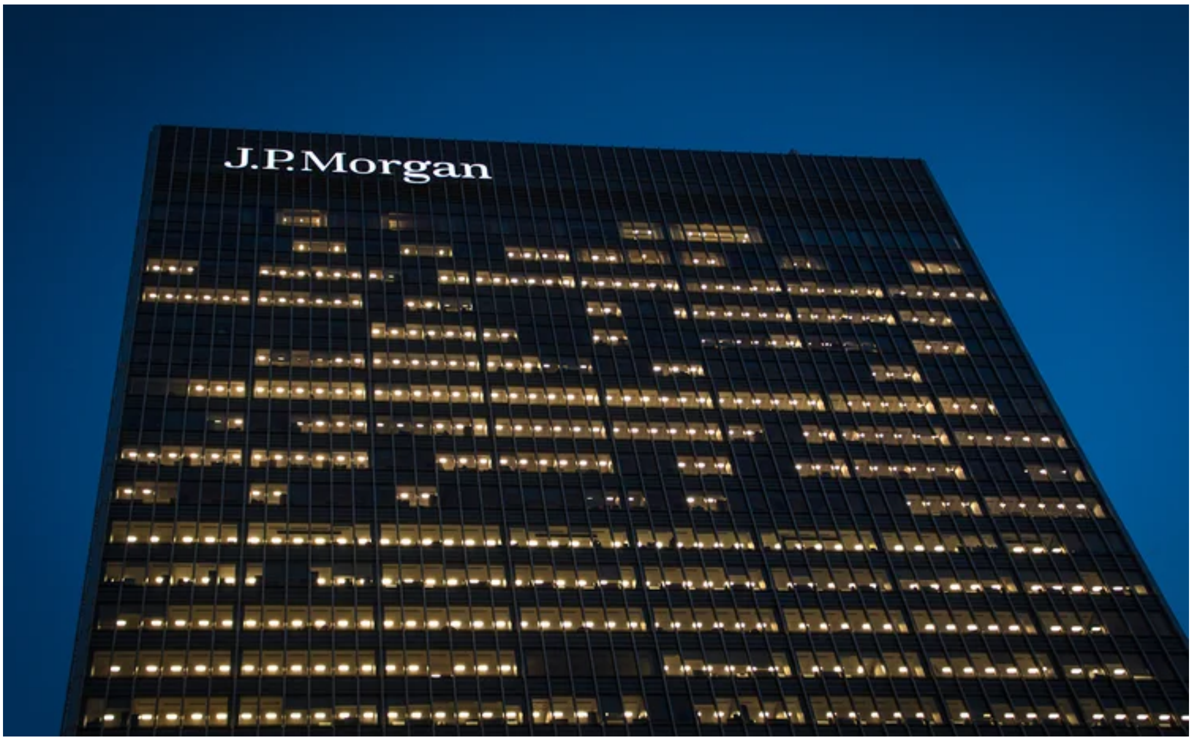
JP Morgan debuts Nexus spinoff for hedge fund exposure

Bank launches matchmaking service for lonely hedge funds and return-hungry investors



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JP Morgan has launched a platform for institutional investors to gain leveraged exposure to hedge fund strategies in synthetic format, via unfunded swaps. An extension of the bank's existing Nexus platform, the managed account service aims to give investors access to more dynamically managed portfolios.

"We've essentially wrapped a prime account solution into a synthetic strategy. This integrates the Nexus platform fully with our large prime business," says Rui Fernandes, JP Morgan's global head of equity derivatives structuring.

Prime Nexus allows hedge fund managers to recreate their strategies, commonly equity long/short, in an index. Institutional clients can then buy over-the-counter total return swaps against the index, typically under an existing Isda credit support annex. Investment via funded notes and certificates is also available.

The launch comes as dealers seek ways to turbo-charge returns and make managed strategies more accessible. The structure allows hedge funds to market their strategies to a wider group of buyers than they would normally be able to, while investors gain leverage opportunities from the unfunded notes.

The concept is not new. Deutsche Bank has offered leveraged exposure to single hedge fund strategies through its own synthetic managed account platform, dbSelect, for a decade. Societe Generale also trades swaps, notes and certificates on hedge fund strategies converted into SG indexes.

"The idea of an asset owner being able to access a hedge fund strategy without having to fully fund a position can be of interest to asset owners, but it can be a business development tool," says Mike Bayley, head of UK institutional solutions sales at SG. "It allows the hedge fund to bring their strategy to life in an environment where additional means of delivery are possible, a swap being one of them."

The structure uses unfunded over-the-counter swaps pegged to an index, which means buyers only pay initial margin and variation margin rather than the full investment size. So, for example, a $100 million trade may require the client to stump up a quarter of that amount, depending on the risk profile of the trade.

"It's a form of leverage while allowing the hedge fund manager to implement their strategy and trade their portfolio essentially in the same way as they operate in a typical prime set-up," says Fernandes.

The first Prime Nexus trade was completed in October for a US hedge fund manager, which replicated an equity long/short strategy in an index. A Middle East institutional investor bought exposure to the strategy by entering into a swap with JP Morgan.

According to the bank, another five to 10 hedge fund strategies are in development, and should be available in the next year. The process of adding a strategy to the platform and converting it into an index takes around two to three months. Minimum trade sizes of $100 million are anticipated, though the first deal is understood to have been significantly larger.

Nexus began life in 2013 when JP Morgan enlarged its exotics platform by bolting on a selection of other trading systems; delta one products were also added. The platform enables investors to build up quantitative strategies, block by block, and automate trade execution. Performance of the portfolio is aggregated in a single instrument such as a swap. The platform now underpins $10 billion net notional in managed strategies.

Prime Nexus takes the model a step further, bringing investments into a legal wrapper known as a segregated portfolio company. The platform gives hedge fund managers more flexibility to pick and choose securities within a set of principles agreed with the end-client and JP Morgan, the bank says. Under the previous structure, managers were only able to reweight exposures within a pre-agreed set of instruments.

"The dynamic of the structure is such that providing the securities just to settle into that account, the actual infrastructure that needs to be wrapped around it is relatively light. It's just an account set-up," says Jon Cossey, JP Morgan's co-head of prime finance. "It's not necessarily going to be the norm for all hedge fund clients, but it's complementary to everything else we do."

The service sits within the bank's prime finance division, separate from the main equities-based Nexus platform. The bank hopes this will appeal to hedge fund managers who may be wary of allowing their strategies to leak into the wider JP Morgan trading function.

"We deliberately warehoused this platform within the prime infrastructure, which already has all the framework around intellectual property protection, meaning it's segregated from our derivatives traders and other parts of the organisation that are developing systematic trading strategies," Fernandes says.

The final index is owned by the bank, which acts as the calculation agent.

A select few

Prime Nexus will go up against rival dealers' services, among them Deutsche Bank's dbSelect. The German bank's platform has 65 strategies managed by third parties including hedge funds and asset managers.

Notional linked to dbSelect strategies peaked at $7 billion at the start of the decade, but has more than halved since. In part, this reflects the platform's recent nomadic existence. Born into the foreign exchange division, dbSelect moved to wealth management, then to the bank's equity division. An exit from equity trading shunted the platform temporarily to the bank's non-core "capital relief unit". It has since been rescued and rehomed in the forex unit.

The emergence of services such as Prime Nexus provides investors with greater choice of counterparties when choosing to make hedge fund investments via a swap contract. Here, JP Morgan may have an edge with its Aa3/A+ rating from Moody's/

S&P. Deutsche Bank's long-term ratings are three notches lower, at A3/BBB+.


Rui Fernandes, JP Morgan

SG's own version of the service is a collaboration between its YouTrack strategy management platform and its prime services division. The operational costs vary depending on the complexity of the strategy, while index creation and calculation carry fixed costs. These are increased if the client opts to outsource index calculation to a third party – so far a preferred option for SG's hedge fund clients. The French bank's long-term credit ratings stand at A1/A.

SG's Bayley says the service may suit hedge funds that lack the initial seed capital to justify the fund set-up costs for a new strategy. For these funds, running a portfolio in index format on the bank's platform allows the strategy to be pre-marketed to a broad audience. Once demand for the index is sufficient, the strategy can be launched as a standalone fund with swap or note exposures switched into units of the fund itself.

The approach could be all the more pertinent against a backdrop of widespread hedge fund liquidations. High-profile funds including Omega Advisors, Highfields Capital Management and Jabre Capital Partners all returned capital to outside investors in 2018. The trend has continued, with more than 500 funds shutting their doors since the start of 2019 according to EurekaHedge.

The closures come as hedge funds struggle to beat equity markets. The S&P 500 has gained more than 20% year-to-date while hedge funds have returned 7.91%, BarclayHedge data shows.

With the synthetic route offering low-cost launch opportunities, former managers of now-defunct funds may be given a lifeline to get new ventures off the ground more rapidly.

"It's particularly relevant for smaller start-up boutique hedge funds who might not have built up their own trading capabilities or at least not in the ability to handle execution quantitatively and systematically," says SG's Bayley.

JP Morgan's latest addition to the Nexus family follows the 2018 launch of Credit Nexus, which allows clients to access a range of credit derivatives, including single-name credit default swaps, CDS indexes, options and tranches, via swaps and certificates.

Editing by Alex Krohn
