



# The State of Our Union 2018

TOO MUCH INFORMATION,  
NOT ENOUGH INTELLIGENCE

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**Jefferies**

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TOO MUCH INFORMATION, NOT ENOUGH *INTELLIGENCE*

## We Shall, From Time to Time...<sup>1</sup>

Each January, the President of the United States typically delivers a state of the union address - speaking on the position of the nation, and laying out an agenda for the year ahead.

Given we are a full decade gone from the 2008 crisis, and in light of the myriad changes shaping the hedge fund industry and the global economy, it seems a perfect time to take stock, examine the state of *our* union, and explore what may lie ahead.

The last decade witnessed many monumental shifts for the hedge fund industry - from heightened regulation to periods of challenged performance – not to mention an explosion of strategies, products and structures to more specifically meet the needs of allocators.

It was a period of challenge, innovation, and endurance. We started 2018 at all time industry asset highs of nearly \$3.22 trillion, across the greatest number and diversity of funds, and following a rebound in hedge fund performance. The recent uptick in volatility has created an additional opportunity set after a period of persistently low vol. As one manager told us recently, “2018 is the year of back to business, and back to basics.”

**We’ve shifted from a landscape of scarcity to one of ubiquity.** Competitive advantage used to come from understanding information, or finding a more efficient way of doing business or more skilled employees before others. Now, with a deluge of data, potential business solutions and an ever-changing talent pool, a manager’s “edge” comes just as much from effectively navigating the flood of what’s become available. We are reminded every day that “more” doesn’t always mean better – and in many cases, can result in confusion, paralysis or mission creep.

Firms need next generation *intelligence* – to comb through all the new data and options - identifying patterns, relationships and opportunities to create smarter, more productive, more efficient firms for the next decade.

The State of Our Union 2018 argues three forces will shape the next decade of hedge fund success: i) **Capital intelligence** - to more effectively navigate the explosion in data, information and analysis, ii) **Resource intelligence** - to more efficiently leverage third party solutions while maintaining a strong but agile core, and iii) **Organizational intelligence** to better align the changing needs of firms with underlying shifts in the workforce.

The hedge fund industry arose in response to investor appetite for uncorrelated returns, downside protection and niche investments - and we have survived and thrived by adapting over market cycles and innovating to meet new and emerging allocator needs.

It is our deeply held belief that the alternative investment/hedge fund industry will continue in this tradition, capitalizing on emerging trends, effectively predicting and navigating challenges, and delivering returns. It is our hope *The State of Our Union 2018* helps better understand the strategic trends impacting and driving our industry forward.

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

## I. NEXT GENERATION CAPITAL INTELLIGENCE

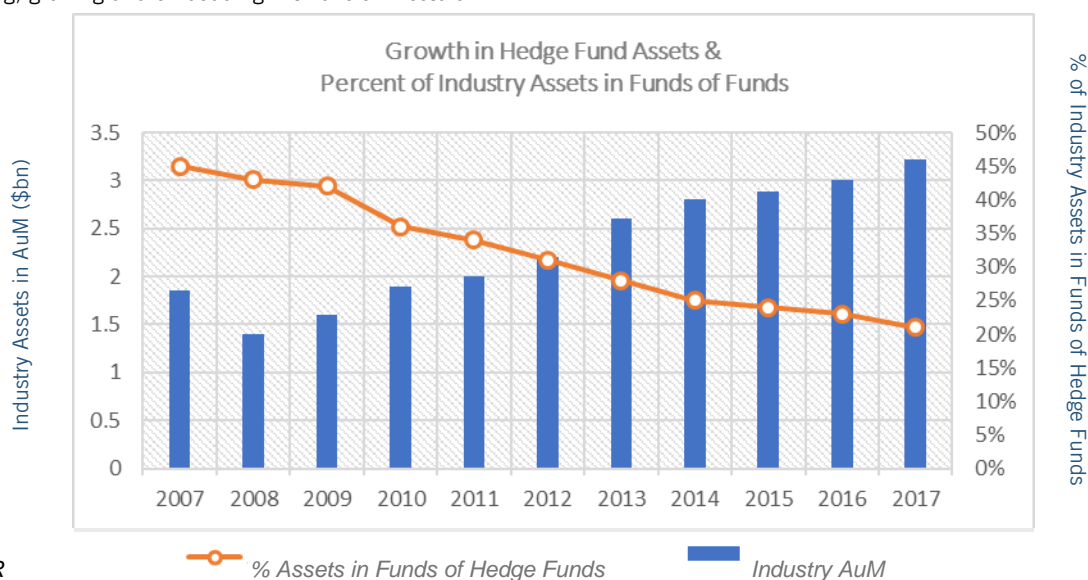
*When information is ubiquitous, intelligence becomes even more valuable*

It's often said we are living in a "Second Information Age" – making it almost mundane to discuss the explosion of available data and information. Most people with a smart phone can consume more data before breakfast than many of our ancestors did in their entire lifetime.

Some of the verticals impacted by this, like investing, are obvious. But the continued growth of available information has upended other verticals that traditionally relied more on "art" than science – particularly the relationship dominated business of sourcing, maintaining and growing the capital base. Investor relations, marketing and business development don't necessarily jump out as clear candidates for a business disrupted by the data deluge, but that is exactly what's happened. A new model of **capital intelligence** is now necessary not just to take advantage of emerging insights, but in many cases simply to remain relevant.

### Quantifying....Partnerships?

In 2007, nearly \$200 billion flowed into hedge funds - a record that hasn't been reached since. Funds of hedge funds made up more than 40% of total hedge fund assets, and in the wake of years of outsized returns, access to many hedge funds remained elusive. A decade ago, even an "introduction" to these funds, many of whom flew far below the public radar, was valuable, and less focus was given to maintaining, growing and embedding with one's investors.



Source: HFR

Since then, multiple factors have converged to upend the traditional capital sourcing, retention and growth model. First, the number of hedge funds has grown considerably in the last decade. There are now nearly twice as many hedge funds in the world as there are listed companies in the U.S. (4,333 companies vs more than 8,000 hedge funds).<sup>2</sup> That means more competitors for managers to be aware of and differentiate from, and more funds for allocators to track.

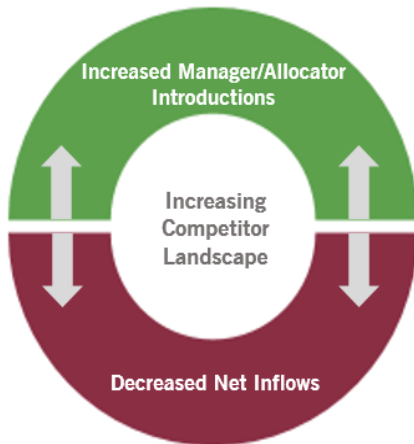
Second, both the hedge fund asset base and IR/marketing processes have become more institutionalized, somewhat democratizing the formerly opaque allocation process. Institutional investors, who now make up more than two-thirds of hedge fund assets, typically include alternative allocations in annual reports or board meeting minutes.<sup>3</sup> Publicly available databases list thousands of allocators reportedly open to investing in hedge funds. This means that investors and allocators often know where to find each other – at least on an organizational level – meaning now, while a fund's capacity may still be an issue, finding them at a company level typically is easier than it once was.

Third, the rise in number of funds and democratization of the allocation process has been accompanied by muted net inflows to the industry. After a year of net redemptions in 2016, hedge funds welcomed slightly under \$10 billion in net new capital in 2017 across more than 8,000 individual funds, and allocators report a continued trend of hedge fund positions within their portfolios.<sup>4</sup> Every dollar is hard won, and keeping and growing allocations over cycles can be just as challenging.

<sup>2</sup> Factset, HFR

<sup>3</sup> Preqin

<sup>4</sup> HFR



So the number of a hedge fund’s potential competitors is up, and it’s somewhat easier to find them (and for them to find allocators), yet the net dollars flowing into the industry are down. While it’s easier for allocators and managers to find each other, that hasn’t translated into an easier time raising, maintaining and growing a capital base. Volume of introductions has taken a back seat to *the right introductions*.

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*What has become of paramount value is next generation capital intelligence – the ability to mine and sift through massive amounts of data to build a more efficient asset raising and retention process – elevating the role of investor relations and marketing professionals, and requiring their intermediary counterparts to strategically deliver the most relevant information.*

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This is taking many forms – and is manifest across the capital cycle, particularly as the landscape has evolved from one in which managers pursued limited partners (LPs) strictly as allocators, to one driven more by relationships – to the current “partnership era.”

**CHART 1**  
**Evolution of Allocator/Manager Relationships**

The “LP Era”	“The Relationship Era”	The “Partnership Era”
LPs	Relationships	Partnerships
Volume of Introductions	Targeted Introductions	Strategic Introductions
Periodic Communication	Investor Letters and/or Investor Days	Ongoing Communication
LPs invest in Master/Feeder	LPs invest in Master/Feeder, Funds of One, SMAs or Co-Investments	Collaboration with LPs to build new structures/vehicles; Enhanced customization
LPs typically invested in single vehicle or less than 3	LPs invested across vehicles	LPs share cross portfolio data with managers

The LP era was defined by scarcity – institutional investors had not yet come en masse to the hedge fund industry, and allocators had a more difficult time finding and getting capacity in leading hedge funds. As we moved into a relationship driven era, IR/marketing teams and allocators institutionalized, creating more regular interaction through investor letters, transparent risk reporting and other communications. Now, allocators and managers engage regularly, with increasing transparency on both sides across their respective portfolios and regarding market intelligence. Customization plays a considerable role in the partnership era – as allocators continue to seek specific best ideas (nearly as frequently as more general strategies or vehicles), individual co-investments top the list of many active searches.

But in this era of working to deepen partnerships across all organizational levels, managers and allocators need to figure out how to stay on top of it all, making sense of the flood of data available, and new information that seems to crop up daily. They need to navigate how to digest data in a way that makes sense for a specific organization, and how to turn information into intelligence, arming senior decision makers with the best knowledge to make strategic decisions.

Firms are focusing on technology, talent and third parties to address the change in relationship between LPs and managers.

First, both allocators and managers are increasingly working to build their own internal intelligence engines or centralized data lakes. Numerous efforts are underway to build more real time systems for sourcing and engaging with allocators, managers and third party groups that leverage multiple data sources to create a more holistic mosaic of the landscape. As they evolve and deepen their relationships, allocators are sharing their cross portfolio positioning, risk management and other market knowledge with their managers, in an effort to better arm them with real time data and analysis that could be accretive to their investment processes. In an era when the majority of incremental dollars come from pre-existing allocators, managers understand that a growing number of intangibles can shape an enduring and mutually productive relationship.

Second, some mature funds are reversing course and strategically shifting from a “specialist” model to an “athlete/generalist” model. Rather than maintaining clear delineation between investor relations and marketing teams, or having employees focus on a particular

allocator channel or vertical, a growing number of funds are shifting to a generalist model that favors athletes over experts – to minimize continuity issues prompted by turnover and better arm *all* employees with more knowledge about the firm, products and what’s happening in the market. There are certain regional or product exceptions to this, but on the whole, the trend in recent years has been towards generalization, not specialization.

Finally, intermediary information brokers - from consultants to Capital Introductions teams to other third parties – must now deliver *capital intelligence* to help managers and allocators make sense of it all.

We focused on hedge fund intermediaries in a June 2017 white paper, so will turn to the Capital Introductions (Cap Intro) function here. Cap Intro teams have long existed as part of large banks’ Prime Brokerage offering – the corner of a firm that provides hedge funds with financing, custody and clearing services. These teams have traditionally helped connect allocators seeking hedge fund exposure with funds that fit their portfolio profile, by continuously meeting with stakeholders in both groups and hosting large events to bring members of both together. They’ve also provided anecdotal information about industry trends like terms, fees, share classes and new product launches.

Now, in addition to making the most efficient introductions for managers and allocators, they are delivering information that bridges the gap or predicts emerging industry trends in ways the deluge of available information (no matter how abundant) cannot. Even the strongest (and largest) IR/Marketing teams efficiently leverage multiple third parties to stay on top of information in real time because the issue of “garbage in, garbage out” still often plague databases or other third party aggregators, specifically:

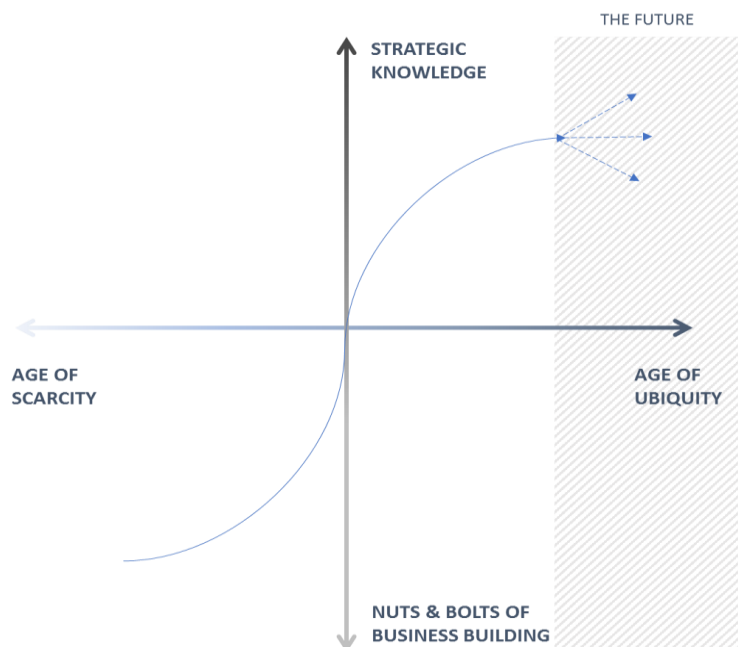
- **Annual reports and board minutes paint a partial picture**, given the lag in time that may exist between an annual or quarterly meeting and the production of minutes, and
- **Publicly available databases**, while a considerable improvement of the years past, can still be unwieldy, with lots of incomplete or obsolete information.

Not to mention the fact that managers and investors alike could spend countless hours simply *meeting* each (and many do). Despite the profusion of data, there are multiple reasons why this corner of the hedge fund industry is less likely to become fully digitized than others – all of the implicit knowledge parties gain (whether personnel or office moves or other organizational shifts), and how information forms a mosaic means different things to different parties.

Next generation capital intelligence has seen information brokers evolve into trusted advisors – **where one’s ability to offer accurate, efficient, valuable information is paramount**. The shift from volume of introductions to strategic introductions and intelligence has required material changes in the traditional Cap Intro model; namely, broadening expertise, upgrading market and industry knowledge, systematizing data gathering and digestion. At a minimum, capital intelligence teams need to manage real time data repositories that pull information from multiple sources, triangulating strategy searches with personnel moves, asset allocation shifts, and other market trends. This data is then prepared, visualized and delivered in ways that make sense for individual organizations – a considerable task given the idiosyncratic nature of many firms.

**CHART 2**

**Evolution of Capital Intelligence: From Introductions and LPs to Strategy and Partnerships**



Moreover, capital intelligence teams are increasingly: a) strategically generalizing their teams to mimic the actions of their largest and most sophisticated clients, eliminating many of the silos that have long separated one type of “specialist” from another, and b) diversifying the backgrounds of team members to help broaden the knowledge base. There is a strong belief that team members should be able to speak to trends across allocator and expert verticals – good ideas and shifts in asset allocation often ripple across industries such that specializing in one vertical (for example, public pensions), can create inefficiencies or gaps in market knowledge. At managers and capital intelligence teams alike – better serving their clients increasingly means better understanding their *clients’ clients* – which means broader knowledge of many different stakeholders, not just the person on the other end of the phone.

In many cases, intelligence also comes from *outside* the allocator and manager community – such that building relationships with the experts that serve the hedge fund industry, and developing an understanding of the emerging trends impacting how all clients do business (whether from a regulatory, technological or strategic perspective), has become mission critical.

Introductions are necessary, information is better, but true *intelligence* – accurate, timely, relevant knowledge gleaned from the deluge of available data - will define the next decade of capital and relationship management.

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*It used to be that it mattered less what you knew than who you knew – now, given the maturity of the industry and the ubiquity of publicly available information – it’s both **who** and **what** you know that matters, and **how** and **when** you deploy it. Introductions are necessary, information is better, but true intelligence will define the next decade.*

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## II. NEXT GENERATION RESOURCE INTELLIGENCE

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### *From Build to Buy to...Build Again?*

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Data isn’t the only thing that’s exploded over the last decade – outsourced and third party solutions are now plentiful (if not commoditized) across multiple business verticals. Particularly in an age of compressing fees, outsourced solutions have gained traction as one way to make an organization more agile, with lower recurring operating expenses. From compliance to IT, to operations, and now increasingly to trading, the number of functions managers are willing to outsource has risen dramatically. But even outsourcing trends shift across a firm’s lifecycle.

As emerging managers, many firms opt to outsource numerous functions to remain “lean and mean” with an agile, smaller fixed expense base. As these organizations grow and mature, they bring in certain operations, finance or compliance functionality in house to show institutionalization and that the firm can shoulder a larger fixed expense base. Finally, once a firm is institutional – typically with layers of complexity added over time – there is a strategic revisiting of sub-functionality (i.e. – types of accounting or treasury) to outsource and reallocate saved expenses to other growing parts of the firm.

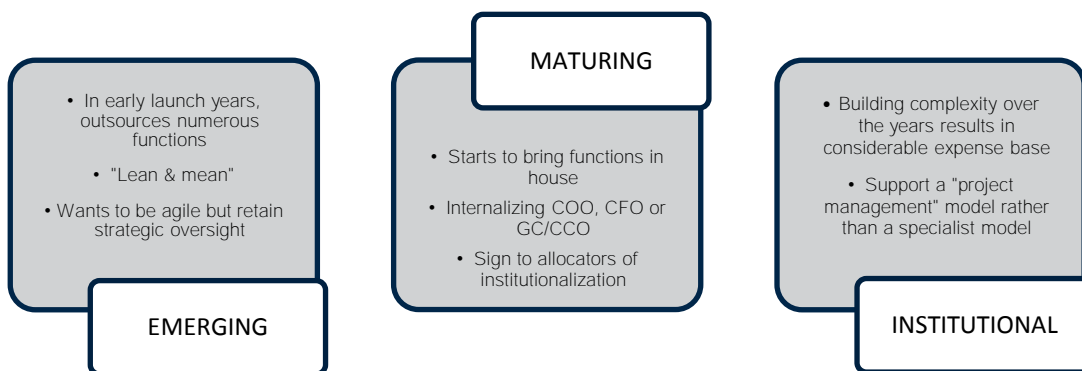
In some cases, the question has become what expertise do we want *to bring back in house?* To get better control of and better leverage their *own* data (which many firms are increasingly identifying as an untapped asset), a number of managers are bringing software developers and engineering talent in house – sometimes instead of having other internal functions. In fact, slightly more than 5% of 2017 new launches started with in house data personnel, while leveraging outsourced trading functionality.<sup>5</sup>

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<sup>5</sup> Jefferies

### CHART 3

#### Evolution of Outsourcing: From Outsource to In-House to Optimize



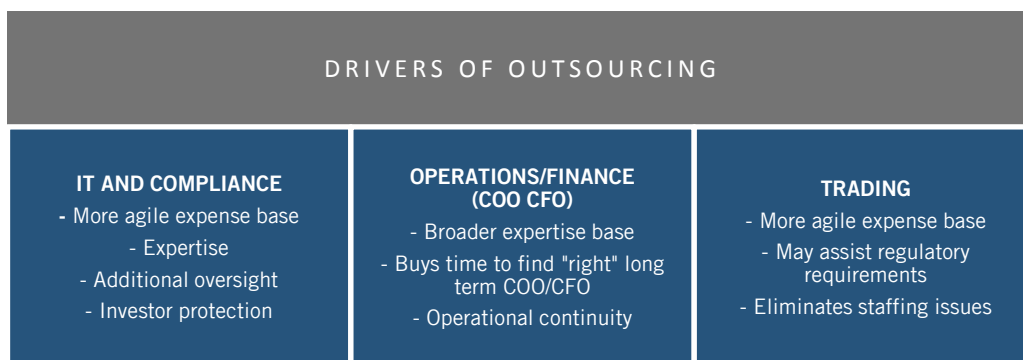
Technology was one of the earliest verticals to experience widespread outsourcing, as emerging managers found little need or willingness to pay for full time, in house infrastructure and support personnel. Then, the heightened regulation of the last decade, and the requirement that someone hold the Chief Compliance Officer (CCO) title, prompted many funds to engage with an outsourced compliance firm. But in opposite of technology, some of the value from outsourcing part of some compliance tasks is not just gaining efficiency scale/expertise – but in making a conscious decision to take an existing function and make it stronger. Most outsourcing is about doing less, engaging with a third party compliance firm is about doing more.

More recently, there has been a slower, but no less notable, rise in start up firms leveraging outsourced COO/CFO solutions - sometimes to fill a gap while the firm seeks the "right" COO for their organization over the long term instead of the "right now" one. In other cases, firms want an opportunity to work with someone with broad experience across multiple fund structures as they're getting up and running rather than working with someone whose experience was more limited. A recent search revealed slightly more than 40% of emerging managers were exploring outsourced COO/CFO solutions for the first phase of launch.<sup>6</sup>

Finally – and most recently, there has been an uptick in the number of firms leveraging outsourced trading solutions. While this number is admittedly still lower than IT or compliance - a few factors are driving it. First, regulations like MiFID II require evidence of best execution, and some firms believe outsourcing trading functions could help minimize running afoul of these rules. Second, we have heard repeatedly that in reviewing operating costs for the years ahead, if outsourcing trading results in lower overhead, but doesn't impact execution performance, some firms would rather reallocate those costs to other parts of the firm. And third, there is a potential multiplier effect in outsourcing trading. If firms have an in house trader, they most likely need someone to serve as a back up trader as well. Outsourcing the trading function eliminates staffing issues that could arise from turnover, illness or prolonged or unexpected absence.

### CHART 4

#### Drivers of Outsourcing Across Organizations



But outsourcing hasn't been absolute. Because of the explosion of data and advanced statistical processing tools, managers are increasingly bringing software developers, engineers and IT professionals back in house. Citing a desire to have more control over their own data, to have the expertise in house to build new systems, or to be able to take advantage of third party data or other emerging

<sup>6</sup> Jefferies Prime Services



trends, engineers and software developers are some of the most in demand hires at hedge funds. In fact, a recent study by [alternativedata.org](http://alternativedata.org) reported the number of alternative data full time equivalents (FTEs) has grown ~450% in the last 5 years.<sup>7</sup> And there are more than 100 current open job searches for data professionals at hedge funds – a trend we only see continuing in the coming years.

While this has happened in the greatest numbers at large institutions with robust IT infrastructure and teams - this trend can also increasingly be seen at smaller and emerging managers as well. There were at least half a dozen emerging managers launching with in-house data personnel in 2017 at discretionary firms – a material uptick from recent years.

The drivers behind these trends are clear. Trading is mostly commoditized. IT infrastructure and support is commoditized. Outsourced COO/CFOs for a period of time may allow emerging funds to leverage either broad expertise as they get their firms off the ground, or to buy them time to find the right leader of their business side - or possibly even both. Data analysis and software development has become *more* important, as managers feel it more important to have complete power over their own data, and any third party information leveraged across the firm. Using *resource intelligence* to properly align internal verticals with broader organizational needs continues to change, as managers revisit their operational footprints to maximize productivity.

### III. NEXT GENERATION ORGANIZATIONAL INTELLIGENCE

#### *Better aligning the workforce with workplace needs*

Just as outsourcing responded to the changing needs of organizations and shifted the expense base of many funds, next generation organizational intelligence is necessary for aligning workplace changes with those in the underlying workforce. The shifting nature of work – what has become automated or commoditized – has changed the type of in demand employees. The hedge funds of the next decade will need to balance investment professionals with different kinds of business professionals than they had in the past. Skills that are increasingly in demand, in addition to the omnipresent need for skilled investment professionals, are STEM (science, technology, engineering and math), robust communication skills that can transcend specialties to reach multiple constituencies, and strategists, whose can balance vision with execution.

While the majority of headlines have focused on the issue of millennials in the workplace, it is just as important for all organizations to find new and effective ways to attract, train and retain many different types of employees - not just those born after 1982.<sup>8</sup>

	STEM PROFESSIONALS	TRANSLATORS	STRATEGISTS
<b>Known For</b>	Acumen in programming, data & engineering	Making complex issues digestible to multiple constituencies	Planning a firm's next chapter and product offering
<b>Challenges</b>	Potential culture clash	Attaching explicit ROI to role	Could lead to mission creep or distraction if expansion not properly vetted
<b>Opportunities</b>	Adding new layers of expertise to investment and business processes	Streamlines communication across multiple stakeholders internally and externally	Can help shepherd efficient and effective business growth to take advantage of new markets, products or regions
<b>Bottom Line</b>	Bottoms up thinkers, most in demand; sometimes hardest to integrate	Organizational bridgers, hard to define reporting lines, but can be one of the most valuable in terms of constituencies reached	Top down big picture thinkers, typically incorporated once firm reaches scale

**STEM (Science, Technology, Engineering and Math) professionals** are increasingly in demand on the back of the explosion of data and analytic tools. While there are ongoing discussions around the perceived cultural differences between STEM employees and traditional finance ones, these individuals have become some of the most sought after next generation employees. The question has become how does my firm adapt to better include STEM, and not necessarily, how can I make my STEM employee adapt to us? Many firms have formalized programs to attract and retain these candidates – and not just for quant roles.

**Translators** are the most recent group to emerge as a “must have” for firms of a certain size. These individuals are more “athlete” than expert, and while they may not traffic in Python (like their STEM colleagues) or EBITDA (like their investment ones), these individuals excel in speaking both these groups’ languages at a high level, and serve as a next generation communications specialist. They aren’t marketers - the closest that currently exists with a standardized job title here is “Product Specialist” and where these individuals sit in

<sup>7</sup> <https://alternativedata.org/buy-side-alternative-data-employee-analysis/>

<sup>8</sup> Or whenever you’ve pinpointed the apparently-controversial topic of “when does the Millennial generation start?”



organizations varies widely - but their ability to make massive topics easily understandable, as well as transcend multiple groups' languages, is one of the truly relevant and emerging skills to make sense of things in this Second Age of Information.

**Strategists** have recently witnessed an uptick in hiring – with more than 20 strategy related roles currently open across firms. As hedge funds have matured and institutionalized, what used to be a “Chief of Staff” role has evolved to a separate group focused on helping shape the organization's future growth and evolution. These individuals often have a management consulting, investment banking or other strategic background, and can add a new, non-financial perspective to how organizations grow and mature over market cycles.

While next generation organizational intelligence is in some ways the most amorphous of the new forms of intelligence needed to navigate the coming decade, it is also one of the most important. The employees that join and develop today – often with completely different skill sets than those prized in the past, will help set an organization's trajectory and help round out the successful investment teams currently at those firms.

## How Jefferies Can Help

Given the changing needs of both managers and allocators, Jefferies has built a Capital Intelligence team predicated on delivering relevant, timely and accurate introductions and knowledge to both groups, to help arm each with the wisdom needed to make decisions more likely to result in the true partnerships both are seeking.

The Jefferies Capital Intelligence team takes a multi-dimensional approach to providing the introductions, market intelligence and tactical content managers and allocators need in an age of information ubiquity – melding the traditional (but sometimes separate) Business Consulting and Capital Introductions team into one force for gathering, distilling and disseminating intelligence. Of note:

1. **Systematized, proprietary database** tracks multiple inputs across verticals, including: strategy searches, product interest, people moves, shifts in asset allocation, peer groups, regulatory changes and service provider trends in real time. At a minimum, next generation intelligence requires data driven systems and processes that result in real time updates (think the “if you liked Stranger Things, you might like The Crown”) mapping market and industry data.
2. **Ongoing strategic market intel** – to ensure general market color doesn't get lost in the shuffle – a concerted and long term effort for Capital Intelligence team members to focus not just on a single sector specialty, but to be athletes that are well versed across strategies, geographies and products. The average client considers launching a new product or share class every 24 -36 months. Jefferies focuses on matching long term data of industry trends with current insight to ensure each organization is contemplating the appropriate strategic move, and has combined its Business Consulting and Capital Introductions teams to better identify and advise on emerging industry trends. We provide clients with the tools and information they need to make strategic insourcing/outsourcing decisions, assistance on developing organizational culture and building teams.
3. **Tactical content** to help managers and allocators understand the emerging trends impacting their businesses now and in the future – whether technology, regulation or other strategic issues. Principals increasingly want to be well informed (but not necessarily an expert) on market changing themes like MiFID II, GDPR, the evolving data science and business technology landscape, demographic shifts or asset allocation adjustments. While most don't feel it necessary to know the minutiae of all these issues, a growing number report wanting to be sufficiently educated on many headline issues to be able to answer questions like “what is your approach to data” or “do you think GDPR will have a material impact” thoughtfully and succinctly.

If you have any questions on the above, or if we may be of assistance as you work through questions around capital, resource or organizational intelligence, please don't hesitate to let us know.

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