# The State of Our Union 2023
# RESET

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Jefferies

# The State of Our Union 2023

## RESET.

Last year was defined by the Collins Dictionary word of the year: **Permacrisis**.

Many major asset classes traded off precipitously, with stock, bond and 60/40 investors all experiencing their worst environment in years. When this happens, **there is not traditionally an immediate and lockstep bounce back across asset classes. More often we see a transition into a new environment with different winners and losers.**

- Following the Dot Com crash in 2000-01, hedge funds performed well up until the Global Financial Crisis, with only one down year of -1.45%.[1] Other sectors and asset classes witnessed far more prolonged challenges. It took the S&P 500 about 7 years to recover its 2000 highs and the NASDAQ only returned to its March 2000 levels in 2015.[2]
- The Global Financial Crisis then inaugurated a global regime of quantitative easing and over a decade of 'easy money' – one that saw muted overall performance for hedge funds, but also one in which **industry assets nearly quadrupled**.
- Now, we are coming off a year in which:
  - The Barclays Agg and 60/40 portfolios had their worst year since the early 1990s[3]
  - Both the S&P 500 and the NASDAQ sold off the most precipitously since 2008[4]
  - Many Central Banks – including and especially the U.S. Federal Reserve – raised rates higher and faster than they have in decades, and crypto currencies crashed. [5]
  - Inflation reared its head, with the U.S., the U.K. and the E.U. at one point battling near double-digit inflation simultaneously *and* passive ownership of U.S. stocks overtakes active for the first time.[6]

Talk about regime change. At the start of this new era, hedge funds are coming off three years of double-digit returns (2019-21) and the biggest outperformance against broader indices in years (2022).[7] But despite this position of strength, outperformance doesn't ensure stability – the incentive fees that can sustain firms across challenging periods or fuel growth amidst dislocation are not guaranteed.

**It is during these transition periods that the strongest managers batten down the hatches and prepare for new investing and operating regimes.**

This is our sixth State of Our Union, and the first that truly reflects a period of RESET, and potentially, renewal. We look into how business decision makers are revisiting and resetting assumptions around:

- Operating efficiency, marketing and IR strategies, counterparty management, the third-party solution landscape, and how senior managers are expanding their strategic bandwidths.
  - If decision makers don't revisit assumptions, they run the risk of: stale business models, bureaucratic operating footprints, outdated approaches to cybersecurity and compliance, an inability to attract and retain the best talent, and missed opportunities to grow and strengthen their firms.

At a time when managed assets are still near all-time highs, but the sandbox of companies and deals are at decade lows, it has **never been more important to be smarter and understand the competitive landscape**. We look forward to working with you to streamline processes, re-evaluate assumptions and better prepare your organizations for the decade ahead.

> We are getting back to a steady state. I think that the last decade was the aberration. Because in a sense…2011 – 2020…if you look at it, relative to financial market history, was the strangest decade that you could have lived through as an investor and as a lender. So rather than thinking of things as being unusual now, really it is a return to normalcy."[8]
>
> Aswath Damodaran
> Professor of Finance, NYU Stern School of Business

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## Embedding Stability and Agility for the Next Decade

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## Contacts


**Shannon Murphy**
+1 (212) 336.1139
shannon.murphy@jefferies.com

**Erin Shea**
+1 (212) 323.3337
eshea@jefferies.com

**Annette Rubin**
+1 (212) 778.8361
arubin2@jefferies.com

**Ariel Deljanin**
+1 (332) 236.6863
adeljanin@jefferies.com

**Leor Shapiro**
+1 (212) 336.6267
lshapiro@jefferies.com

**Barsam Lakani**
+1 (212) 284.1783
blakani@jefferies.com

**Gregory Desroches**
+1 (212) 708.2606
gdesroches@jefferies.com

# 10 Top Objectives to Navigate a Reset in 2023 and Beyond

Here are ten of the top objectives alternatives decision makers are focused on to shore up their firms, and to take advantage of opportunities in a dislocated decade.

## 1. Relentless Focus on Working Capital and Operating Expenses

In challenging markets, incentive fees are not guaranteed – even in years of strong outperformance. This, coupled with the changing realities of operating a successful hedge fund, are requiring decision makers to review and reassess their expense footprints.

## 2. Expand Strategic Bandwidth of Key Decision Makers

Time. It's the single most valuable resource in a fast-paced industry – from founders to senior decision makers and the next generation of leaders. Given the growth in outsourcing and workflow solutions, many firms are revisiting employees' individual responsibilities to ensure they reflect the highest and best use of time.

## 3. Renew Discipline to Help Drive Potential Growth

By revisiting fixed versus variable cost tradeoffs, it may be possible to create some flexibility and tactically innovate or grow.

## 4. Protect Capital to Advance and Thrive

You cannot compound capital you don't protect. Given growing volatility and dispersion, firms are more focused than ever on protecting their capital base and delivering downside protection for LPs in choppy markets.

## 5. Take Advantage of Opportunities While Competitors Are Retrenching

Volatile environments present challenges – *and opportunities*. For well positioned firms, markets with considerable headwinds can also offer opportunities to differentiate from competitors.

## 6. Work on the Talent Development You'll Need Tomorrow, Not Yesterday

Talent seems to be one dimension where all players agree – identifying, hiring, and retaining top talent is as difficult as it's been in a decade. Smart investors are looking to hire the talent they will need in 2025….not 2020.

## 7. Recognize the Importance of an Institutional Due Diligence Process

The convergence of post pandemic norms with the failure of corporate controls that facilitated the FTX collapse renewed firms' focus on due diligence processes. Best practices (and those most efficient for managers *and* LPs) diverge from those five or more years ago.

## 8. Create New Share Classes to Ensure Best Alignment with LPs

Managers are not shying away from creating new share classes, which can offer better opportunities for alignment with LPs. There are many different levers to create balance for both managers and allocators.

## 9. Review and Enhance Your Investor Relations and Marketing Plans to Get That Incremental Dollar

One of the biggest changes has been in how marketing and investor relations decision makers develop and implement their strategic initiatives in this market. We see marketing and IR heads revisiting their LP bases, crafting plans that increase sustainability and bolster pre-existing relationships. Many are rethinking the recurring investor letter – is it still a differentiator? Would other forms of transparency and communication be better in this era?

## 10. Understand Changes in Structuring Trends: Why are SMAs So Popular? What Are the New Standard Liquidity Terms?

Separately Managed Accounts (SMAs) have become a critical tool for allocators to develop their portfolios and managers to build an investor base. Why have both parties been so willing to develop what was considered an operationally heavy lift?

## 2022 | How Strange A Year Was It?

Without the benefit of hindsight, sometimes it can be hard to see how unusual and eventful a year has been. Here, we map some of the highlights defining our current transition period.

**CHART 1**

**A Visualization of 'Permacrisis': Selected Events Driving Markets in 2022**

### January
With Omicron still raging across the globe, Covid cases top 300 million globally, as global supply chains work to fully recover.[9]

### February
Russia launches attack on Ukraine, prompting new geopolitical concerns, adding to factors affecting inflation and impacting the cost of commodities globally.[18]

### March
The U.S. Federal Reserve "takes away the punch bowl," as quantitative easing era ends and interest rate hikes begin.[10]

### April
Elon Musk purchases a 9% stake in Twitter, followed by a $43 billion offer to acquire the company.[19]

### May
The European Union proposes to ban all oil imports from Russia by the end of the year.[11] Cracks on the surface of the crypto industry deepen and broaden, with BTC's -40% decline in two months.[12]

### June
U.S. CPI appears to peak at 9.1%, standing at the largest increase in inflation in 40 years.[20] Passive ownership of U.S. stocks overtakes active for the first time.[21]

### July
The Fed hikes 0.75 *again* marking the second of four consecutive three-quarter point hikes during the year.[13] The last time the Fed hiked 0.75 points in *any* meeting was 1994.[14]

### August
U.S. Senate passes Inflation Reduction Act, a $700 billion policy aimed at climate change and tax reform, among other issues.[22]

### September
All three major U.S. indices in bear market territory, with the S&P 500 having its worst YTD performance in 20 years.[15]

### October
Following death of Queen Elizabeth, Prime Minister Liz Truss announces new economic plan, but the British Pound plunges ~10% and Truss lasts only 44 days in office. Yes, less than the head of lettuce.[23]

### November
Crypto exchange FTX collapses, triggering negative ripple effects across the digital assets landscape.[16] New SEC Marketing Rule goes into effect.[17]

### December
2022 closes with some of the worst cross asset performance in decades across equities, fixed income, and a 60/40 portfolio.[24]
Lionel Messi finally wins a World Cup title in what is called the greatest final of all time.[25]

# 2022 | The Hedge Fund Silver Lining

Where to go when equities aren't working, fixed income isn't working (2022 witnessed the worst performance for the 10 Year in 234 years), and even your 60/40 portfolio isn't working?[26] A very solid case can be made for hedge funds – ideally, a diversified portfolio of them.

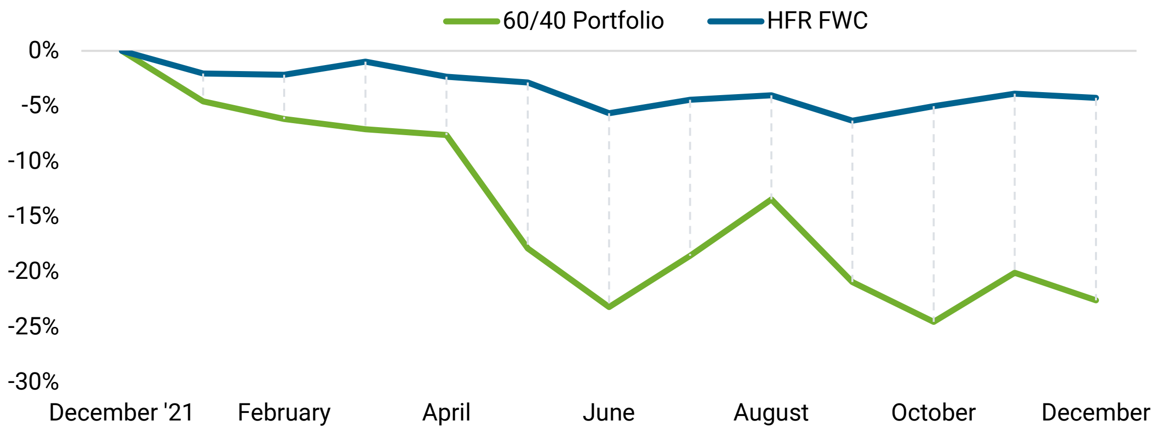
In 2022, through one of the most challenging market environments in over a decade, **hedge funds delivered risk-adjusted returns and downside protection** when investors needed it the most. You cannot compound capital you don't preserve, and hedge funds executed on what they are intended to do – hedge downside risk, take advantage of an environment with more dispersion and strongly outperform broader indices across asset classes.

Passive indices such as the S&P 500 and NASDAQ suffered drawdowns of nearly -20% and -32% respectively in 2022, their worst years since 2008.[27] Pain was felt across asset classes, as the standard 60/ 40 portfolio fell around 20% last year – resulting in one of the best years of hedge fund outperformance.[28] The HFR Fund Weighted Composite fell ~4%.

**CHART 2**

**60/40 Portfolio* vs Hedge Funds: 2022**

*60% SPY + 40% Barclays AGG

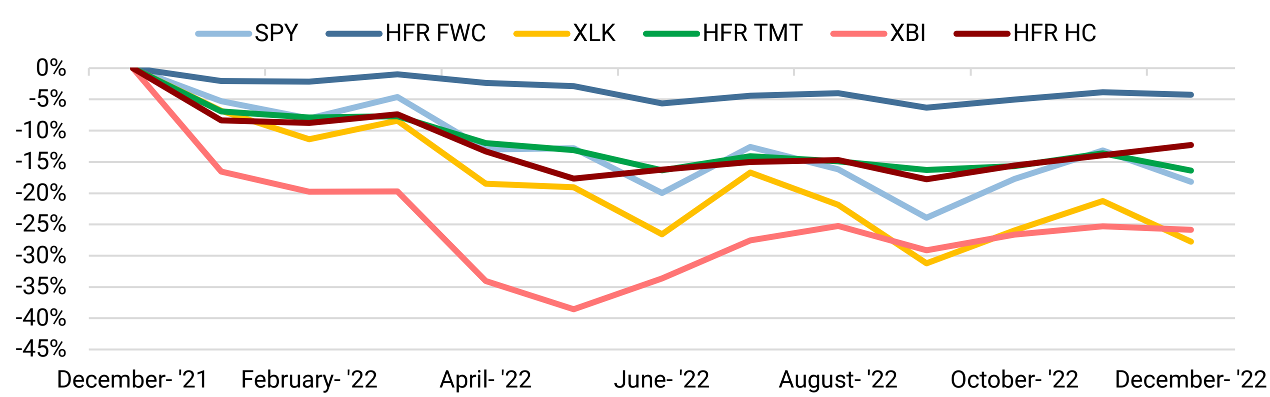



Source: FactSet, HFR, Jefferies

We looked at some sectors particularly hard-hit last year – namely, tech and healthcare, to see if this protection was true across industries that struggled. Outperformance is evidenced there (on average) as well.

**CHART 3**

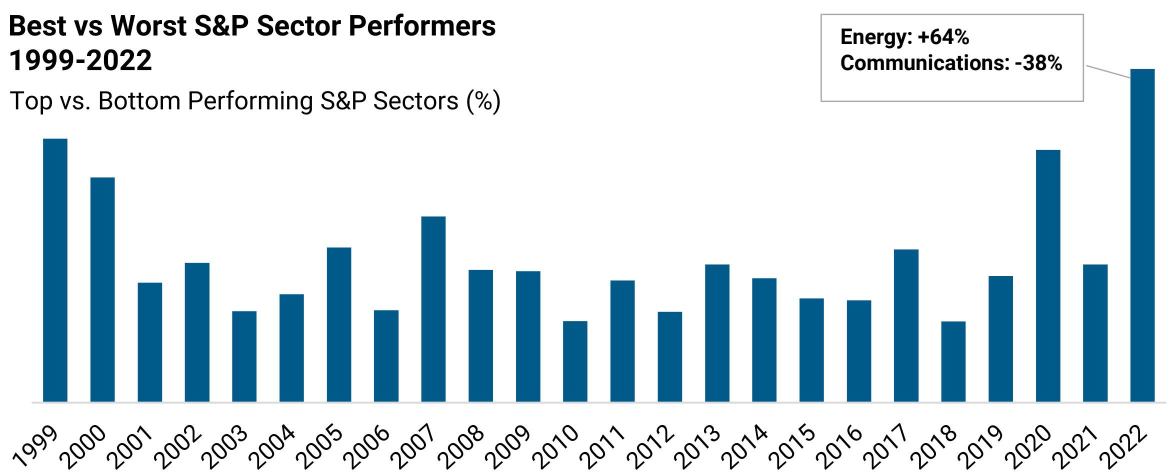
**2022 Market Performance Inclusive of Sectors**




Source: FactSet, HFR, Jefferies

This outperformance is particularly relevant as we increasingly see dispersion across and within sectors. In fact, 2022 has witnessed some of the most considerable sector dispersion in the S&P in decades (though much of this was driven by Energy's standout year). Most allocators and managers are expecting this dispersion to continue – with some feeling this decade will be the return of the stock picker's environment. Many expect continued hedge fund outperformance when dispersion is elevated and correlations dampened.

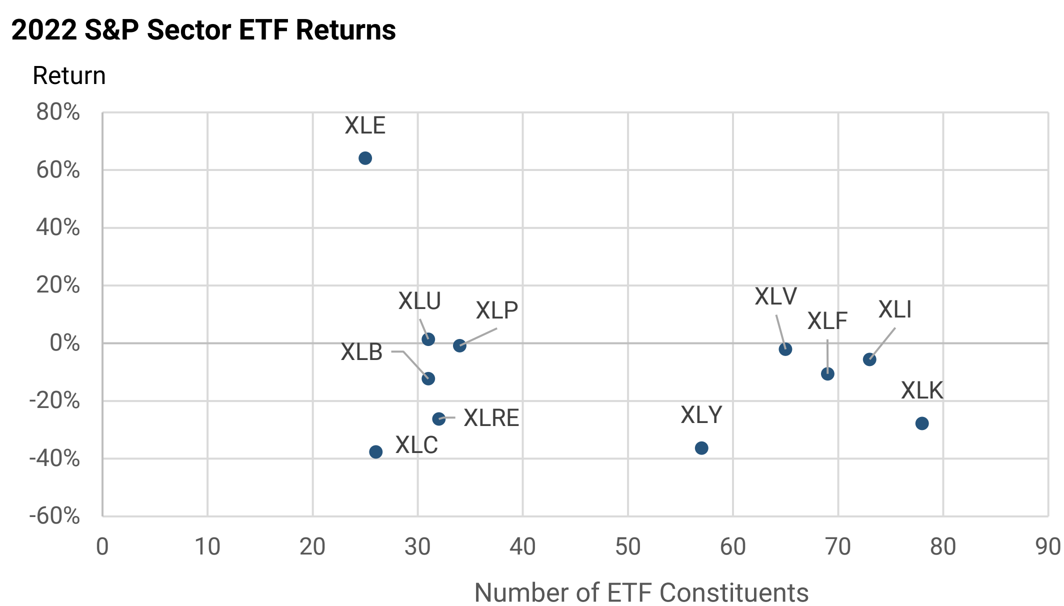
### CHART 4




Source: FactSet, Jefferies

To dive deeper, we additionally looked at the dispersion of sector ETF returns across 2022 and measured the number of constituents in each. It is clear that most sectors struggled, with the exception of energy, which broke out of its years long doldrums. These charts reflect three things: 1) The potential return to a stock picker's market, where dispersion allows for more optionality among winners and losers, 2) How challenging it was to make money and generate flat to positive returns in 2022, and 3) The extent to which hedge fund performance reflected **true outperformance** in a challenging market.

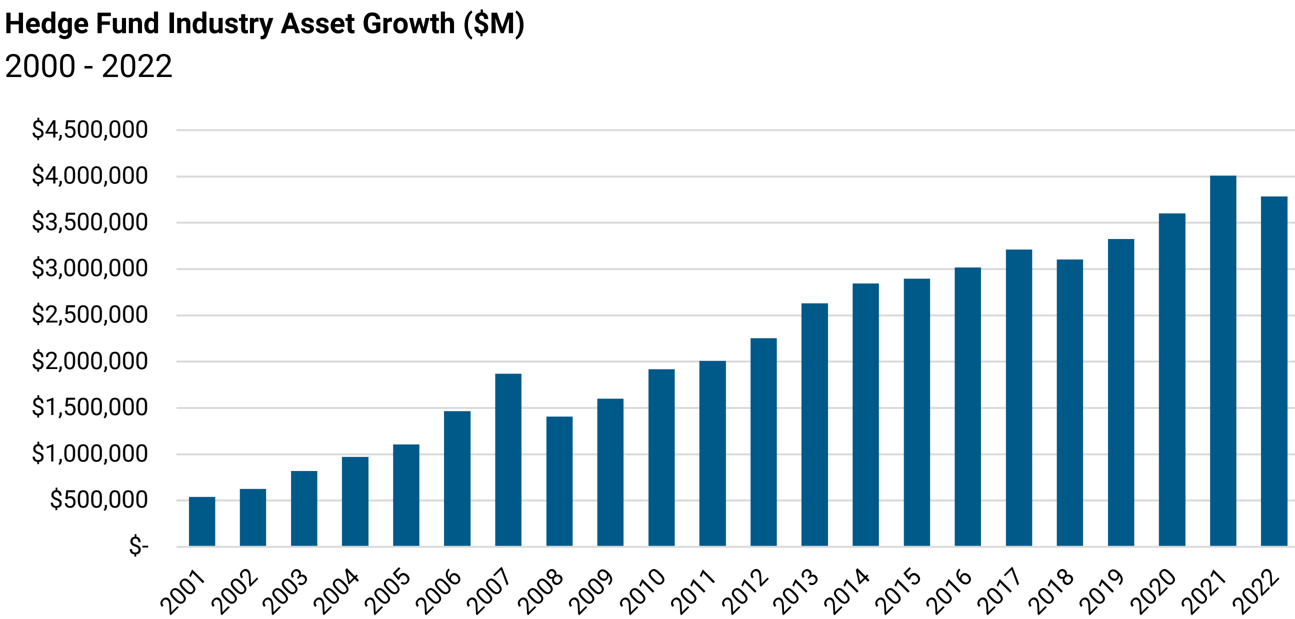
### CHART 5




Source: FactSet, Jefferies

It is in this environment we expect hedge fund industry assets to continue to grow materially. Hedge funds' strong outperformance have positioned them to be able to return to a high-water mark that's measured in months, not years – as some broader indices may be facing. After their decline of nearly 20% in 2008, and more than 10% of total industry assets withdrawn during the Global Financial Crisis, the industry roared back largely on the back of organic performance to nearly triple its assets between 2009 and 2021.[29]

**CHART 6**




Source: HFR, Jefferies

The other corner of the market seemingly poised for a "reset?" The broader U.S. equity market. Looking at the cycles between 1970 to post the Dot Com Bubble bursting in 2002, and then 2002 to 2022, there are a number of parallels.[30] The S&P price performance tracks quite closely across the two periods, so if history is to be a guide, we could be heading for a period of ongoing muted U.S. equity performance following a broad-based tech selloff.

In fact, some academics have explored whether accommodative monetary policies characterized by persistently low rates *may* have driven investors to under diversify their portfolios in a hunt for returns.

"Our finding suggests that low-interest-rate monetary policy may influence the risk premium of income-generating assets, lead to under-diversification of investors' portfolios, and cause redistributive effects across firms that differ in their dividend policy," wrote Professors Kent Daniel, Kairong Xiao and Lorenzo Garlappi wrote in an NBER working paper in 2018.[31]

## Resetting Your Operating Footprint

Ironically, despite the biggest outperformance for hedge funds from broader indices in about 30 years, a number of firms did not earn incentive fees in 2022.

This, together with the considerable shifts that are affecting how to successfully manage hedge funds across cycles, puts the spotlight back on fee structures and working capital. There are three paths to optimization and success during challenging markets:

1. Increase management fees or diversify the fee pool to avoid precipitous redemptions at once
2. Reduce operating expenses, or
3. Do both

In uncertain periods like this, decision makers across industries pause and revisit assumptions - not just to shore up finances, but to take advantage of opportunities amidst dislocation.

#### WORKING CAPITAL | How Much Are We Talking About?

The charts below highlight the advantage of not only increasing AuM over time, but also strategically aligning management fees to sustain firm operations *across* cycles and facilitate growth. There can be peril in pricing a share class too low. A 25-basis point difference when you are managing $500 million results in $1.25 million per year in additional working capital.

**These numbers become extremely material as firms grow – both organically and with new inflows.** Over time, that $1.25 million delta can grow to $7.5 million for assets around $3 billion. The math is straightforward, but planning can be less common for anticipated growth *or unanticipated* contraction. These differences can be consequential and in markets like these, may separate managers who *can* reinvest in their businesses, incubate new strategies, onboard best in class technology and IT and hire the best talent - from those who *can't*.

**CHART 8**

**Operating Expense Analysis**

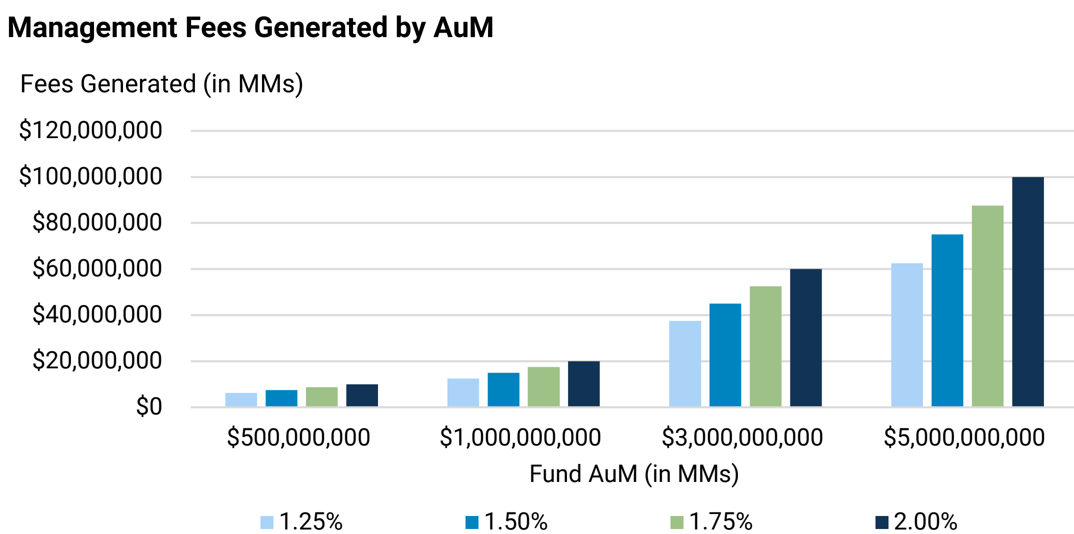
| AUM (in MMs) | Management Fees | | | |
|---|---|---|---|---|
| | 1.25% | 1.50% | 1.75% | 2.00% |
| $500,000,000 | $6,250,000 | $7,500,000 | $8,750,000 | **$10,000,000** |
| $1,000,000,000 | $12,500,000 | $15,000,000 | $17,500,000 | **$20,000,000** |
| $3,000,000,000 | $37,500,000 | $45,000,000 | $52,500,000 | **$60,000,000** |
| $5,000,000,000 | $62,500,000 | $75,000,000 | $87,500,000 | **$100,000,000** |

Sources: Jefferies

There are at least 20 different levers to optimize operating footprints. While most costs are seen as "fixed," decision makers are revisiting budgets for the next 24 months to understand where fixed costs may be replaced with variable, where charges to the management company may be converted to fund charges (if appropriate), and if there are third party solutions that can substitute for internal headcount or resources.

Over time and with performance driven organic growth, management fees can balloon to north of $50 or even $100 million per year. Managed growth is as important as considerable fee generation to ensure funds can reinvest in best-in-class talent, data or technology and other forms of research and development.

**CHART 9**




Source: Jefferies

Markets like these remind us why a critical topic for both emerging and established managers is strategic share class construction. Launch with too low a management fee, and it could be difficult to compete for talent, leverage the data and technology you need or invest in the business – especially if the firm is weathering a challenging period.

For more mature managers, taking their firms to the next level may involve upgrading facilities and real estate space, hiring human capital with new or differentiated skill sets, opening new offices, or launching new products. To do so, they need durable capital to help ensure growth initiatives are sustainable across business and economic cycles.

A dominant driver of the war for talent has also been the continued strength of pass-through fee structures. While some firms have longstanding pass through models, a small but notable number of firms have or are transitioning to pass through models. The firms that are making (or have made) these changes manage billions in assets, affecting their bottom line, their ability to invest in best-in-class technology and compete for top talent.

Some allocators are precluded from investing in firms with pass through fee structures, but others look at the historic return streams of these organizations and are comfortable with the tradeoff.

## Evolution of Operating Footprints | Revenues and Expenses

| THEN | NOW | AHEAD |
|---|---|---|
| Set and Standardized Fees | Creative Fee Structures Become Standardized | Ongoing Alignment of Fees with Creation of New Share Classes |
| Less Nimble | More Streamlined | Maximize Efficiency Across Fund and Management Company Expenses |
| Higher Fees | More Diverse Fee Base | Optimized Fees across LP base |
| Building Systems in House | Tactical Outsourcing | Outsourced Solutions Embedded in Organizational Footprint |
| Higher Top Line Expenses: Binary Choice of Build or Buy | More Efficient Expense Base: Third Party Solutions Diversify | Build AND Buy; Solutions Providers Create Bespoke Products for Firms |

If managers don't have the capital they need to thrive, they may be able to backfill with incentive fees earned during years of strong performance. But a more efficient, effective, and responsible way to operate is to have sufficient working capital that allows firms to take advantage of industry shifts to optimize operations or pursue opportunities in dislocations.

Outsourcing has considerably changed the ways decision makers look at their operating footprint. Previously, the very binary options of "build vs. buy" challenged managers to find the right solution for their firm. The world has evolved such that outsourcing is seen as a precise and more tactical tool to achieve the right mix of execution and strategic growth across multiple verticals including: trading, compliance, operations, finance and data/analytics. This agility comes precisely when managers are also more focused on offering more levers of alignment to potential LPs and are building slightly more nuanced portfolios of share classes than the traditional flagship and early stage/founders' options.

## Expanding Decision Makers’ Strategic Bandwidth

Expenses have often grown alongside both outsourcing options *and* share class diversification. Other than capital itself, the single most valuable resource most funds have is how their founders and decision makers spend their time. Increasingly, decision makers across firms are taking a step back to review and enhance how they spend their time.

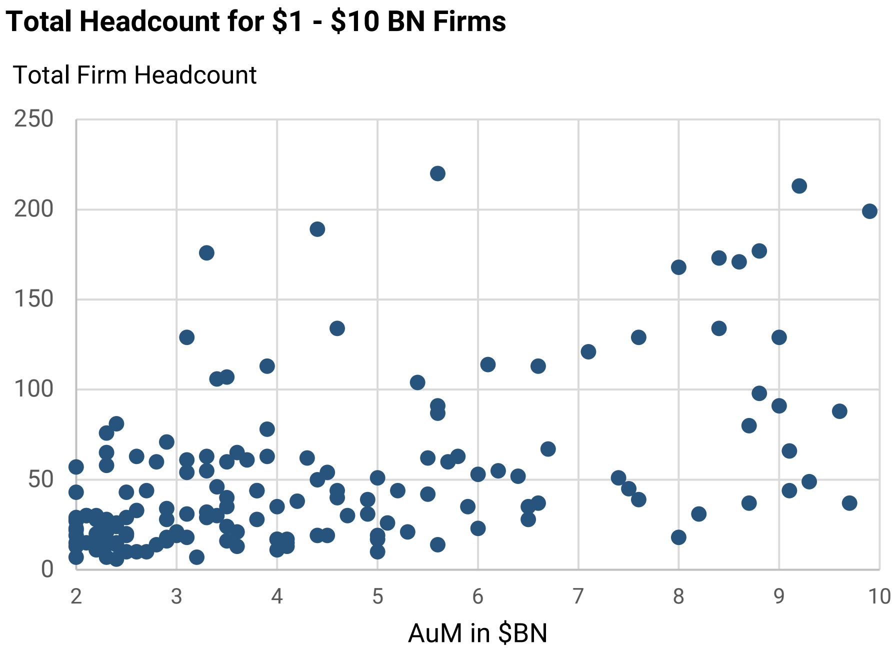
Whether it’s pre-launch or year 10, decision makers are responsible for thinking strategically, executing efficiently and adapting to build stronger firms. In periods of transition like this, it becomes even more critical to allocate time responsibly, minimizing unnecessary or manual tasks. Here, we explore some best practices for building a more efficient, profitable and successful firm.

1. Take a step back to revisit workflows, tasks and responsibilities. Are any outdated or more fitting with another person’s current roles and responsibilities? Optimize internally first, minimizing unnecessary tasks that don’t align with 2023’s objectives to start freeing up time and resourcing.
2. Review the service provider and counterparty landscape to tactically delegate where appropriate. The post-Covid era has seen the launch of numerous third-party solutions, and the evolution, maturation and institutionalization of many more. Sector M&A has witnessed the consolidation and growth of certain functions like Administrators and Middle/Back Office functionality, growth in compliance firms and an explosion of fintech and productivity solutions for the Office of the CFO.
3. As firms grow, there are internal transition periods where dedicated headcount isn’t warranted *yet*, but there are also limits to how many responsibilities can be piled on current employees while maintaining focus and job satisfaction. Are there *tasks* that can be strategically outsourced before they merit a full new *role*? Outsourcing may fill the gap both as a cost cutting measure or productivity solution.
4. Very few decision-making roles look the same as they did a decade ago. Are there additional opportunities for collaboration or cross-disciplinary engagement that could benefit the firm? For example, we see much stronger collaboration across IT/technology and compliance teams to meet changing regulatory standards and expectations around proper cybersecurity management.
5. Get ahead and plan for a more active regulatory era. Review and update compliance processes, ensuring all are in line with new rules that went into effect in 2022, the 26 that were proposed during the first eight months of last year, and those which are most likely to be on deck for going live in the next 24 months. [32] Most managers are preparing for increased costs in association with recently passed, or proposed rules. In particular, there is much focus right now on reviewing materials ensuring they are in line with the SEC’s new Marketing Rule which went into effect in November.

## Resetting Your Approach to Talent and Headcount

There are nearly 500 firms globally managing between $1 and 10 billion of assets.[33] We reviewed publicly available filings, and many of these firms run quite lean operations by headcount – with the vast majority employing fewer than 50 people, even those managing more assets. As firms grow, a common question is when to bring dedicated human resources headcount in house.

**CHART 10**




Source: Jefferies, ADVs

**Talent is the most expensive outlay for firms annually** – as such, it is important to review employees' roles, responsibilities and potential to leverage third parties to serve as an extension of your firm, an important component of business continuity planning, or most importantly, as an effective method for ongoing and strategic allocation of tasks across skill and seniority.

Coming into a new year, competition for talent is fierce across industries as unemployment levels remain near decade lows. Many employers are still grappling with changes during the pandemic that effect what prospective hires want, and many managers report challenges recruiting and retaining talent.

As such, many are revisiting their approaches to hiring and sourcing talent. The challenges facing managers are diverse and far reaching. Some funds report challenges hiring PMs and Analysts due to the runaway growth of multi-manager shops. Others decry the difficulty in hiring and retaining CPAs or finance professionals for CFO or comptroller roles. A small but growing number of firms who traditionally only hired laterally or more seasoned employees report developing their own training programs in house or in conjunction with third parties in order to hire employees earlier on in their professional careers.

Below we explore trends across established and non-established hedge funds, senior and junior talent, back and front office roles, and the broader hedge fund community.

| TALENT | | |
|---|---|---|
| **Established Funds vs. Emerging Funds** | **Established Funds**<br>• Managers running more than $10B in assets accounted for almost half of all hedge fund hires in July of 2022. Four of the top 10 hedge fund firms by net new hires in July were multi-strategy specialists. [34]<br>• Leveraging outsourcing to help increase efficiency across many verticals. | **Emerging Funds**<br>• These groups theoretically have the most flexibility when thinking about strategically allocating resources and leveraging technology and outsourced solutions.<br>• People are more carefully selected to fill a defined role and fit into the culture, which can result in a slower hiring process. |
| **Senior Talent vs. Junior Talent** | **Senior Talent**<br>• Non-competes and notice periods are becoming longer than historically reported.<br>• Multi-strategy, multi-manager firms based around the 'pod' model have become increasingly attractive destinations for portfolio managers and traders, typically in lieu of starting their own firms. | **Junior Talent**<br>• The non-investment side talent at the junior operations role continues to be fierce.<br>• Junior analysts are spending less and less time on the sell side and typically looking for the buy side jump within 1.5 years.<br>• Platforms increasingly offering internship programs and more defined growth trajectory. |
| **Investment vs. Non-Investment** | **Front Office**<br>• Investment side talent is still in high demand especially those coming from sell side banks.<br>• With the banks increasing pay, buy side shops are also having to increase pay to retain talent, or structure their compensation packages more creatively.<br>• Buy-side firms more open to post-undergrad or 1-year of banking, with sector expertise less of a requirement | **Back Office**<br>• Those with CPAs are extremely hard to identify and hire, and it's affecting both managers *and* industry service providers.<br>• Individuals with controller/marketer skillsets are most in demand.<br>• Companies are trying to stay flexible for employees while also raising wages in some cases. |

As firms are refreshing their approaches to identifying, hiring and retaining talent – there is renewed focus on the human resources function. Particularly for firms managing between $1 and 10 billion, human resources professionals increasingly serve as critical decision makers in terms of helping to set onboarding and training strategies and ensuring benefits and compensation policies remain best in class.

Firms with multiple office locations also have had to dedicate more resources to staying on top of regulatory changes around salary transparency and the changing rules of individual jurisdictions. California, New York and Massachusetts, for example, have had somewhat more active rulemaking around human capital, and it can be challenging for firms with offices in different legal regimes to stay on top of these changes.

Typically, we see managers adding dedicated human resource or talent headcount at ~20 full time employees. This is typically the number when HR related tasks start to accumulate and require serious and focused headcount. Before that, firms transition from heavily relying on third parties to provide support and advice, to partially assigning some internal responsibilities – creating onboarding or offboarding programs or serving as the liaison with the third party. As employees are hired, there can be exponentially more responsibilities required to ensure the firm is an environment that can not only attract and retain talent, but stay on top of an increasingly active set of local regulators and rule makers.

**Talent – Evolution of Human Resources Function**

| Early Stage | Growth Stage | Institutional Stage |
|---|---|---|
| • Heavily leverage PEO and payroll firms to manage logistics<br>• Managed internally by office manager, administrative assistant, or COO depending on organizational structure | • Office manager/COO takes greater role in creating formal onboarding, creating more robust policies and procedures<br>• Continued reliance on PEO, payroll firm<br>• Potential addition of Outsourced COO/CFO firm to manage payroll | • Formal hire<br>• Evolves into a more strategic role that includes onboarding, enhancing policies and procedures, participation in compensation, creating strategic initiatives<br>• Typically at the point of 20+ employees and/or $1-3bn AUM |

**Spotlight on Employment Agreements**

Non-competes are in the spotlight given the FTC's proposed rules strongly constraining employers' abilities to foster and even enforce them. There is a fragmented approach to these types of agreements already – with considerable differences between California's approach and other states. We will be keeping an eye on this issue as the comment period ends, as the potential impacts on managers could be far reaching.

**Hybrid, In Office or Remote: Real Estate in 2023**

While many are creating flexible hybrid to remote work policies as a talent retention and attraction tool, others are **using real estate as a way to bring employees back into the office**. Interestingly have heard real estate referenced as a talent retention/incentive tool more over the last month than the last few years. **Firms are encouraging employees to come back to the office with internal events, office upgrades, etc.**

Tenants in the financial sector have been **leading the return to work** as many want to be in front of investors.  Many funds primarily boutique funds with 4-20 people are currently looking to upgrade the quality (and sometimes size) of their offices as a way to attract talent and get people motivated to be back in the office on a more regular basis. People are viewing quality of space as a way to attract and maintain talent post Covid. Tenants are hoping to convince employees to come back into the office with nicer spaces.

The subject of WHERE people's offices are now meaningful from a **commute, quality of space, office environment, level of productivity**. Flexibility is important for this group and 80% of hedge funds now offer hybrid jobs in some corner of the organization.[35]

**There is record level demand for top tier buildings**, with a huge disparity across pricing and quality of buildings. **High end buildings are at or near record highs**, and there is a higher-than-normal demand for new construction with amenities such as conference centers or well-equipped gyms or even wellness centers.

## Resetting Capital Raising and Retention Approaches

While 2022 was a challenging capital raising environment for many, there are lessons to be learned from those who **did successfully raise assets last year**. Hedge funds witnessed $30 billion of outflows in the first 9 months of 2022, before reversing to net inflows in Q4, their worst year since 2019.[36] Among these, appetite for new launches endured, with some of the smallest funds – groups managing between $250 and $500 million welcomed $1.4 billion.[37] Unique forms of strategic investment also continue to appear with the rise of separately managed accounts.

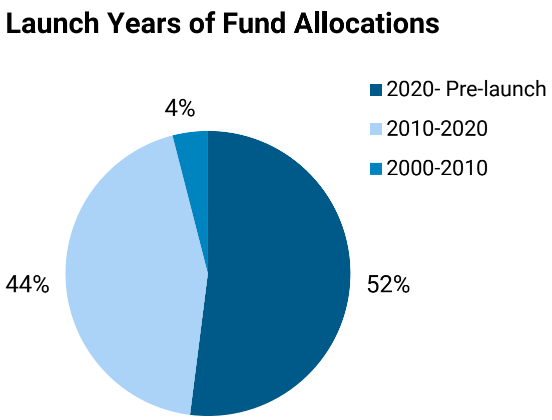
Less than 1% of hedge fund assets were redeemed from the industry; by contrast, the industry saw more than 10% of its assets redeemed in the Global Financial Crisis.[38] More recently, redemptions are more often recycled to different managers or strategies, and don't leave the asset class entirely. This has considerable implications for understanding the competitive landscape, where your firm fits, and what your value proposition may be.

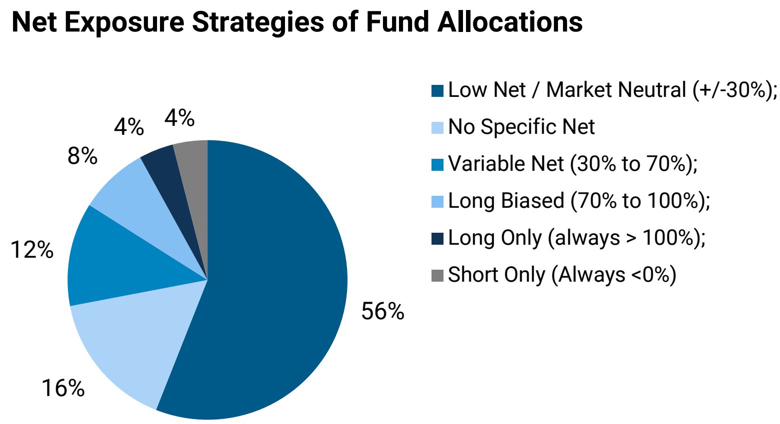
### Who *DID* Raise Money?

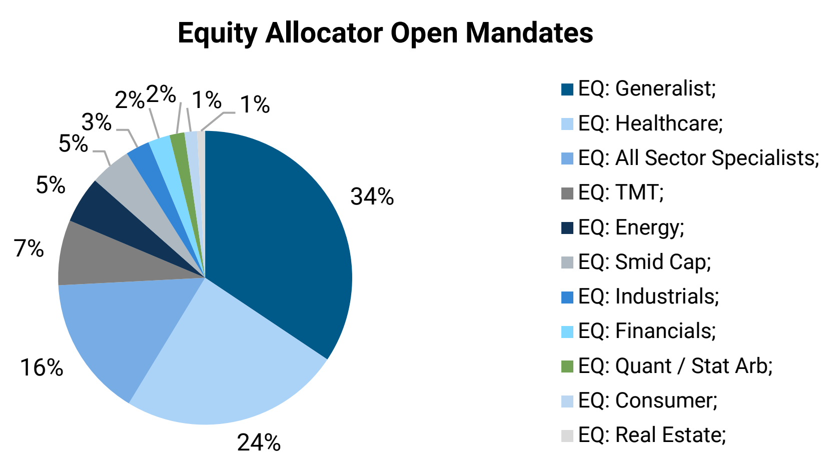
Looking at the equity hedge fund space, **energy-focused and multi-strategy groups** were the largest beneficiaries across the industry, raising around a billion dollars each.[39] The **recent class of emerging funds is garnering investor interest** and tickets even in a challenging market environment – nearly half of 2022 allocations observed went to funds launched in the last 3 years.[40] A number of tickets were also written to strategies with an **emphasis on hedging and lower net exposure.**[41] Open LP mandates are also a leading indicator of strategies which may see inflows in the coming year. **Healthcare** continues to be a focus for long term believers in the sector, and **Energy** has resurfaced as a top sector specialty.[42]

**CHART 11**

**2022 Mandates and Allocations Via Jefferies Capital Introductions**




Source: Jefferies Capital Intelligence

In addition to capital that flowed steadily into multi-manager firms, a notable portion of capital raised in 2022 came in the form of Separately Managed Accounts (SMAs), which have been steadily gaining popularity over the past decade as a form of strategic investment. This structure initially emerged as a popular seed or anchor investment strategy for newly launched managers. More recently, this style of investment structure has matured into a solution **that serves a wide range of needs for *both* investors and managers.**

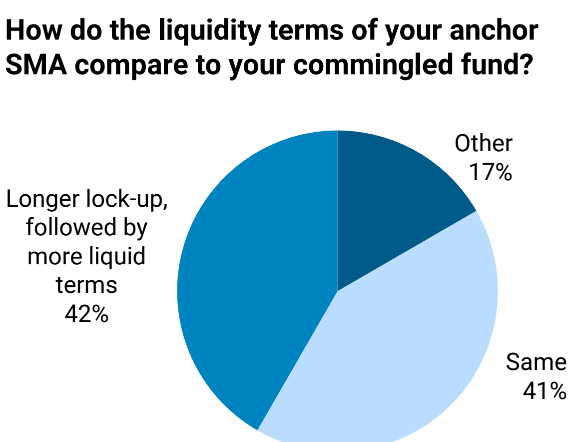
### Make Your Own Multi-Strat?

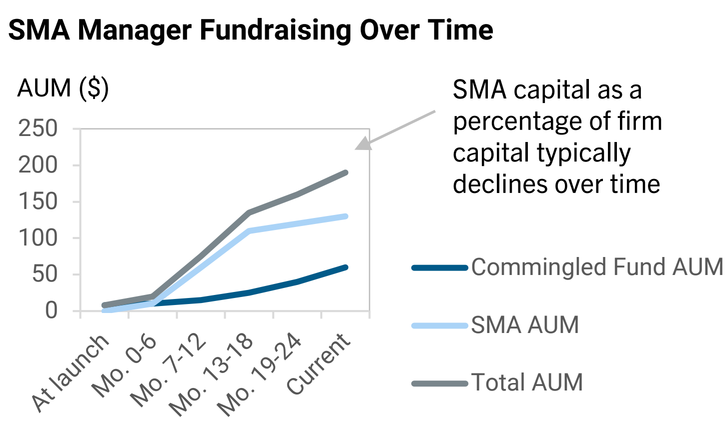
Given the rise and growth in multi-manager shops, which **averaged +6% performance in 2022,** investors, via SMA platforms, are strategically creating 'in-house' multi-manager shops through separately managed accounts with various hedge fund managers. [43] While the SMA model is not a fit for every manager, in 2023 it's worth exploring the potential business scaling opportunities.

| Capital Raising Considerations via Separately Managed Accounts |
| --- |
| Opens additional **capital raising channels** for both established and emerging managers.<br>• Sizable and growing number of SMA platforms looking to engage in Day 1 fundraising conversations<br>• Workaround for **capacity constrained ERISA pensions** or investors with underlying clients that cannot be more than a certain percentage of total AUM |
| Increased **variety and creativity** in negotiated terms & fees can result in better alignment and partnership with LP's. |
| Investors take on ***most*** operational needs – typically choosing the service providers and setting up the structure. This can be additive to funds with smaller operations teams and outsourced solutions. |
| As the account (and asset) owner, investors typically have **full transparency** into the portfolio. These groups may inquire about positioning and liquidity as an additional risk management overlay. |
| Taking an SMA does not necessarily mean that continued AUM growth will skew heavily to SMAs or that commingled funds will struggle to raise assets. |

CHART 12

SMA Fundraising – Compare and Contrast to Commingled Funds




Source: Jefferies Capital Intelligence

## The Capital Raising and Retention Checklist for 2023 and Beyond

When market conditions change, the competitive landscape and where you fit in it can change. We all know managers who say they do the same repeatable process across market cycles. In some cases, this is clearly true. For others, during periods of transition and regime change, how your story and value proposition is articulated needs to change as well.

We are finding a number of managers are working hard to gather intel on changing competitive landscapes. They want to understand how certain strategies are growing, who the dominant players are and what are the basic business models in 2023. And they're looking not only across the *external* landscape, but they're doing deep dives on their own LP base and pipeline to ensure it is stable, diverse, and growing.

## The Capital Raising and Retention Checklist

- Does your capital raising strategy serve 2025…or 2020?

  A lot has changed in the last three years around travel, in-person due diligence, virtual first meetings and the importance of conferences – not to mention changes in geopolitics and sanctions, interest rates and inflation. Ensure that LPs and prospective LPs haven't materially changed *their* approaches.

- Review your current LP base

  Where is it concentrated? Are any of your partners inflation sensitive? Could geopolitical events or volatile markets challenge any current or potential LPs?

- Review your most recent allocations

  Are there patterns among allocator type or region? Are they initiating new tickets or incremental adds from old partners?

- Examine your pipeline

  Is your pipeline diverse or concentrated? Should you use new conferences or cap intro in 2023 to develop this?

- Revisit your approach to communication

  Are your investor letters getting lost in your LPs' inbox? Has your communication plan kept pace with post-Covid norms and what your competitors are doing? Things as simple as cybersecurity and firewall upgrades can increase the odds of communications getting lost – or not even going through in the first place. Ensure what you're saying is landing and being heard by your target audience.

# Asset Allocation Around the World

Despite – or perhaps in part because of – the permacrises of 2022, people started getting on the road again. **The Jefferies Capital Intelligence team logged more than 100,000 miles across nearly 30 cities globally** to meet face to face with managers and allocators and get a true sense of industry themes amidst transition.

Looking forward, uncertainty is here for at least the short term, but we can reflect on 2022's takeaways from across the globe to better formulate our plans to engage with partners and potential partners.

## TOP 5 TAKEAWAYS FROM INVESTORS ACROSS THE GLOBE

1. **Asia on Everyone's Mind – One Way or Another**
   Asia-based investors are continuing to allocate to China, although Asia ex-China is an emerging trend amongst U.S. investors, and we have seen an uptick in interest in India opportunistically in 2023.

2. **Rise to Prominence in the Greater Middle East and Israel**
   More accommodative regulatory environment across the region, dominance of the Israeli tech ecosystem, and dry powder from the local sovereign wealth funds have increased the economic attraction to the region. We are also seeing a growing number of managers opening offices in Dubai.

For more information on any of these regional investor perspectives – contact your Jefferies salesperson.

3. **US East Coast Interest in Multi-Strats**
   From the tri-state area to 'Wall Street South' in Florida, multi-manager, multi-strategy shops are sweeping up investor dollars and top talent… if you can get in.

4. **US West Coast Interest in Specialty Finance**
   A market with oversized exposure to tech equity through adjacent industries– from Biotech to Crypto, seeing a pivot to specialized, alternative asset classes, through private credit and direct lending.

5. **European Investors Long for Liquidity**
   2022 was a year defined by distinct uncertainty and disparate asset performance across Europe, drawing investors to UCITs, a well-regulated investment product that offers flexibility and attractive liquidity terms.

## TOP TAKEAWAYS FROM REGIONS ACROSS THE GLOBE

**Oslo & Copenhagen**
Nordic allocators concentrate in the same “blue chip” multi-billion dollar funds. The region is well-positioned for:
1) Multi-Strategy funds 2) $1-5bn+ Macro or Equity Long short managers with excellent pedigree.

**Singapore**
Investors are mostly interested in Distressed & Private Credit, Multi-Strategy, Low Net Healthcare/TMT & Event Driven. Asia based investors may be adding US exposure, but they are not reducing China/Asia exposure. They are short term and medium term bullish on the region, but want to be more geographically balanced over the long term.

**Atlanta**
Atlanta investors indicate interest in Healthcare – with a focus currently on lower-net, non-directional biotech was the primary mandate.

**Cincinnati**
Investors are looking for Multi-Strategy and Multi-PM platforms and for private investors. Cincinnati investors are more conservative about actively allocating right now as they are overweight and have concerns about illiquidity.

For more information on any of these regions – contact your Jefferies salesperson.

**Nashville**
Nashville investors have a current interest in Healthcare, and prefer long-biased. Clear interest in Multi-PM or Multi-Strategy exposure.

**Richmond**
Investors in this region continue to be relatively concentrated. Investors have consistently mentioned that they are looking into or have actively allocated to Multi-PM or Multi-Strategy managers. Some investors in the region are seeking market neutral strategies and simultaneously reducing long-biased exposure.

**Seattle**
Seattle allocators generally had an interest in Direct Lending and Specialty Finance, but are keeping an eye on the Credit space broadly.

**Oklahoma**
In terms of sector specialists, Energy Transition was a recurring theme across investors, with additional interest in Digital Health and Biotech. Hedge fund allocators in Oklahoma have established portfolios, with a number working with consultants.

## Understanding the Active Secondaries Market

Another active corner of the alternatives market has been in secondaries. The Jefferies Private Capital Advisory Team recently released its Global Secondary Market review, and noted:

- **Global secondary volume was $108 billion**, which makes 2022 the second biggest year on record. **LP portfolios accounted for 52% of volume**, representing a larger share of the market than GP-led transactions for the first time since 2019[44]

- **GP-led volume was $52 billion**, as transactions involving high-quality, recession-resilient buyout assets continued to be in demand[45]

- Most LP sellers sought to rebalance their portfolios given overallocation to private equity, and **approximately 50% of all LP sellers were first-time sellers. LP portfolio volume was $56 billion**[46]

- **Average pricing for LP portfolios was 81% of NAV**, representing a 1,100 basis point decline from 2021 pricing, primarily due to a growing disconnect between public and private company valuations[47]

- The ratio of available capital to LTM volume (capital overhang multiple) increased to 2.1x by the end of 2022. Despite buyers ultimately raising larger secondary funds, the fundraising environment was more challenging in 2022, causing buyers to become increasingly selective[48]

Please contact your Jefferies salesperson to learn more or be connected to our Private Capital Advisory group.

## Resetting Cybersecurity and Compliance

In 2022, the SEC proposed more new rules than it has in decades, harvested more in fines than it has in years, and oversaw a number of new regulations going live.

Managers across the board are gearing up for a more active regulatory era, after a relatively more muted one. In the first 8 months of 2022, **the SEC proposed 22 new rules and regulations, far exceeding recent years.** This is one of the many corners of firms' operating footprints where managers are expecting costs to increase in the coming years and is prompting a reassessment of resources focused on the regulatory and compliance function.

Adding a layer of complexity is the agency's proposed rules around cybersecurity. Especially in the wake of Covid and the growth of remote or hybrid work, firms have had to upgrade their cybersecurity processes.

**SELECTED 2022 RULES AND REGULATIONS IMPACTING MANGERS**

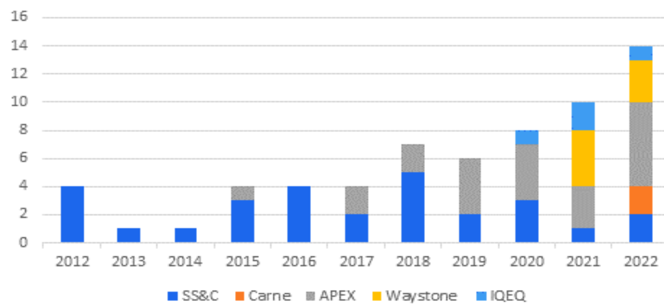
| Rule | Affected Decision Makers |
|---|---|
| **SEC Cybersecurity Regulation**<br>**March 9, 2022** | All decision makers, but especially IT/technology, Compliance, General Counsels and Chief Operating Officers |
| **SEC Proposal Amendment to Fund Naming Rule**<br>**May 25, 2022** | Founders, Marketers, Investor Relations professionals |
| **SEC Communications / Devices Rule**<br>**August 2022** | All Employees |
| **SEC Rule Requiring Service Provider Due Diligence**<br>**October 26, 2022** | Decision makers who engage with Third Parties |
| **SEC New Marketing Rule**<br>**November 2022** | Marketers, Investor Relations professionals, Founders |

## Understanding the Third-Party Solutions Landscape

In order to understand much of the shifts in operating footprints, it helps to understand the changes in the third party and service provider landscape. As funds **are chasing efficiency through technological advancements, they** are increasingly **leveraging fund administration tools** and services such as treasury and cash management modules. The impact of this evolution is providing industry players with increased optionality going forward. Selecting a fund administrator requires careful considerations regarding cost vs. performance, service, and understanding how the account will be serviced in years 3, 5, 10+.

**CHART 13**

**Number of Acquisitions**




Sources: Fundrecs, Allvue Systems, Jefferies

**M&A in the service provider landscape has** propelled platforms as robust **one-stop-shop solutions** for alternative funds providing offerings from fund compliance, operations, marketing, and administration. It has also allowed for providers to expand the breadth and location of these offerings showing presence across various locations and lines of business. Platforms focused on **seamless & full integration** on deal-closing are viewed as the emerging leaders.

Across the outsourced COO and CFO space, there have been several acquisitions into larger admins. In the compliance landscape, acquisition of larger groups and some outsourced COO/CFO groups are growing a compliance offering as well.

**Potential benefits of "one stop shop model"**

- **Streamlined processes** for the client
- Better **negotiating and** pricing power
- More meaningful as a client overall
- Access to **expertise and resources** across a broader organization
- **Lower cost** to bundle services
- **Less time** spent on due diligence providers

**Potential drawbacks of "one stop shop model"**

- **Aggressive cross-selling** can be confusing for the client
- Some managers may **want a greater separation** of church and state and more **diversification amongst their providers**
- Sometimes there's a **greater comfort level with a firm that is focused on one thing** – i.e., independent compliance consultant, etc.

**Expanding Footprints**

- More lines of business in different locations can allow for clients to use as **they scale globally.**
- Difficult times in the talent market may allow for teams to become more successful in **growing number of employees through an acquisition**.
- Many have focused on building unique investor service portal interfaces, and on developing a proprietary general ledger. **Most fund administrators have their own proprietary system**, with a few utilizing Geneva.

The middle office functions include all post-trade and pre-settlement services such as P&L reporting, corporate action processing, and cash management. This function has been a focus area for many years in the fund administration space, but commonly, groups now have a sufficient middle-office offering either in-house or outsourced which is less common for the space. The items including in this offering vary across providers as many chose different definitions.

## Next Generation Operational Due Diligence – Building Relationships to Drive Efficiencies

The ability to underwrite new investments in the asset management industry has historically been based on a combination of in-person meetings supported by heavy documentation. The COVID pandemic prompted the entire industry to question existing assumptions and processes and find innovative ways to get comfortable conducting due diligence when on-sites were no longer a possibility. Now, as we move out of a world dominated by COVID restrictions, the transition to the "Future of ODD" has begun. And while there has never been and will never be a one size fits all solution, there are some consistent themes that have emerged.

| Pre-Covid | March 2020 - January 2022 | 2023 and Beyond |
|---|---|---|
| **Onsite viewed as standard part of Due Diligence Process**<br>• "No exceptions mentality"<br>• "I would never be able to invest in a manager without conducting an onsite first" | **Early Covid heavy reluctance to conduct new diligence without a traditional on-site meeting**<br>• Similar hurdle existed on the talent side where many employers hesitated to hire people they had never met in person | **Shift to relationship building focus**<br>• ODD teams want to strategically meet with managers, exchange best practices, create a relationship based on true collaboration |
| **Sharing Sensitive Information**<br>• Documents such as compliance manuals, lifecycle of a trade workflows were typically shared "across the table" at these meetings and then taken back | **Innovation driven by fiduciary responsibility** enabled ODD teams to get comfortable conducting due diligence fully remotely, on both new and established managers<br>• Increased use of data rooms<br>• Heavy referencing<br>• Increased collaboration and information sharing across the ODD community | Most important going forward for **underwriting new relationships** – specifically:<br>• Evaluating inter-team dynamics<br>• Assessing talent<br>• Observing office culture and working environment |

**Risk and Efficiency – Defining the Future of Travel**

While there has always been a risk-based component of conducting operational due diligence, there was also a greater level of standardization pre-pandemic that ODD teams are now re-evaluating.

- **Re-focus on a true risk-based approach** to determine how frequently travel and in-person meetings need to be conducted. Most organizations are still currently evaluating what cadence – whether an annual, bi-annual, or less frequent in-person meetings will be required.
- The **time and cost efficiency factors** are also significant factors in how ODD teams are evaluating the way forward – with some **consultants now charging a premium for going on-site**.

# Optimizing Your Wallet in 2023 and Beyond

Like nearly every facet of running an alternatives business in the 2020s, the counterparty landscape has changed materially in the last five years. With some providers stepping back or de-emphasizing offerings and others who have become resurgent after building new businesses in the 2010s, firms are revisiting their counterparty relationships to ensure they are maximizing relevance and bang for their buck.

As firms grow (or contract), it becomes important to review counterparty management to ensure your wallet is being leveraged in ways that best benefit them. Often, counterparties' *own* business objectives and mix of business can change across cycles, and **in periods of transition like this, it's important to sit across the table from them** to understand *their* goals and objectives for the coming years to ensure relationships built over time are still in equilibrium.

**Revisiting Counterparty Relationships in 2023 and Beyond**

### What are your counterparties' objectives and desired business mix for the next five years?

The investment, risk management and market structure environments are changing materially. What needs do your counterparties have? Will this impact your firm's ability to get the service it needs?

### What are your firm's objectives for the next five years?

Has it changed, do you anticipate changes, or are you exploring new strategies or enhancements to your business model that will need additional help?

### Have there been shifts in global presence that could accrete to or draw back from the service you are receiving?

The global landscape has shifted considerably in recent years, with firms increasingly focused on (and operational in) places like Dubai, Singapore, India or Miami. In some cases, the growth of counterparties' presence on the ground or focused on these locations may help managers continue to build knowledge of these markets for investment or expansion.

### Market structure has shifted considerably – has this impacted your counterparty relationships?

Passive investing outpaced active management for the first time in the U.S. In 2022. If this continues to accelerate, how banks, market makers and broker dealers will operate will be considerably affected. Understanding the implications of this ahead of time is important for playing counterparty offense.

### Revisit your approach to communication

This is as important as maintaining robust and transparent communication with managers' LPs. Many in the alternatives fund ecosystem refer to the importance and resilience of relationships and a "relationship business." But that doesn't mean that the shape of relationships doesn't change across decades – especially during regime changes like this. In an era of: changing monetary policies, fiscal policies, geopolitical relationships and market structure, understanding how your counterparties are being impacted and are planning ahead is critical.

## Looking Ahead: What Is Hiding in Plain Sight Now?

Each new year brings successive surprises: 2022 witnessed explosive interest in crypto, investors drawing hard lines on ESG, and ongoing attraction to private investing.

Here we lay out potential things that are "hiding in plain sight" for 2023 and beyond.

- **Shifting views on company headcount.** While rising inflation and recessionary concerns swarmed headlines, our jobs market has never been stronger. The tech layoff story paints a pessimistic picture, but we've seen a narrow range of **3.5% to 3.7% unemployment since March.**[49]
- **Continued hedge fund outperformance.** In one of the worst performing years for the broader markets, hedge funds protected investor capital and saw **record outperformance.**[50] Some of the most liquid products up last year were a sigh of relief for investors and triggered reconsiderations of the role hedge funds play in portfolios.
- **Entrepreneurs will come to market.** In one of the most challenging years to start a business, dozens of founders were driven by market opportunity to **launch their own hedge funds,** and we see a strong pipeline of pedigreed new launches into 2023**.** New entrants are a sign of health and resiliency in any industry.
- **Rebound in Biotech.** Over the past 2 years, bad science was funded, and biotech valuations tanked… but positive clinical data readouts turned the corner in 3Q 2022, **hitting a 2-year record.**[51] Could we start to see more positive readouts and market reactions?
- **Mega cap tech implosion and comparison to 2000.** Of the largest 1,500 companies by market cap in 2021, 200 (or 13%) were unprofitable in the prior 3 years. May see a paradigm shift to emphasis on the profitability of investments in tech.[52]
- **Rise of India**. India GDP is expected to double by 2031.[53] Appetite for APAC investment remains, but there may be new beneficiaries in the post-COVID era.
- **Lower market volatility.** After considerable drawdowns and record intraday volatility, equity markets may remain muted and range bound. Allowing traders to focus more on blocking & tackling.
- **Leadership changes coming faster -** the average tenure of an S&P 500 company is expected to decline from 24 years in 2016 to 12 years by 2027.[54]

## How Jefferies Can Help

Jefferies Capital Intelligence team works to provide clients with cutting edge insights to help run more efficient and profitable business across their life cycle.

In this period of transition, we work across our Strategic Content, Business Consulting and Capital Introductions teams to source and synthesize data and insights to help decision makers focus on what's important and minimize noise. Much has changed in the alternatives industry since the last economic downturn and many firms are revisiting basic assumptions to optimize their business models.

If you have any questions on the above, or if we may be of assistance as you work through questions around how to reset your operating footprint, upgrade your capital raising and retention strategy, or enhance your approaches to human capital, please let us know.

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[1] HFR
[2] Factset
[3] Ibid
[4] Ibid
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