Reprinted from
Issue 156 December 2013/January 2014

HEDGE FUNDS REVIEW

THE VOICE OF THE GLOBAL ALTERNATIVE INVESTMENT INDUSTRY

ESCAPE TO VICTORY

Napier Park Global Capital

Risk publications

With a strategy that profits from pricing anomalies in credit derivatives, six years after its founders were persuaded to set up shop in Citigroup, Napier Park Global Capital has finally emerged as an independent, employee-owned hedge fund, writes Kris Devasabai.

Hedge fund Houdinis

For one of his most famous stunts, Harry Houdini was shackled in chains, stuffed in a crate and thrown into New York's East River. He escaped in less than three minutes, to the surprise of the thousands that gathered to watch.

That was pretty much the situation in which Jim O'Brien and Jonathan Dorfman found themselves in 2010.

Bankers tend to complain that regulators have put them in a strait-jacket in an effort to prevent another financial catastrophe. But for bank-owned hedge funds – especially those running complex credit strategies such as the one O'Brien and Dorfman managed at Citigroup – the Dodd-Frank Act and its Volcker rule were more like a death trap.

Citi opted to jettison its internal hedge fund business, Citi Capital Advisors (CCA), to comply with the Volcker rule, which prohibits banks from putting more than 3% of their Tier 1 capital in alternative investments such as private equity and hedge funds. The business would have to sink or swim in a market roiled by regulatory changes such as the closure of proprietary trading desks and the move to central clearing for over-the-counter derivatives.

Surprisingly, Dorfman and O'Brien engineered a Houdini-like escape from their predicament.

Starting in early 2011, they hammered out a deal with Citi to spin off CCA as an employee-owned hedge fund firm, with the bank retaining a non-voting minority stake. The deal – which handed CCA executives 75% of the new firm – raised a few eyebrows when it was made public at the end of 2012. The press dubbed it "the great hedge fund giveaway" and practically accused former Citigroup chief executive Vikram Pandit of signing off on a sweet deal for his old hedge fund buddies.

> "The elimination of proprietary trading and the substantial reduction in risk positioning among financial intermediaries is resulting in more frequent liquidity gaps. That's a real opportunity for asset managers."
> **Jonathan Dorfman**

O'Brien and Dorfman firmly refute this. The interests of CCA's investors were the main factor in how the deal was structured, they say. Pandit wasn't involved in the negotiations, which was handled by Citi's M&A team.

"The investors had to give their consent for a change of control and they made it clear they wanted [CCA] to be a private, employee-owned business," says Dorfman. He says, given the regulatory landscape, investors opposed a sale in general – especially to another bank.

That left Citi with two options: either give control of CCA to its management team or shutter the business and liquidate its assets. "We quickly came to the conclusion that spinning out was the right thing to do," says O'Brien.

From there, the focus was on negotiating a deal that would have the support of external investors and ensuring that Citi's investments in CCA's funds was returned ahead of the July 2014 deadline to comply with the Volcker rule.

Citi was reported to have around $2.5 billion in CCA's funds. O'Brien and Dorfman decline to confirm this figure. The final deal agreed with Citi called for roughly half the bank's capital to be returned by the end of September 2013, with the remainder to follow in the next nine months.

Once the framework of the deal was in place, O'Brien and Dorfman met with CCA's investors and employees and sold them on the plan. The plan was unanimously approved and CCA officially spun out of Citi in March 2013. The business, since renamed Napier Park Global Capital, operates as an independent, employee-owned hedge fund with more than $6 billion in assets.

The transition has gone as well as could be expected. Importantly,

Jim O'Brien (left) and Jonathan Dorfman

AE Fletcher Photography

the firm continued to generate strong performance in the past three years despite the uncertainty over its future. Napier Park's funds have posted annualised returns of nearly 12% with a Sharpe ratio of 1.92 since inception, according to data collected by *Hedge Funds Review*, which puts it in the top quartile of funds reporting to the HFRI index in terms of returns and in the top decile by Sharpe ratio.

Capital replacement

The biggest problem Napier Park faced was replacing the capital that that had to be returned to Citi in the initial months. But the withdrawals were offset by around $1.2 billion in new commitments from large investors in the first three quarters of 2013. The vast majority of this new capital – roughly 90% – is locked up for three years or more.

"The quality and tenor of our capital has improved even as we've returned Citi's money," says O'Brien.

The firm's assets have remained stable at around $6.2 billion even after returning more than $1 billion to Citi in accordance with the pre-arranged schedule. This includes around $2.2 billion in collateralised loan obligations (CLOs), with another $1 billion in longer-dated private

AE Fletcher Photography

"We… combined the cash and derivatives traders into a single team. We were by far the first to do that and globalise that model."
Jim O'Brien

equity-style investments and the remaining $3 billion in market strategies. "We're succeeding in the space where private equity meets hedge funds," says O'Brien.

Free of Citi's regulatory headaches, O'Brien and Dorfman are eagerly looking to the future.

The idea is to capitalise on the regulatory pressure on the banking system by positioning Napier Park as a liquidity provider of last resort in credit markets.

"The elimination of proprietary trading and the substantial reduction in risk positioning among financial intermediaries is resulting in more frequent liquidity gaps," says Dorfman. "That's a real opportunity for asset managers with long-term capital and the ability to invest across the credit markets."

Napier Park certainly has the right credentials to do this, with teams specialising in everything from mortgage securities and municipal bonds to US and European corporate and structured credit, and more than 80% of its capital locked up for two years or more. The firm also has another $1 billion in undrawn commitments that it can call upon if opportunities arise.

So far, the strategy seems to be working. Napier Park was able to capitalise on this summer's sell-off in mortgage securities. Real estate investment trusts and over-levered hedge funds indiscriminately offloaded these securities after the Federal Reserve indicated that it planned to begin 'tapering' its monetary stimulus program.

"These securities were being sold off without much thought to their risk profile," says Dorfman. "In mortgage and structured securities, we were able to buy a number of bonds that we thought should have been going up rather than down."

There was a similar story in Europe a couple of years ago when investors started dumping European structured credit assets amid growing concerns about the continent's debt problems. "We bought a lot of European structured products on the secondary market in 2011 and 2012 at yields far exceeding anything we could achieve elsewhere," says Dorfman. Prices soon rebounded and Napier Park's European Credit Opportunities Fund finished 2012 with a gain of 56%, according to external sources.

The irony is that the same regulations that forced Citi to discard CCA are now providing Napier Park with its best investment opportunities.

The Volcker rule has made market-makers wary of carrying large inventories of corporate credit for fear the regulators will see these as speculative positions. As a result, dealers are struggling to facilitate the transfer of risk among clients in periods of market turbulence.

Dorfman thinks investors may be taking the risk of liquidity gaps in credit markets too lightly. "Credit is liquid when you don't need it to be and illiquid when you do," he warns. "Today, the market is far more prone to disruption than it was pre-Dodd-Frank."

Historically, dealers positioned their books when markets sold off, which brought some stability in times of crisis. "These days, there's no smoothing mechanism," says Dorfman.

Napier Park deals with this by raising long-dated capital from investors and limiting the use of financial leverage in its portfolios. One of the first things O'Brien and Dorfman did when they joined Citi in 2007 was to slash the leverage in its fixed income funds. After being eight times leveraged in 2007, the group had completely delevered by the time Lehman collapsed.

Risk management is based on scenario analysis. The firm looks at how its portfolios would perform in the 10 worst market events of the past 30 years and adjusts its positions to minimise losses.

"We make sure we're not overly exposed to any one outcome," says Dorfman. "A lot of hedge funds started to do [scenario analysis] after 2008 but it has been a principle of the way we've managed risk since long before the Lehman collapse."

These days, Dorfman is keeping a close eye on the Fed's expected taper, which could spark a major reversal in fixed income markets. He reckons Napier Park could profit from the transfer of risk from retail investors exiting longer-duration bonds to the insurance companies that stand ready to buy them at the right price.

The Fed's actions may also spark volatility in fixed income markets across the globe as policy-makers in Europe and Asia respond to rising real interest rates. "Everyone focuses on the risk to US bond markets, but the bigger issue is how that feeds through the global financial system," says Dorfman.

The firm is an active and sophisticated user of derivatives, which it employs to hedge risk and create tailored exposures on the long side. This goes back to O'Brien and Dorfman's many years on the sell-side at Morgan Stanley, where they played a major role in the development of credit derivatives.

Sell-side origins

Dorfman started his career in the global derivative products group in the fixed income division at Morgan Stanley in 1984. After a couple of years in New York, he worked in the bank's Tokyo office before moving to the European credit trading desk in London in 1991.

O'Brien joined Morgan Stanley a couple of years after Dorfman in 1986 and built his career in the fixed income international sales and product management group. Their paths didn't cross until 1994 when O'Brien was shipped to London to build a cash-trading business in European corporate and structured credit products.

By this point, Dorfman was running the bank's credit derivatives trading operation in Europe. O'Brien set up a meeting with Dorfman soon after he arrived in London and the pair agreed to work together rather than have the cash and derivatives groups competing for business. In 1995, they effectively merged their trading teams in Europe, with cash and derivatives traders working side-by-side.

This proved to be a visionary move. "Combining the teams significantly enhanced our ability to source, repackage, risk manage and distribute credit risk in a variety of forms," says O'Brien.

The decision to combine the teams was vindicated during the Asian financial crisis and the Russian debt default in 1997 and 1998 that rocked the fixed income markets. "Because we were trading cash and derivative instruments, we had a much clearer sense of where the problems were coming from," says Dorfman. In 1999, O'Brien was asked to return to New York to globalise the trading operation. "We did the same thing in New York – combined the cash and derivatives traders into a single team," he says. "We were by far the first to do that and globalise that model."

This approach gave the group an edge in the marketplace. "We were thinking about credit as a holistic asset class, which was very rare at the time," says Dorfman. At a practical level, it meant the trading desk was taking positions based on signals from the cash and derivatives markets as well as the banking system.

Trading cash and derivatives side-by-side also allowed for more flexibility in positioning portfolios. "It wasn't really possible to short cash bonds at the time, so credit traders were always long the market," says Dorfman. "Having an integrated business meant we could be net long or net short or somewhere in between. That had never been done before, and it gave us a huge advantage."

As the trading business grew, O'Brien and Dorfman were eager to bring more institutional investors into the credit markets. The credit market at the time was exclusively single-name, with no index products that provided broad exposure to the asset class. So the credit derivatives group at Morgan Stanley created the first-ever investable credit index – called Tradable Custodial Receipts, or Tracers – which consisted of 30 of the most liquid corporate bonds.

"We made a two-way market [in Tracers] trading with big institutions and it just took off," says O'Brien.

Tracers were originally offered as cash products at the end of 2001 with a derivatives version launching in 2002. Other banks soon took notice and in 2003 Morgan Stanley agreed to combine Tracers with JP Morgan's high yield and emerging markets credit indexes to create the Trac-X family of indexes. Trac-X was ultimately licensed to Dow Jones and became the CDX.

The launch and subsequent popularity of the CDX opened up a world of possibilities for credit traders. "We always saw a lot of opportunity in the credit markets from an investment and risk perspective, but the problem was always liquidity," says Dorfman. As credit derivatives gained traction, "the market became more tradable than ever. It was no longer a case of being long or flat credit. We could be very creative in how we managed our exposures."

AE Fletcher Photography

"We always saw a lot of opportunity in the credit markets from an investment and risk perspective, but the problem was always liquidity."
Jonathan Dorfman

O'Brien and Dorfman won plenty of plaudits for their pioneering work in the credit derivatives business. *Risk* magazine named Morgan Stanley the credit derivatives house of the year in 2003 (www.risk.net/1497427) for its role in developing the Trac-X indexes.

Moving on

But in 2005, the state of affairs at Morgan Stanley took a turn for the worse. A bitter boardroom power struggle led to the departure of dozens of senior bankers, including Vikram Pandit, then the president and chief operating officer of Morgan Stanley's institutional securities and investment banking group, and his top lieutenant John Havens.

O'Brien and Dorfman followed the line of senior executives heading for the door. The pair had devised a strategy to profit from pricing anomalies in the burgeoning market

AE Fletcher Photography

for credit derivatives, which they thought would work best in a hedge fund environment.

"We were able to identify some very deep flaws in credit derivative modelling that still exist to this day and design a structure to take advantage of those," says Dorfman.

The problem with standard credit derivatives models is that they treat all credits with the same spread and expected recovery rate the same way, regardless of the fundamentals of the issuer or the industry sector they're in. "The models are credit blind," says Dorfman. "They're not really credit models – they're derivatives models." The models also make assumptions about correlation, which is not an observable output in credit markets.

Dorfman saw that an asset manager with credit and derivatives expertise could take advantage of mispricings triggered by purely model-based investors, such as banks and hedge funds running credit correlation portfolios.

The duo put a plan together and presented it to some contacts in 2006. They soon had an insurance company lined up as a lead investor and were ready to launch the fund

> "Credit is liquid when you don't need it to be and illiquid when you do. Today, the market is far more prone to disruption than it was pre-Dodd-Frank."
> **Jonathan Dorfman**

in 2007. But the onset of the credit crunch threw a spanner in the works. Prospective investors were nervous about backing a start-up credit hedge fund employing complex derivatives strategies in the circumstances. That was when they were approached by Pandit and Havens, who had sold their multi-strategy hedge fund Old Lane Partners to Citi earlier in 2007 and were now running the bank's alternative investments business.

Dorfman and O'Brien hadn't worked with Pandit and Havens in their time at Morgan Stanley – the latter pair rose up the ranks of the bank's equity division, while the former were in fixed income. By the time the deal was actually done, Pandit had been made Citi's chief executive and Ned Kelly had taken over as head of the alternatives group.

Citi wanted to invest in the pair's fund – called Synthetic Portfolio Equity (SPE) – and its backing would also help seal the deal with other big investors. In return, it wanted O'Brien and Dorfman to run its fixed income alternatives business. Though the pair always planned to run their own firm, a deal made sense in the circumstances. Dorfman and O'Brien joined Citi in November 2007 and launched SPE on the bank's hedge fund platform.

SPE sold first-loss protection on a bespoke single-tranche synthetic portfolio of investment-grade names and used some of the proceeds to short weaker credits. "We were long [the investment-grade] risk because we thought it was the most mispriced piece," says Dorfman. The fund had the ability to replace the names in the portfolio so it could dynamically manage the long exposure.

SPE was essentially a simple term-financed, long-oriented credit portfolio expressed via derivatives, rather than cash instruments. This approach offered greater flexibility and more attractive risk premiums than was available in the cash markets. But it also entailed more counterparty and liquidity risk. To mitigate this, the group hired JP Morgan to provide a full OTC intermediation service, meaning the bank took the credit risk on all transactions.

"We took no counterparty exposure as we replaced the names [in the structure]," says O'Brien. "It was all done through JP Morgan."

The group also went to great lengths to ensure the assets, liabilities and funding requirements of SPE were perfectly matched. The lead investor was an insurance company that committed its capital for eight years, while the longest tranche in the structure was seven years.

"This wasn't a case of investing in illiquid assets with quarterly liquidity capital, which was what a lot of people were doing back then," says Dorfman.

This careful approach to structuring paid off in 2008. SPE was one of the few synthetic credit strategies that held up in the financial crisis. The portfolio avoided 90% of the 500 credits that have widened the most since 2007, resulting in a cumulative realised loss rate of less than 2%, compared with 60% for the equivalent static index first-loss investment.

O'Brien attributes this to the team's bottom-up credit-picking skills. "The up-front portfolio selection was critical," he says. "We were also able to actively manage the credit risk to minimise drawdowns in the crisis, while taking advantage of mispricings caused by the dislocation."

Strong returns

SPE has posted annualised returns of around 11% since inception, with the gains coming mostly from cash flows, according to external sources. The fund had returned around 75% of investors' capital at the end of September 2013.

Following the SPE launch, O'Brien and Dorfman turned their attention to building out Citi's alternative fixed income platform, focusing initially on credit strategies. The bank acquired former UBS executives James Duplessie and Herbert Seif's distressed debt firm Epic Asset Management in November 2008. Rajesh Agarwal and his team of mortgage traders joined from Halcyon Asset Management around the same time. They also salvaged the event driven and global macro teams from Old Lane Partners, which closed in June 2008, and hired corporate and structured credit traders and a municipal bond team from within Citi.

The team O'Brien and Dorfman assembled is still largely together at Napier Park. The main exceptions are Rajesh Kumar who ran CCA's mortgage funds, who left before the spin-out, and macro manager Kevin Bespolka, who left in the summer after Napier Park decided to close its macro strategy.

Dorfman and O'Brien seem to have come full circle in the six years since events conspired to push them into the arms of Citigroup and they are finally running their own firm. But the world around them has changed considerably – for better and worse.

For one thing, big investors would rather put their money in an independent, employee-owned firm these days than in a bank-owned hedge fund. The burgeoning interest in regulatory capital relief transactions suggests investors are also rediscovering their appetite for synthetic credit investments. O'Brien says Napier Park has had multiple conversations with investors about new SPE-style vehicles, which he thinks are "a better and more transparent way to create the same return profile as regulatory capital relief transactions."

AE Fletcher Photography

But some changes are less welcome. Regulators have cracked down on complex credit derivatives and many investors are still wary of them. "The fact is most people don't understand derivatives and that's not going to change anytime soon," says Dorfman.

Though he supports the goal of central clearing for OTC derivatives – "the market will benefit from the risk reduction" – implementing this at the same time as Basel III capital rules has proven to be disruptive.

The punitive capital charges for non-cleared derivatives have flushed dealers out of the bespoke index tranche business. Liquidity in the single-name credit default swap (CDS) market has also dwindled steadily since 2010, when the Dodd-Frank Act was enacted.

Dorfman reckons the single-name CDS market has suffered from the decision to exclude it from the initial wave of mandatorily cleared derivatives. "The lack of mandatory clearing and the confusion over margin requirements for uncleared and voluntarily cleared positions has definitely hurt the single-name market," he says. "The bigger question is what's going to happen a few years from here. I think [liquidity] will improve, but it may never come back to where it was."

> "The quality and tenor of our capital has improved even as we've returned Citi's money."
> **Jim O'Brien**

As a result, Napier Park has reduced its single-name CDS positions to "around a third to a half" of what they were three years ago, according to Dorfman. "We still feel comfortable using [single-name CDS] in certain circumstances, but the premium we expect to realise is higher relative to options or indexes," he says.

That isn't stopping Napier Park from making creative use of derivatives. "We never buy anything that we can create more cheaply with derivatives in synthetic form," says Dorfman. The firm has found plenty of creative ways to replace illiquid derivatives with a combination of index derivatives and options, cash securities, secondary structured securities and loans.

As the market continues to evolve in the face of mounting regulations, Dorfman and O'Brien's creativity and knack for escaping tight spots should come in handy. ■