Resilience and Resurgence of Active Management
Funds, Flows, and the Future

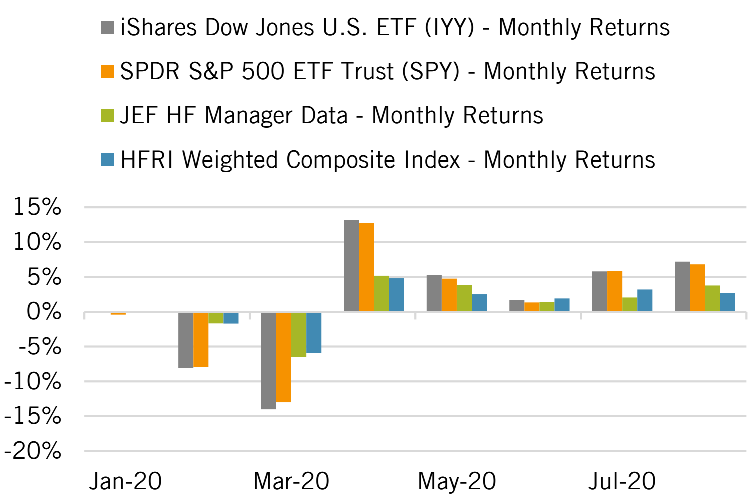
Active Managers have been a staple in Investment Management, with **hedge funds hitting their critical mass in the late 90's through the 2000's**. Then, a rise in **Passive Management**, and perceived outperformance of this cheaper alternative, impacted investor demand for active managers during the recent bull market. A volatile year has now signaled the end of an otherwise quiet decade, and Jefferies Capital Intelligence team is asking the question we're all thinking: **is active management roaring back to life?**

Signs of Industry Health: ☑ Performance ☑ Asset Inflows ☑ New Launches

A Product That Can Perform Over Cycles

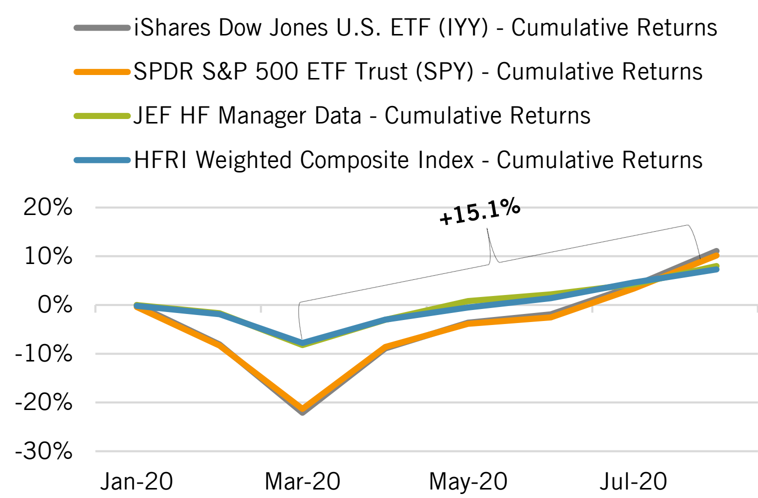
Hedge funds have protected capital and outperformed passive funds and market indices in 2020. While there is dispersion among various strategies, taking a bird's-eye view of industry returns, hedge funds by-and-large executed on what they are meant to do… HEDGE. In addition to dampening volatility, many funds generated enhanced alpha for their investors. Looking at April-August 2020, the HFRI Fund Weighted Composite Index surged **over 15.1%**[1], which marks the strongest five-month gain since the period ending February 2000. In the wake of a precipitous March drawdown**, these returns came when investors needed them the most.**

Monthly HF Performance vs the Market
01/01/20 – 08/31/20



Source: Factset, HFR, Jefferies

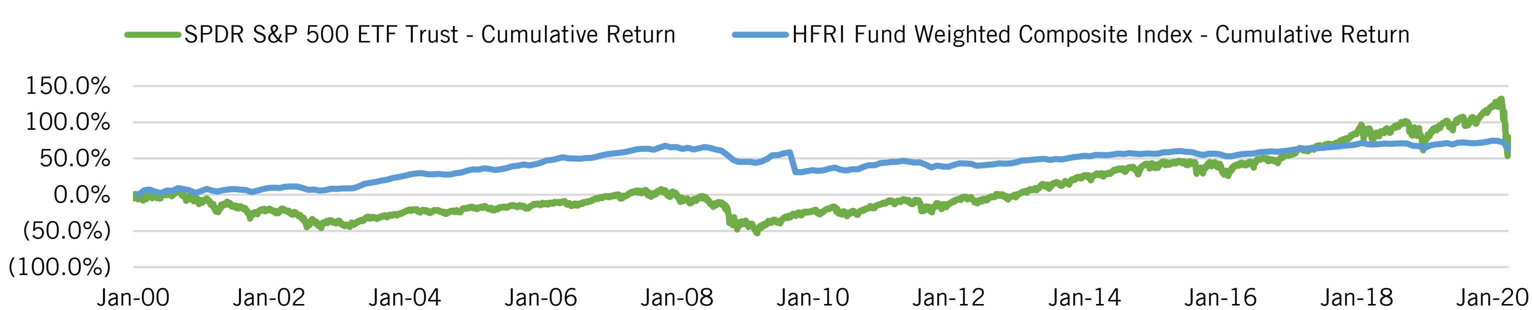
Cumulative HF Performance vs. the Market
01/01/20 – 08/31/20



Source: Factset, HFR, Jefferies

During periods of acute stress, the longer the drawdown, the more substantial outperformance tends to be for active managers – regardless of the downturn's cause. 2020's record-setting market recovery reduced the hedge fund industry's outperformance into year-end. But after a decade-long focus on passive, active managers were still able to **remind investors of their value proposition**.

Who Weathers the Storm?
Cumulative HF Performance vs. S&P 500
01/01/00 – 03/31/20



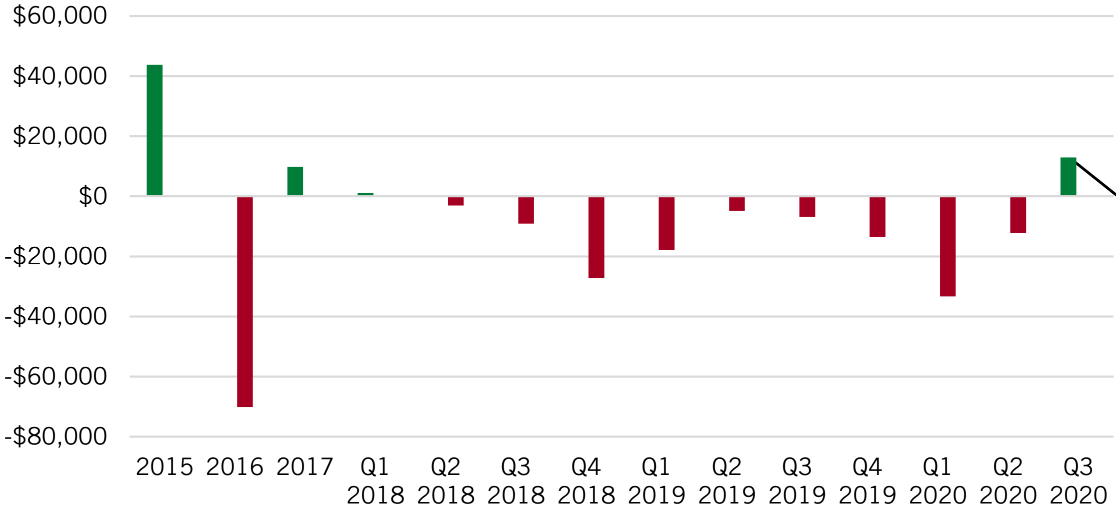
Source: Factset, HFR

Sustained Inflows Across the Board

Despite exhaustive headlines around fears of offsite/virtual ODD potentially halting allocations this year… hedge funds have seen the opposite**. Net inflows of $12 billion** to the hedge fund industry in Q3 2020 were the **first net positive flows witnessed in ten quarters.** These inflows (reversing a two-year trend of constant outflows), were observed across asset classes and fund strategies. This is a **further sign of industry-wide growth in 2020** as active management reasserts itself as a **critical component for portfolios**.

Reversing the Trend: Largest Net Inflows in *Five Years*

Hedge Fund Industry Net Asset Flows ($mm)
Q1 2015 - Q3 2020



"Investors are gaining market share in this environment, have money to put to work, and NEED to"
-HF Manager, COO

Industry assets have now surpassed all-time highs, reaching over **$3.3 Trillion,** attributed to net new allocations and organic growth through performance.

Source: HFR

Who's Receiving *Remote* Allocations?

The bulk of net inflows from Q1 2020 stemmed from allocators writing new tickets for managers they had previously invested in, along with investors topping up and adding when possible to existing allocations. Additionally, many larger managers which had previously closed to outside capital, reopened to take advantage of **market opportunities and resolve liquidity crunches**, among other reasons. In an unfamiliar virtual environment, allocators noted a tendency to invest with groups where existing relationships had been previously **established through onsite ODD and in-person meetings**.

Investors began to realize, **virtual diligence is here to stay**, and may be a change for the better…

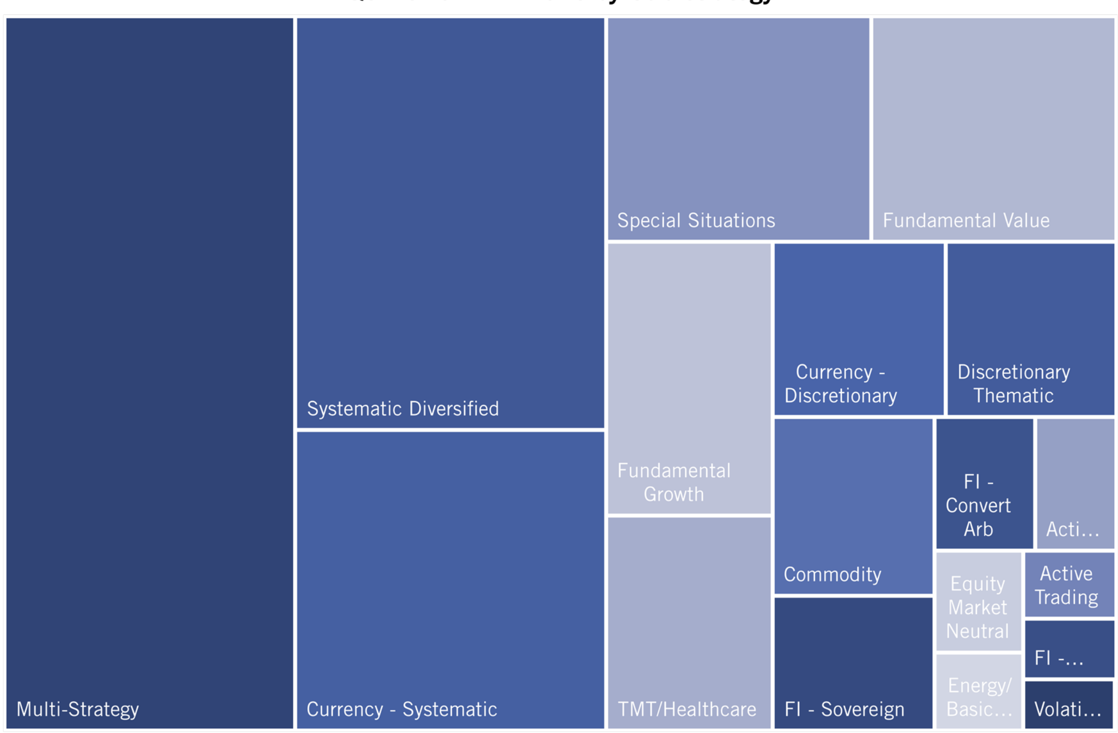
"I didn't know HOW I could underwrite a manager if I had never met them… yet in the past 6 months we have unwritten a handful of new managers"
-Outsourced CIO, Head of ODD

LPs became more comfortable with the **remote ODD and VC meeting processes**, and began to actively meet and invest with new manager relationships, which may have contributed to **the upswing in allocations to hedge funds in Q3**.

The only strategy which saw net outflows in Q3 2020 was Event Driven, but even here it was **under $200 million.**

Q3 2020 HF Inflows by Sub-strategy

Source: HFR



Nevertheless, New Launches Persist

One of the most relevant barometers of an industry's strength is the **willingness of new entrants to launch…** and that's exactly what we've been seeing from **emerging hedge fund managers in 2020**. New launches appear to be more resilient than expected, given what one might have expected in a harrowing year to say the least. Emerging managers' **appetite to come to market** and take advantage of **alpha-generating opportunities** has been unphased by challenging asset-raising conditions and increased volatility.

Launching During a Global Pandemic

Upon receiving hedge fund launch industry data in Q1 2020, there was slight cause for concern… **net closures in Q1 were on par with the unsettling 2008 numbers.** News articles and business leaders forecasted that it was realistic to expect **rising net closures through the end of this year**.

However… in Q2 2020, **the market turned a corner**.

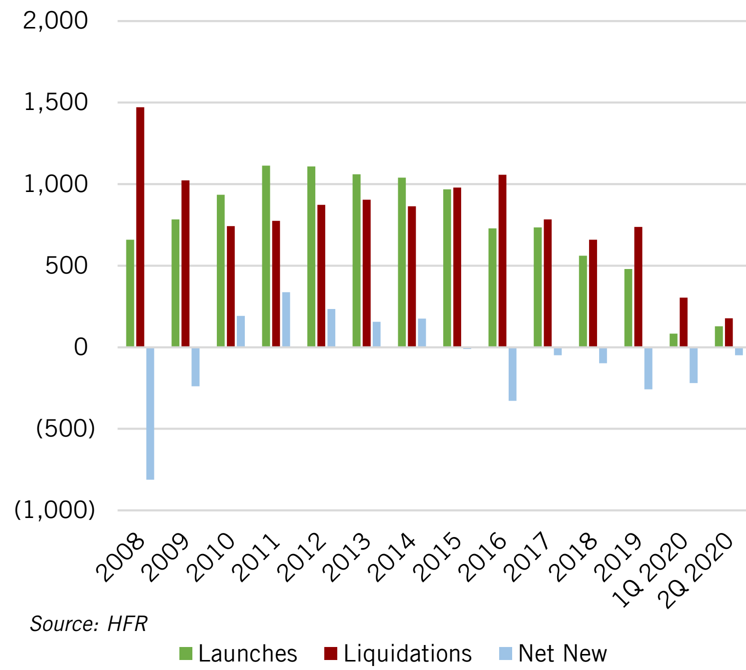
Liquidations Declined.

- Quarterly liquidations nearly cut in half… **decreasing 41% between Q1 and Q2 2020** from 304 to 178 total hedge fund liquidations.

Resilient New Launches Came to Market Anyways.

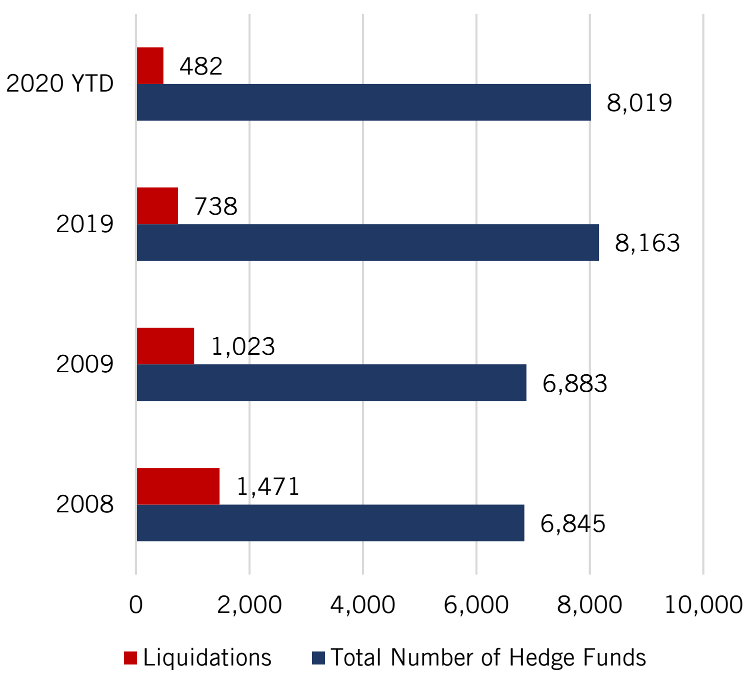
- Q1 2020 reported a near-record low number of hedge fund launches, however, this metric **rebounded considerably in Q2**.
- New launches in Q2 totaled 129, **more than doubling** (+53%) Q1's numbers.

Annual Hedge Fund Launches and Closures
2008 - Present



Source: HFR

Liquidations as a % of Total Hedge Funds
2008 & 2009 vs. 2019 & 2020 (through Q2)



Source: HFR

It's Both *Never* and *Always* a Good Time to Launch a Fund

Launching a hedge fund is a challenging endeavor when times are normal… **let alone when the world is so turbulent**. Looking at the Global Financial Crisis (GFC) as the most recent downturn we can use to compare, analyses between **2008-2009** and **2019-2020** are being leveraged to **gauge how the industry is faring amidst recent volatility.**

There has been a **lower amount of liquidations this year,** as a percentage of total number of existing funds, suggesting that the hedge fund industry is **more stable than during the GFC.**

GFC

18% **Average liquidations (1,247) as a percent of total number of hedge funds (6,864) between 2008 and 2009.**

COVID-19

8% **Average liquidations (610) as a percent of total number of hedge funds (8,091) between 2019 and 2020 YTD (through Q2).**

The Long & Short of It: Why Invest In Hedge Funds Now

While Active Management may have justified its place in the investment management ecosystem in 2020, **their work is far from over.** Numerous catalysts lie ahead for hedge fund managers to **navigate and capitalize on** in 2021 and beyond. As year-end prompts portfolio reassessment, investors might think about the opportunities to take advantage of **favorable terms and fees**, alpha-generation from **macro theme positioning and sector specializations;** entrusting their capital with **skilled hedge fund professionals**.

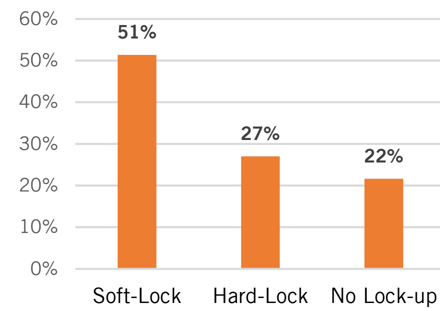
Seeds Planted Prior to 2020

Trending operational shifts, which were in effect before the global pandemic, have been accelerated by the events of this year. These changes in how active management operates have caused Hedge Funds to **grow more favorable in investors eyes.**

Alignment of Interests – Hedge fund terms and fees have never been more favorable, *especially in the emerging manager space.*

- From Q1 to Q2 2020, average industry-wide **Management and Incentive fees both declined to 1.37%, and 16.37%,** respectively. This represents the *lowest level for hedge fund fees* since HFR first began publishing these estimates.
- Over the past 5 years, Jefferies Capital Intelligence Team observed average **Founders Share Class fees shifted from 1.5% / 17% to 1.2% / 15.4%**
- **The Soft Lock-Up Model**: Utilized by **over half** of Jefferies 2018-2019 new launch managers. **94%** of these soft lock-ups were for a **1-year duration** with **early redemption fees** ranging from 2% to 5% **(3.78% average).**

JEF 2018-2019 New Launches
Main Share Class Lock-ups



Source: Jefferies Data

Increased Transparency – Managers are more willing and able to peel back the curtain and communicate their investment processes, operations, and thoughts with investors.

- **Transparent ODD:** Managers that historically always said no, are saying "maybe" on sharing documents and best practices, and newer managers are exceedingly transparent.

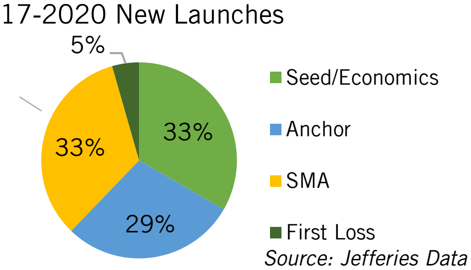
  "I NEVER thought a manager would share their SEC deficiency letter, and they shared it on their SCREEN"

- **More Frequent, Informal Communication:** Instead of a few formal interactions per year, ODD teams are engaging with managers on a **more frequent basis** with one-off questions, sharing insights, and checking in for clarification, to see how managers are doing.

- **Rise of SMAs:** Since 2017, **39% of JEF new launches** entered into a "**strategic relationship"** with an investor(s).

Strategic Capital Trends
JEF 2017-2020 New Launches

In an **SMA,** largely popular due to their **transparency,** LPs see all portfolio positions, while the **manager has full authority** to trade for the account.

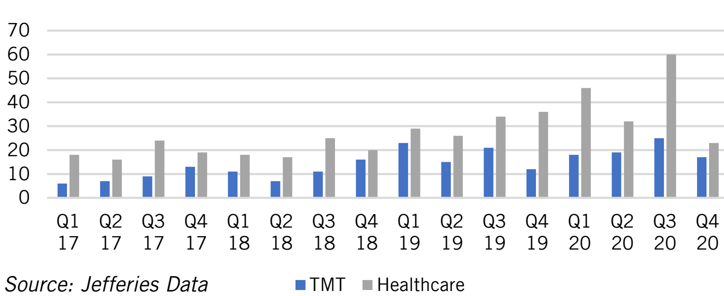


Source: Jefferies Data

Customization: Funds Are Not All Things to All Investors

Hedge funds are staying focused on their current and prospective fiduciaries, and are keenly aware that their strategies may not be a fit for all investors. Jefferies Capital Intelligence team has observed a increasing trend of customized products for LPs, dependent on **return profiles, risk appetite, and thematic interest**. Sector-specialist funds, **mainly in Healthcare and TMT,** which are uncorrelated to the broader markets, continue to be in high demand from allocators. Additionally, **Financials-focused managers** are emerging as we see a robust pipeline of **new launches dedicated to the opportunities in this industry.**

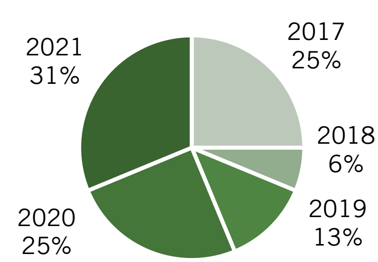
Investor Demand for Healthcare & TMT Specialists
Q1 2017 - Present



Source: Jefferies Data

Financials-Focused New Launches
2017 - Present

Over half of the financials start-ups *since 2017* launched this year, or plan to launch in 2021



Source: Jefferies Data

Footnotes

[1] HFRI Indices August 2020 performance notes. 2020. Available At: https://www.hedgefundresearch.com/hfri-indices-august-2020-performance-notes

---

Disclaimer