

# Jefferies Prime Services Monthly

OCTOBER 2017

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# Jefferies

## Life Ain't a Track Meet, It's a Marathon

It's been said the last 6 miles of a marathon are the hardest. As we enter Q4, here is some of what we're focused on as we head towards the 2017 finish line.

- 1. Staying focused on performance** – the year began with numerous headlines focused on perceived and persistent hedge fund underperformance. But we closed September with the average Equity Long/Short Hedge Fund up +9.76% YTD - nearly double *all* of 2016, and considerably higher than the slightly down average numbers of 2015. Macro has had a harder go, down slightly YTD, with a handful of managers down considerably more than that. Event Driven has kept up, with the average fund +6.19% YTD, and considerable dispersion. Finally – Relative Value funds are up +4.01% YTD. Many firms are also posting strong double digit returns and are hopeful the last few months of the year will bring continued positive results.\*
- 2. What's your benchmark?** We've had numerous conversations recently around asset allocation and benchmarking. As investors continue to evolve and iterate their portfolios, identifying the best benchmark for their particular strategy and long term goals can be challenging. Despite the media's tendency to reference S&P performance as if it serves as one of the main benchmarks measuring hedge funds, allocators and funds rarely – if ever – use a broad Equity index as a primary benchmark. The most common? Proprietary blended benchmarks or broad based hedge fund ones like HFRI. It makes no sense to benchmark a marathon time versus an Ironman time, and yet many people do exactly that when evaluating alternative investment performance.
- 3. Legends aren't born. They're made.** Whether on a 26.2 mile course or across the many years of an investing career, endurance is a critical component of each long term success story. Interestingly, we've heard of a number of funds working with crisis consultants to conduct various simulations – to plan how to react in various acute situations and build 'muscle memory' in how to deal with them. Future crises rarely look like the last, and a number of firms report having learned valuable lessons in how to deal with investors, each other and even the court of public opinion through these exercises.

\*All performance numbers from HFR Indices

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Jefferies - Capital Introductions September & YTD 2017 Performance		
Strategy	Sept-17	YTD 2017
HFRI Event Driven	0.94%	5.85%
HFRI Macro	-1.21%	-0.53%
HFRI Relative Value	0.52%	4.10%
HFRI Equity Hedge	1.37%	9.63%
<b>HFRI Fund Weighted Composite Index</b>	<b>0.46%</b>	<b>5.70%</b>

Source: HFRI

## It's Not You, It's Fees.....

Given the considerable focus on terms and fees, we recently conducted a deep dive on various term and fee structures **across 200 funds who launched from 2013 – 2017**.

The perceived compression in fees is clear and measurable, and there has been a material shift towards streamlining share classes.

While this study focused on new launches, **it is clear terms, fees and expenses will remain in focus for 2018**. Now is a good time for managers to re-examine their own and ensure they can clearly and effectively communicate their unique value proposition, and why their charge and spend ratio suits their firm.

### New Launch Management and Performance Fees 2013 - 2016

	Founders Share Class		Main Share Class	
	Management Fee	Performance Fee	Management Fee	Performance Fee
Max	1.50%	20.00%	2.00%	20.00%
Avg	1.50%	17.00%	1.70%	19.00%
Min	1.00%	10.00%	1.00%	10.00%

Source: Jefferies Prime Services

The most material moves have been in management fees. Average management fees have compressed in Founders' Share classes, on average, to 1.30%, and in Main Share classes from 1.70% to 1.50%.

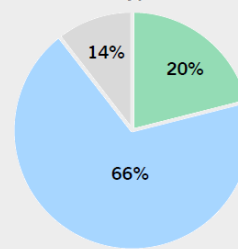
### New Launch Management and Performance Fees 2016 - 2017

	Founders Share Class		Main Share Class	
	Management Fee	Performance Fee	Management Fee	Performance Fee
Max	2.00%	20.00%	2.00%	20.00%
Avg	1.30%	16.70%	1.50%	19.00%
Min	0.00%	10.00%	0.00%	15.00%

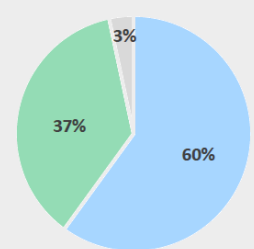
Source: Jefferies Prime Services

Firms are also more commonly offering two share classes – Founders and Main, nearly one-third of the time.

New Launch Hedge Funds by Share Class Type 2013 – 2016



New Launch Hedge Funds by Share Class Type 2016 – 2017



Source: Jefferies Prime Services

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## Expert Corner

### Q&A with Peter Greene of Lowenstein Sandler

#### LEGAL/REGULATORY ISSUES & THE RISE OF DATA

On September 26<sup>th</sup>, the Jefferies Capital Consulting team hosted **Peter Greene, a Partner with Lowenstein Sandler**, to dig into some of the legal and regulatory issues that emerge with the rise of data. A summary of the questions and themes explored follows.

**1. We've entered a new era in which investment managers now frequently explore and onboard alternative data sets as part of their investment process. What are the broadest implications from a legal and compliance perspective?**

Purchasing and using alternative data sets requires the same – if not a higher – level of consideration from a compliance perspective as any other sources of information, because of contract, privacy, piracy, copyright and, especially, insider trading concerns.

**2. Let's start with insider trading. What issues do alternative data sources raise from an insider trading perspective?**

When we conduct an insider trading analysis, we examine: i) materiality, ii) public versus non-public and iii) whether the information was misappropriated or obtained in breach of duty. Each are important, but the government must check all three boxes in order to prove an insider trading case. Materiality is the most straightforward – as the majority of managers probably aren't accessing or paying for data that isn't material. Non-public issues raise questions around whether the information is truly public, how many individuals access these data sets (exclusive vs. semi-exclusive), how the data was obtained, who the 'end owner' of the data is, among others. Finally, it's important to determine if a breach of duty has occurred at any point in the collection, aggregation, sharing or accessing of the data.

**3. That's a lot – it seems like there are a lot of compliance dimensions to the data question.**

There are. And those are just some of the questions that are relevant for insider trading laws in the U.S. We haven't even started talking about breach of contract (terms of use), privacy, piracy, or copyright laws, or the laws of other relevant jurisdictions like the EU or Singapore.

**4. Where should managers start with all this?**

From a policy and process perspective, data should be approached in the same way other forms of information make its way to the business arm of the firm. We can talk specifically about web scraping in a moment, but you should build policies, procedures and training specifically around data issues. Just one example - compliance personnel should be looped in before any data sets are onboarded – but all policies crafted around data should be thoughtful, thorough and robust.

**5. So in some sense, is "KYV" (Know Your Vendor) the new KYC?**

Well said! Data vendors cover a wide spectrum of sophistication – managers have the responsibility to understand how their data providers source, aggregate, own and distribute their data, and to ensure in the contract negotiation process, the correct reps and warranties are secured. Ideally, the CCO should get on the phone (or meet) with the provider before any data set is on-boarded.

**6. Web scraping is another data related issue that's gotten a lot of attention.**

Web scraping is one of the topics we're asked about most frequently these days, and it's certainly one for which managers need a clear policy. There should be ongoing discussion between those conducting the web scraping and compliance personnel as to the nature of each new scrape (what's being scraped, how, for what purpose, etc.) in the same way each new data set is vetted. The question of whether the scraper passes through an authentication gateway is crucial. In many cases, managers are writing brief on-boarding or scraping memos each time a new provider is brought on or a new scrape is conducted so that the process is memorialized in the event that the manager ever needs to revisit it.

**7. Data onboarding. Web scraping. Privacy. Piracy. Copyright infringement. Insider trading. The growth of new forms of data raises a lot of questions. What's the top line takeaway?**

At the top line – this is just another issue that needs to be built into compliance manuals, with policies written, procedures followed and training for staff held. Even though there is no guidance in securities law around data specifically in the U.S., what we do have is case law and rules around related issues that should be interpreted through a data-usage lens. Whether it's PII (personally identifiable information), MNPI (material non-public information) or the E.U.'s GDPR (General Data Protection Regulation), there are several issues managers should be familiar with and responsive to as they leverage new or alternative forms of data.

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## JEFFERIES CAPITAL CONSULTING NOTES

### Letters from London

The Capital Consulting team also traveled to London in October, to speak with investors, managers and other industry experts to find out what's top of mind across the pond. Of particular note:

- Considerable focus on **impact of MIFID in the middle market space**, whether on capital formation for SMID cap businesses, or increasing fixed costs at the same time fees are falling for smaller alternative fund managers, or cannibalizing the business of boutique research houses who lack a broader banking franchise to help absorb increased costs or revenue loss.
- **Good Business Development** professionals can be worth their weight in gold, and have become aggressively sought after for firms who need this role.
- **Fees are as in focus and under pressure here** as they are in the U.S. Anecdotal information about household name firms revising headline management fees down more broadly than thought.
- **It's been a more active year for start ups** than in 2015 and 2016, with considerable belief this momentum will continue into 2018.
- Trend for investors – **there is no "trend."** Highly diverse, and even organizations with similar mandates report active searches for widely divergent things, whether high gross/high returns, UCITS, niche/off-the-run vehicles or co-investments.
- **Brexit exhaustion.** This one is self-explanatory.

### U.S. Securities Lending Commentary

**GHL – 9mm share tender offer @ \$17 announced last week (25% of fully diluted shs out). Expires 10/25. Also like playing for back end downside via. conversions**

Board and Insiders will not be participating, so true min prorata equates to approx. 35%. Removing Blackrock and Vanguard gets to an approx. min of 43%

Deal is subject to financing, with commitments due for \$300mm 1L TL due 10/11. While this is highly likely to get done, we have seen some cheap protection buying in Oct 15P's (which would not encompass the close of the tender).

Stock is up from 16% from pre announce levels. Given the worsening credit profile, boards position that this is not the first step in an LBO, and elimination of dividends would expect the stock to reprice to prior levels on the back end of the deal. Conversions have traded in the \$0.15 range, which is a cheap put to convert/tender and come out short on the back end.

**MNKD** - was removed from the TA 125 index in Israel at the end of July. This is when the name was trading as deep as -250%... a lot of institutions especially in Israel had to sell out. Given price movement and volume today off the back of news assuming this will ease short term and possibly get tighter as locates come in.

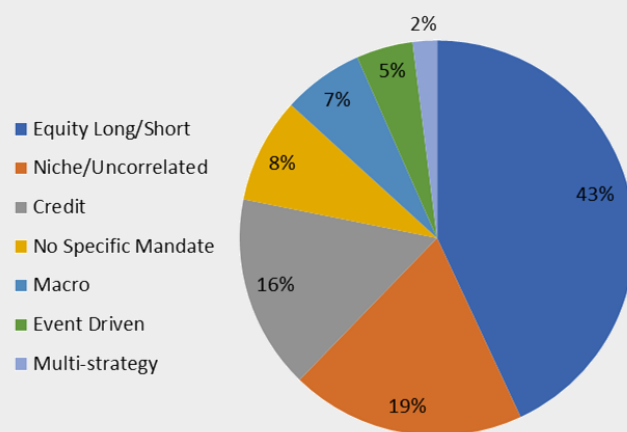
**AAOI** – We have seen a significant spike in implied short interest of nearly 55% since August 1<sup>st</sup> (7.7mm shares vs. 12mm shares). Though street average borrow costs are still in the -50's we are seeing significant jumps in overnight borrows rates, with prints as deep as -90%. With the stock selling off over \$5 over the past two sessions we anticipate further street wide recalls which should add to the continued pressure on the borrow cost which will limit short approvals.

### Capital Notes from the Mid-Atlantic

Before the trees fully change for fall, the Capital Consulting team traveled down the Mid-Atlantic to learn more about what is going on in this active region. Among the takeaways:

- **Financial Advisors are more willing to talk to their clients about hedge funds** than they were over the last few years. One private wealth platform saw inflows last month into hedge funds over \$100 MM, considerably higher than in recent months
- **Sentiment around long short funds is improving.** Given market highs and some political uncertainty, some feel there is more of a case for active management going forward, and have appetite to move money from long biased back to long/short. **The majority of investors had made at least one allocation to long short equity this year or were planning to by year end.**

Strategy Mandates for Open Searches  
Across Mid-Atlantic YTD\*



Source: Jefferies Prime Services

- **Quant continues to remain a focus.** They're following a common path of initial allocations going to household names with longer proven track records and perceived lower business risk. Smaller and emerging quant managers remain harder for allocators to justify at this point.
- **Endowments continue to increase focus on new and emerging managers** – one endowment's investment committee just approved a new emerging manager program. They will be able to allocate half size positions to a number of smaller and emerging funds to take advantage of reduced fees – a considerable focus. This new program will have a different approval process and depending on the manager's success, would eventually be considered for a larger full size allocation.
- **Asia continued to be an area of interest**, as many had traveled to the region this year, and Japan was identified specifically as of particular interest. **Also in focus: Catastrophe or Reinsurance Funds** – given recent weather related headlines and high interest in niche/uncorrelated opportunities.
- **Finally, growing interest in building new factor and risk models in house** to better understand cross portfolio risk and evaluate new funds.

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# JEFFERIES EQUITY RESEARCH DIFFERENCE MAKERS

## Top Jefferies Research Reads in recent weeks

### Leaders of the Pack:

- [JEF's Macro Weekly: Instability Brings Stability, Budget Deal by Xmas?](#)
- [FANG: Initiating on E&Ps: Best Opportunities Still in the Permian](#)
- [GOOGL: Google Picture Book: No Shortage of Value in These Search Results](#)
- [Shale is Getting Good, But Not Too Good](#)
- [JNJ: Upgrade to Buy: Pharma TIRADES to Drive EPS Growth & Dividend Momentum](#)

### Other Notable Reads

- [Reading the Yee Leaves – Top Events & Discussions for October](#)
- [Frac Stack: Initiating Coverage on FRAC, PUMP and TUSK](#)

### Global Equity Strategy\*

- We recently updated our global sustainable income basket (see [Global Sustainable Equity Income - October Basket Rebalance](#)). The below US stocks offer a stable dividend yield, capital gains and good credit scores.
- Are US equities that over-valued? We have consistently argued that in a low inflation environment, equity valuations would be driven by the performance of bond yields. In this respect, equities are not necessarily out of line with bonds. In exhibits 11 to 15 we highlight some financial ratios over time. Based on FCF yield ex-financials, the market trades in line with history and also against treasuries. Furthermore, equities look good value against real US treasury yields based on cash-flow measures. Indeed, equity valuations based on the 'running yield' – trailing dividend yield and buyback yield – are also fair value. Full note available here: [Equity Strategy: Identity Theft](#)

Sean Darby, Chief Global Equity Strategist  
Kenneth Chan, Quantitative Strategist

- Source: Bloomberg, EPFR, Jefferies. All references to mutual funds and ETFs

## Binary Banks: Virtuous and Vicious

Jefferies Banks Analyst, Ken Usdin, published a Franchise note looking at Banks into 2019. The run-up in bank stocks has been fueled by deregulatory signals, fiscal policy hopes, and rising bond yields. Fundamentals are steady, with slowing loan growth offset by ever-improving credit. The '19 EPS roll and rising capital return (helps growth/returns) provide room for appreciation, while the re-rating case could go further if talk turns to action. Abs. multiples are up, putting the burden on fwd. revisions and relative P/Es (i.e. sentiment).

[Access the full note here](#)

### Of note to Usdin and team:

1. Fundamental outlook for '18'19: a little different, but not much better.
2. Net interest income and provisions are likely the out-year focus.
3. Regulatory reform could help empirically and sentimentally.
4. Tax reform and rates/curve are more in the 'hoped for' camp.
5. Absolute multiples extended; relatives remain attractive.

Ken's large-cap picks: KEY for valuation, BAC/CMA/ZION for rates/other, STI for quality. Casey's top SMIDs: SBNY, WAL, FNB, IBKC. We upgrade IBKC to BUY (from HOLD) to play hurricane recovery/asset-sensitivity with optionality on tax reform at a discount multiple.

Ken Usdin

### Global Equity Strategy\*

In China, following the recent national day and mid-Autumn festival breaks, investors pumped in a net US\$1.3bn into mutual funds and ETFs, the sharpest in more than two years! Meanwhile, there was a net inflow of US\$2.0bn into China domestic shares via Northbound trades. Elsewhere, equity inflows remained intact within Latin America and EMEA. In terms of trade ideas, we maintain 1) long Japanese banks relative to the market, and 2) long Eurozone equities relative to UK equities.

Kenneth Chan, Quantitative Strategist  
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### Upcoming Conferences & Events

November 1-2	HONG KONG	Jefferies 7 <sup>th</sup> Annual Greater China Summit
November 8	LONDON	Jefferies 2 <sup>nd</sup> Annual London BDC Summit
November 15-16	LONDON	Jefferies London Healthcare Conference
November 16	BOSTON	Jefferies A.I., Blockchain and Cryptocurrency Summit
November 16	NEW YORK	Jefferies IT Services Summit
November 28	LAS VEGAS	Jefferies Public Cloud Summit
November 28-29	HOUSTON	Jefferies Global Energy Conference
November 29-30	SAN FRANCISCO	Jefferies European Consumer Conference
December 4	NEW YORK	Jefferies 2017 Bank CEO Summit
December 4	LONDON	Jefferies A.I., Blockchain and Cryptocurrency Conference
December 7	NEW YORK	Jefferies Crossover Consumer Finance Summit: Credit and Equity
December 14	NEW YORK	Jefferies Office & Industrial REIT Summit

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