Jefferies Halftime Report

Hedge Funds Navigate Uncertain Markets

Whiplash defined markets in 2022.
This year hasn't been much different.

Strategic planning for ongoing shifts in the markets, portfolios and asset allocation has risen to the top of many decision makers' to do lists, even as volatility has eased.

The war for talent is real, pervasive and unrelenting. Identifying, interviewing and onboarding talent remains a challenge even for the most well resourced of firms.

Strategic growth is often coming from Separately Managed Accounts (SMAs), and the increase in Managed Account Platforms is a notable and material trend for the industry.

Articulating your value proposition in a rising rate world is critical for fundraising. It's been over a decade since persistent mid-to-high single digit rates dominated discussions. Funds that claimed similar returns are now in a position of justifying their performance in an environment where risk-free, fee-free returns are also available.

The second half of the year **may witness a slowing in new allocations** on the back of uncertainty around the markets, the opportunity cost associated with staying with a manager way under its high water mark, and potential need for liquidity.

2022

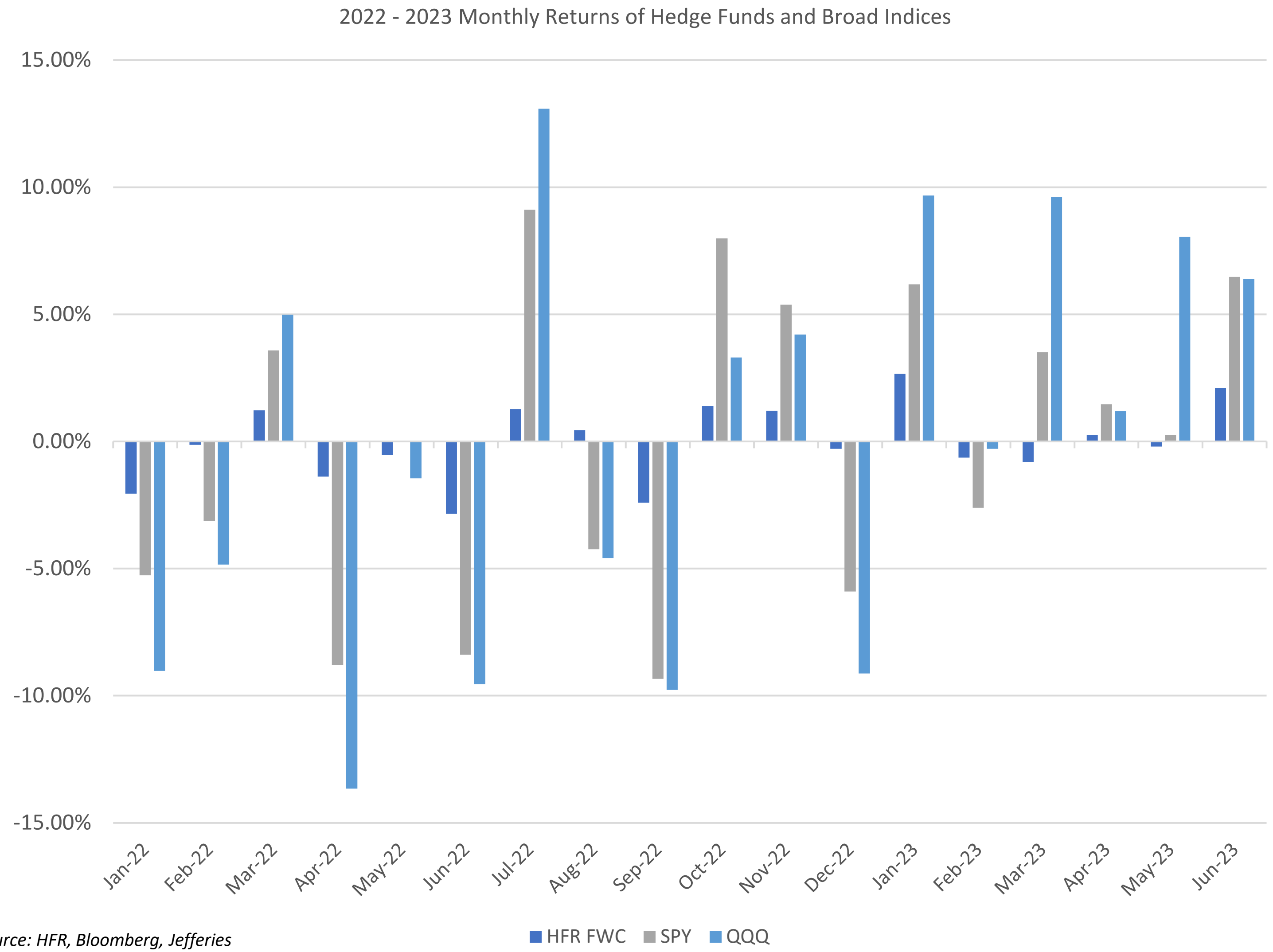
- **S&P**: Worst 1st half since 1970
- **BTC**: Biggest monthly drop in June since 2011
- **ESG**: First retail outflows since 4Q2018
- **GDP:** U.S. economy contracts for two consecutive quarters (1Q, 2Q '22)
- **USD:** Dollar strengthening creates headaches for emerging markets and some corporates
- **CPI:** U.S. inflation surging to 40 year highs
- **VOL:** Elevated and hovering near 25

2023

- **QQQ**: *Best* 1st half ever
- **BTC**: Rebounds to hover near $30,000
- **ESG**: Appetite for ESG funds split – with ESG bond funds experiencing four straight quarters of inflows while equity funds saw outflows in 2Q23
- **GDP:** U.S. economy grew at a 2% annualized pace in 1Q23 on the back of 2.6% growth in 4Q22
- **USD:** Dollar strengthened in May and June after notching 20 year high in 2022
- **CPI:** Annualized inflation in the U.S. cooled to ~3% in June
- **VOL:** Declined to multi-year lows, trading below 15 for the first time since 2020

With higher rates and rebounding equity markets, hedge fund performance has been challenged

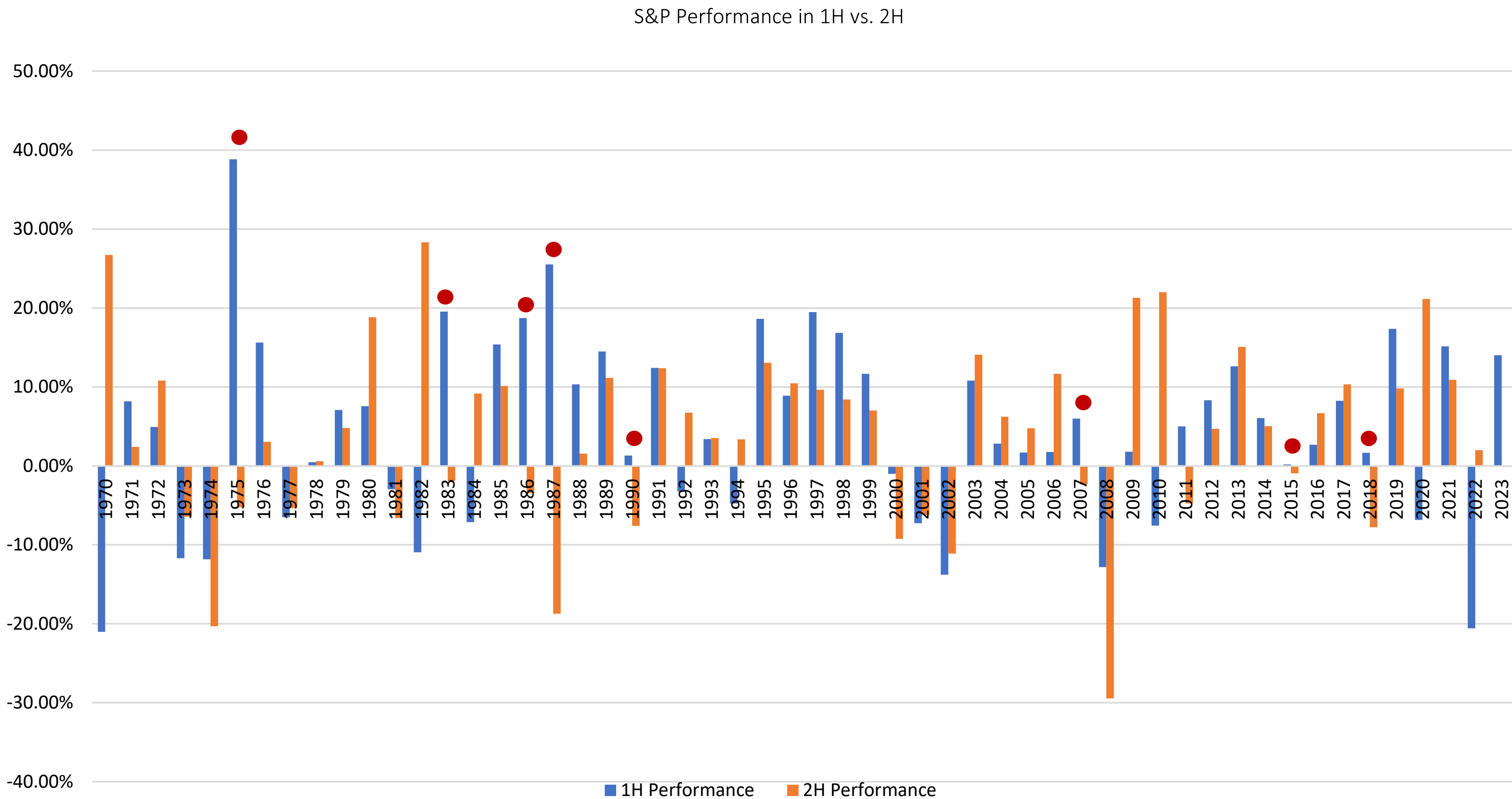
- With tech stocks powering ahead, hedge funds struggled to keep up
- Coming off the best year of outperformance since 2008, funds are working hard to navigate an environment with both rising rates and a solid showing for equities, creating a tough environment for shorting
- The HFR Fund Weighted Composite reflected a 3.36% gain through June



Source: HFR, Bloomberg, Jefferies

How are investors thinking about a potential second half rebound?

- Since 1970, the S&P has had a positive first half **more than 35 times**
- In about 8 **of those cases, performance turned negative for the second half** – most notably in 1987 in the wake of the Black Monday market crash (but even in 1987, S&P was positive for the year, +2%)



Source: Bloomberg

● Signifies years with positive 1H S&P performance but negative 2H

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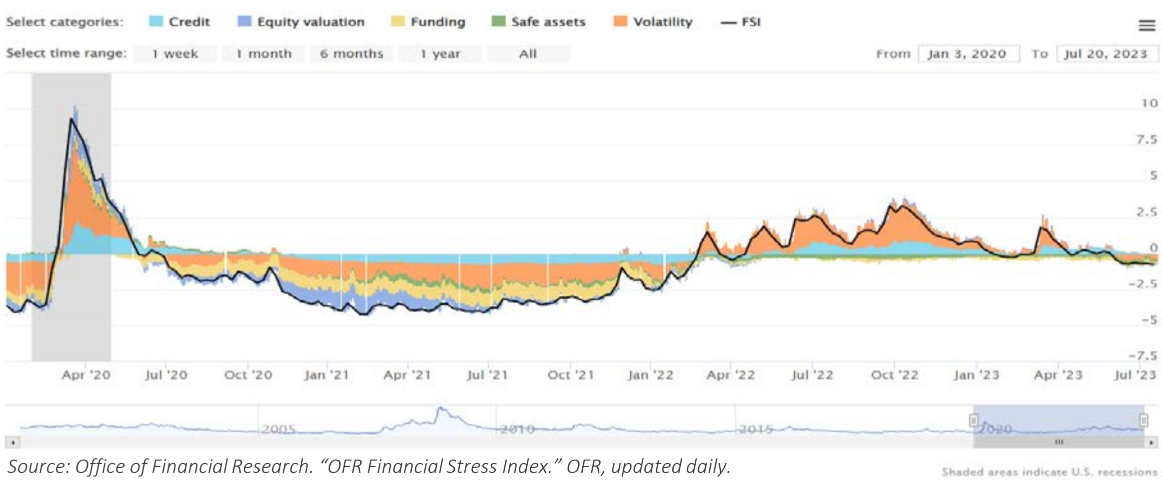
What may impact second half performance?

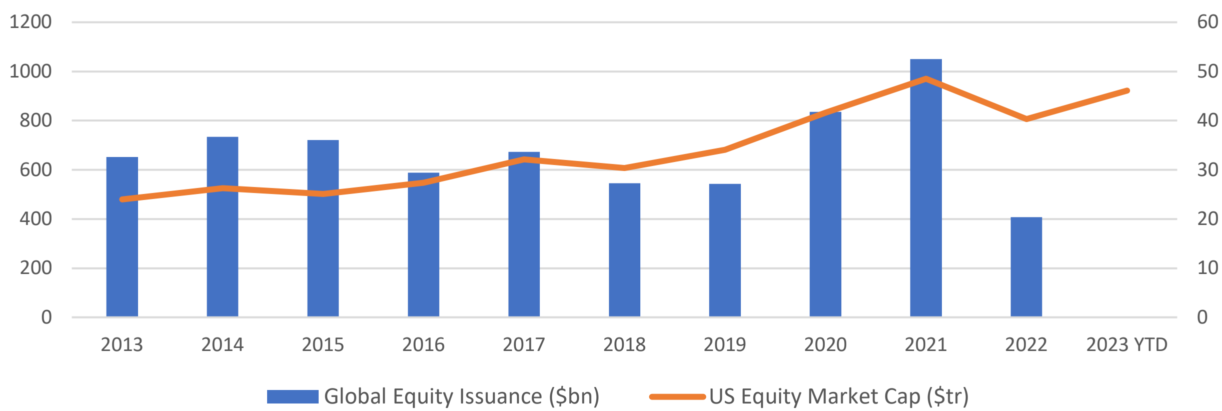
- As of July 25th, the Office of Financial Research's Stress Index is suggesting that market stress "is at normal or below normal levels." But investors are split on what may lie ahead.
- There may be green shoots in the issuance market, with recent performance of IPOs, but questions remain about the durability of 1H23's rally in the U.S.

Office of Financial Research Financial Stress Index



Source: Office of Financial Research. "OFR Financial Stress Index." OFR, updated daily. https://www.financialresearch.gov/financial-stress-index/ (accessed Tue. Jul. 25, 2023).

Global Equity Issuance and U.S. Equity Market Cap



Source: 2023 SIFMA Capital Markets Factbook

- What is the opportunity set and potential future equity issuance?
- The Office of Financial Research's Financial Stress Index shows a retreat across metrics, after the last year of heightened stress across categories
- The gauge is now "at normal or below normal stress levels"
- With the rebound in U.S. stock market, U.S. market cap has surged back towards highs, but across an increasingly small number of companies
- The U.S. has maintained its nearly 40% share of global market cap since 2014, as the EU's contribution has shrunk from 17% to ~11% and China's has doubled from 5% to more than 11%

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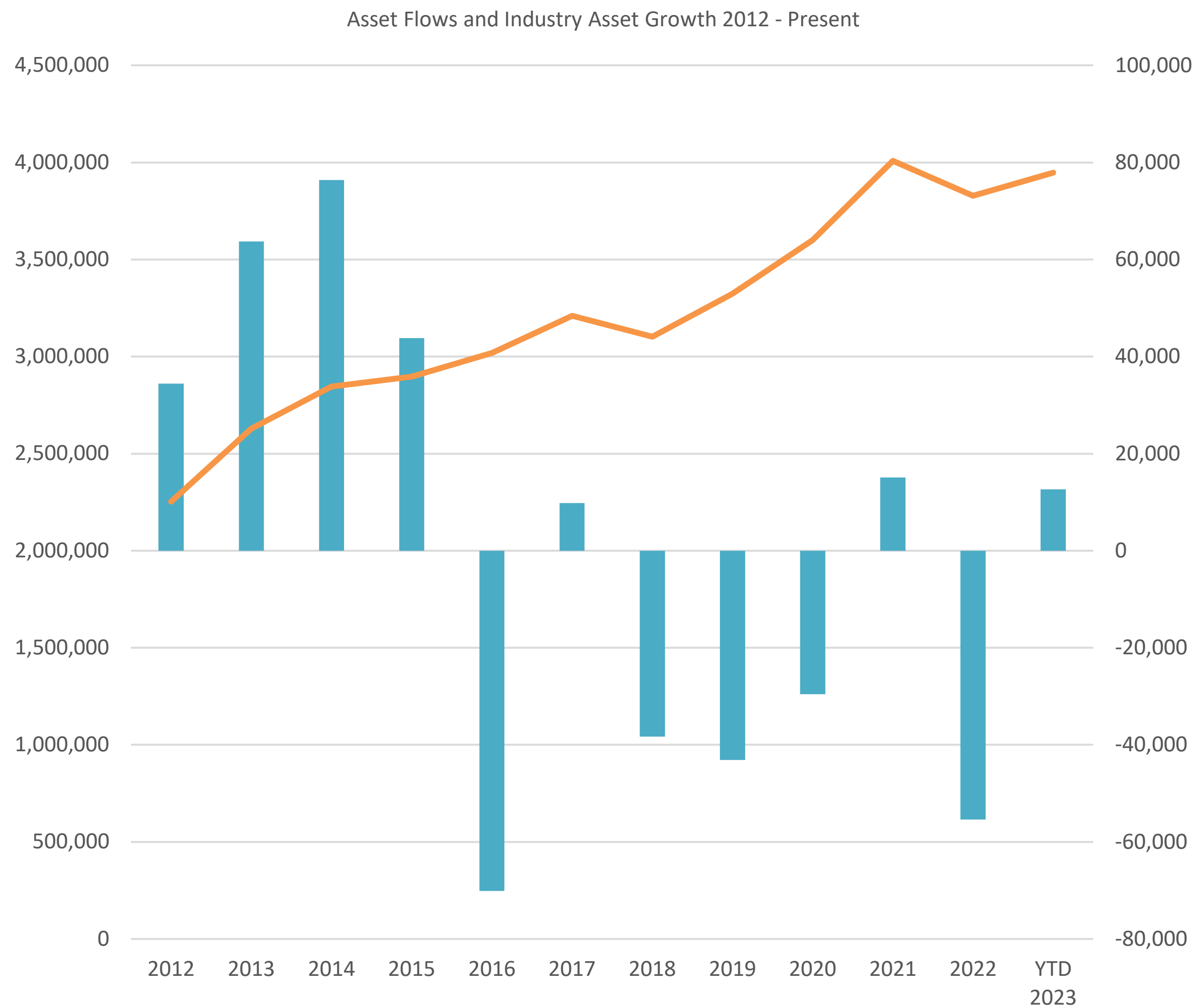
Hedge funds notched reversal of outflows, attracting nearly $13 billion of new assets in 1H2023

- Hedge funds have created nearly $800 billion in value since 2018
- Industry assets are hovering near all time highs at $3.95 trillion – positive performance in Q3 could vault industry assets to all time highs over $4 trillion
- After experiencing three consecutive quarters of net outflows in 2022, funds welcomed net inflows in both Q1 and Q2 in this year
- Despite allocators' uncertainty, many report increased appetite for hedged vehicles; however, the time it takes managers to earn new allocations can be long
- In a higher rate world, with resilient equity markets, funds are increasingly required to articulate their value proposition in this new environment



Source: HFR, Jefferies

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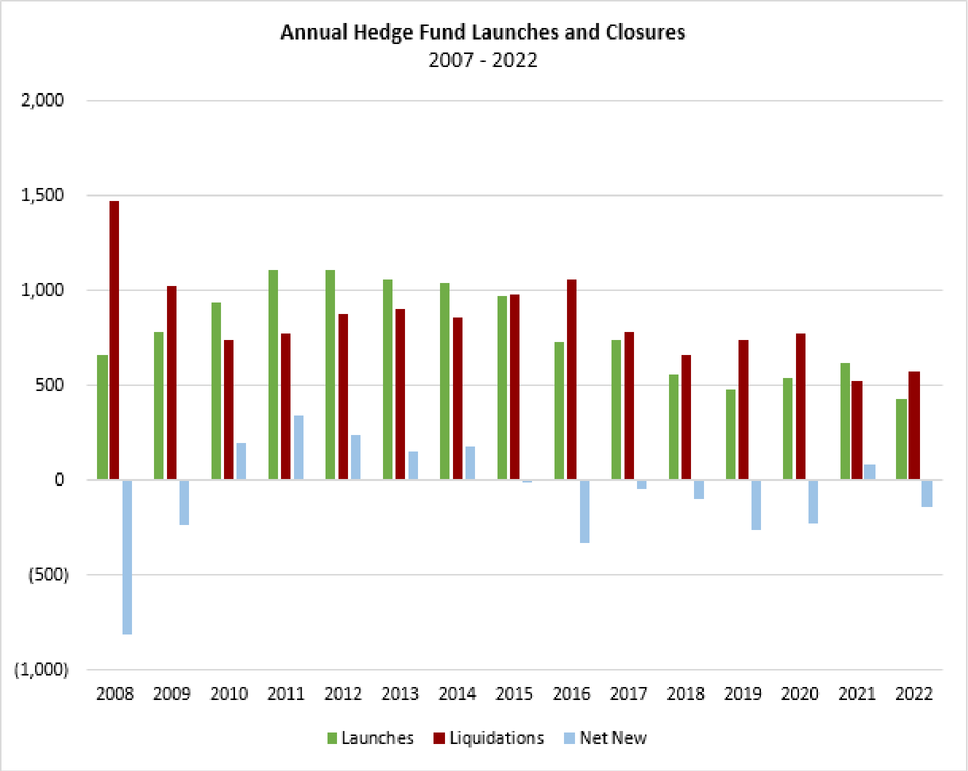
Launches are off highs of ten years ago, but liquidations are also near the lows

- With the overall number of funds remaining steady at ~8,200, new entrants continue to emerge
- While net new launches turned negative last year, liquidations overall remain near decade lows
- However, the pipeline for launch ahead of 2024 remains robust, as founders wait out non-competes
- The pendulum has swung strongly with momentum behind multi-manager/platform organizations, as they have grown significantly by both assets and headcount, potentially affecting the launch landscape



Source: HFR, Jefferies

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What has the first half of 2023 indicated as the path forward for hedge funds?

TAILWINDS

- Hedge funds continue to protect capital with positive returns YTD and some stand out performance across strategies
- Fundraising has rebounded after three quarters of outflows in 2022, with funds welcoming more than $12 billion year to date
- Nearly 500 new funds launched in 2022, off the highs and nearly half of funds launched in 2011 and 2012 – but the number of liquidations are also half of those in 2015 and 2016
- In the secondary market, the Jefferies Global Secondary Market review reports for the first half of the year, LP portfolio pricing rebounded, GP-led activity remained robust and dedicated available capital holds steady
- On the back of one of the strongest years of outperformance in a decade, some funds continue to perform and are establishing new track records across cycles and transitions

HEADWINDS

- Overall muted performance against a backdrop of higher rates and rebounding equity markets creates questions about the enduring value proposition of hedge funds in the new environment
- The war for talent is hobbling the growth of some firms, while others are expanding headcount at a rapid clip
- Considerable uncertainty about the markets on a go forward basis has resulted in some paralysis on the part of many allocators, creating an even more challenging fundraising environment
- Rising rate environment may create considerable changes to the competitive landscape

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