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Risk Awards 2015

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Hedge fund of the year

NAPIER PARK
GLOBAL CAPITAL

Risk Awards 2015

The roll of honour

Derivatives house of the year
Societe Generale

Lifetime achievement award
Andrew Feldstein

Interest rate derivatives house of the year
Deutsche Bank

Currency derivatives house of the year
BNP Paribas

Equity derivatives house of the year
Societe Generale

Credit derivatives house of the year
Citi

Inflation derivatives house of the year
HSBC

Structured products house of the year
Bank of America Merrill Lynch

Risk solutions house of the year
Societe Generale

OTC client clearer of the year
Citi

Deal of the year
Blackstone/Morgan Stanley

Quant of the year
Mats Kjaer/Christoph Burgard

Bank risk manager of the year
Deutsche Bank

Credit portfolio manager of the year
Credit Agricole

Clearing house of the year
LCH.Clearnet

Exchange of the year
Eurex

OTC infrastructure service of the year
TriOptima

Sovereign risk manager of the year
IGCP

Asset manager of the year
DoubleLine Capital

Hedge fund of the year
Napier Park Global Capital

Pension fund risk manager of the year
PKA

Corporate risk manager of the year
Electricity Supply Board of Ireland

Sef of the year
MarketAxess

OTC trading platform of the year
UBS Neo

Single-dealer platform of the year
Deutsche Bank

Law firm of the year
Linklaters

In-house system of the year
Danske Bank

Trading technology product of the year (bank)
Morgan Stanley

Trading technology product of the year (vendor)
Algomi

Risk management technology product of the year
IBM Risk Analytics

Back-office technology product of the year
KPMG

A final flurry

Big portfolio disposals, baffling market moves, hedge funds making hay while others lost a fortune, balletic risk management, the recovery of eurozone fallen angels – for a year that was relatively quiet during its first nine months, 2014 eventually managed to generate a fair amount of drama.

Arguably the biggest story for risk managers, traders and investors was the huge intraday swing in US Treasuries on October 15, and the forces that provoked it. Press reports initially blamed it on electronic trading and thin dealer inventories, but *Risk* later pieced together a more complex tale of hedge fund crowding (*Risk* December 2014, *www.risk.net/2384515*).

At the time, confusion reined, but it was a defining moment for a number of this year's *Risk* award winners.

At Deutsche Bank, October 15 kicked off with an all-hands-on-deck meeting of senior traders and risk managers after a bank-wide value-at-risk limit was hit. A decision to slash exposure was taken quickly. The plan was communicated to Deutsche's board and the next day-and-a-half saw the bank shed roughly a third of its risk, as measured by VAR.

"In my 18 years at the bank, I have never seen such a single-minded approach to take risk down so dramatically when called to do so," says Stuart Lewis, the bank's chief risk officer.

Elsewhere, the burst of volatility and risk aversion became an opportunity. Napier Park Global Capital had been cautious for a while, viewing credit default swap (CDS) spreads as too narrow. The credit fund ventured into equity markets to execute a well-timed macro hedge in late August, and was positioned perfectly for the panic that would later hit CDS markets as spreads widened – October 14 was "one of our biggest buying days," says James O'Brien, the fund's chief executive.

In the old days, Napier Park would have had a lot more company, but O'Brien notes the field is now a lot thinner: "The banks can no longer arbitrage the mis-pricings during these sell-offs, and that's where we can take advantage." That highlights one of the themes of this year's awards – the retreat of dealers, and the corresponding advance of the buy side – with a number of the write-ups documenting the blurring, shifting boundary between the two.

But while banks certainly are retreating, that story can be overdone. In reality, dealers are part-way through deciding what they want to do, and focusing on it – take Citi's purchase of a $250 billion hedged portfolio of single-name CDSs from a European bank. Citi declined to reveal the seller, but enquiries by *Risk* journalists revealed it was Deutsche Bank.

While Deutsche wanted out of the non-cleared CDS market, Citi wanted in – sort of. The US bank acquired $450 billion of credit assets from various peers last year, but only because it believes it can use expertise gained while winding up its bad bank to recycle, compress or sell the assets at a gain. In the case of the Deutsche Bank portfolio, it has given itself six months to do so, and claims to be on track.

Societe Generale (SG) was also on the front foot, picking up four CDS portfolios worth €140 billion in notional from two European peers, taking on an inflation portfolio – not one of its traditional strengths – executing a big, creative longevity trade, and beginning the process of integrating Newedge into the bank. "SG has been consistent in doing what we are best at doing," says Didier Valet, head of SG Corporate & Investment Banking. The bank wins this year's derivatives house of the year award, and also gets the nod for equity derivatives and risk solutions.

It was not easy to pick winners. Where decisions were tight, client feedback often helped settle the issue. The *Risk* editorial team thanks all this year's participants for their time and help.

Banks were asked to submit information on their business in each of the asset class and product categories during 2014, and shortlisted companies underwent face-to-face and telephone interviews. *Risk* then gathered feedback from clients and other market participants.

The final decisions were made by *Risk*'s editors and journalists, weighing a number of factors, including risk management, creativity and innovation, liquidity provision, quality of service and engagement with regulatory issues. **R**

Risk Awards 2015

Hedge fund of the year

Napier Park Global Capital

October 14, 2014 was a day of misery for many hedge funds. Managers were desperately trying to cut losses and raise cash after a drop in oil prices and a surprise US Treasury rally upended some of the year's biggest hedge fund trades, with the collapse of merger talks between pharmaceuticals firms AbbVie and Shire magnifying the pain for some (*Risk* December 2014, *www.risk.net/2384515*).

As funds sold assets, and losses spread across the industry, Napier Park Global Capital, a New York-based hedge fund specialising in credit strategies, was similarly busy – but for very different reasons.

"It was a great time to be putting on risk," says Jonathan Dorfman, the firm's chief investment officer. "A lot of firms were desperate to lay off risk, and we were one of the few firms willing to commit capital on that day."

Napier Park focused on credit default swap (CDS) indexes, which saw massive dislocations as hedge funds rushed for the exits. The Markit CDX North American Investment Grade index and its high-yield counterpart were fairly priced in early October, according to Dorfman, with implied cumulative default losses in line with the 30-year median.

The junior tranches were trading much richer, however. "That's because a lot of credit hedge funds with quarterly liquidity were buying the first-loss and mezzanine tranches to get leverage, yield and carry. We felt they were completely mis-valuing the mark-to-market risk," says Dorfman.

Napier Park gave the CDS indexes a wide berth over the summer, anticipating that spreads would widen at the first hint of volatility. Instead, with rising geopolitical tensions and weaker economic data suggesting a potential bump in the road for markets, the firm implemented a well-timed macro hedge in the form of S&P 500 put spreads in late August.

Realised volatility in equities was still very low at the time, while the skew in options was abnormally high – a function of investors buying deep out-of-the-money puts to hedge against a 20–30% market crash.

"We felt a decline of that magnitude was extremely unlikely in this economic environment. We were worried about a correction rather than an implosion," says Dorfman.

The firm put on a bear put spread position designed to pay out in the event of a 6–17% decline in stock prices.

"The cost was *de minimis* because we got paid an excess premium for selling the way out-of-the-money options," says Dorfman.

It was the right call. The S&P 500 dropped 7.4% from a high of 2,011 on September 18 to a low of 1,862 on October 15. At the same time, CDS index spreads widened massively as hedge funds cut risk en masse.

On October 14, the Markit CDX North American indexes were pricing in a level of cumulative portfolio loss due to default in excess of the period from 2007, the start of the credit crisis, to the end of 2013.

"It was a great time to be putting on risk. A lot of firms were desperate to lay off risk, and we were one of the few firms willing to commit capital on that day"
Jonathan Dorfman, Napier Park

"Credit derivatives went from fairly valued to incredibly cheap in the space of two weeks," says Dorfman.

The first-loss and mezzanine tranches owned by hedge funds were worst hit – with valuations falling around 10% from the start of the month.

Napier Park was in the perfect position to take advantage. The firm acquired first-loss and mezzanine tranches of the investment-grade and high-yield indexes and bespoke derivatives at deep discounts from other hedge funds desperate for liquidity.

The trade was hugely profitable. The mis-pricings corrected within two weeks, with implied cumulative portfolio losses for the indexes reverting to near their seven-year rolling average by the end of the month.

All told, the firm increased its risk 20–25% in mid-October, one of the most frenetic periods of trading in recent memory. October 14 in particular "was one of our biggest buying days", says James O'Brien, chief executive of Napier Park. "We were positioned correctly going in and the structure of our funds allowed us to increase risk when everyone was selling. The banks can no longer arbitrage the mis-pricings during these sell-offs, and that's where we can take advantage." (*Risk* September 2014, *www.risk.net/2361104*.)

October was an illustration of the sort of liquidity gaps Dorfman and O'Brien have been warning prospective investors about for years. "The new regulatory framework has put an end to the sort of liquidity that was provided in credit markets historically," says Dorfman.

The result is that investors need to accept more restrictive liquidity terms, especially when trafficking in more complex and esoteric credit assets, they argue. The firm's flagship Select strategy – an opportunistic, multi-asset, multi-strategy portfolio – requires a minimum three-year capital commitment, while some of its more specialist vehicles have even longer lock-ups. Napier Park's most liquid vehicle, the European Credit Opportunities strategy, offers quarterly liquidity after an initial one-year lock-up, but was launched in September 2010, when liquidity constraints were less severe.

These liquidity terms were not always well received by investors. "A lot of people thought we were crazy when we talked about liquidity constraints in 2010," says O'Brien. "Investors asked: 'Why should we put money with you when other firms are running similar strategies with quarterly liquidity?' It made it difficult to raise assets."

In 2010 and 2011, the fund was "a lone voice" warning against liquidity mismatches in credit markets, says O'Brien. A handful of large and sophisticated investors could see the case for longer commitments, but most balked at the firm's liquidity terms, and many were still able to demand increasingly generous liquidity terms from credit managers.

"We were shocked to see so little change in the fund management community. In fact, credit managers went the other way, offering more and more liquidity to investors," says Dorfman.

That changed after the European sovereign debt crisis in 2011, when dealers explicitly rationed the liquidity provided to clients. The story was repeated in the 'taper tantrum' of 2013 and again during the volatility in October last year.

"Investors are now very aware of the liquidity problem in credit markets. They read about it in the financial press every day and many of them have experienced it first-hand. So now when we tell people we need a three-year commitment, they get it. The long-term investors don't want to take that liquidity risk in quarterly hedge fund vehicles," says O'Brien.

In some respects, the relative underperformance of some prominent credit firms has validated Napier Park's stance on liquidity. Hedge funds such as Boaz Weinstein's Saba Capital and Claren Road reported negative returns for 2014 through the end of October.

In contrast, Napier Park's family of six credit strategies was positive for the year. The firm's flagship Select strategy was up 6.45% through the end of September, while the European Credit Opportunities strategy gained 8.95%.

Some well-regarded credit firms have responded to liquidity constraints by shifting more of the risk in their multi-strategy funds into equities. Others are holding significant cash reserves to weather periods of volatility, which can be a serious drag on performance. Napier Park's solution is more direct – around 85% of its capital is locked up for two years or more.

Those terms allow the fund to make its bets more safely, says O'Brien: "There is a liquidity premium to be captured in the credit markets, but it is irresponsible to do that with short-dated capital. Sophisticated investors understand that and they're willing to make long-term capital available for certain strategies. It's a mistake to put capital at risk in the type of assets we invest in with quarterly liquidity terms. That's a liquidity trap."

This caution makes it easier for the fund to get longer-term committed financing facilities from its prime brokers, Dorfman claims. "The banks are not going to lend term to hedge funds that give quarterly liquidity. We have a huge advantage because we're more like a private equity firm in the

James O'Brien, Napier Park

tenor of our capital, so we can negotiate multi-year facilities," he says.

Having a stable, long-term capital base allows the firm to be active in "complex, highly structured, credit-intensive assets", such as first-loss and lower-mezzanine tranches of residential tax liens and small business loan securitisations, to name a couple. Napier Park is also a buyer-of-last-resort for more plain-vanilla transactions, stepping in to rescue busted securitisations on favourable terms.

The firm closed such an investment early in the fourth quarter of 2014. The US collateralised loan obligation (CLO) market had seen meaningful spread-widening as global growth prospects were called into question at a time of record issuance. Going into October, CLO new issuance outpaced inflows, leaving an overhang of deals seeking equity and mezzanine investors.

Napier Park negotiated a series of CLO equity investments on extremely favourable terms. In one instance, it struck a deal where it received 40% of the manager's fees and 95% of the originator's fees for a CLO in which it was the controlling equity investor. The CLO manager and originator were racing to close the deal in time for it to be included in the year-end league tables, so they accepted the terms.

Such transactions are becoming more common, says O'Brien. "The banks no longer originate to retain. Credit is a pure originate-to-distribute business. But when the natural buyers step away, the banks are willing to do business on very uneconomic terms."

The Select and European Credit strategies are Napier Park's core hedge fund products, and between them account for $1.1 billion of the firm's roughly $6 billion in total assets. The remainder is in a series of bespoke single-investor vehicles for large institutions, and a couple of even longer-dated funds.

Dorfman and O'Brien see lots of opportunities in niche sectors of the credit markets – rescuing a securitisation of rail car leases in 2013, for example, and repeating the trick late last year with a $2 billion airline leasing fund. The firm is eyeing an entry into middle-market direct lending, and in the closing weeks of 2014 was looking to hire a team to run that strategy. "Direct lending isn't particularly attractive at this point in the cycle, but we have a strong view that over the next five years, as we see credit risk rising, there will be lots of things to do at both ends of the spectrum – in originating new loans and working out legacy loans that have blown up," says O'Brien.

The bigger picture, O'Brien says, is that Napier Park will increasingly serve as a conduit for institutional investors to fund sectors of the economy that are no longer supported by large global banks. That could even see the firm entering the mortgage origination and servicing business. **R**

A.E. Fletcher Photography