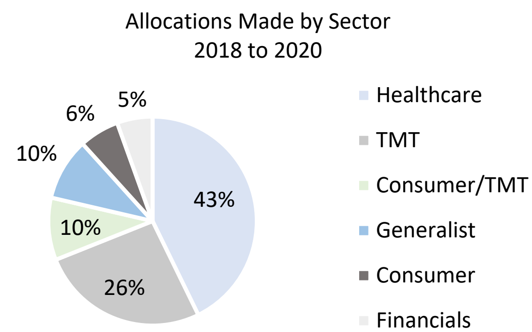
Investors want them. Managers create them.

After many years of the ascendancy of multi-strategy hedge funds, allocator demand has turned to specialists. Even some of the largest index providers recently commented on a trend towards customization.[16]

In the hedge fund space, over the past two years, the Jefferies Capital Intelligence team has observed a growing demand for sector specialist hedge funds, particularly in the Healthcare and TMT industries. **This trend shows no signs of slowing down**, as over 80% of allocations made in 2020 through Jefferies CI introduction were to sector specialists. This stat is up from 63% of allocations made to sector specialists as of 2018.[17]

Chart 10: Robust interest in TMT and Healthcare over the past two years





Source: Jefferies Capital Intelligence

Sustainable Strategies

It is now generally accepted that there are metrics of financial materiality that don't show up in traditional financial reporting, many of which can have a significant impact on a firm's long term profitability or operating model.

A number of these fall under an ESG umbrella or focused on sustainability.

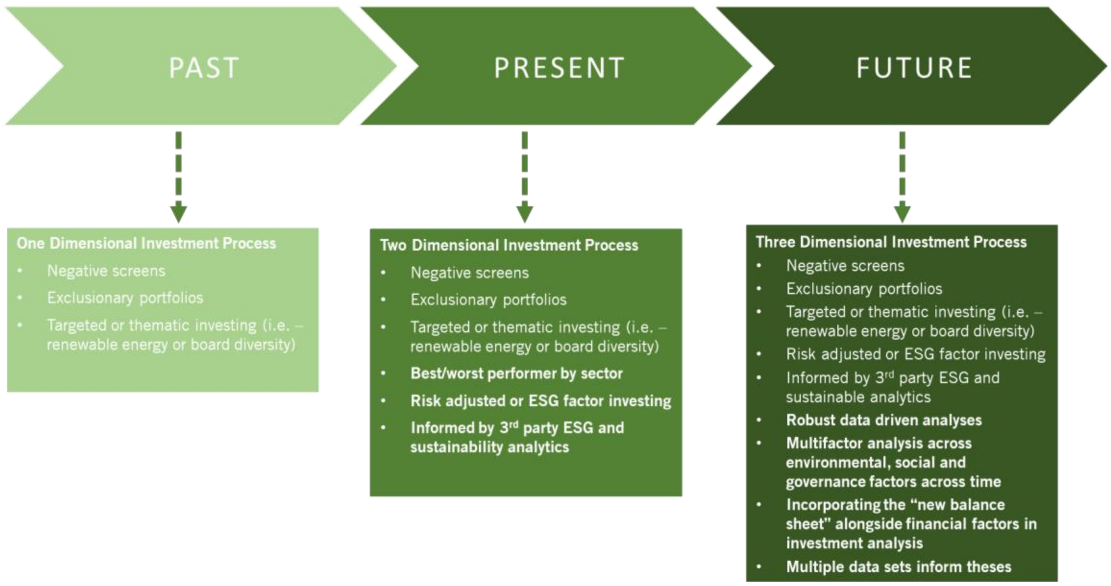
We anticipate the coming three to five years will bring new expectations or requirements around transparency and reporting at both the company level and the manager/firm level. Many of these metrics will relate to:

- Carbon footprint or associated carbon transition metrics
- Governance data
- Workforce and talent statistics, particularly vis-à-vis homogeneity that may result in confirmation biases
- Supply chain data around labor or workforce

We have seen a particular uptick in hedge fund and alternatives managers crafting ESG/sustainability policies *for their own organizations*, with considerable variability. More frequently, we are seeing **a resource dedicated to focusing on ESG/sustainability for the firm, a written acknowledgement in policies of the materiality of these issues, and in some cases building internal proprietary dashboards of ESG/sustainable metrics**.

This is a constantly evolving topic – and the majority of managers, allocators and even companies themselves – understand that there will need to be a standardized method for reporting the most financially material of these metrics.

Future of financial materiality and sustainable investing



Source: Jefferies

So you want to market in Switzerland…

One of the most fertile markets for capital raising for alternatives and hedge funds outside the U.S. continues to be Switzerland. But the cornerstone rules governing the marketing of products in the country are shifting.

- **What?** Swiss Rules are in the process of **moving away from the CISA** (Collective Investment Scheme Act) **and CISO** (Collective Investment Schemes Ordinance) regime and **toward the FINSA & FINSO** regime. This began Jan 1, 2020 and is being phased in until Jan 1, 2022 when it will be complete and live.
- **Why?** FINSA & FINSO are wider in scope than its predecessors and apply to all Swiss providers of financial services. The goal is to increase compliance in different capacities to improve transparency for asset managers, raise the bar for back-office functions, and ease distribution (marketing) rules.
- **When?** The FINSA Compliance Deadline is **December 31, 2021**. Existing CISA rules continue to apply until 12/31/2021 or earlier if full compliance with FINSA. The CISA new rules apply starting Jan 1, 2022.
- **New Concepts:**
    - Increased transparency of distribution and associated activities, to create a more clear-cut process for accessing capital in a compliant manner in Switzerland.
    - New classification of investors. Under CISA regime the focus was on "qualified investors", under FINSA it evolves to "institutional, professional, elective professional and private." These new classifications are intended to make it easier for investors to understand in which bucket they fall.
    - Improving operational/business stability via ensuring certain groups hire a mediation function. This is known as the "Ombudsman affiliation."
    - Enhanced organizational and conduct rules

Source: ARM Swiss Representatives SA

Table 7: Jefferies Health of the Hedge Fund Industry Dashboard

INDUSTRY ASSETS	# OF HEDGE FUNDS	QUARTERLY 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 2 years of constant outflows	Near decade lows	Heightened in the face of broader headwinds	Diverse, increasing
$3.6 trillion	~9,000	+$16 billion (2H20)	~7%	Nearly 900 (2019-2020)	Focused on specialists and customization

We are launching the Jefferies Health of the Hedge Fund Industry Dashboard as a barometer for understanding the undercurrents of various indicators of industry health. Of particular importance are:

- ✓ **Growth –** Increase (or decline) in industry assets
- ✓ **Funds** – Changes in total number of hedge funds globally
- ✓ **Flows –** Shifts in net asset flows
- ✓ **Resilience –** Ratio of liquidations to total number of hedge funds
- ✓ **Resurgence –** The creation of the next generation of managers and the forward pipeline, as reflected in number of new and emerging managers over a 24 month period
- ✓ **Demand –** The depth and breadth of open mandates from allocators

We anticipate updating the dashboard on a quarterly basis.

The health of any industry is gauged by growth of new entrants, maturity and institutionalization of existing firms, accelerating interest of customer/partner base and the ability of these firms to innovate and endure over market cycles.

How Jefferies Can Help

We have written four *States of Our Union*.

In the wake of one of the most challenging in memory – and with our deepest thoughts with those directly impacted by the Covid-19 pandemic – we write this with an optimistic spirit.

We could not have foreseen what the last twelve months have brought. But on the back of trends that began prior to 2020, and as a result of the innovation, adaptation and resiliency of colleagues, partners and counterparties, we have not been as bullish on the future of the hedge fund industry as we are at the start of this new year.

Together with our clients, the Jefferies' platform has matured and institutionalized, and we are delighted to now offer new outsourced trading capabilities, a robust SPAC capital markets offering, a truly global prime brokerage and securities lending platform, and best in class client service, trading and execution capabilities.[18]

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.

DISCLAIMER

THIS MESSAGE CONTAINS INSUFFICIENT INFORMATION TO MAKE AN INVESTMENT DECISION.

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[1] HFR, eVestment

[2] HFR

[3] HFR, Jefferies

[4] HFR, Jefferies

[5] HFR, Preqin, Jefferies

[6] HFR

[7] Jefferies, Hedge Fund Alert

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[9] McKinsey

[10] Jefferies, Market Structure Minute FROM WHAT DATE.

[11] HFR

[12] HFR

[13] Pivotal Path

[14] Eureka Hedge August 2020

[15] Jefferies

[16] BlackRock earnings transcript 4Q20, January 14, 2020

[17] Jefferies Capital Intelligence

[18] Greenwich Associates survey, April 2020