September 2016

HEDGENORDIC

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Insurance linked Strategies
Uncorrelated risk Premia and active Management

Time to Look at European Asset Backed Securities

Bringing Direct Lending to the Nordics

Alternative Credit:
an Oasis of Yield in the NIRP Desert

Fixed Income Strategies and Alternatives in a Zero-Interest Rate Environment

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HEDGENORDIC

INTRODUCTION

HedgeNordic is the leading media covering the Nordic alternative investment and hedge fund universe. The website brings daily news, research, analysis and background that is relevant to Nordic hedge fund professionals from the sell and buy side from all tiers.

HedgeNordic publishes monthly, quarterly and annual reports on recent developments in her core market as well as special, indepth reports on "hot topics".

HedgeNordic also calculates and publishes the Nordic Hedge Index (NHX) and is host to the Nordic Hedge Award and organizes round tables and seminars.

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The Editor

Faith and Fixed Income...

Kamran G. Ghalitschi
CEO / Publisher HedgeNordic

Our monetary system is built on faith and trust. The Fiat system we are so accustomed to today is no more than intrinsically valueless money used as tender by government decree. It is mere faith and trust that if we take this legal tender of printed paper and engraved pieces of metal to the market, we will receive a loaf of bread, bananas, or whatever may be on the menu plan in return.

Consequently, the principle of interest-bearing instruments is the belief that someone will hold their promise to pay back the principle on promised value you lent them, along with another promise to pay you a coupon - more Fiat money.

The real problem arises when this chain of faith is broken. Your marketer demands you barter your bread for a piece of ham or a kilo of carrots, rather than with a piece of paper. Some things work just fine, until they don´t. And the way we regard money may be just such an example. To me, a clear indication is that, when lending out money and upfront agreeing to be paid back less than its nominal worth today, everyone in the system is essentially admittung to money being "worth-less." From this perspective, the whole system appears to be resting on rather shaky legs.

Banks and central banks have been in collusion to print - some would say forge - paper money that has no intrinsic value and no asset backing. Just last summer, US Senator Rand Paul succinctly attacked the Federal Reserve Bank, saying: "Once upon a time, your dollar was as good as gold. Then, for many decades, they said your dollar was backed by the full faith and credit of government. Do you know what it's backed by now? Used car loans, bad home loans, distressed assets and derivatives." Or, as another American politician put it, "the US Dollar is no longer backed by gold, but by aircraft carriers and armed drones, and our capability and willingness to use them to protect our interests."

With sovereign interest rates hovering at record lows, many investment professionals believe we are experiencing an unsustainable bubble in the fixed income markets. Fitch Ratings estimates that as of mid-August 2016, as much as $13.4 trillion of bonds were trading at negative interest rates. That is nearly as much as a third of all outstanding global debt. Governments are issuing debt at negative interest rates while running up unsustainable deficits. Compounding the pressure, spreads have tightened as investors reach further and further for yield.

In this Special Report on Fixed Income strategies, the objective is to identify and investigate where investors can turn to in the hunt for yield, and which strategies, products and managers may have an edge in this daunting, historically unprecedented zero (if not negative!) interest rate environment.

Faith, it seems, is more confidently tendered in the search for solutions.

2008 ALL FORGOTTEN-

NORDIC FIXED INCOME HEDGE FUNDS HIT NEW HIGHS

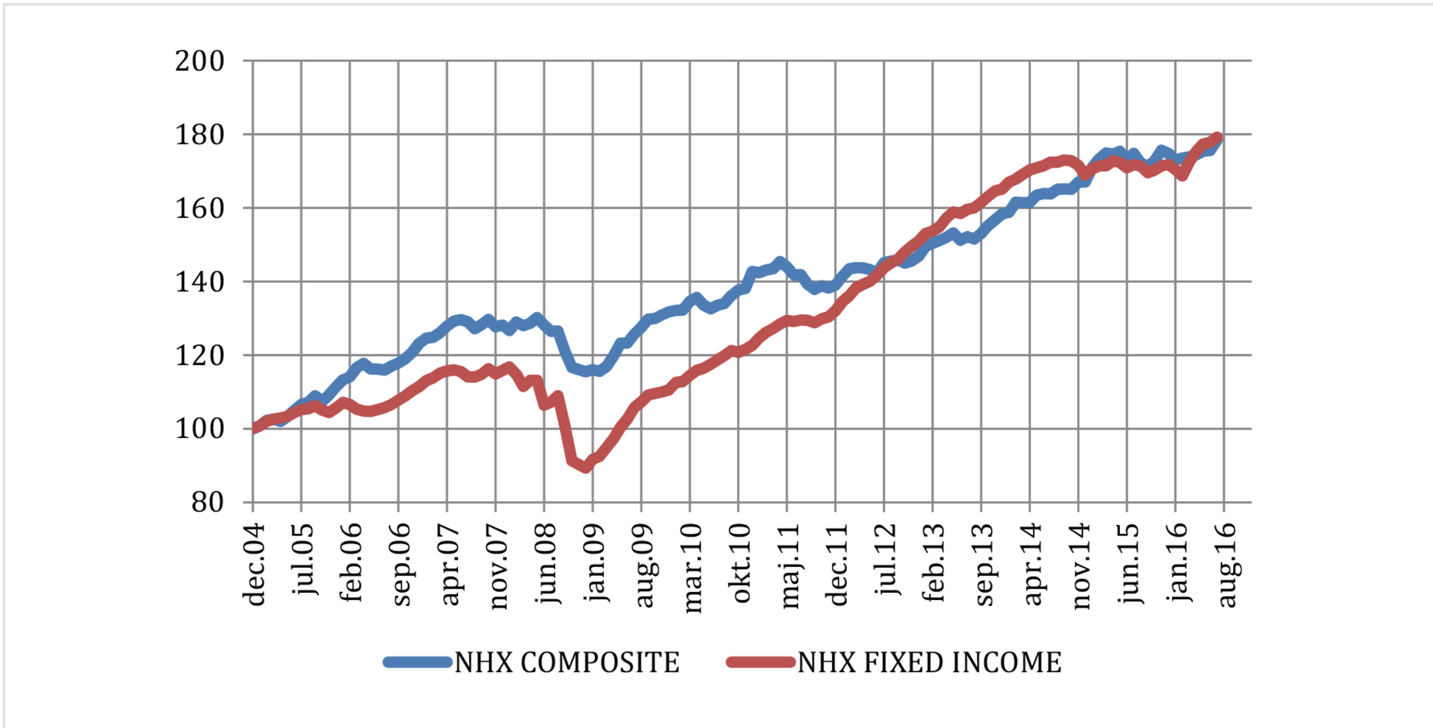
by Jonathan Furelid – HedgeNordic

Among the five hedge fund categories tracked by HedgeNordic, the fixed income category was by far the biggest loser during the financial crisis in 2008. Since then the recovery has been strong and Nordic fixed income funds, as measured by the NHX Fixed Income index, ended the first half of 2016 at a new high.

Since HedgeNordic started tracking the performance of Nordic Hedge Funds in December 2004, the fixed income category has been on a rollercoaster ride. With underlying strategies typically aiming to deliver single digit returns to a low risk profile, the dislocations experienced during the financial crisis year in 2008 came as a shock to many managers. The NHX Fixed Income Index dropped a whopping 23 per cent during the year with the worst performing manager (among those still reporting) losing 83 per cent of its value. There were also a number of funds that were closed as a result of performance setbacks experienced during the year.

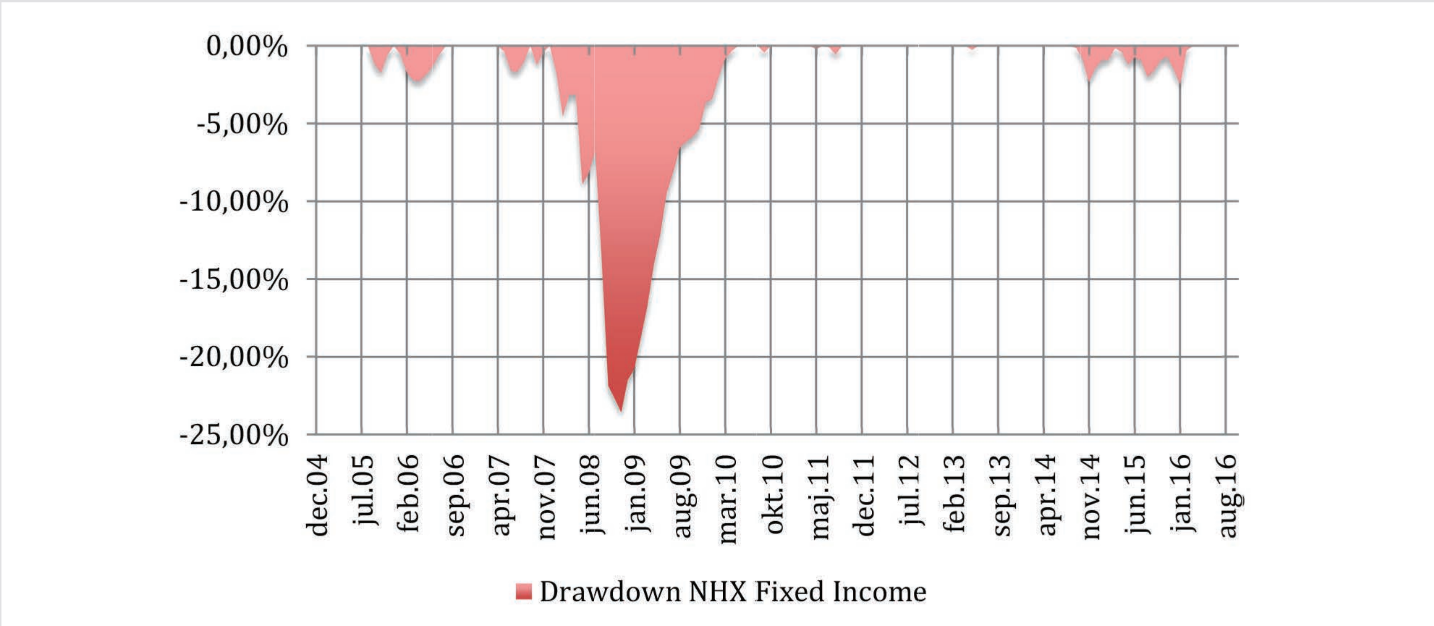
However, the recovery for the fixed income category is noteworthy. On an aggregate level, Nordic fixed income hedge funds had recovered completely from the drawdown in 2008 already by mid-2010. Since then, the fixed income category has outperformed the NHX Composite index significantly, and in July 2016 the compounded return since inception was at the same level as the composite index, reaching a new high.

NHX FIXED INCOME VS NHX COMPOSITE



The NHX Fixed income index suffered signficant losses during the financial crisis in 2008, but has since then revovered strongly, in July of 2016, the index reached a new record high. Source: HedgeNordic.

DRAWDOWN NHX FIXED INCOME

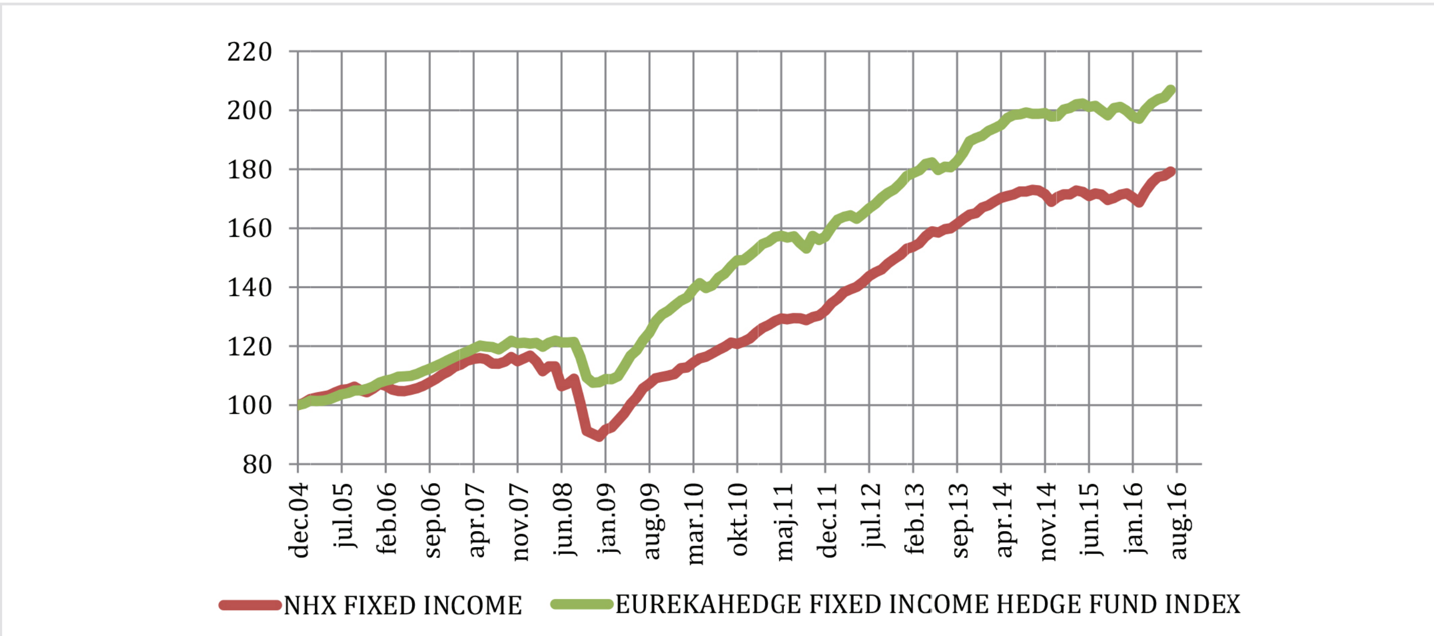


At its worst point, the NHX Fixed Income Index recorded a drawdown of 24 per cent in December of 2008, the drawdown was recovered in June 2010. Source: HedgeNordic.

Summarizing the statistics, the NHX Fixed Income Index has generated an annualized return of 5.2 per cent since inception to an annualized volatility of 5.3 per cent, the corresponding numbers for the NHX Composite is 5.1 per cent and 4 per cent respectively.

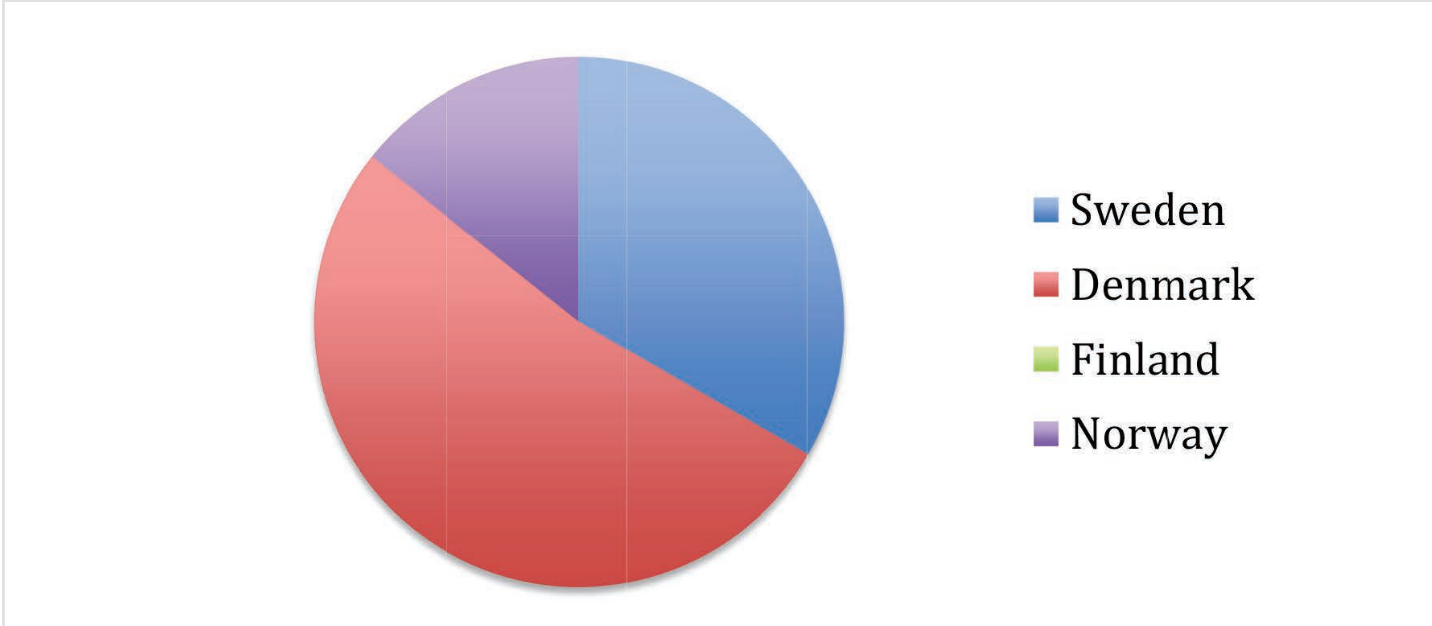
An international comparison reveals that the NHX Fixed Income Index has underperformed international peers since inception of the NHX index. The Eurekahedge fixed income hedge fund index, which tracks 325 fixed income hedge funds globally, has compounded approximately

NHX FIXED INCOME VS THE EUREKAHEDGE FIXED INCOME INDEX



The NHX FIxed Income Index compared to the Eurekahedge Fixed Income hedge fund index. Source: HedgeNordic, Eurekahedge.

NHX FIXED INCOME VS THE EUREKAHEDGE FIXED INCOME INDEX



The NHX Fixed income index suffered signficant losses during the financial crisis in 2008, but has since then revovered strongly, in July of 2016, the index reached a new record high. Source: HedgeNordic.

106% since 2005, with the corresponding performance for NHX Fixed Income at 79%. The risk profile of the two indices are more or less equal.

The number of fixed income funds included in the NHX Index is currently 21, a relatively small number given that the entire universe is made up of 155 funds. A distinct feature of the fixed income category is also that it is heavily dominated by Danish funds. As of July 2016, 52 per cent of the category was made up of Danish funds while Sweden and Norway had 33 per cent and 14 per cent respectively. No Finnish fund was listed in the database.

One reason for the heavy dominance of Danish fixed income funds might be the unique structure of the Danish mortgage bond market offering a one-to-one relationship between a loan and the bonds issued by the mortgage bank to fund the loan. The so-called mortgage covered bond market is an important alpha generator for many of the Danish funds listed in the NHX-database.

Reviewing the performance of NHX Fixed Income constituents also underscores the dominance of Danish hedge funds when it comes to fixed income investing. Among the five top performing names in the category during the last 36 months, all are of Danish origin, The best perfoming fund, Asgard Fixed Income, has also received numerous recognitions at the Nordic Hedge Awards, being named best Nordic fixed income hedge fund as well as best Nordic hedge fund overall in 2015.

TOP PERFORMING NORDIC FIXED INCOME HEDGE FUNDS – LAST 36 MONTHS

	36M ROR	Sharpe	Max DD
Asgard Fixed Income Fund	43.83	2.03	-10.40
Midgard Fixed Income Fund	31.00	2.14	-7.48
Danske Invest Hedge Fixed Income	26.76	1.34	-22.30
Nykredit MIRA Hedge Fund	26.17	1.53	-9.17
Danske Invest Fixed Income Relative Valu...	22.45	1.72	-4.42

Source: HedgeNordic

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ATTRACTIVE RETURNS IN DANISH MORTGAGE BONDS!

by Hamlin Lovell – HedgeNordic

Michael Nielsen
Co-portfolio manager
HP Hedge

Denmark's 200 year old mortgage bond market, valued at around 2.75 trillion Danish Krone (DKK), is larger than the country's GDP of around 2 trillion DKK. The asset class has distinctive features. "It is very easy to repossess, and sell, property if borrowers default," according to HP Hedge co-portfolio manager, Michael Nielsen. Unlike in the US, lenders in Denmark have full recourse to other assets and income of the borrower, in addition to the property on which the mortgage is secured.

The frequent claim that Danish (and indeed Dutch) mortgage bonds have never defaulted needs some clarification. "Though some individual borrowers have defaulted, mortgage bondholders have never lost money nor seen a cut in payments," Nielsen points out. "Virtually all Danish mortgage bonds have AAA credit ratings from foreign rating agencies," he adds. In contrast to countries where homeowners borrow more than 100% of a property's value, loan to value ratios in Denmark are capped at 80% at inception, and most are now much lower due to home price appreciation.

There is abundant local demand for mortgage debt. Fixed income is the bread and butter of saving in Denmark, which is a much less equity oriented economy and society than is Sweden. There is also some demand from overseas. Though only Euro-denominated Danish debt is eligible for ECB purchases, Danish mortgage bonds have benefitted from substitution effects owing to their yield premium. US and German investors have been attracted to Danish mortgage bonds that have offered higher interest rates – usually measured as Option Adjusted Spreads (OAS) – than have other bonds such as German ones.

OAS adjust for borrowers' embedded call option. In common with US mortgages, borrowers have the potential to pre-pay or refinance loans, in part or in full, prior to maturity. This is locally described as "redemptions". Nielsen views this call option as beneficial to the overall system. This prepayment risk is probably far more relevant than credit risk for these bonds. Indeed, "callable bonds can trade at the highest spreads, of 2% or so for a 30 year bond," says Nielsen. Such callable bonds are trading at a price of 97 or 98, but the vast majority of the Danish market now trades above par, making it vital to get comfortable with prepayment risk. Investors owning bonds above par could incur capital losses if prepayments or re-financings occur at par (and these losses could be multiplied for leveraged strategies). There are apparently enormous incentives to refinance given that some older mortgage loans have interest rates as high as 5-6%! Yet prepayments in the Danish market have been relatively subdued. Many borrowers have not refinanced because doing so can entail prohibitively high transaction costs for some older bonds, Nielsen has found.

For some investors, Denmark's currency is the icing on the cake. The Danish Krone's peg to the Euro is seen as something of a "one way bet". Investors remain confident in the peg holding but also think that, if the single European currency did break up into two or more units, the Danish Krone would be pegged to a stronger, mainly Northern European, bloc (which might include countries such as Germany, Austria, the Netherlands, and Finland) – and would therefore appreciate in value.

Regulatory Risk in 2008, 2015 and in future?

Despite all its attractions, the Danish mortgage market has not always gone up in a straight line. Nielsen recalls how in 2008 there were serious problems when lower interest rates increased liabilities for pension funds, and forced them to sell Danish mortgage bonds. According to Nielsen, "investors used Danish mortgages as a source of liquidity because other government bond markets were frozen in late 2008". Subsequent issuance of 30 year Danish Government bonds has now satisfied the pension funds' appetite, Nielsen reckons. More recently, 2015 saw another jitter with regulations the culprit once again. But this time around it was Danish banks that were selling. The banks had also encouraged borrowers to shift from one year adjustable rate mortgages to longer term loans with interest rates re-set at two, three, four or five year intervals. When local mortgage spreads widened, HP's hedge fund had its worst ever year in 2008 (down 27.53%) and saw a small loss in 2015 (of 1.69%).The fund bounced back strongly after these drawdowns, making 54.24% in 2009 and it is up 8.5% in 2016 to July. Nielsen is aware that new, international, banking capital and solvency regulations, such as Basel III, could make life somewhat more difficult for Danish mortgage lenders, though he is not sure on the timing or quantum of any impact.

The HP Strategies

HP Hedge runs around 7 billion DKK in their long only strategy, and roughly 450 million DKK in the hedge fund strategy. Nielsen envisages more capacity exists for the hedge fund strategy but does not want to get too big, for risk management reasons, - so that "we can cut risk when and if we need to". The master fund is denominated in DKK and HP Hedge has launched a Swedish Krone (SEK) feeder fund that is hedged using a currency swap. The DKK fund can be bought by retail or professional investors in Denmark while the SEK fund is currently only available to professional investors in Sweden.

HP's hedge fund strategy is primarily a "carry trade" approach that levers up the interest rate spread between its funding costs, based broadly on government yields, and its income, based mainly on mortgage bond yields. Local bank Nordea provides leverage (and is also custodian and depositary). The fund's financing costs are based on repo rates, which are currently negative, and the fund's cost of leverage is negative. Meanwhile, its assets earn between 0.25% and 2%, resulting in a spread ranging from at least 0.25% to 2.00%. The leverage, which has typically been in a range of 4.5 to 6.5 times, (and has never hit the maximum permitted level of 11 times) multiplies the spread up to a gross return that is intended to give investors net returns of at least 5-6%, after costs.

Since inception in 2007, the fund has annualised at 8.93%. The fund has exceeded its return target for much of the post-crisis period, often by a factor of two or three or more, and HP Invest has won performance awards. Returns have surpassed the target thanks to the tightening of Danish mortgage bond spreads, and the very low level of borrowing costs. At the macro level, the fund aims to hedge interest rate risk, mainly through shorting German government Bunds and Schatz, and using DKK swaps (though options can also be used to hedge interest rate risk).

As well as spread compression, the strategy has benefitted from the fact that realised prepayments have turned out to be lower than anticipated. Clearly, if spreads widened and/or prepayments exceeded expectations, returns might suffer.

In some respects HP seems rather plain vanilla compared with some other mortgage hedge funds. On the long side HP buys bonds backed by whole loans. It does not trade mortgage derivatives, such as IO (Interest Only) or PO (Principal Only) strips. Nor does it invest in structured credit vehicles, such as CMOs (Collateralised Mortgage Obligations). HP buys shorter duration bonds and buys "the safest bonds which are immensely secure" Nielsen claims. The fund is administered by Nykredit Bank A/S subsidiary, Nykredit Portefølje Administration A/S, which marks the portfolio to market prices. "We have not had any marked to model assets historically" confirms Nielsen.

HP is not completely restricted to residential mortgages however. HP can also allocate to bonds issued by Ship finance, which are perceived to be part of the Danish mortgage market – but pay higher yields than mortgages partly because the Ship finance bonds have a lower credit rating, around single A.

THE ADDED INTEREST OF GLOBAL HIGH YIELD BONDS

By Tom Ross, co-manager of the Henderson Horizon Global High Yield Bond Fund

Added interest? In a world where yield is scarce, it would be easy to extol the attraction of high yield but of greater appeal is the interesting space that high yield bonds occupy in the investment world.

As sub-investment grade bonds, high yield bonds by their very nature carry risk – primarily the risk of default – with the high yield acting as compensation for assuming this risk. This contrasts with government bonds and investment grade corporate bonds that tend to be more influenced by interest rate risk, making high yield bonds a valuable diversifier within a fixed income portfolio.

In some respects, high yield bonds have more in common with equities in that corporate conditions have a greater impact on their prices. That is why an investor in high yield bonds needs to pay attention to the balance sheet of an issuing company and the direction of earnings and cash flow since these will ultimately support the coupon and the maturity repayment (the repayment of par value on the redemption date).

The high yield market comprises a vast range of companies from fallen angel (formerly investment grade) giants such as Tesco through to household names such as Volvo or small and medium-sized companies that are raising funding for the first time. This creates an attractive and expanding mix of issuers that can reward a selective approach.

Careful credit analysis allows underlying trends – whether deterioration or improvement – to be discovered that may not show up for some time in a bond's price. This is particularly true of smaller issues that are less well covered by research and credit ratings agencies. In this way, an investor can seek to pre-empt ratings changes, better avoid defaults and capture the high yields offered by the bonds, using either the cash bond market or the credit default swaps market to express a view.

Beyond having a redemption date and fixed coupons, where high yield bonds differ from equity is that they rank higher up the capital spectrum, so in the event of a company running into difficulty, it is the equity capital that is exhausted first before there is any call on bondholders' capital. Additionally, high yield bonds normally come with protective terms attached – known as covenants. For example, the covenant might mean that a higher coupon is triggered if a company engages in a takeover or if a specific balance sheet ratio deteriorates.

Tom Ross, co-manager of the Henderson Horizon Global High Yield Bond Fund

A reduced covenant package is often a sign that a credit market is turning more late cycle – an environment in which investor complacency and higher demand for bonds permits companies to issue under less onerous conditions. Late cycle corporate behaviour is typically less bondholder friendly and more shareholder friendly so companies might borrow to pay dividends to shareholders or to finance aggressive acquisitions rather than for refinancing.

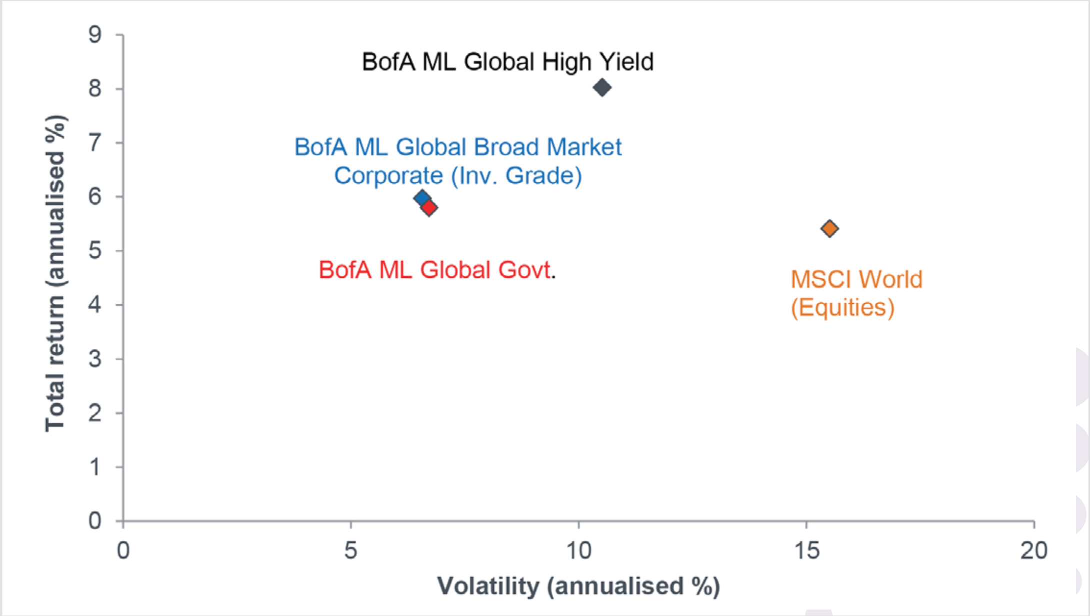
The US is arguably in more of a late cycle phase while European companies are earlier in the credit cycle. The fallout in the energy sector is a prime example of what can happen when companies that have become overextended on debt struggle if revenues tumble. Nervousness about the creditworthiness of US energy companies saw yields soar in this sector in 2015 as investors demanded a higher yield to compensate for the high risk of defaults. The oddity in high yield is that index yields are being skewed by the resources and energy sector, so there are a lot of double-digit yields alongside many high quality names that trade at yields of around 4-5%.

Another key factor driving high yield bond prices is the market technicals – by this we mean the supply and demand for bonds. In Europe, the European Central Bank (ECB) is buying investment grade bonds, and this is causing some spill-over demand for high yield bonds. Nor does Europe have as big a CCC rated or energy component as the US, which with the ECB purchases, generally makes it a more defensive market.

There is arguably more relative value in the US because yields and spreads (the additional yield over the equivalent government bond) rose in 2015 and are higher than in Europe. Higher US yields reflect the energy sector fallout, fears (subsequently unfounded) of an economic slowdown and the fact that the US Federal Reserve has been tightening monetary policy. New issuance in the US is also more robust. One of the intriguing aspects of the European market this year has been the relative dearth of issuance in the first eight months of 2016. Despite this scarcity premium, European high yield bonds were still offering, on average, a yield premium of more than 300 basis points over investment grade corporate bonds in August. In the global grab for yield, there remains plenty of potential for spread compression to fuel price rises in high yield, particularly if the positive but tepid economic momentum can be maintained. A caveat to this is political risk given the Italian referendum, the US presidential election and European elections that are looming.

High yield bonds, therefore, occupy an interesting space between investment grade bonds and equities. As the chart demonstrates, historically this has made them an attractive asset class from a risk-return perspective.

Total returns versus volatility, June 2001 to June 2016



Source: Thomson Reuters Datastream, 30 June 2001 to 30 June 2016, total return indices in US dollar; volatility is standard deviation using monthly data returns. Indices used are Bank of America Merrill Lynch (BofA ML) Global High Yield, BofA ML Global Broad Market Corporate, BofA ML Global Government and MSCI World. Past performance is not a guide to future performance.

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"The Nordics offer a diverse suite of credit opportunities, ranging from the relatively low risk Danish mortgage bonds market dating back over a century, to 'covered bonds' and safe corporate blue chip issuers, and also some distressed and equity linked issues for more adventurous investors."

Alternative Credit:

AN OASIS OF YIELD IN THE NIRP DESERT

by Hamlin Lovell – HedgeNordic

We incessantly hear about the trillions of sovereign and corporate debt with negative yields, but this relates to sovereign, and some investment grade corporate, credit, mainly in Europe and Japan. We hear much less about the trillions of dollars of corporate and asset backed securities, and associated structured credit, that still offer positive yields of roughly between 1% and 7% (or possibly much more for the junior tranches of structured credit vehicles, naturally with commensurately higher risk).

Additionally, there is plenty of emerging market sovereign debt paying yields comparable to developed market corporate and asset backed debt. Headline yields can be enhanced by capital appreciation from spread compression, which, all else being equal, happens automatically as investors 'roll down' upwards sloping yield curves. Leverage can also be used to augment returns.

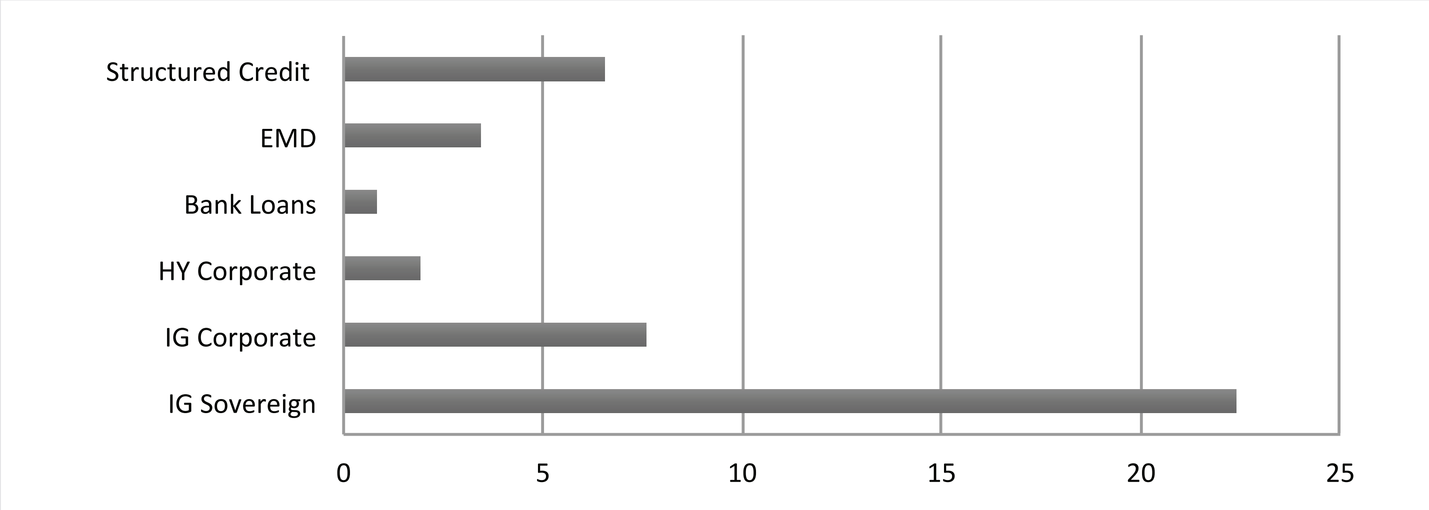
For long-biased, long-only, or buy and hold investors, providing default losses can be contained, unleveraged returns from alternative credit are respectable while inflation and risk free interest rates remain subdued. Some credit assets offer a floating rate yield that should track increased interest rates. Hence many of the largest family offices, and tier one institutions, are actively allocating to – and increasing allocations to - a range of alternative credit asset classes and strategies, according to surveys by Prequin.

Investment consultants Willis Towers Watson define 'alternative credit' to be high yield corporate debt, bank loans, emerging market debt and structured credit. A chart showing the relative sizes of different parts of the credit market appears on the next page.

Willis Towers Watson claims that "alternative credit represents over 25% of the global credit universe; yet Towers Watson clients have only invested 8% of their total credit portfolios into alternative credit and less than 1% into illiquid credit". It seems that many allocators are still very much "underweight" of alternative credit.

Institutional investors can access credit, and alternative credit, in various ways: ETFs, index funds, long only funds, absolute return funds, UCITS hedge funds, and offshore hedge funds. Passive, or index tracking, investing approaches

Global Credit Market Size, Trillions



Source: Towers Watson Alternative Credit Perspective

have become very popular in equity markets but remain less so in credit. When credit indices can contain thousands, or tens of thousands, of issues, replicating index performance is not a straightforward task. Indeed, some high yield ETFs (exchange traded funds) seem to have lagged behind high yield credit indices by a massive margin over the past few years. Part of the problem is that offering intra-day liquidity is not well aligned with the widely documented, and deteriorating, liquidity conditions in many parts of the credit markets. This problem may be exacerbated for the largest ETFs. By contrast active funds with disciplined capacity ceilings, and fund liquidity terms appropriately aligned with portfolio liquidity, are better equipped to navigate liquidity conditions. UCITS funds are widely used for more liquid credit strategies, but do not always have enough flexibility in terms of instrument types for all types of hedge fund strategies.

A Growing Universe

The continuing growth of the corporate credit markets broadens the range of opportunities available to active investors. Europe and emerging markets have for some years been growing their share of global credit markets. The number of issuers has grown so far that active credit managers are able to be extremely selective. Some of them may only select 100 or so names from a benchmark that could contain 10,000 names. Some managers emphasise particular geographic regions. The four Nordic nations make up only a small percentage of global credit markets, but they account for a third or more of some active portfolios. The Nordics offer a diverse suite of credit opportunities, ranging from the relatively low risk Danish mortgage bonds market dating back over a century; to 'covered bonds' and safe corporate blue chip issuers, and also some distressed and equity linked issues (particularly in energy and shipping in Norway), for more adventurous investors. Iceland is perhaps a special case but patient investors into Icelandic bank paper are finally being rewarded as the economy - powered by hydroelectricity, aluminium, fishing and tourism- demonstrates a robust recovery.

Investment Grade or High Yield or Both?

The climate for corporate and consumer defaults remains generally benign, outside US energy and materials. Some managers have been able to profit from defaults through running an active short book. In asset backed securities, US agencies in theory have no default risk and are often a defensive asset class, profiting in 2008 for instance. Mortgage-backed securities in the US can often be well collateralised, and house prices in many parts of the US remain below previous peaks.

Investment grade credit rarely defaults. The asset class is perceived to be expensive, in absolute and relative terms, but it is also the most direct beneficiary of central bank asset purchase programmes since a high proportion of investment grade credit is eligible for them. High yield can also benefit from the 'crowding out' effect of asset purchases whereby investors who can no longer meet their return target from investment grade credit are forced into high yield credit. Many active managers retain some

flexibility to invest in both investment grade and high yield debt, since the former can sometimes yield more than the latter. The so called 'crossover' segment, made up of the lowest rated investment grade names and the highest rated high yield names, is thought to be a source of inefficiencies that make it ripe for name selection.

Interest Rate Duration Risk

Fixed income entails some interest rate duration risk, which is generally greatest for investment grade credit. For investors who expect the Federal Reserve to raise interest rates much faster than the consensus expectations (which are still only one or two rises over the next year or so after the Jackson Hole symposium), leveraged loans or many asset backed securities could be an alternative. These offer a floating rate yield, so should swiftly benefit from any interest rate rises. Senior, secured loans have also historically seen higher recovery rates from defaults, than have high yield bonds, which are generally lower down the capital structure.

Of course, the most true and pure hedge fund strategy need not be concerned about interest rate or credit spread risks at the big picture level. A duration neutral, credit spread neutral and market neutral approach should avoid these macro risks in order to focus on identifying alpha from selecting sectors, names and issuers. Hedge funds can also construct arbitrage trades designed to profit from discrepancies between the valuations of similar instruments, such as cash and derivatives related to the same company.

Private Lending and Direct Lending

Hedge funds are increasingly viewed as "the new banks" filling the gaps left by bank deleveraging, particularly in Europe. Private lending and direct lending strategies, pursued by hedge funds and private equity funds, are garnering growing allocations from institutional investors, according to Prequin, which surveyed a range of public pension funds, private pension funds, foundations, insurance companies, asset managers, family offices, fund of funds managers, endowment plans, banks and others around the globe, for its Investor Outlook Alternative Assets 1H 2016 report. Direct lending and private lending strategies may offer an illiquidity premium for investors who can cope with a three or five or seven year lock up. The collateral for direct lending strategies could range from hard assets such as property, railroad cars, canal barges, tractors, and farming equipment, to intangible, intellectual property, such as brand names, trade marks, patents, film and music rights, and associated royalties.

Alternatives to Alternatives

Therefore, investors who want to diversify their risk factor exposure away from corporates and consumers could also allocate to a growing choice of other securitised instruments. Insurance linked securities (ILS) can pay a premium for taking on any number of insurance risks, and natural catastrophes are one of the most well-known ILS. These should, in theory, be completely uncorrelated to financial markets. It is true that in 2008 some CAT bonds incurred losses, but the main reason was counterparty exposure to Lehman Brothers. Post-crisis, CAT bonds are structured with collateralisation, segregation and other safeguards that substantially mitigate counterparty risk.

> *"Hedge funds are increasingly viewed as "the new banks" filling the gaps left by bank deleveraging, particularly in Europe."*

As well as CAT bonds, a growing number of more exotic sources of income can come under the umbrella of "alternatives to alternatives". These include litigation finance, where there are two closed end funds listed on the LSE. Life settlements and life premium finance are another asset class where the key risk factor – life expectancy – should move independently of financial markets. Aviation leasing is another niche strategy where the valuation of particular aeroplane types is a key risk. Peer to peer lending has seen its media profile rise and fall with the travails of Lending Club. Concerns have been raised about potential conflicts of interest and corporate governance issues at Lending Club, but these contentious points need not be inherent defects of the peer to peer lending strategy.

Thus there is immense variety in the growing universe of credit asset classes and strategies. This underscores the importance of exploring a broad spectrum of approaches that have different return drivers and different risk factors that may be more or less suited to different investors' risk tolerances and liability profiles.

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MOMA ADVISORS ROLLS OUT ASGARD CREDIT STRATEGY

AWARD-WINNING MANAGER EXTENDS EXPERTISE TO CREDIT

by Hamlin Lovell – HedgeNordic

Copenhagen-based Moma Advisors' Asgard Fixed Income fund, advised by Morten Mathiesen, Jesper Obeling Kring, and Jorgen Jorgensen, is a classic fixed income arbitrage strategy fund. The strategy, running half a billion Euro, has delivered 14.2% annualized performance since inception in 2003 at a 6.7% volatility - resulting in an impressive Sharpe ratio of two. Next to winning the Nordic Hedge Award in the fixed income category in 2015, it picked up the trophy as "Best Nordic Hedge Fund (overall)", amongst many other international awards earned.

Negative interest rates (in markets including Sweden, Denmark, Germany, Switzerland, Hungary and Japan as of August 2016) have not handicapped the strategy because, unlike many long only or long biased approaches, Asgard's strategy does not depend on declining yields. Asgard hedges interest rate duration and constructs relative value trades where rates can be negative on both, or all, legs of the trade. The spread between or amongst the trade components, such as swap rates, repo rates, interbank rates, covered bond yields and government bond yields, is what generates returns. And "spreads are still here" stresses Mathiesen.

Now, after much planning, Moma Advisors has hired portfolio manager Daniel Vesterbaek Pedersen to launch a new liquid credit strategy. Mathiesen says Pedersen is "one of the best credit managers in Scandinavia" and the pair sat on the same desk at one former firm. Pedersen has a track record from PFA pension, the largest privately owned life insurance company in Denmark, where he ran a long/short credit fund, showing consistent alpha generation over many years since 2008.

So, Moma Advisors is now applying its tried and tested proprietary analytical and risk management techniques to a new investment universe of liquid credit – and taking a more directional approach in order to pick up some credit risk premiums, as well as adding alpha through country, sector and security selection.

CREDIT RISK PREMIUMS AND CROSSOVER

Pedersen says "risk premia in the crossover segment at the lower end of investment grade and the higher end of high yield are key". He views this sleeve as being subject to structural anomalies, whereby forced selling and market segmentation preferences mean that the lowest rated investment grade credits and the highest rated high yield bonds has a higher systemic risk premium relative to the total credit spread. Pedersen elaborates "names rated BBB- or BBB can be shunned by ratings-driven managers while those rated BB+ or BB often trade too wide due to yield hunting among high yield managers focusing too much on the lower end of the high yield market". As such, there is enough value to justify the new fund's minimum 50% weighting in investment grade. There is also plenty of dispersion between names, allowing for issuer selection.

Default risk premia are one of several that Pedersen seeks to harvest, along with liquidity and systemic premia. The balance amongst these varies for different parts of the credit markets. Pedersen reckons "on average for investment grade markets only one quarter of the credit spread is default risk and the rest is liquidity or systemic risk, whereas for high yield the default component typically accounts for 50-70% of the total spread". Asgard Credit can also buy cash bonds to earn a liquidity premium in the corporate bond market.

> "Risk premia in the crossover segment at the lower end of investment grade and the higher end of high yield are key."

Asgard Credit targets returns of plus 8% per year through a full cycle. This is comparable to equity returns, but the manager aims for much lower downside risk over multi year periods. Asgard Credit will use notional leverage, obtained through Credit Default Swaps (CDS), to multiply credit spreads up to the target return (and aims to add alpha on top of this). Net leverage is capped at six times, and will typically be four times, but would probably be lower in August 2016 because Pedersen is mindful that credit markets could experience contagion from any

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correction in equity markets, which he views as expensive. Moma Advisors has stress tested the impact of margin and 'haircut' increases seen in 2008, and thinks that a typical Asgard Credit portfolio would have avoided forced liquidation under that scenario.

Still, Pedersen thinks the return target "is not very aggressive". His base case expectation is that default losses should be roughly balanced out by the benefits of 'roll down' – the capital appreciation arising from credit spreads shrinking as assets approach maturity. This occurs because the term structure of credit spreads is nearly always upward sloping (except for some distressed credits, which are not expected to be part of the strategy).

Though the credit strategy will lever up credit spreads, it should have limited interest rate duration as the main instrument used - CDS - pay a credit spread over interest rates. Though Asgard Credit can sometimes buy longer dated bonds, the general preference for shorter duration assets is one commonality between Asgard's two strategies. Hence Pedersen is confident about keeping the DV01 sensitivity metric (measuring sensitivity to a one basis point move in interest rates) well below its ceiling of 10. This is one of many hard risk parameters that are independently monitored by administrator SS&C GlobeOp, which has worked with the Asgard team since the funds inception in 2003. SS&C oversees compliance with risk constraints on a daily basis for the existing fund and will do the same for the new fund.

Morten Mathiesen, Daniel Pedersen and Birger Durhuus looking forward to launching the new credit fund

A GLOBAL STRATEGY

The two funds share an investment philosophy and process but are quite separate vehicles, run by different portfolio managers, and are very unlikely to have any intentional position overlap. Asgard's fixed income strategy predominantly trades Scandinavian markets in Sweden, Norway, Denmark and Finland, whereas the new credit strategy may have little or no exposure to these local Nordic markets. Pedersen expects its Scandinavian exposure to range between zero and 5%, and views local markets as sometimes boasting safe haven qualities. He explains that "the Scandinavian countries each make up less than 2% of global credit markets but the US and Europe are the largest markets for corporate credits and ABS". In August 2016 Pedersen is finding much better value in US markets, which will normally account for 50% of more of the fund's exposure. "European investment grade is too expensive and too dangerous" he opines. Pedersen is finding that the lowest rated investment grade names in the US can pay spreads of 200 basis points while comparable issues in Europe only pay half as much. Nonetheless, a typical weighting will be 80% for the US and Europe combined. Pedersen can allocate to emerging markets– and would have done so in early 2016 – but he feels that in August 2016, emerging markets now offer little incremental value over developed markets.

Indices are the first building blocks of Pedersen's portfolio construction because it is much quicker to execute trades via index exposure. In contrast it may take some weeks to locate single names and execute trades in the more fragmented CDS markets. Additionally, the fund can use CDS options, interest rate swaps, futures, repos and FX forwards. Leveraged loans are outside the scope of the fund and structured credit such as CLOs is also not part of the strategy.

SECTOR ROTATION

In August 2016, Pedersen anticipates being entirely invested in corporate credit risk, but over other periods he has found compelling value in asset backed securities (ABS). In 2011 Pedersen had 15% allocated to covered bonds or other secured bonds. "Back in 2011-2012 Spanish covered bonds were trading so low – in the 60s - that you could cope with 100% defaults on developers, 50% on commercial mortgages and 25% on residential mortgages and you would still profit from that investment he recalls. Unfortunately, today the European peripheral markets are much more expensive and not very attractive anymore. Why were these bonds so oversold? "They behave systemically as do aircraft leasing EETCs" Pedersen observes. Neither asset class now appeals to him as they have all been lifted by the search for yield.

Though the strategy is long biased, Pedersen has high conviction in expressing short ideas and some relative value trades. The 2011-2012 'covered bonds' trade should be seen in the portfolio context of some hedges against European risk. At the same time Pedersen bought protection on subordinated financial debt issued by Italian, Spanish and French banks. Pedersen is generally not keen on COCOs (contingent convertibles) at current valuations, but has identified value in some issued by Danish mortgage lender Nykredit. Nor does he find convertibles from non-financial issuers attractive at present. Pedersen is concerned that some convertibles are being valued on the assumption that they will be called at the next call date, and could be vulnerable to spread widening if they are not called – since their maturities can sometimes extend for decades beyond the next call date!

CAPACITY AND FUND STRUCTURE

Having run as much as 4 billion USD in his former fund, Pedersen is confident about the scalability of the strategy. While there is no predetermined hard close level, Asgard Credit fund might pause for breath at assets of 500 million USD. The fund is expected to launch on October 1st, 2016 with initial capital of 100 million USD, comprised of both proprietary capital and institutional investors. Neither of Asgard's strategies are marketed to retail investors.

Asgard Credit has created an institutionally robust framework. A monthly dealing, Irish ICAV fund structure was chosen, based on advice from Asgard's administrator, SS&C and other counterparties, such as prime brokers and custodians. Having historically ran Cayman vehicles, Moma Advisors– which became an AIFM, authorised by the Danish FSA in 2016 – was keen to set up a European domiciled AIF to facilitate marketing throughout Europe.

Excursion to Norse Mythologie

In Norse mythologie, **Asgard** (Old Norse: ''Ásgarðr''; "Enclosure of the Æsir" is one of the Nine Worlds and home to the Æsir tribe of gods. In Grimnismál, a collection of Eddas songs, Asgard is described as enormous castle made up of the twelve palaces of the Gods and surrounded my invincible walls. The palaces are made from gold and jewels, fencing is made from golden spears and from the ceilings hang the shields of the heroes. Odin and his wife, Frigg, are the rulers of Asgard. One of Asgard's well known locations is Valhalla , in which Odin rules and can oversee all nine worlds from his throne, Hlidskialf.

Time to Look at European Asset Backed Securities

BY BEN HAYWARD, PARTNER & PORTFOLIO MANAGER, TWENTYFOUR ASSET MANAGEMENT

The asset backed securities (ABS) market remains an anathema for many investors. The reluctance to look at ABS through a rational investment perspective stems from the financial crisis which started in the US and where American ABS – in the form of "sub-prime" loans – were a key culprit. This historical burden should not lead bond investors to ignore the European ABS market, which is distinctly different from US ABS.

The European ABS market is characterised by solid fundamentals, high underwriting standards and attractive spreads. In fact, historically, expected cumulative lifetime losses for European ABS are just 1.0% whereas in the US, the loss rate has been 7.3%*. Even during periods of market stress, such as the 2008 financial crisis, very low default rates were observed. Given that European ABS have attractive yields, improving fundamentals and limited supply, with the potential for capital gains if spreads tighten, now is the time for fixed-income investors to look at investing in this asset class.

ABS are bonds secured on a specific pool of financial assets, issued by a special purpose vehicle (SPV). The SPV buys a pool of loans or other assets from a financial institution, such as a bank or building society, packages them and issues them as bonds to investors. Just like corporate bonds, they pay interest periodically on a defined basis. The difference to traditional bonds is that these interest payments are not usually fixed rate, they typically offer a margin over a floating rate index such as 3 month GBP LIBOR or 3 month EURIBOR. However, just like all fixed income products, they pay the principal back at maturity.

ABS CAPITAL STRUCTURE

This key difference between ABS and other structures is that the bonds are tranched according to seniority. It means that the cash flows from the underlying asset pool is used to pay the ABS tranches in turn, from senior to junior. Thus, the cash flows appear to flow down the ABS structure, while any defaults would flow up the structure.

To compensate investors for the risk they take, junior tranches will offer higher returns than more senior tranches. An investor can then purchase the tranches they need to satisfy their appetite for risk and yield.

In addition, ABS investors benefit from three types of protection:

1. **Homeowner equity.** Any initial losses would be absorbed by the home owner's equity in the property. Before ABS bondholders suffer any losses, three things would need to happen: on average house prices would have to fall, homeowners would need to default and the other protections mentioned below would need to be exhausted.

2. **Excess interest.** This is the interest in excess of what is needed to pay the coupons on the ABS. It normally goes to the issuer of the ABS. However, if there is a loss on the sale of a defaulted property, this excess interest from the rest of the performing mortgage pool covers the loss. Therefore, it provides additional protection for the bondholder and helps to align the interest of the bondholder and issuer.

3. **Reserve fund.** This is a cash account set up by the bond issuer. It acts as a further cushion for protection and can be drawn down to offset losses.

Once these three layers of protection are exhausted, losses are allocated to the most junior tranches. The tranche has to be written down to zero before losses are recorded in the next tranche. This affords additional protection for ABS in more senior tranches, such as those rated triple-A.

Collectively these three layers of protection plus tranching provide "credit enhancement". ABS risks also reduce with time. Firstly, as the loan is paid down, the outstanding principal is reduced. Secondly, rising asset prices improve the collateral's value. The same is also true for the ABS deals themselves. As the underlying asset pool is amortised (through prepayment, maturity or even the gradual amortisation through scheduled monthly repayments), the relative size of the protection layers generally increases: junior tranches, home owner's equity and the reserve fund.

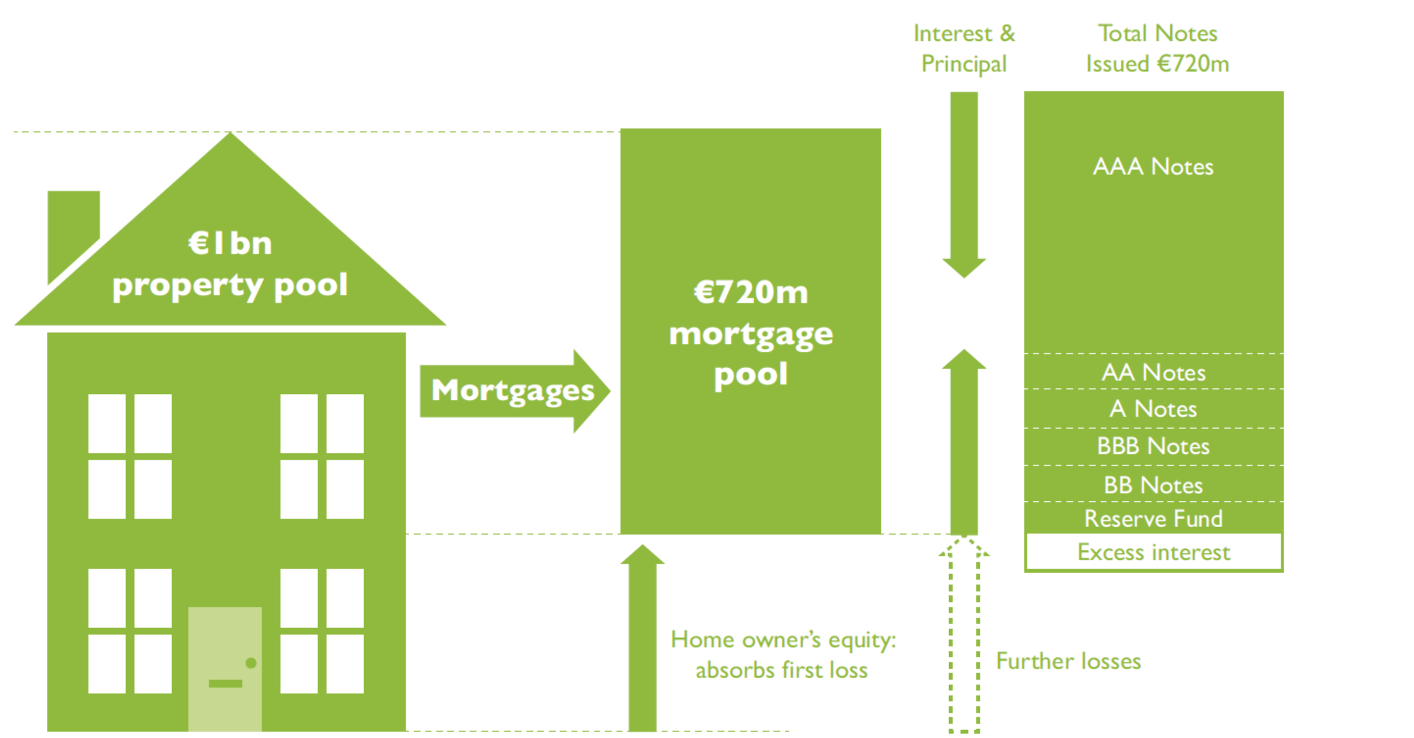
ADVANTAGES OF EUROPEAN ABS

Unlike their US counterparts, European ABS are more investor friendly, with a much better track record. In Europe, lending standards for residential mortgage backed securities (RMBS) are generally higher than their US counterparts, as borrowers are required to hold significant equity in the property and demonstrate proof of income before loans are granted.

In Europe, the focus is on aligning the interests of the issuer with the end investor. In the majority of deals, the first loss piece is retained by the issuer of the ABS. Historically, in most US RMBS all the risk was fully transferred from issuer to the bondholder, encouraging the issuer to focus on increasing volume to earn origination fees rather than maintaining quality.

One of the main reasons for low default rates in Europe compared to the US has been the ability for the lender to continue to pursue borrowers for recovery after default for a multi-year period. This has a material impact on the post-default life of the borrower, creating a more powerful

RMBS: A Sample Structure



obligation to pay. Conversely, the US mortgage market is a non-recourse market, so the property is the only way of mitigating a loss in a default scenario. This means that borrowers in default can hand the keys for a property back to the bank with no threat of further action to enforce repayment.

MARKET OUTLOOK

Thanks to improving fundamentals, European ABS enjoy a period of decreasing credit risk as a result of falling unemployment and a recovering housing market. European ABS has performed consistently well through a number of market cycles. During the depths of the financial crisis, European ABS outperformed other asset classes from a default and a loss point of view.

As such, Brexit is not expected to present significant challenges to fundamental performance. A further tailwind can be found in the limited supply of the market. As cheap funding is readily available from central banks, there has been a drop in ABS issuances. The current low supply is likely to support price performance due to the scarcity of the product. In the current yield-starved environment European ABS offer higher yields than traditional fixed income.

Highly transparent reporting means that experienced managers are able to gain exposure to pools of specific assets and find value within this under-researched segment. It is for these reasons that now is an opportune time to invest in ABS, given their attractive yields, improving fundamentals, limited supply and potential for capital gains if spreads tighten.

Ben Hayward

Partner & Portfolio Manager
TwentyFour Asset Management

TwentyFour Asset Management is a fast growing independent fixed income specialist based in the City of London. Founded in 2008 by a group of leading fixed income professionals, TwentyFour currently manages client assets of more than EUR 8 bn**. In 2015, Vontobel acquired a 60 percent shareholding in TwentyFour, with the working partners retaining a 40 percent stake in the business.

* Structured Finance Losses 2000-2014, Fitch Global, 7th February 2015, ** as of 30.6.2016

Europe and US are Different	Europe	US
Majority of RMBS Originated by Banks	✓	✗
Generally Higher Lending Criteria	✓	✗
Historical Use of Affordability tests	✓	✗
Typically Recourse Lending	✓	✗
Personal Stigma of Insolvency	✓	✗
Banks Generally Service Securitised Assets	✓	✗
Banks Typically Retain First Loss	✓	✗
Cumulative expected lifetime loss rate[4]	0.3%	8.1%

4 RMBS Losses 2000-2014, Fitch Global, 7th February 2015

Bringing Direct Lending to the Nordics

With investors being drawn from traditional fixed income assets in search for yield, the private debt market has emerged as a fast growing investment option. Within this space, investment strategies focusing on offering loans to private companies, so-called Direct Lending strategies, have emerged as a new asset class. Stockholm-based asset manager Kreditfonden aims to bring Direct Lending to the Nordics through its Scandinavian Credit Fund 1.

Fredrik Sjöstrand, founder and CIO of Kreditfonden

”The Scandinavian Credit Fund 1 looks to tap into an opportunity created by the inreased regulation imposed on banks following the financial crisis. As banks have become more restrictive in their lending activities to companies, there is huge need for financing offering very attractive yields for those that can provide short and medium term financing options”, Fredrik Sjöstrand, founder and CIO of Kreditfonden says.

> “It is by being flexible when it comes to the structure and the duration of loan deals that we can create the yield required to meet our return target.”

Direct lending, as an emerging asset class, has existed for years in the U.S. and has become increasingly popular following the 2008 financial crisis. In recent years, Europe has overtaken North America as the leading fundraiser in direct lending funds with 18.8 billion USD of assets raised in 2015. Between 2012 and 2015 Europe-focused direct lending fundraising increased by a staggering 437 per cent, according to hedge fund data provider Preqin.

”There has been a huge interest for the strategy internationally, especially given the extreme interest

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rate environment we are in and the strong risk/return characteristics that the strategy has offered historically. However, there has been no obvious way for Scandinavian investors to enter into these type of investments. We are the first to offer the strategy as an easily accessible investment option in the Nordics, Sjöstrand says.

When setting up the Scandinavian Credit Fund 1 in Sweden, Sjöstrand and the team behind Kreditfonden wanted to create an investment vehicle that was offered to the broad public rather than as a closed-end fund targeted towards professional investors only. This was made possible by the AIFM-directive.

bridge financing, i.e. to solidify a company´s short-term position until a long-term financing option can be arranged, typically done ahead of an IPO. The duration of loans will range from 1 to 36 months, with all lending secured and shorter-term deals offering the most attractive levels of yield, according to Sjöstrand.

”It is by being flexible when it comes to the structure and the duration of loan deals that we can create the yield required to meet our return target”, Sjöstrand argues.

The fund aims to offer to investors a long-term annual return of 6-8% to a low volatility profile corresponding to a

”Through setting up the fund as a listed entity on the Nordic Growth Market, NGM, and by offering profit sharing loans in the fund we could address a retail audience in accordance with the AIFM-directive. We will issue new loans on a monthly basis to secure ongoing transactions and also allow investors to buy and sell their loans on a montly basis. In the end we aim to reach 3 billion SEK in loans outstanding”, Sjöstrand says.

Loans will be issued to small and mid-sized companies that are in need of short and medium term financing for different reasons, for example to expand, to restructure, to compensate for seasonality effects or to contribute with

”2” on the KIID risk scale. The average yield on underlying loans is relatively high with levels ranging from 6 to ”well above 10%”, according to Sjöstrand. However he notes that it is not about entering into financing deals with ”counterparties that are questionable from a credit rating perspective”.

> “Europe has overtaken North America as the leading fundraiser in direct lending funds.”

”We conduct a thorough analysis before entering into a loan deal. This encompasses anything from a regular credit check to getting a feeling for the management of the company, its board of directors, CEO, accountants,

> “The duration of loans will range from 1 to 36 months, with all lending secured and shorter-term deals offering the most attractive levels of yield.”

product, and markets. It is about having as much information as possible in order to make a proper assessment of the company´s ability to repay the loan.

Previously head of trading at Handelsbanken Markets, Fredrik Sjöstrand has a long experience from fixed income and credit trading and has tied the former head of credits of Handelsbanken, Hans Lundholm to the team. Together they will be responsible for evaluating new loan deals and to make sure to avoid entering into deals where companies fail on meeting their obligations.

”By making an investment in the fund you are trusting our team of experienced team of credit analysts to make proper evalutions of the companies entering our portfolio. The inherent risk is that we will have credit events, which is something that will happen eventually. However, over time we believe default risks to be very limited and more than compensated by the yields offered on the loans that are fully repaid.”

Since the fund launched in January of this year, performance has been in line with expectations with gains of 3.6 per cent year-to-date as of August. In order to grow the fund further, Kreditfonden is now looking to tap into the disitribution networks offered by major financial advisors and insurance companies.

Peter Norman, co-founder and head of business development, says that the challenge short-term is to educate the investor community about direct lending as an asset class and to demonstrate its benefits in a portfolio context.

”Direct lending is an emerging asset class that the broader investment community needs to get acquainted to, however, from a portfolio context it is currently one of the most interesting ones. Given that the strategy shows little or no correlation to traditional assets such as stocks and bonds while offering attractive and stable yields over time, there is a strong case to be made to have it included in any model portfolio”, Norman argues.

Peter Norman, Co.founder, CEO and Head of Business Development

According to Norman, there has been an ever increasing interest for the fund since the launch, both among private indviduals and larger institutions. Although the first version of the fund has been targeted towards non-professional investors offering a minimum investment as low as 100.000 SEK, he sees the possibility of expanding the investor base to institutions in forthcoming versions of the fund.

”As the name ’Scandinavian Credit Fund 1’ suggests, there is a plan to launch additional funds going forward. In the end, this is a product suitable for professional and non-professional investors alike and we foresee great demand among Scandinavian institutions for complementary fixed income investments, of which direct lending should be considered a very interesting option.”

Does the 2016 Bounce in Emerging Markets Have Legs?

THE "CREDIT IMPULSE" SUGGESTS AN INFLECTION POINT

by Hamlin Lovell – HedgeNordic

If macro markets are efficient at discounting consensus views then, in theory, only economic surprises should move markets. But active managers cannot realistically hope to "out-forecast the market at every stage of the cycle", according to GAM's Michael Biggs, who helps manage the JB Local Emerging Bond Fund. However, he finds "the market is prone to making specific forecast errors in a systematic way" particularly in terms of how credit data is interpreted. Biggs views the market consensus and IMF mind-set as being that credit growth must be good for economic growth, and vice versa. But this conflates two conceptually different variables: the stock of credit and the flow of growth. Biggs argues that flows should be compared with flows, and on this basis the second derivative is what counts. Whether credit growth is positive or negative matters far less than whether it is accelerating or decelerating, Biggs contends. Hence, when he worked as an economist on the sell side at Deutsche Bank, Biggs coined the term "Credit Impulse", defined as the change in the rate of credit growth. The indicator has been the subject of some collaborative academic and central bank research papers, for instance with St Anthony's College at Oxford University and the Central Bank of the Netherlands.

> "...the market is prone to making specific forecast errors in a systematic way..."

When credit growth is high, but slowing, as in 2007-2008 in the US, this can be a warning sign. Conversely, negative credit growth can be consistent with positive economic growth, when the rate of credit contraction is declining. This has occurred in the US since 2009 and in Spain since 2012: when credit growth was negative but the Iberian economy was the strongest in the Euro area.

Currently, Biggs concurs with consensus views of weak US growth around trend level of 2%, but thinks anything above 1% growth is above trend for Europe and reckons the continent could be more resilient than the market thinks given strong domestic demand in some countries such as Spain and France. China has clearly been slowing down every year since 2010, with a negative credit impulse each year and downwards IMF revisions every year as well. Biggs is not in the hard landing camp but does think that China's policymakers are well aware that credit growth needs to further decelerate – to below nominal GDP growth – to prevent the debt to GDP ratio from rising.

IMPROVING TRADE BALANCES AND CURRENCIES

China has been typical of emerging markets (EM). Credit growth in EM has been falling since 2011, and the negative credit impulse helps explain the lacklustre performance of EM economies, currencies and asset prices, according to this analytical framework. However, the slowdown has had some positive repercussions as well. Weak domestic demand has lowered imports, and as a result EM current accounts have improved. Some investors fret that improved trade balances are not being driven by export growth, but import reduction has always been behind trade improvements, according to Biggs.

Improved current account balances have helped EM foreign currency reserves too despite persistent capital outflows. Reserves are well correlated with EM FX and, after a long and deep bear market, EM currencies have bounced higher in 2016. Current account adjustment alone might not drive more of an EM FX rally from here, but a mere calming of EM currency volatility could be enough to revive the carry trade as yield is so scarce.

> "...a mere calming of EM currency volatility could be enough to revive the carry trade as yield is so scarce..."

For the EM FX rally to extend further, however, Biggs believes we need a rebound in EM growth. If the credit impulse analysis is correct, this rebound could be imminent. Credit growth has fallen a long way in EM and is now below nominal GDP growth. Biggs expects credit growth to stabilise through 2016 and for the credit impulse to recover. These improvements are already evident in the economic data. EM GDP growth strengthened in Q1, and "emerging market car sales are growing and industrial production is picking up" Biggs points out.

Biggs observes that the growth differential between developed and emerging markets explains relative equity and bond market performances. If EM growth rebounds as anticipated, Biggs expects EM assets to outperform their DM peers.

INVESTMENT APPROACHES AND VEHICLES

Investors can access EM sovereigns through either local currency bonds or hard currency bonds. Though there can be small relative value discrepancies between hard and local currency bonds, the difference in performance is largely driven by the currencies. Biggs expects EM FX to rally due to stronger GDP growth, and as a result prefers local currency to hard currency bonds.

The number of "blended" EM debt funds has increased sharply in recent years, but Biggs is cautious as to whether these funds can provide additional returns over pure local or hard currency funds. He argues that the bulk of the differences in returns between hard and local funds can be explained by movements in the USD against other G10 currencies, and is not clear that EM managers have a particular comparative advantage in calling trends in the USD.

MIKE BIGGS
MACRO STRATEGIST AND INVESTMENT MANAGER

Benchmarking EM debt funds raises some conundrums. GAM's fund has maintained a consistent benchmark, the JPM Emerging Local Markets Index Plus (bonds denominated in emerging market local currencies) because an index reflective of the fund's investment universe did not exist when the fund was launched in 2000. That index, the JPMorgan Government Bond Index-Emerging Markets (GBI-EM), launched in 2005, effectively adds some duration risk and volatility to the raw EM currency index. Consequently, while the fund appears to be somewhat more volatile than the EMLI+, it is not much more volatile than the GBI-EM.

The nuances of trading local currency emerging market debt include currency restrictions and timing issues, registration requirements, tax complications and a frequent need for local custodians. GAM is experienced at navigating all of these areas.

RATE RISES AND US POLITICS

Biggs is confident about the liquidity and scalability of the strategy. Running $5bn today, he points out that the fund was once much larger. Its assets reached $9bn in 2013 and it was able to meet large redemption requests after the Bernanke 'taper tantrum' contributed to an EM sell-off around a stronger dollar and weaker commodities. These market dynamics, which might be associated with Fed rate rises, remain risk factors for the EM asset class.

> "...I am far more concerned about Trump than about Clinton..."

Politics also poses potential risks for EM local debt. "I am far more concerned about Trump than about Clinton" says Biggs as Trump could arrest, and reverse, the broad, multi-decade, trend of more open economies and more global trade. In particular Biggs views Mexico as potentially vulnerable to a Trump victory as "It depends on exports to the US and remittances from the US". But Biggs' big picture view is that the EM recovery story remains compelling – and is still a somewhat non-consensus view, meaning it may not be baked into current prices.

GAM's 'Crisis Cycle Filter' is another analytical tool that suggests investors should give serious consideration to emerging markets. The filter is a framework of nine variables, measuring the economy's balance sheet; its policy settings; its competitiveness and qualitative gauges of fiscal and banking health. Their approach to the filter is similar to his Credit Impulse – the rate of change is what matters, and fewer variables now suggest potential weaknesses. But with some of these indicators still signalling vulnerabilities, macro "tourist" investors may be reluctant to return to emerging markets.

Indeed, though investors are not as underweight of EM as they were at the start of the year (according to the Merrill Lynch survey), investors remain somewhat underweight – and at the top of the cycle they were overweight of the asset class. There is therefore scope for inflows into EM.

THE LONG AND SHORT OF IT – A DYNAMIC APPROACH TO HIGH YIELD INVESTING

by Jonathan Furelid – HedgeNordic

As interest rate markets are expected to offer lower rates for longer, the search for higher yielding debt instruments has become increasingly intense in recent years. High yield corporate credits, although coming with higher default risks, may be one way for investors to be compensated for bearing the extra credit risk.

"The asset class is however not for the uninformed investor and requires significant analytical resources and an approach that allows to dynamically adjust to changing market conditions", says Jason Horowitz, lead portfolio manager of the Muzinich LongShortCreditYield Fund.

The award-winning Muzinich LongShortCreditYield Fund aims at generating high single digit net per annum returns over a full market cycle through investing in high yield US and European corporate credits. Since inception, the Fund has generated a cumulative net return of 26.54%.

The USD 1.9 billion UCITS Fund holds a structural long bias and implements its investment ideas across four different trading books. First, its long holdings which are implemented in the "long book". Second, the Fund also actively shorts credits in the "short book" and features a third "arbitrage strategy book". The Fund further diversifies

Jason Horowitz, lead portfolio manager of the Muzinich LongShortCreditYield Fund

through holding highly stable bonds with near-term maturity in its fourth book, the "short maturity book".

According to Horowitz, who has been running the Fund since its inception in July 2012, the portfolio construction process, resting on the four independent trading books, is key to navigating the underlying volatility of the high yield credit market.

"We have seen a significant pick-up in volatility in high yield credits since mid-2014 and we expect it to remain elevated. Our multi-strategy approach, trading credits from both the long and the short side, should allow for stability while capturing the relatively attractive yields that the sector has to offer".

With high yield bonds currently yielding approximately 7 per cent, there is a steady income stream to be generated by having long exposure to the sector, Horowitz argues. However the attractive yields come with a flip side - a higher default risk.

"By avoiding defaults, investors may potentially clip a consistent attractive coupon throughout the market cycle while also having the opportunity to enhance returns by capturing price appreciations. Our in-depth credit analysis selects companies that offer opportunities for capital appreciation through drivers such as credit improvement, ratings upgrades or credit enhancing corporate actions."

In the process of identifying opportunities on the long side, the Muzinich credit analyst team, consisting of 17 credit specialists divided into groups covering the US, EU and Emerging Markets, also come up with ideas of companies showing deteriorating credits. Shorting these credits provides for a degree of portfolio protection and allows the Fund to stay agile and respond to changing market dynamics, according to Horowitz.

In the short book, the Muzinich team aims to generate alpha through a variety of tools including shorting bonds via total return swaps, buying credit defaults swaps and using indices to hedge macro exposure as well as purchasing puts on individual equities.

> "Through shorting credits we seek to benefit from the asymmetric risk-reward relationship inherent to any fixed income market"

"Through shorting credits we seek to benefit from the asymmetric risk-reward relationship inherent to any fixed income market trading at a high dollar price. We also focus on industry trends to try and identify credits that are likely to suffer from cyclical trends, structural changes or increased competitiveness", says Horowitz.

The Fund's credit arbitrage strategy allows for capturing relative mispricing in the high yield space and acts as a complement to the directional long and short books.

"The credit arbitrage book creates the potential for us to generate alpha by identifying securities that we believe are mispriced against each other. It also reduces volatility by providing opportunities to hedge exposures or balance risks", Horowitz says.

In the short-term maturity book, the Muzinich credit team looks for bonds with near term maturities and a clear path to repayment.

"Our goal is to identify short maturity bonds that we believe will be repaid regardless of the economic environment. Because of the near-term maturity, the liquidity, and the free cash flow characteristics of the companies, these bonds typically exhibit very little beta.", Horowitz explains.

Since its inception, the Muzinich LongShortCreditYield Fund has outperformed both the broad HFRI Hedge Fund Index as well as the HFRI Fixed Income Corporate Bond Index with a significant lower volatility. The Fund showed particular resilience in late 2015 and early 2016 when increased risk aversion in financial markets sent U.S. high yield credit spreads to levels not seen since 2011. The Fund has since been able to reap the benefit of improving market conditions in the second quarter of 2016 and continues to do so during the third quarter.

> "High Yield is likely to remain relatively attractive, in a world with few yield alternatives."

According to Horowitz, the Fund has benefited from its balanced dynamic approach while also providing attractive relative returns through reducing the exposure to a weak energy sector, a sector that currently comprises 14 percent of the US high yield universe.

"Starting in the third quarter of 2014 we took a number of steps to manage risk associated with lower oil prices. For example we reduced the exposure to exploration and production companies as well as to energy services companies which are the most sensitive to changes in the oil price. We have recently increased our energy exposure but will not invest based on a directional view of oil prices."

Horowitz sees three key themes currently driving the high yield credit market. First of all, higher quality bonds have been favoured by investors over the last two years on the back of global growth concerns, idiosyncratic risk and low interest rates. According to Horowitz, idiosyncratic risk remains high, leading the team to be selective on where to take credit risk. Duration has been another key driver of the positive performance which the market had to offer outside of more challenging commodities sectors in late 2014 and 2015. Thirdly, the development in the energy sector, which has seen falling energy prices having a severe impact on the high yield market in recent years, is continuing to contribute to the volatility of the sector although "there are segments which should be less subject to volatility driven by oil prices", according to Horowitz.

The Muzinich LongShortCreditYield Fund is not aggressively positioned as the market's initial risk-off reaction to the Brexit vote was replaced by a strong market bid for risk. Horowitz highlights that there are a number of factors that could adversely affect the current positive development seen in high yield credits and the Fund will remain defensively positioned in this environment.

"While recent bouts of volatility have been notably short and shallow, we think future US interest rate policy, commodity prices, US elections, and global macroeconomic concerns may still have the potential to temporarily knock markets off course. High Yield is likely to remain relatively attractive, however, in a world with few yield alternatives. We firmly believe that fundamental credit analysis will be a key in navigating markets going forward", Horowitz concludes.

by Jonathan Furelid – HedgeNordic

Global Corporate Bonds - In search of coupons

Mathias Lundmark & Stefan Ericson
Portfolio managers Pareto Global Corporate Bond Fund

By investing in corporate bonds globally while holding part of the portfolio focused on the Nordic region, Stefan Ericson and the team behind the Pareto Global Corporate Bond Fund aim to deliver 4-6 per cent annually to its investors, a quest that has become increasingly challenging given the current interest rate environment.

"We are focusing on niche companies within defensive sectors while trying to be as diversified as possible on the portfolio level. We don't just go for well-known global brands, we look through the entire value chain in order to find global suppliers to these companies. Our focus is to find 'best-in-class' players with a significant market share", Ericson explains the overall strategy of the fund.

The fund's mandate is global, spanning across a wide number of issuers and sectors, albeit with a somewhat sharper focus on the Nordic region when compared to global peers, which Ericson sees adding value over the long haul.

"Benefiting from our local presence we can find issuers overlooked by the large international players. We are, however, not overly exposed to the commodities sectors given our commitment to favouring defensive sectors. We look to build a portfolio of stable companies and sectors, not being too reliant of boom and bust cycles such as those experienced in commodity prices".

According to Ericson, the Nordic corporate bond market is liquid enough for a relatively small player such as themselves to be able to trade this market efficiently. He notes however that the number of new issuances are relatively limited, which is one of the reasons it makes sense to trade globally.

"We are rather active in buying into new issuances. In recent months we have participated in seven new deals, of which two were Nordic names".

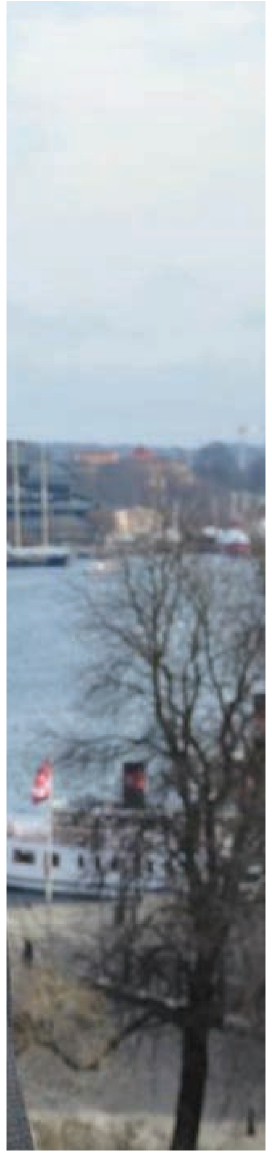
As an example of a Nordic name that the fund holds exposure to, Ericson mentions Global Connect, a Danish supplier of IT-infrastructure and fiber optic networks supporting businesses in Scandinavia and a growing number of clients in Germany.

"Global Connect is an entrepreneurial B2B company that has grown in the shadow of the major player TDC and has created a strong position in delivering internet access to highly demanding clients such as Nasdaq OMX and Viasat. The company has shown steady growth but continues to grow conservatively. We like the case given a yield of approximately 4 per cent compared to global players such as Telefonica, which yields approximately 0.2 per cent."

> **"In considering a credit, we look at sector specific characteristics, company specific ones as well as criteria linked to the bond itself..."**

Talking of risk factors, Ericsson says that the overall ambition of the fund is to limit underlying risks to the highest degree possible. Before making an investment decision, the investment team, consisting of Ericson and his colleague Mathias Lundmark, looks into three separate grouos of criteria.

"In considering a credit, we look at sector specific characteristics, company specific ones as well as criteria linked to the bond itself. We have a strong focus on sector diversification as well as diversification across markets and regions. We typically create shadow portfolios, allowing us to follow how a potential investment would contribute to the overall risk profile



of the portfolio before hitting the buy button".

The analysis conducted by the team is less linked to macroeconomic factors although the current environment merits heightened attention to central bank policy, Ericson notes.

"The negative interest rate policies and the quantitative easing measures currently conducted by central banks will have an obvious impact on our investments and need to be taken into serious consideration, he says, continuing;

"The risk with the current policies is that you get a universe of zero notes in the investment grade space. A recent example I came across was a 2-year bond issued by Volvo Trucks yielding 0.06 per cent in nominal terms. Four years ago I was buying that same bond at a yield of 5.6 per cent, which reflects the extreme environment we are in."

The fund invests at the lower end of the risk spectrum in the high yield sector and at the higher end in the investment grade space.

> **"The risk with the current policies is that you get a universe of zero notes in the investment grade space..."**

"Our holdings have an average credit rating of BB but investments range all the way from A+ to B-. Given our return target for the fund, which is in the range of 4-6 per cent, we need to take some credit risk looking for companies that can give us the additional yields required to reach that."

The fund is currently exposed to 52 individual bonds held across 46 companies with a weighted coupon of 6 per cent on the portfolio level. According to Ericson, the coupons earned, although increasingly difficult to find in the current environment, provide an efficient way to reduce the volatility profile of the fund's holdings. He compares it to owning a government bond that currently is yielding zero and therefore often comes with a higher volatility than a corporate bond, given the dampening effects that the coupon payments have on the return streams of high yield corporate bonds.

> **"I have never before witnessed a more difficult environment when it comes to generating returns in global fixed income markets..."**

Since the fund launched in March of 2015, it has delivered an accumulated return of 4.7 per cent with a standard deviation of 3.5 per cent. Year-to-date, the fund has delivered 5.3 per cent (as of end August).

Although having reached the return target for the fund already this year, Ericson emphasizes that there are a lot of challenges ahead given the current interest rate environment and the "central bank casino" that in his view is dominating the financial marketplace.

"I have never before witnessed a more difficult environment when it comes to generating returns in global fixed income markets. Since government bonds are yielding zero, you need to find good enough coupons to compensate for that shortfall in the credit space".

Ericson currently prefers to focus on regions that are not affected by the extreme interest rate policy conducted by the ECB, but emphasizes that he will not go further out on the risk scale in order to reach the stated return target for the fund.

"We currently see much better return profiles outside of the ECB QE-affected universe even though we have benefited from the increased appetite for corporate credits following the announcement from the ECB to start buying investment grade bonds. However, I am not willing to add to the risk profile of the fund but would rather lower the stated return target."

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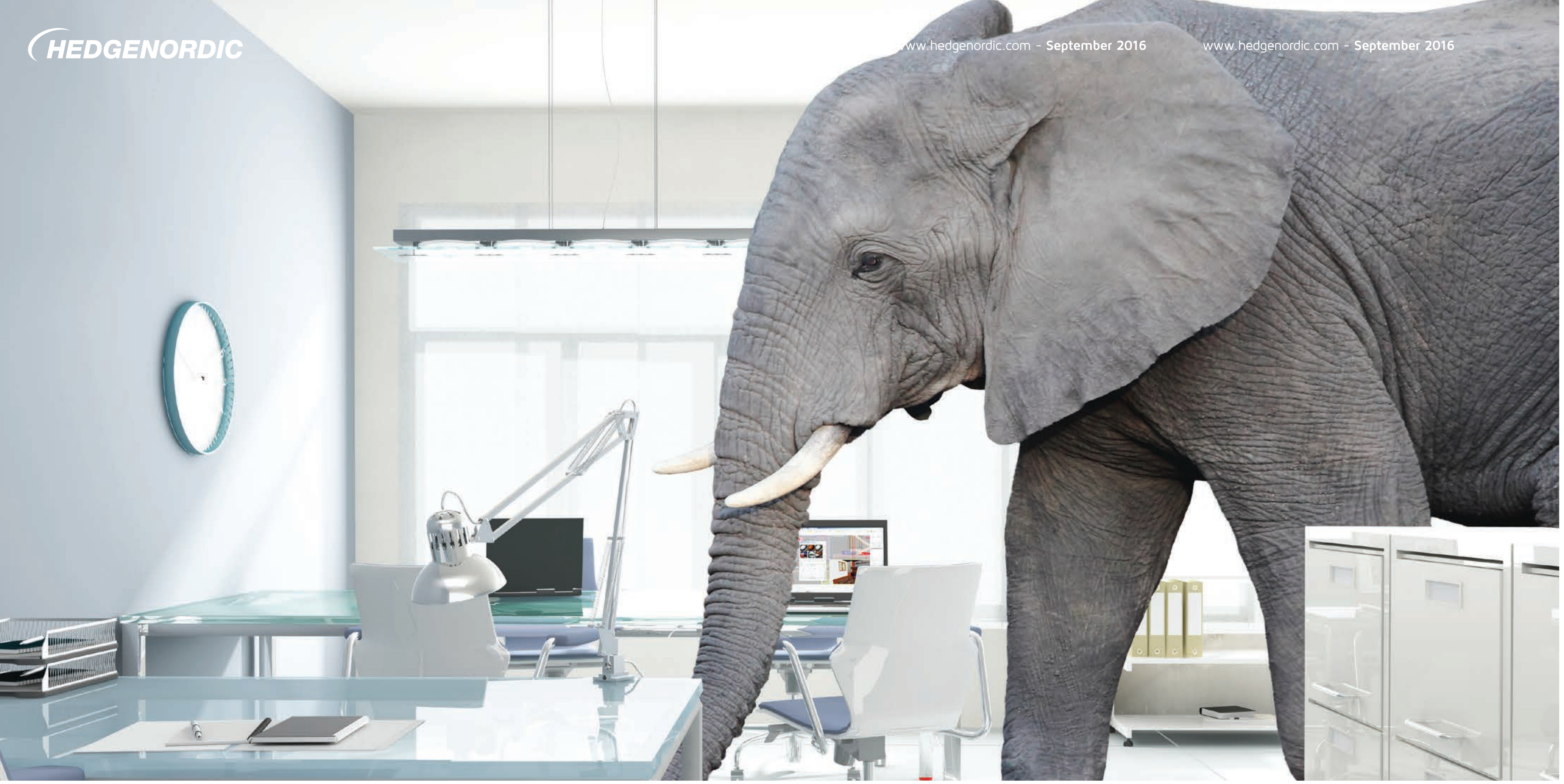

EXPENSIVE VALUATIONS, BUT SUPPORTIVE TECHNICALS FOR KAMES INVESTMENT GRADE GLOBAL BOND FUND

BY HAMLIN LOVELL – HEDGENORDIC

Recent, high single digit annual returns on the fund, for instance of [7-8%] seen year to date as of August 2016, are "very hard to repeat without incredible further moves in yields and spreads" says co-manager Euan McNeil. The strategy has been riding on huge tailwinds from the collapse of interest rates and compression of credits spreads. McNeil does not expect much capital appreciation, partly as it is hard to see government bond yields going much lower. Given where overall yields are most bonds are priced well above par, but the fund tends to buy close to par rather than above par. Though Kames sees some scope for further credit spread compression, most future returns are expected to be from income. The fund can offer an annualised distribution yield of 3%, paid quarterly (accumulation share classes are also available).

CENTRAL BANK ASSET PURCHASES

Currently, "valuations in isolation are very expensive, but technicals suggest they could stay expensive or become more expensive" is McNeil's view. The elephant in the room is central banks – the ECB and Bank of England. Brokers say the ECB is doing purchases of EUR 350mm per day. Investment banks say this is 25% of daily volume, but as the ECB is only buying, 50% of all purchases are from ECB. Additionally "the Bank of England's plan to buy up to GBP 10bn is a big chunk of a small market" points out McNeil. Clearly noisy buyers in the market must have influence on spreads and demand.

Kames positioned the portfolio to profit from asset purchases, by over-weighting Europe. The fund increased European exposure from the benchmark weighting of 20% in late 2015, to an overweight stance of 30% by June 2016, reflecting a view that the ECB would be active in the market and the Euro market would gain from that.

The ECB can buy certain bonds with yields as low as minus 0.4%. The fund may own some assets with negative yields, such as German Government bonds, and can own up to 33% in government debt. But this is more a short term parking space for cash inflows than a long term investment strategy. As such it can be seen as an alternative to cash weightings that can reach 20%. In August the fund has a top ten position in German Bunds but is looking to redeploy this into USD denominated debt with positive yields.

The strategy started in November 2007 and has outperformed its benchmark (Barclays Global Corporate USD) with top quartile performance for the past one, two, three, four and five years. Asset allocation decisions- such as accentuating European exposure

> "...it takes a very brave investor to bet against Draghi and underweight the sectors being bought by the ECB - that technical has been the biggest influence for our markets."

- are one of six active sources of potential outperformance. The others are macro calls on duration and yield curve; and bottom up conviction on ratings, sector and stock selection.

CREDIT SPREAD EXPOSURE KEY

The portfolio is neutral duration now, relative to the index duration of 6.8 years. The strategy was overweight duration earlier in 2016 - but has never used its full flexibility to go plus or minus three years versus the benchmark. The relative composition of Kames' duration risk may be more informative. The index duration of 6.8 years is comprised of five years USD, one year Euro, half a year GBP and the rest in Canada and Australia. Kames are overweight US duration at 5.5 years, and GBP at 0.6 years, but are as of August 2016 underweight EUR at 0.74 years. USD investment grade debt now offers considerably higher credit spreads than Euro debt.

Although the fund's core asset class, investment grade credit, (which has a minimum allocation of 67%) does have more interest rate risk than generally shorter maturity high yield bonds, the fund's over-riding risk factor is being long credit risk. "It has a disproportionate impact from credit spreads narrowing and rising" says McNeil.

Some of the credit spread sensitivity comes from high yield, to which the fund can allocate up to 20% with a minimum rating single B. Less than 3% of the book is in traditional, original issuer, high yield however. Most of it is 'fallen angels' (which were formerly investment grade) and subordinated financials.

SECTOR VIEWS

Sector over/under-weights are based on a mix of top-down and bottom-up analysis. Kames views bank paper as generally less attractive than non-financials, as it is not admissible to the ECB CSPP purchase programme. But sometimes the valuation disparity is such that valuation outweighs

Euan McNeil

Manager of the Investment Grade Global Bond Fund

technical support from the CSPP, which is why Kames has selected some subordinated financials. Still, McNeil thinks "it takes a very brave investor to bet against Draghi and underweight the sectors being bought by the ECB - that technical has been the biggest influence for our markets."

"...spreads and fixed income markets are well supported by technicals. It is hard to see a selloff having any traction as any hint is met by more buying"

Drilling into stock selection, the fund selects around 150-170 holdings, and the benchmark contains nearly 10,000. Examples of some single names owned include many household names, such as a new issue in generic drug-maker TEVA Pharmaceuticals; a holding in French bank BNP Paribas; Microsoft, and brewer Anheuser Busch.

The underlying portfolio is currently 60% in USD bonds, 30% EURO denominated, and 10% GBP but this is hedged back to the relevant currency share class (including USD, GBP, EUR, SEK) using FX forwards. The fund does not take emerging markets risk nor equity risk eg via convertibles. "We could take inflation risk but would need a particularly strong view from the rates team" says McNeil.

VOLATILITY AND LIQUIDITY

Kames' outlook is sanguine but McNeil is cognizant of potential for volatility to arise from events such as the Italian referendum in October; issues in Portugal at present; the Presidential election in the US, and uncertainty around the Fed, for instance if Yellen's Jackson Hole symposium remarks are interpreted as a surprise. "Yellen has been very poor at guiding markets, but if she became very hawkish that could be a shock" McNeil opines. At the same time, "spreads and fixed income markets are well supported by technicals. It is hard to see a selloff having any traction as any hint is met by more buying" he adds. The fund targets strong risk-adjusted returns over a rolling 36 month period so will weather some setbacks along the way, and returns were negative in 2008.

Liquidity as well as volatility is a concern for some allocators, and Kames has been very public on the topic for many years. The manager has compiled a composite liquidity measure comprised of trading volumes, dealer inventories, and bid/offer spreads, which together suggest that liquidity has dropped as much as 90% since 2008. Kames runs EUR 1.75bn in the investment grade credit strategy and McNeil argues "the fund is very liquid, and can rotate exposures to take advantage of relative value". Kames are active in primary and secondary markets and pay heed to liquidity when constructing portfolios. The portfolio's liquidity also needs to align with the dealing terms for the Irish, UCITS-compliant OEIC fund structure.

ABOUT KAMES CAPITAL

Kames Capital is a specialist investment management business. From offices in Edinburgh and London Kames manages EUR 76 billion (30 September 2015) on behalf of UK and international clients - including wealth managers, financial institutions, pension funds, charities and financial advisers.

INSURANCE LINKED STRATEGIES

– UNCORRELATED RISK PREMIA AND ACTIVE MANAGEMENT

by Hamlin Lovel – HedgeNordic

Catastrophe bonds are almost entirely uncorrelated with macro-economic variables – a characteristic which makes them highly relevant for those investors seeking diversification away from equities while securing returns amid the low-yield and volatile environment. Lombard Odier Investment Managers recently launched a CAT Bond Fund, a weekly dealing UCITS that targets long-term returns of money market yield +2-4%, from owning and trading CAT Bonds.

The Birth of CAT Bond Markets

The market for ILS emerged in the mid-1990s, following hurricane Andrew (1992) and the Northridge earthquake (1994). Andrew caused property damage in excess of USD 26 billion, primarily in Florida and Louisiana, while Northridge is estimated to have caused more than USD 15 billion of damage to the Los Angeles area. Natural catastrophes occur relatively rarely, but can be devastatingly destructive when they do. The societal and environmental consequences of such events are often tragic, and from a financial viewpoint all it takes is for one disaster to hit a highly populated area, and an insurance company's capital base can be completely depleted.

> **"The market for ILS emerged in the mid-1990s, following hurricane Andrew (1992) and the Northridge earthquake (1994)."**

These two major events awoke the insurance industry to the significant financial impact of large catastrophes and highlighted the need for the industry to tap into financial markets to replenish its capital base. Since then, increasing regulatory pressure and the inefficiency of using equity capital to fund extreme event risk, as well as investors need for diversification and investment returns have, provided the impetus for the CAT Bond market growth.

Why Catastrophe Bonds

The appeal of CAT Bonds for investors is three-fold. CAT Bonds are financial instruments whose risk is linked to the occurrence of natural events. As such, their return profile is related to factors such as meteorology, geology or engineering and is unrelated to the economic cycle. Unlike other asset classes, where, as highlighted by the recent financial crisis, all individual securities tend to move in one direction, CAT Bonds are characterised by a high level of intra-class diversification.

As an illustration, one can build a CAT Bond portfolio by selecting assets linked to independent risk factors such as Japanese earthquake, California earthquake, European wind, US tornadoes, Florida hurricane, and Australian cyclones. If each of the six events covered has a 1% probability to occur, the probability of a total portfolio loss is 0.000000000001, or once in a trillion years. Moreover, in the more likely scenario where only one or two of the six insured events occur, the other bonds in the portfolio will continue paying a coupon, thereby dampening the capital loss.

> **"CAT Bonds' prices are largely immune to movement in interest rates (their duration is close to zero), a particularly interesting feature in the current interest rate environment."**

The second element is driven by returns, which are relatively higher when compared to most other fixed income assets. CAT Bonds have returned an annualised 8.2% on a historical basis (Swiss Re CAT Bonds Index 31 December 2001 – 31 December 2015). Spreads, or the insurance premium an investor is paid in exchange for taking natural event risk, currently stands at 5.5% (measured by the Swiss Re Index) and have come round almost full circulate to the 5% level seen on the first CAT Bonds in 2002, as show on the graph below. In the interim, spreads spiked to 10% after Hurricane Katrina in 2005; to 6% in 2008 and to 9% in 2013.

Thirdly, CAT Bonds are structured as floating-rate notes, meaning that on top of the aforementioned fixed spread, their quarterly coupon includes a floating element that is directly linked to money market rates. When and if interest rates rise, the floating component of the returns should swiftly follow suit.

The floating component of CAT Bonds coupon payments exists because the proceeds of a CAT Bond issuance are kept as collateral in a special segregated account during the life of the bond, while waiting for the bond's outcome (the occurrence or not of a qualifying event). Another advantage CAT Bonds offer is that because the cash has already been raised, investors do not have to worry about the risk of the insurance company failing to make good on its commitments after a catastrophic event" explains Gregor Gawron, Head of Insurance Linked Strategies at Lombard Odier Investment Managers. Volatility on some bonds in 2008 came from the collateral exposure to counterparty risk, principally from total return swaps with Lehman Brothers. These are no longer a feature of post-crisis CAT Bond structures, which are typically invested in AAA-AA rated money market funds and held by a trustee."

This substantial mitigation of credit risk, combined with the floating rate nature of CAT Bonds, may mean that CAT Bond spreads are not an 'apples to apples' comparison with those on other fixed income instruments. But to provide some perspective, CAT Bond spreads of 5.5% are close to US high yield bonds offering 6% (including credit and duration risk) and a bit higher than senior secured loans offering 4.8% (with credit but minimal duration risk). The real draw, though, is not just the level of returns but the pattern of returns. In a portfolio context CAT Bonds have historically provided diversification because their returns are not correlated to, bonds, equities or commodities as shown below (31 December 2001 – 31 December 2015).

LOIM's UCITS only invests in CAT Bonds, which have an active secondary market. Other LOIM strategies can allocate to private insurance contracts (such as industry loss warranties and collateralised reinsurance) that

Figure 2: CAT Bond Diversification Benefits

	CAT Bonds	Equities	Bonds	Commodities
CAT Bonds	1,00			
Equities	0,19	1,00		
Bonds	0,13	0,17	1,00	
Commodities	0,14	0,48	0,32	1,00

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currently offer a slight illiquidity premium and greater diversification potential, in return for lock-ups of one year or more. Liquidity in CAT Bonds is, according to Gawron, easier when exiting than entering. "Currently, it can take time to source bonds at a good price, but it is relatively easy to sell them" he finds. LOIM has a dedicated fixed income trading desk that also services the CAT Bond strategy and helps to ensure best execution.

The maximum capacity of the UCITS, of $400mm, is not due to liquidity. It is specific to CAT Bonds and not other ILS; it is related to the UCITS diversification criteria, and an additional constraint comes from new Luxembourg domicile limits on risk exposures that translate into a 35% limit on the largest peril and a 20% cap on all others. A non-UCITS fund or one under another domicile could have greater capacity.

Active Management

The investment strategy used by the CAT Bond team at LOIM aims to actively exploit arbitrage opportunities in the market, which differentiates the strategy from the buy and hold players. The Relative Value sub-strategy does not short bonds but can rebalance the book, for instance to take advantage of seasonal fluctuations. For example, US wind bonds tend to cheapen over the summer months, when hurricanes occur, but still pay coupons over the winter months, when the insured risk is irrelevant.

The lower case - event driven strategy seeks to capitalise on market anomalies related to natural events that cause significant price disruption for specific CAT Bonds; meaning the team takes active views on bonds during, or after, events. For example in 2011 Gawron was of the opinion that the developing Hurricane Irene would not be severe enough to trigger losses on North Carolina or Massachusetts CAT Bonds. He bought one bond at 70 cents and another very senior one at 90 cents. Neither incurred losses, which illustrates the importance of researching types of CAT Bonds. Uncertainty, and the associated volatility, around the level of losses, creates trading opportunities. For instance one bond in 2005 paid out only on losses attributable to wind, and not floods. In 2012 Gawron also profited from his view that Hurricane Sandy would not cause losses for bonds covering New York and New Jersey, which recovered from his purchase price of 70 back up to par.

These inefficiencies arose from asymmetric information. "This type of bottom-up, bond-specific, analysis could be difficult for those market participants that allocate to CAT Bonds as an asset class on a top down basis, for the broad diversification benefits" argues Gawron.

Analytical Processes

In contrast, LOIM has developed deep and detailed analytical processes combining in-house and external resources.

"But we also have the expertise to assess the insurance-related features" explains finance phD Gawron. He has spent over 10 years honing and refining his proprietary optimisation techniques, which he says "take account of seasonal, regional and event-based interdependencies and are more robust methods that generate a better efficient frontier".

> **"Our philosophy is to view CAT Bonds as fixed income instruments rather than reinsurance contracts"**

Appropriate datasets and statistical approaches are used. The probabilities of catastrophes occurring is so low that 300,000 years of simulated data is needed to capture these long-tailed events. Gawron illustrates why: "the probability of two, independent, once in a century risks occurring in the same year is once in 10,000 years". And as a normal distribution is clearly not relevant, fat-tailed statistical distributions, such as Pareto, and Generalised Pareto, are used. "External specialist companies, which have the latest data on meteorological developments and on US property prices, are also used." says Gawron.

Risk Management

Risk management is undertaken by the team using instrument-specific tools on insurance risk, models, and actuarial underwriting analysis including resets, coinsurance, and stress testing for event probabilities. Legal and structural analysis looks at motivations, underwriting, and transaction structures, and service providers such as trustees, paying agents and administrators, all of which are independent. In addition there are weekly meetings looking more at fund-specific risk guidelines such as compliance, legal and internal policies on concentration and cash.

Gregor Gawron, Head of Insurance Linked Strategies at Lombard Odier Investment Managers

The LOIM fund has diversification criteria somewhat tighter than the UCITS 5/10/40 Rule. "The maximum position size is capped at 5% for very senior 1 in 1000 year type risks such as extreme mortality bonds, while position size is usually smaller in junior bonds" says Gawron. Wider limits apply to perils, but investors should appreciate how much diversification exists within peril categories. "A peril is not the same as an event. North America is one peril category but it offers diversification by junior or senior bonds, residential or commercial properties, coastal and inland properties, New York, Florida and Texas, hurricanes and floods and so on" explains Gawron.

The benefits of diversification and bond selection have been seen in 2016 with the Kumamoto earthquakes proving to be a non-event for the fund. "This was not severe enough to trigger relevant loss thresholds and was away from the densely populated Osaka and Tokyo regions" explains Gawron. Japan is not in fact a particularly large part of the catastrophe bond market because the Government has traditionally borne the brunt of most losses, stomaching most of the $300bn of economic losses, while the insurance industry loss was only around $30bn, Gawron recalls.

But Japan is unusual: elsewhere, insurers' inability to pay out policy holders following disasters such as Hurricane Andrew was the genesis of the CAT Bonds market.

Capital adequacy rules, such as Solvency II, further increase the imperative for insurers to transfer risk and obtain capital relief through CAT Bonds. In the meantime, the CAT Bond market should continue to grow as the insurance industry seeks to cope with an ever-increasing concentration of wealth in urban centers.

CAT Bonds provide a truly diversified revenue stream that is not related to the macroeconomic cycle and there risk reducing properties are highly valuable to both bond and equity investors, particularly insurance companies.

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TARGETING OPPORTUNITIES IN U.S. LEVERAGED CREDIT

By Sebastian Vargas, CFA, Business Development Director, Eaton Vance

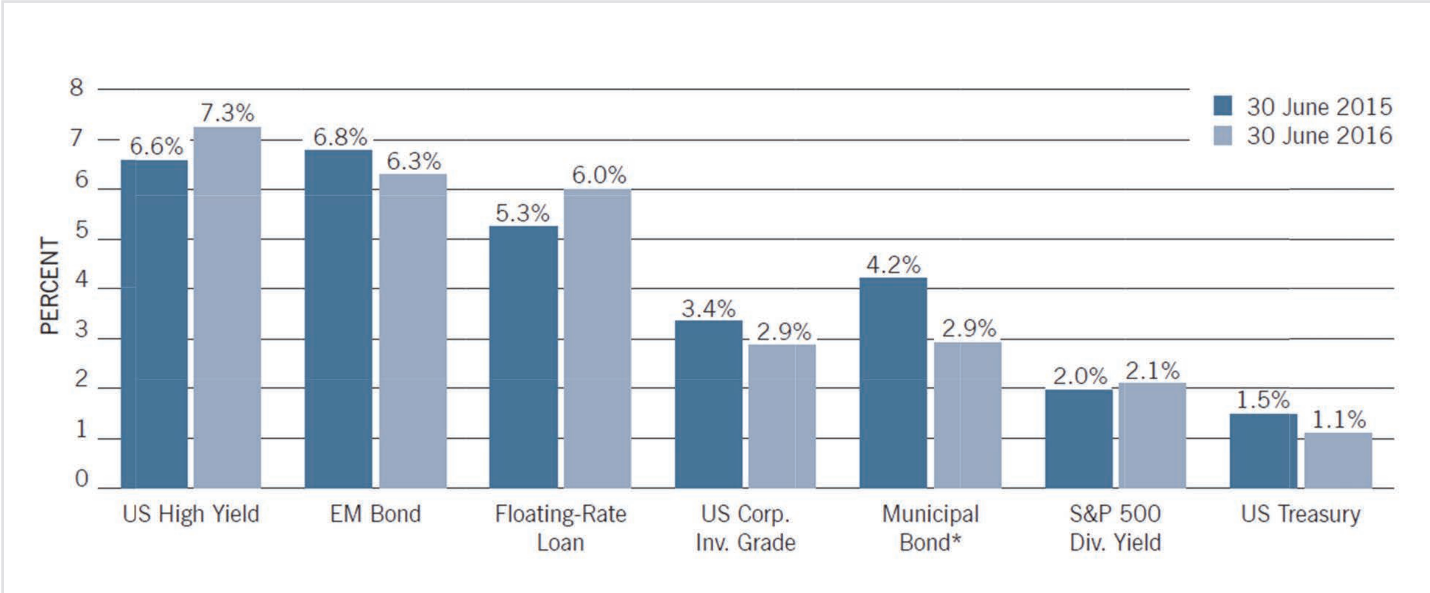
Tepid economic growth, record low government bond yields and the prospect of lower-for-longer interest rates is continuing to see income-oriented investors taking advantage of opportunities to reallocate to higher-yielding assets. The leveraged credit market is a case in point. Having been buffeted by risk-off sentiment in 2015 and early 2016, the market has rebounded strongly since mid-February, brushing aside a temporary setback following the Brexit referendum result.

As represented by the US-dollar denominated S&P/LSTA Leveraged Loan Total Return Index, bank loans gained 2.9% in the second quarter of 2016 (4.5% for the year to end June 2016). Meanwhile, US-dollar denominated high yield bonds, as represented by the BofA Merrill Lynch US High Yield Index, gained 5.9% in the second quarter (9.3% for the year to end June 2016). Compared to the 3.8% gain in the S&P 500 Index for the first half of 2016, these are impressive results.

US high-yield bonds and floating-rate loans have, in our view, now moved closer to fair value, but still offer a compelling risk/return proposition. A low-growth, low-expected-return environment that is supported by central banks represents a very supportive backdrop for below-investment-grade US corporate credit. Any sharp sell-off in these sectors – or in specific securities that are insulated from the direct impact of Brexit – could present even more attractive buying opportunities.

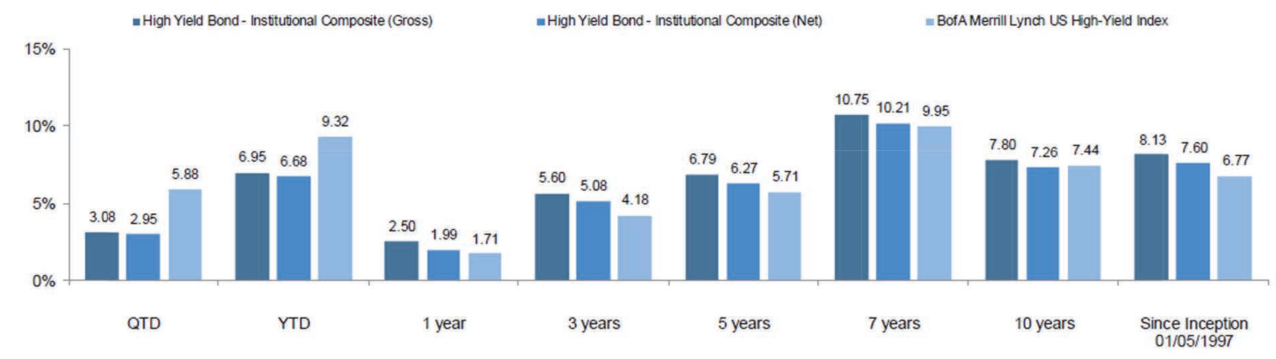
Currently (as per the chart below) high-yield bonds and floating-rate loans continue to offer attractive yields relative to many other asset classes. And, unlike other fixed-income sectors, their yields are higher than a year

HIGH YIELD AND LOANS OFFER ATTRACTIVE YIELDS IN TODAY'S ENVIRONMENT.



Sources: Eaton Vance, Factset, Morningstar as of 30 June 2016. S&P 500 is represented by the S&P 500 Index. EM Bond is represented by JPMorgan GBI-EM Global Diversified TR USD. Municipal Bond is represented by Barclays Municipal Bond Index. U.S. High Yield is represented by Barclays U.S. Corporate High Yield Index. Floating-rate loans are represented by S&P/LSTA Leveraged Loan Index. U.S. Corp. Inv. Grade is represented by Barclays U.S. Corporate Investment-Grade Index. U.S. Treasury is represented by Barclays U.S. Treasury Index.

EATON VANCE'S U.S. HIGH-YIELD BOND INSTITUTIONAL COMPOSITE: ANNUALISED RESULTS AS AT 30 JUNE 2016



Annual Results	2015	2014	2013	2012	2011	2010	2009	2008	2007	2006
High Yield Bond - Institutional Composite (Gross)	-0.62%	4.15%	7.99%	15.57%	5.53%	16.02%	55.72%	-27.05%	2.58%	12.68%
High Yield Bond - Institutional Composite (Net)	-1.11%	3.64%	7.46%	15.00%	5.01%	15.45%	54.97%	-27.43%	2.07%	12.13%
BofA Merrill Lynch US High-Yield Index	-4.64%	2.50%	7.42%	15.58%	4.38%	15.19%	57.51%	-26.39%	2.19%	11.77%

Sources: Eaton Vance and BofA ML.

ago. Even factoring in an expected pickup in default rates (and lower recovery rates) at this point in the credit cycle, we believe investors are being adequately compensated for risk. (We believe their high coupons should more than offset possible credit losses). Putting this in context, it is worth noting that in the government bond sector, the sum of negative-yielding issues is now US$13 trillion. (Source: Bank of America Merrill Lynch calculations in July.)

In our view, the case for a strategic allocation to leveraged credit remains intact. Its two sectors – floating-rate loans and high-yield bonds – occupy a special capital market niche. Their shorter duration characteristics and often higher yields relative to other income assets mean that they can add value not only in today's environment of low and negative yields, but also when interest rates eventually turn up.

Investors looking to add strategically to leveraged credit may wish to consider investment via standalone floating-rate and high-yield strategies – which can be especially attractive as complements to Core and Core Plus portfolios designed to substantially mirror major fixed-income benchmarks – or via a multi-asset credit (MAC) strategy. For pension plans struggling with governance budget constraints, a MAC strategy can potentially offer a convenient one-stop solution. The low correlation of loans and high-yield bonds with traditional fixed-income debt also means that a MAC portfolio can serve as a cornerstone for diversifying a traditional fixed-income portfolio.

A key due diligence consideration for institutional investors and their advisers when considering MAC options is whether the investment manager offering the strategy has the requisite expertise in the underlying asset classes. In this regard, we think Eaton Vance has very strong credentials.

Few income-oriented managers can match the experience, expertise and professional continuity of Eaton Vance's dedicated income sector investment teams. Our investment professionals helped shape the historic growth in the US of the floating-rate loans and high-yield bond sectors, and our high yield and floating rate loan strategies have demonstrated unequivocally that they can add value over different cycles.

Our investment approach combines bottom-up, fundamental credit research — employing quantitative and qualitative tools to generate proprietary views on value – with systematic risk-weighted portfolio construction. Our investment time horizon, given our contrarian approach, is typically longer term, but we can also be nimble when shorter-term, potentially high-return opportunities arise.

Our US high-yield portfolios employ rigorous fundamental credit research and market-factor analysis to capitalise on inefficiencies in the high yield bond market. Via an opportunistic, value-driven approach, we seek to deliver consistent risk-adjusted performance with high information ratios and a favourably skewed up/down market capture.

According to eVestment Alliance Peer Group Rankings as at 30 June 2016, our US high-yield composite ranks in the top quartile over 3, 5, 7, and 10 years.

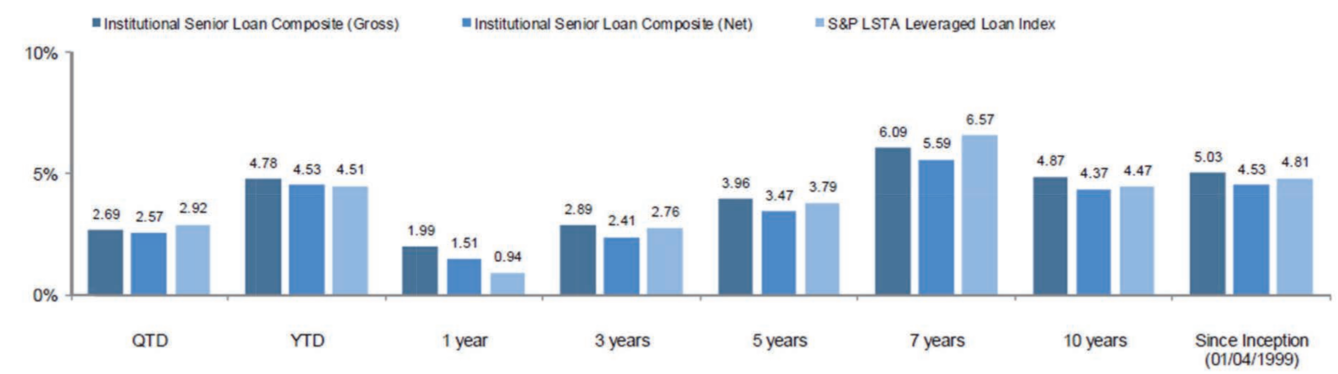
Our loan portfolios are conservatively managed. We endeavour to outperform the market on a risk-adjusted basis over full cycles, but with a strong emphasis on limiting downside risk. To this end, our portfolios have a bias towards higher quality credits (we believe there is an asymmetrical relationship between credit risk and return potential in this asset class) and are broadly diversified in terms of industry exposure and number of positions (450-550 positions).

Our floating rate loan strategy is designed for investors who want a high, steady return – higher than that offered by investment grade bonds – but who also want to sleep at night. Performance will typically tend slightly to lag risk-seeking peers whose portfolios have a bigger emphasis on less liquid, more exotic credits. However, it is worth noting that whereas our strategy has survived many cycles, previous downturns have claimed the scalps of a number of opportunistic, risk-seeking strategies.

The performance of our senior loan composite highlights our conservative approach. Over the year to 31 March 2016 – a generally difficult period for risk assets globally – the strategy held up well, returning -0.26% (gross of fees) versus -1.26% loss for the in S&P/LSTA Leveraged Loan Index. In the second quarter of 2016, however, a very strong rally in lower quality areas of the index (second-lien loans and loans rated CCC and D) saw the strategy gaining less than the overall index.

At Eaton Vance, we believe our leveraged credit capability represents a compelling proposition for investors. With financial market stability risks having risen and more volatility in risk assets likely, we believe our tried-and-tested approach should continue serve investors well in a world where central bank-dispensed medicine continues to fall short of stimulating real economic growth. In our view, the outlook for the US leveraged credit market remains positive. Adequately healthy corporate fundamentals, a light new issuance calendar for the remainder of 2016 and the continuing prospect of low to negative global yields should continue to underpin demand for US credit.

EATON VANCE'S INSTITUTIONAL SENIOR LOAN COMPOSITE: ANNUALISED RESULTS AS AT 30 JUNE 2016



Annual Results	2015	2014	2013	2012	2011	2010	2009	2008	2007	2006
Institutional Senior Loan Composite (Gross)	-0.28%	1.35%	5.19%	8.30%	3.51%	9.71%	45.73%	-24.82%	3.09%	7.10%
Institutional Senior Loan Composite (Net)	-0.76%	0.87%	4.70%	7.79%	3.02%	9.19%	45.06%	-25.19%	2.60%	6.59%
S&P LSTA Leveraged Loan Index	-0.69%	1.60%	5.29%	9.66%	1.52%	10.13%	51.62%	-29.10%	2.02%	6.77%

Source of Data: Eaton Vance, as of 30 June 2016 unless otherwise stated

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New brooms to sweep clean at Catella's fixed income funds

by Pirkko Juntunen – HedgeNordic

Continuous change is the name of the game in the world of investments. Modern risk management aims to mitigate the worst of these shocks but changes within an investment organisation itself in particular can be an uncomfortable ride both for clients and those working within the organisation.

Fund management companies have long discussed how to best deal with the so called key-man risk, whether a founder, CEO or a star portfolio manager. In the case of the latter many opt for moving away from a single star fund manager and instead have a more team-focused approach. This all well and good in theory but if a lead portfolio manager is not only good at his or her job of managing money but also charismatic and eloquent they often become the focus on both media and client attention, despite efforts to emphasise a team ethos.

During the summer Catella was thrown in at the deep end with the departure of four portfolio managers from its team, including the oft-quoted hedge fund manager Ulf Strömsten and his colleague Mikael Hanell. The team managed some SEK40bn so ensuring a smooth transition was vital. The ink had hardly dried on the news headlines focusing on the 'exodus' when Catella's hedge fund team hired Martin Jonsson and Anders Wennberg, adding that continuity had been secured by also retaining three existing team members.

The other two departures came from the fixed income team, which also handles the elements of interest-bearing investments in the Catella Hedgefund. Replacements were announced in August with Thomas Elofsson and Stefan Wigstrand joining on September 5 from Skandia, replacing Magnus Nilsson and Fredrik Tauson.

How do the new recruits envisage making their mark while ensuring continuity?

Elofsson and Wigstrand were interviewed before their official start date so would not comment on portfolio specifics but said that transition is expected to be smooth since they will be working alongside existing managers. Both also insisted they left Skandia in order to take on new challenges rather than because of any misgivings about the company or their roles.

> "You can analyse and make judgement calls on the likelihood of certain events, but as an industry our job is to make decisions under very uncertain circumstances and knowing that the risks are often much greater than you can anticipate."

Elofsson, as a former Swedish Junior High-jump champion, is used to setting the bar high (pun intended) and believes that everything can always be improved. At Skandia he was head of investment strategy and deputy CEO responsible for the teams managing fixed income, foreign exchange, credit, tactical allocation as well as balanced and fixed income funds.

The duo also concurred that coming from a life insurance company to a fund company will be a change in terms of investment horizon and culture, adding that both are fundamentally risk averse, but yet taking risk is what the job is all about. "I am looking forward to working in a new team and challenging myself rather than staying perhaps another five years doing the same thing. Change can be challenging but it is also an opportunity," Elofsson said.

Elofsson and Wigstrand agree that one of the biggest changes will be to manage a more liquid, flexible portfolio at a smaller organisation, compared to Skandia. In addition, they said it is very different to being part an overall portfolio with many asset classes compared to a single portfolio, as handling the down-side risk is very different with new opportunities. "I am particularly excited about working on the Hedgefund and the different instruments used," Wigstrand said.

Neither expect any immediate or dramatic changes to the current portfolio but are confident they can add value and over time making it their own. "I want to make sure that we

> "Most of the time it´s just stupid to fight the central banks, but we´re getting closer to the moment that fighting them is the only reasonable thing to do."

take our time to develop the product and reflect over how to improve it. It is not always as easy as it sounds as you have to also focus on your day job, which is busy enough, but it is nevertheless important," Elofsson said.

Speaking on market opportunities and challenges Elofsson said that one of the main things he has learnt is that predictability is very low overall. "You can analyse and make judgement calls on the likelihood of certain events, but as an industry our job is to make decisions under very uncertain circumstances and knowing that the risks are often much greater than you can anticipate," he said.

On the macro outlook both said the unprecedented situation where the central banks' interference does not have the desired and intended effect on the economy but does affect the market and asset pricing is challenging. They argue that the current environment impedes traditional analysis because the context and cause and effect have all changed. The duo expect the low interest-rate environment to continue with the implications that companies will survive and are able to pay their debt, i.e a low default rate. "However, this does not mean that these companies are particularly financially healthy companies. Instead the central bank policies are artificially keeping them alive," Wigstrand said.

The actions of central banks have and will continue to have long-term consequences and often unforeseen and unexpected consequences since their actions are short sighted, he said, adding that security selection is therefore more important than ever as is diversification.

"Most of the time it´s just stupid to fight the central banks, but we´re getting closer to the moment that fighting them is the only reasonable thing to do.", Elofsson says. He believes the monetary policies designed to increase growth and higher inflation have so far failed. Low interest rates have just led to higher asset prices and ever increasing debt levels throughout the world economy, that could be perfect storm lining up for a dangerous world for investors. Alternative investments and long only strategies are very crowded in the historical context, he observes. "Adding the increasing popularity of passive funds you have an environment where true value based investment strategies should perform. It is more important than ever to be concerned about downside risks, and this is why you should be careful of long only investments." Wigstrand agrees with his co-portfolio manager and says: "long-only strategies in particular will suffer, in favour of absolute return and hedge funds, focused value oriented strategies with asymmetric pay off profiles is what a sober investor should aim for."

Stefan Wigstrand

Thomas Elofsson

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Elofsson thinks the outlook will continue to be sluggish and that a low return environment is here to stay for the foreseeable future, something investors better get used to. He is convinced it is important that the investor understands that expected return figures will need to come down due to the inflation of asset prices. "For us as a manager we are much appreciating the unconstrained possibilities some of the fund mandates offer us, we can work with the complete capital structure of the company. The mandates allows us to be opportunistic investors and to add on protection when needed," he says.

The Nordic region remains somewhat of a safe haven, despite country differences, the duo said. The culture of politically stable societies, transparent corporate governance and focus on returns still remain. They believe the region as a whole will continue to grow faster than the rest of Europe. In addition, the Nordic capital markets play a more important role today. Historically, banks have been the main source of funding for companies but are now on the defensive due to increasing regulations and higher capital requirements. Consequently, companies are increasingly turning to the capital market to fund themselves, creating opportunities for credit investors.

Norway's dependency on oil is an obvious area to watch. "As the oil price has fallen companies in the sector with a lot of debt on their books have been hurt and there is less appetite for new development. Domestic financial institutions' natural exposure towards the energy sector creates interesting opportunities elsewhere in the Norwegian market that Catella with its strong Nordic presence will take advantage of. "We see opportunities within the Norweigan market but will still be careful with credits in oil, oilservice and shipping".

Swedish domestic risks are the increasing household debt, with a generational difference in that younger people are the borrowing and the older are saving, combined with a potential real estate bubble. "This has an effect on consumption because the younger generation, who are supposed to build the country, are too indebted by their mortgages to be able to buy much of anything else," Elofsson said, adding that the banking sector is very much in a sweet spot in the country catering for both the young borrowers and the old savers.

According to Elofsson the main issue in Denmark is that the currency is pegged to the Euro and will be affected according to its movements. "In general the Danish industries are more defensive and have done well. Particularly when a large company such as NovoNordisk

> "Outlook will continue to be sluggish and a low return environment is here to stay. It is important that the investor understands that expected return figures will need to come down due to the inflation of asset prices."

does well it usually has a positive follow-on effect whereas shipping and energy are doing less well," he said. However the number of opportunities within the corporate bond market are limitied within the Danish market relative to the Nordic as a whole.

The risks in Finland are again the euro but also its geopolitical position next to Russia. "That is a constant risk and very hard to assess but the risk of armed conflict remains low," he added. The local investors are much in favour of their home market and therefore bonds are relatively high priced.

Elofsson and Wigstrand find the lack of growth particularly worrying, combined with arbitrary and short-sighted monetary and fiscal policies. However, on the the positive side the Nordic and European credit markets are relatively small and new and are likely to continue to grow and provide deeper and broader investment opportunities over time.

Elofsson closes by telling us "this is not the right time to take large overall risks, it´s rather one of those moments in time where you should take selective risks and reduce overall risks within an investment portfolio. This is and has always been the whole aim behind Catella Hedgefund and we are proud to be stepping into and strengthening that heritage."

Scouring the Globe for Income

Henderson's launch of a global high yield strategy in November 2013 was client-driven and marked a natural progression for a globalising credit team: nine portfolio managers (PMs) and 18 analysts cover credit worldwide.

"We have a truly global team" says co-manager Tom Ross, who sits in London, while co-manager Kevin Loome is in Philadelphia. Ross argues that predominantly North American or Europe-oriented competitors lack a balance of expertise in both continents. Henderson is also distinguished by operating a flat structure with a two-way dialogue between PMs and analysts, who have real ownership of ideas. This promotes "more efficient idea generation and helps us to attract and retain talent" finds Ross.

> "A global remit allows the strategy to select from additional diversity within Europe and emerging markets."

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"A global remit allows the strategy to select from additional diversity within Europe and emerging markets." adds Ross. The team's opportunistic mentality has also sought out opportunities in smaller and lower rated credits that are too small for very big funds, according to Ross. The Henderson Horizon Global High Yield Bond Fund has outperformed its benchmark (the BAML Global High Yield Constrained Index), the Morningstar peer group average by a larger margin, and major passive global high yield ETFs by still more since launch.

Underweighting the US and the energy sector contributed to outperformance in 2015. This decision was based partly on the top-down asset allocation view, informed by the US, Europe and emerging markets being at different stages of the credit cycle.

Issuer Selection

But bottom-up issuer selection is paramount. The fund typically owns 75-200 names while its benchmark contains 1,700. Henderson can invest outside its benchmark and assesses each credit on a standalone basis, irrespective of credit ratings. "Some investment grade bonds trade at quite high yields and we do not want to be restricted from them" says Ross. At the other end of the credit spectrum the team readily exploits value in under-researched CCC-rated names.

Henderson always scrutinises covenants in bond prospectuses, and has lately become more discriminating as some borrowers have eased these clauses that afford investors protection against creditor-unfriendly activity.

Covenant analysis is just one aspect of a multi-layered approach to risk management. Henderson looks at total portfolio risk, including scenario stress testing, and also breaks risk down to more granular levels. Linking back to analyst responsibility, the analysts who specialise in particular sectors monitor sell triggers such as credit quality deterioration and communicate this to the PMs. Overseeing the fund is an independent risk team and compliance team.

Liquidity is another risk that is closely monitored. "Liquidity has reduced across all asset classes", says

> "Derivative markets are nearly always larger and more liquid than cash markets, and credit is no exception."

Ross, "so it is an important consideration when determining position sizes." A dedicated central dealing desk helps to manage and source liquidity, keeping Henderson close to critical trading information, a fact not lost on Ross who started out in the industry as a fixed income dealer. Derivative markets are nearly always larger and more liquid than cash markets, and credit is no exception. Alongside long cash bond positions, the fund is able to use credit default swaps to express both long and short views. An example was the short position held in Galapagos, the heat exchanger manufacturer. In expectation that low oil prices would weaken demand for its products, the fund profited from increasing concerns about the company's cash generation.

Ross expects income of 4-6% on good quality high yield bonds to be the primary driver of total returns but anticipates some capital appreciation given that "high yield spreads are some way from their tightest historical levels and have room to compress." Central bank intervention is indirectly helpful. Though high yield bonds are not eligible for Asset Purchases, central bank buying of investment grade has a "crowding out " or ripple effect that forces investors into riskier debt in the search for yield.

Brexit means GBP denominated bonds offer relatively good value: spreads widened to 1% above the euro benchmark just after the referendum and Ross thinks the market priced in the worst case scenario. "Spreads have already retraced to about 80 basis points above European levels and we expect further compression" says Ross, "Often the key to success is cancelling out the emotional market noise."

by Hamlin Lovell – HedgeNordic

Scandinavian, Independent, ESG, CAT Bond Investing

by Hamlin Lovell – HedgeNordic

The company name Entropics is derived from the word "entropy", from the world of physics, which indicates a consistent increase over time – something that Entropics co-founder and CEO, Robert Lindblom, views as relevant to catastrophe bonds, given the increasing frequency of extreme weather events.

Entropics is the only dedicated ILS manager based in Scandinavia (with one person in Helsinki and the others in Stockholm), and feels this location brings several benefits. "It is politically and economically stable, offers a good framework for finance and we are close to our Nordic investors for site visits and local language reporting".

Entropics is also distinguished by being an independent asset manager, owned by its staff. For Lindblom this means Entropics' investments avoid the complications of internal politics and groupthink, and decision making is consequently accelerated.

> "CAT bonds, offering far greater capacity than traditional reinsurance, marked a major change for the insurance industry"

The creation of Entropics pulls together several strands from the founders' careers. Lindblom and co-founder Gunnar Roos had worked together at Brummer Life Insurance in Sweden. "We were both interested in insurance and passionate about it – and had many contacts in the industry. We thought Insurance Linked Securities (ILS) were an interesting, uncorrelated, asset class for investors. And CAT bonds, offering far greater capacity than traditional reinsurance, marked a major change for the insurance industry" explains Lindblom.

In addition to Lindblom's experience of management and risk management, at asset manager Brummer & Partners, insurer Brummer Life and insurance broker ProSecur, Entropics has a broad range of expertise in house. Lindblom views "ILS as insurance risks that require an actuarial and reinsurance approach rather than relying only on key financial indicators". There are three actuaries, including Chief Underwriter Roos who has experience of underwriting while Chairman of the Board, Tyrel Jonsson, has first-hand experience of assessing triggers for catastrophe claims. Chief Metereologist, Martin Hedberg, helps to assess weather and climate risks.

"Global warming, without any doubt, increases the severity of extreme weather events." states Lindblom – but whether these lead to larger or more frequent catastrophe losses is more complicated. In developed countries, the answer is somewhat paradoxical. Urbanisation means more events hit sparsely populated areas but when densely populated areas are hit, the economic impact can now be greater. In contrast, for developing countries, with a greater reliance on agriculture, the effects of extreme events, such as draughts can be expected to be more disastrous.

Risk and Diversification

Entropics is cognisant of concentration and correlation risks in CAT bonds and aims for a diversified portfolio. US wind risks that offer the highest yields (and as a result dominate some other fund portfolios) are complemented with diversification from Japan, Australia, Europe and developing countries. These developing country bonds are sought after as portfolio diversifiers and therefore they tend to pay lower yields than developed country CAT bonds. The developing country CAT bonds are all in hard currency, and Lindblom welcomes the World Bank's frequent involvement as this ensures "a solid bond framework and reduces the risks of funds being diverted to any purposes other than reconstruction and saving lives".

Some 59% of Entropics' portfolio has indemnity triggers and 35% industry loss triggers with the rest split between second generation parametric triggers or modelled loss, or others. Though the probabilistic expected loss on the portfolio is 2.34% per year, the frequencies of natural catastrophes are such that most years are not expected to see any claims or losses. Based on historical stress testing, events such as the 1906 California earthquake or the 1926 Great Miami hurricane could cause losses of 25-30%. Lindblom argues that such as loss "could be recovered in two to three years as such an extreme event would reduce insurance industry capital and lead to an increase in insurance premiums".

Entropics views CAT bonds as a long only business, primarily driven by investors' search for diversification, and does not anticipate shorting CAT bonds. Lindblom argues that today there is no real method to go short on cat bonds. However, you could work with Industry loss warrants, but would then induce basis risk.

ESG and Excluded Investments

Entropics view CAT bonds as having inherent benefits to society, and want to differentiate their brand, both through being committed to ESG (Environmental, Social and Governance) and in terms of how they apply and communicate their ESG policies. As Director Communications and Responsible Investments, Henrik Sjoholm leads the effort but the whole team have been believers in ESG from the start. Entropics has joined the Swedish Sustainable Investment Forum (SWESIF) and held a seminar in September 2016, discussing CAT bonds and sustainability, with speakers including Dan Bergman from Sweden's AP3.

Entropics are amongst a growing number of alternative investment managers that are signatories of the United Nations Principles for Responsible Investment (UN PRI). Entropics released their first annual UN PRI report this year and Lindblom thinks UN PRI is "very well developed and builds on solid experience". But UN PRI does not yet provide prescriptive guidance for all asset classes and situations, so "Entropics has extended UN PRI principles in some areas" Lindblom explains. For instance, Entropics thinks that the beneficiaries of CAT bonds are more relevant than are the sponsors of 144A bonds, which are in most cases simply leading insurers and reinsurers that do not pose contentious ESG issues, according to Entropics. If Entropics starts investing in less liquid bonds then sponsors could become more relevant.

> "Man-made risks, such as terrorist attacks and environmental liabilities, are also avoided."

Lindblom is well aware that different managers may have different opinions about the ethical merits of various types of CAT bonds and related or other bonds. Entropics has used their discretion to exclude certain types of CAT bonds, including those insuring gambling jackpots; losses related to fossil fuels. Man-made risks, such as terrorist attacks and environmental liabilities, are also avoided. Alcohol, tobacco, pornography and military equipment are excluded as well. Lindblom thinks that these criteria have a high overlap

Robert Lindblom, CEO Entropics Asset Management

with those employed by some Sharia, and some Christian, investors, but also recognises that some investors may need more specific and customised criteria.

When it comes to human rights, the environment and corruption, Lindblom acknowledges that "a sharp line cannot be drawn". Entropics uses inputs such as NGO reports to form opinions on these areas, and Lindblom argues that being able to demonstrate an audit trail showing a process of consistently applied, traceable and documented criteria, matters more than which way borderline decisions go.

Entropics' ESG principles mean the manager distances itself from a strategy that could be pursued by some types of distressed debt investors. There is potential to buy CAT bonds after an event and then pursue aggressive, legalistic and technical tactics to try and avoid paying justified claims. Entropics would not follow such a strategy as Lindblom thinks it could threaten the trust underlying risk transfer to capital markets that provides the foundation of the CAT bond markets.

Entropics does not currently invest in longevity or extreme mortality related risks, but this is not for ESG reasons. Lindblom would not rule them out when and if they offered appropriate risk/return. One subset of cat bonds, so called life-settlements, are, however ruled out, as Mr. Lindlom argues that "the exploitation of people in distress is not something an ethically inclined manager should even go near."

Investment vehicles

Entropics' UCITS fund, SEF Entropics Cat Bond Fund, offers liquidity with 14 days' notice, has well defined liquidity policies, and expects all holdings to be liquid. However, Lindblom has noticed that trading volumes in CAT Bonds can be erratic so two safeguards exist to protect longer term investors from the costs of liquidity provision. An anti-dilution exit fee of up to 1% can be charged, and a gate provision (of 10% per dealing day) can be invoked to slow down redemption outflows. Lindblom expects the latter would be "extreme even under stressed financial markets".

The fund is available to retail investors in Sweden, Finland and Luxembourg; institutional investors outside the US; and has launched an unhedged USD class to cater for some investors' preferences. Managed accounts could be offered.

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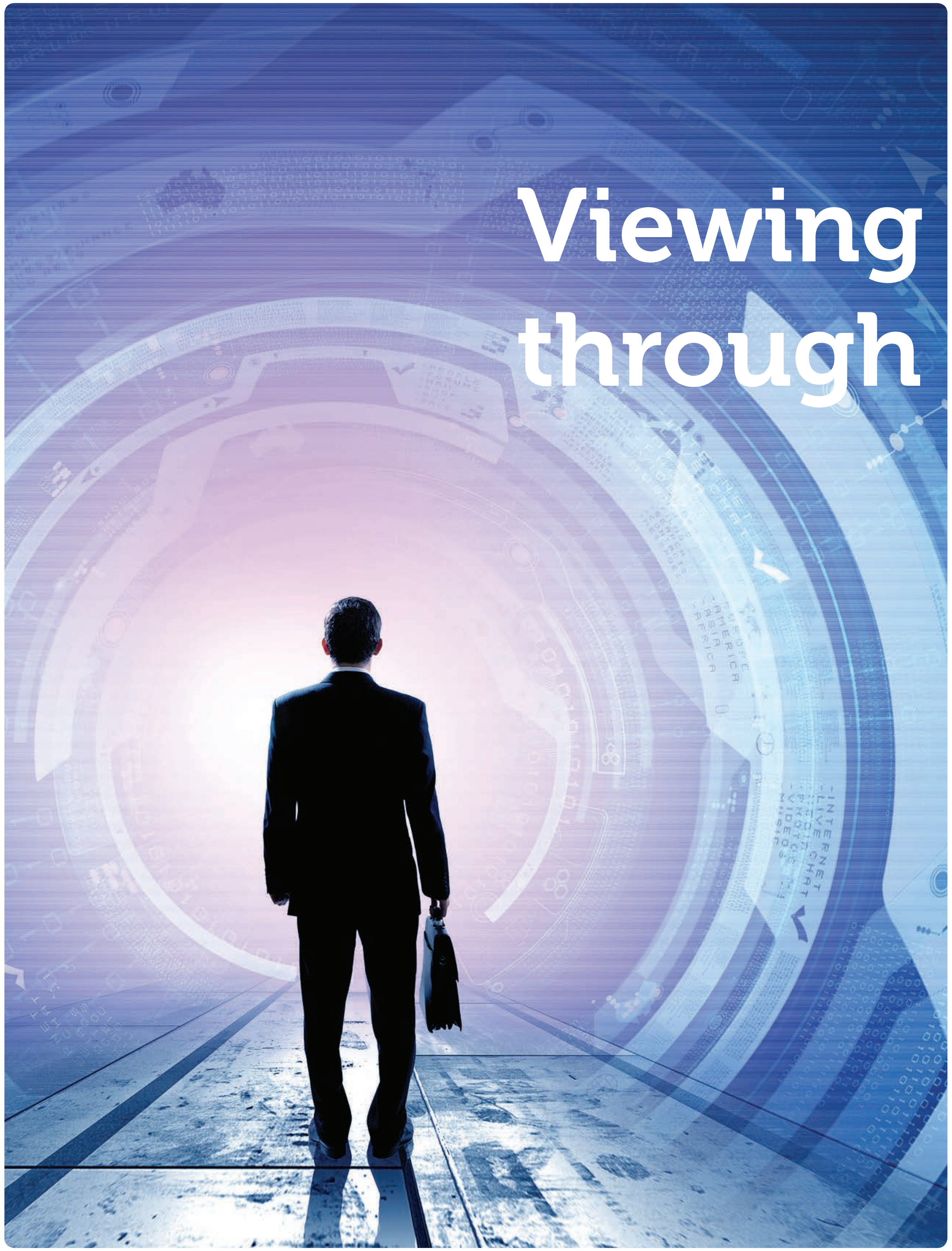

By Deborah Shire, Head of Structured Finance, AXA Investment Managers

Viewing the Credit Landscape through an Alternative Lens

Government and most other quoted debt increasingly appear to offer investors limited upside potential and lower-than-usual compensation for the risk of default. In such an environment, AXA Investment Managers holds that the agile and opportunistic diversification of a traditional credit portfolio becomes inexorable when managing risk.

A Range of Investment Opportunities

As one of the largest financial markets in the world, the credit market holistically offers wide and diverse investment opportunity across a range of risk and return dimensions, with varying degrees of liquidity, complexity and cash flow across capital structures. For investors willing to consider the full credit spectrum, this wider choice provides the opportunity to construct robust, tailored credit portfolios suited to specific needs and tolerance levels, allowing for the diversification of specific risk.

A number of alternative sources of return thereby become instantly identifiable:

- Private transactions: A large proportion of invest-ors are unwilling to invest (lend) in unquoted markets. However, default risk being equal, an investor can expect to earn a higher spread when investing in (lending to) the unquoted market due to the higher coupon rate borrowers are maybe willing to pay to attract limited lenders in such markets;
- Complexity: Unique and exclusive return opportunities are available to investors willing to allocate additional resourcing and expertise to understand and structure complex credit transactions;
- Illiquidity: For investors willing to invest for a long period, illiquidity is an exploitable source of return. Lease finance and commercial real estate loans are examples of credit assets where the borrowers are maybe willing to pay a higher coupon to lenders willing to lock their money in for longer;
- Distressed Credit Recovery and Rescue Lending: By carefully identifying assets distressed for technical short-term reasons – as opposed to for fundamental

Deborah Shire
Head of Structured Finance
AXA Investment Managers

reasons - investors can expect to see values recover from distressed levels as soon as the short-term dislocating shock dissipates;

- Market Insufficiencies & Dislocations: Excess return can be generated by identifying mispriced securities through rigorous fundamental analysis and implementing long/short or relative value trades to benefit from normalisation of market dislocations;

- Regulatory Arbitrage: As banks increasingly transfer parts of their balance sheet risk to institutional investors at attractive premiums in the wake of Basel III rules, unconstrained investors have the opportunity to capture returns by getting exposure to bank assets or entering into private regulatory capital transactions with the deleveraging banks.

Diversification, Dynamism, Agility

Despite this fertile landscape of opportunities in the alternative credit market, harvesting them is not straightforward, and investors would be wise to be diversified, dynamic and agile in their approach:

- Diversification: A well-diversified credit portfolio will be exposed to sources of return from different geographies, credit ratings and companies, and across sectors and industries. This in turn should mean low correlations between the components of such a portfolio, which, on aggregate, means a lower level of risk for the same level of return. Alternative credit portfolio that is allocated across these different classes of debt can enable the construction of a well-diversified credit portfolio.

- Dynamism: History shows that for most debt classes, there is a good and a bad time to buy. Across the alternative credit landscape, opportunities appear and fade away as market conditions change and different classes of debt come into favour. Investors should be dynamic in their approach and continuously evaluate new investment ideas as they arise.

- Agility: An agile approach ensures the timely execution and implementation of an identified opportunity. To consistently exploit opportunities presented by the alternative credit universe over a market cycle, investors need to be swift in reacting to changing market conditions. Liquidity becomes important for this aspect of portfolio management. While investing in illiquid assets acts as a source of return, it is important for investors to maintain liquidity in their alternative credit portfolio to seize new market opportunities as they occur.

The Evergreen Approach to Generating Return

Approaching the credit market holistically, then, provides exposure to corporate and consumer credit across capital structures through various sources of return and liquidity profiles. Additionally, a well-diversified, dynamic and agile alternative credit portfolio with sufficient liquidity has the potential to weather systemic events to some degree, manoeuvre to safety in certain market conditions, and capture new sources of return through carry and capital appreciation. There are therefore significant benefits to investing in alternative credit in the current environment, with its best in class managers and smart implementation in efficient vehicles.

Wealth Manager Perspectives on the Zero Interest Environment

By Glenn Leaper, PhD – HedgeNordic.

Like many other investors with a Fixed Income component in their portfolios, Asset Allocators and Family Offices are trying to get their heads around the question as to how to obtain yield in a zero, or even negative, interest rate environment. Following the Brexit referendum in the UK, the dilemma appears set to remain for the foreseeable future. Is there a single solution to the situation, or how do allocators and family offices cope with the fact that previously high yielding assets are now becoming liabilities? Views differ on how to address this issue. Some investors have made minor adjustments to their strategy, while others have changed their direction dramatically.

Jonas Andersson, CIO of Navare Invest, a single family office and investment company based in Stockholm, explains that the experiments being conducted by central banks at present – pouring gasoline on the fire, in Andersson's view, causes all asset class valuations such as fixed income, equities, real estate, etc. to skyrocket to previously unheard-of levels.

"That puts everything out of order right now, and the problem is it can continue for a long time, powered by the central bank stimulus. So it's just to face facts and adjust," he says. Navare Invest has therefor made changes to its overall investment strategy.

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"We have made both minor adjustments to the current portfolio as well as an overview on the strategy, resulting in changes in how we will invest from the longer perspective," says Andersson.

Within the fixed income portfolio more specifically, Andersson explains Navare Invest presently has no exposure to Investment Grade. The portfolio initiated investment just recently and it hasn't had any "old" bonds, purchased at lower levels, to enjoy during the spread tightening. At current levels Andersson views the risk/reward ratio as far too negative, even after the Brexit referendum that ensured the lowest interest levels for many years.

"We have therefore invested more into a well-diversified high yield bond portfolio," says Andersson. "We acknowledge the fact that there is higher volatility within the high yield space, but with a thorough selection process, finding the best issuers delivering high risk/reward, we believe that we can outperform our benchmark. We have also decided to keep the fixed income allocation at neutral level compared to benchmark. We are prepared to reduce risk for other alternatives when interest rates start to hike, or the volatility in the fixed income market rises."

The million Dollar question remains what the alternatives to fixed income exposure with similar risk/reward charecteristics are. "We are looking at strategies outside both equities and fixed income that simplify things.

"There are way too many highly skilled portfolio managers that don't make returns in today's market. That in itself tells you a lot about the challenges out there." Jonas Andersson

We do not believe in complicating things right now," says Andersson. "It is the strategies that have a transparent business model, with a high conviction in delivering high returns at a low volatility, that will be sought after." But where does one find investments like that? Surely high return at low risk sounds like an impossible combination? "Not among traditional hedge fund strategies," Andersson suggests.

"There are way too many highly skilled portfolio managers that don't make returns in today's market. That in itself tells you a lot about the challenges out there. Instead, we have really been looking into alternative strategies, among alternative funds, that are highly cash flow-generating strategies, with a long proven track record and a simple model. In many cases they come with high entry barriers and are less liquid strategies. That means that we want to shift the focus from taking risk on a yield curve, a specific issuer or a market, and instead use strategies with a higher tail risk than traditional markets (that often have a built-in volatility). Such as, for example, trade finance, insurance linked securities, cat bonds, direct lending, etc. – nothing that should correlate with interest rates or equity markets."

Andersson continues: "Many times you will end up with higher, not so diversified, counter party risks (tail risk), which you will have to diversify by investing in many different strategies with the same risk/reward profile, but in different markets." Navare has thus mitigated the lower yield by changing focus in the investment process. Andersson affirms: "We do not want to take risks in the traditional markets any longer – at least not to the same extent as previously. We rather search for truly uncorrelated revenue streams that we can profit from. That also includes a higher activity on the Private Equity side, where the risks are much more correlated to a thorough due diligence process and skilled investment partners, rather than depending on the market for the end result. In times like this, when nothing is as it used to be, I prefer to hold the investment risk very close..."

"We do not want to take risks in the traditional markets any longer – at least not to the same extent as previously. We rather search for truly uncorrelated revenue streams that we can profit from." Jonas Andersson

Another Single Family Office wealth manager, who requested anonymity, described their adjustments of asset management in a contrary fashion to Andersson's perspective. "We are invested into all asset classes, using a trend-following strategy to give us the allocation," 'the asset manager' explains. "Right now, we have a low risk portfolio with 50% fixed income bonds, 25% hedge funds, 10% commodities, and 15% equities. The long-term normal weighting in this portfolio is: 20% bonds, 10% hedge funds, 10% commodities and 60% equities."

But how has this manager handled the fact that there is no interest to be gained in the bond market today? Have they been able to mitigate this effect in some way? "We do not consider the actual yield level of the interest rate and haven't made any changes in the portfolio based on lower yield on our bonds. Employing a trend-following strategy, we are only interested in where the interest rates are moving," the asset manager tells us.

"We have made large returns on our investments this year within the bond market, due to the continuous spread tightening. We are investing in ETF's and various bond indices that have delivered 8-13% YTD. As long as the spreads are getting even tighter, due to the massive ECB asset purchase programme sweeping up the market, bonds will probably continue to perform well. But the risk for a shift in the yield curve has of course increased, and if we see the yield curve trend begin to move in a negative direction (from a bond perspective), we will reduce the risk exposure in that asset class."

"As long as the spreads are getting even tighter, due to the massive ECB asset purchase programme sweeping up the market, bonds will probably continue to perform well." Single Family Office wealth manager

Anna Hallsten, CEO of Arctic Securities, a broker firm within the Nordic fixed income market, noticed a change in behaviour among asset managers and allocators due to the continuing falling yield levels. "There has been a clear change among our clients with regard to how and what they invest to" confirms Hallsten. "If we look at credit managers, they try to prolong the duration in existing names in their portfolio (e.g., they buy new issues in well known credits), but they never venture further out on the credit risk scale – and very seldom below BB credit rating. They want to reduce the liquidity risk by buying into larger issuers and reducing the number of names in the portfolio."

By contrast, Hallsten says, pension fund managers may be more opportunistic. "They want to have an as optimal-as-possible risk/reward, regardless of what currency investments may be in. They have reduced their exposure to credits and tilted more towards equities. Those who only manage credit portfolios have moved more towards well-known names, with larger volumes in fewer names and holdings."

"Credit managers try to prolong the duration in existing names in their portfolio, but they never venture further out on the credit risk scale – and very seldom below BB." Anna Hallsten

"Managers are very much at odds as to what should be done in this situation," she continues, "but are more or less all driven by the issue around Mark-to-market valuation and NAV discussion. Credit fund managers earlier this year had large outflows, and simultaneously very poor liquidity in the market, which hurt the pricing of the bonds and hence the funds' NAV performance."

Ulla Agesen
Head of Manager Selection, Nykredit Asset Management

Ulla Agesen has more than 16 years of experience with manager selection. Before joining Nykredit in 2011, Ulla spent four years with Aon Hewitt, London, as UK Head of Equity Investment Management. Prior to that she spent nine years at Kirstein Finance A/S where she was responsible for manager selection on behalf of Danish pension funds and Nykredit. She covers equities, fixed income and infrastructure.

Ulla has a Master degree in Finance from Aarhus Business School, Denmark.

The hunt for yield

Negative or near-negative interest rates, which was unthinkable not so long ago, are now a reality in the Nordic region and elsewhere. This, combined with plunging bond yields across the world, has forced investors to re-focus their fixed-income allocations.

According to Kirstein Finans' latest Nordic Investor Survey, allocations to fixed income continue to decline. One reason is that diminishing diversification benefits combined with the aforementioned low yields has made the asset class less attractive. Instead investors in the region are looking to invest in private debt or riskier pockets of the asset class in terms of duration, liquidity, credit, macro and other risk premia.

In the traditional space, global and US high yield assets continue to attract interest, as does emerging market hard currency debt. The popularity of direct lending is of interest but less so than senior secured loans, according to the survey. However, there are concerns that the space is becoming crowded and pricey. Many are therefore looking further afield to alternatives such as real estate, private equity and hedge funds. Infrastructure also continues to be of interest despite concerns about the sustainability of the economies of scale, particularly in capital deployment.

Nykredit Asset Management has also implemented changes along some of those lines in its fixed income strategy. So far, some of the changes have been to reallocate part of the short duration fixed income portfolio to infrastructure. "We have moved towards the more illiquid asset class because of the cash yield and stable return outlook even if we are tied in for 10-15 years," said Ulla Agesen, head of manager selection.

So far Nykredit has made a small allocation with three infrastructure funds and is expected to double the allocation in the next couple of years.

"We looked at a whole spectrum of alternatives in order to mitigate the negative or low interest rate environment. We considered forestry, real estate as well as private equity but for us the characteristics of infrastructure fit the bill," Agesen said.

Apart from the stable cash yield infrastructure also has a more positive J-curve compared to private equity as well as good IRR after fees, she noted.

Agesen said one of the issues with infrastructure investments is that your commitment isn't deployed immediately. Nykredit focuses on the OECD region rather than specifically Denmark, even if one of the managers, Copenhagen Infrastructure Partners is Danish. So far they are invested in biomass and windfarms.

> **"We have moved towards the more illiquid asset class because of the cash yield and stable return outlook even if we are tied in for 10-15 years."**

"Our focus is core or core plus. Beyond the OECD we may consider emerging markets if the manager has competence in the region but we would not seek a dedicated emerging markets manager," she added.

Because of the pressure on returns Agesen is aware of the competition within infrastructure. "There is still value there in a number of areas and we are working with managers who know how to manage the assets. If you look at the need for infrastructure and the trillions and trillions of investments needed globally, these funds only raise a fraction," Agesen said.

Nykredit continues to see value and avoids investments and areas which are crowded, specifically so-called trophy assets, she said.

Agesen also noted that there is not really any political pressure as such for Nykredit to get into infrastructure for the good of the society, but it is obviously an added bonus. "We do it because it is a good investment for our clients. ESG considerations are an important part of our investment beliefs and certain standards need to be met. However, we are not investing just for the good of the community, it does also have to make financial sense where good returns are key," she explained.

Apart from infrastructure Nykredit has also moved to broader mandates, Agesen explained. "We used to have emerging markets local currency debt only but we have changed this to a blended mandate with hard currency as well. We felt that we did not have a strong call on the local currency so it would be better to let the manager, who is closer to the market, decide," she added.

Nykredit made a similar change to its investment grade credit investments which previously solely focused on European credits. It is now a more tactical fund and can invest in high yield and investment grade asset. "This gives the manager more flexibility and makes it easier to implement their views and re-allocate assets. It is of course also more cost effective than having managers for each segment of the fixed income spectrum," she pointed out.

As the hunt for yield intensifies it is important so increase the number of sources of alpha, Agesen said, adding that to some extent most are doing the same focusing on the so-called go-anywhere products.

Nykredit uses external managers for more a number of asset classes beyond the Danish fixed income and European credit investments, but retains all asset allocation decisions in-house, which makes broader products more attractive.

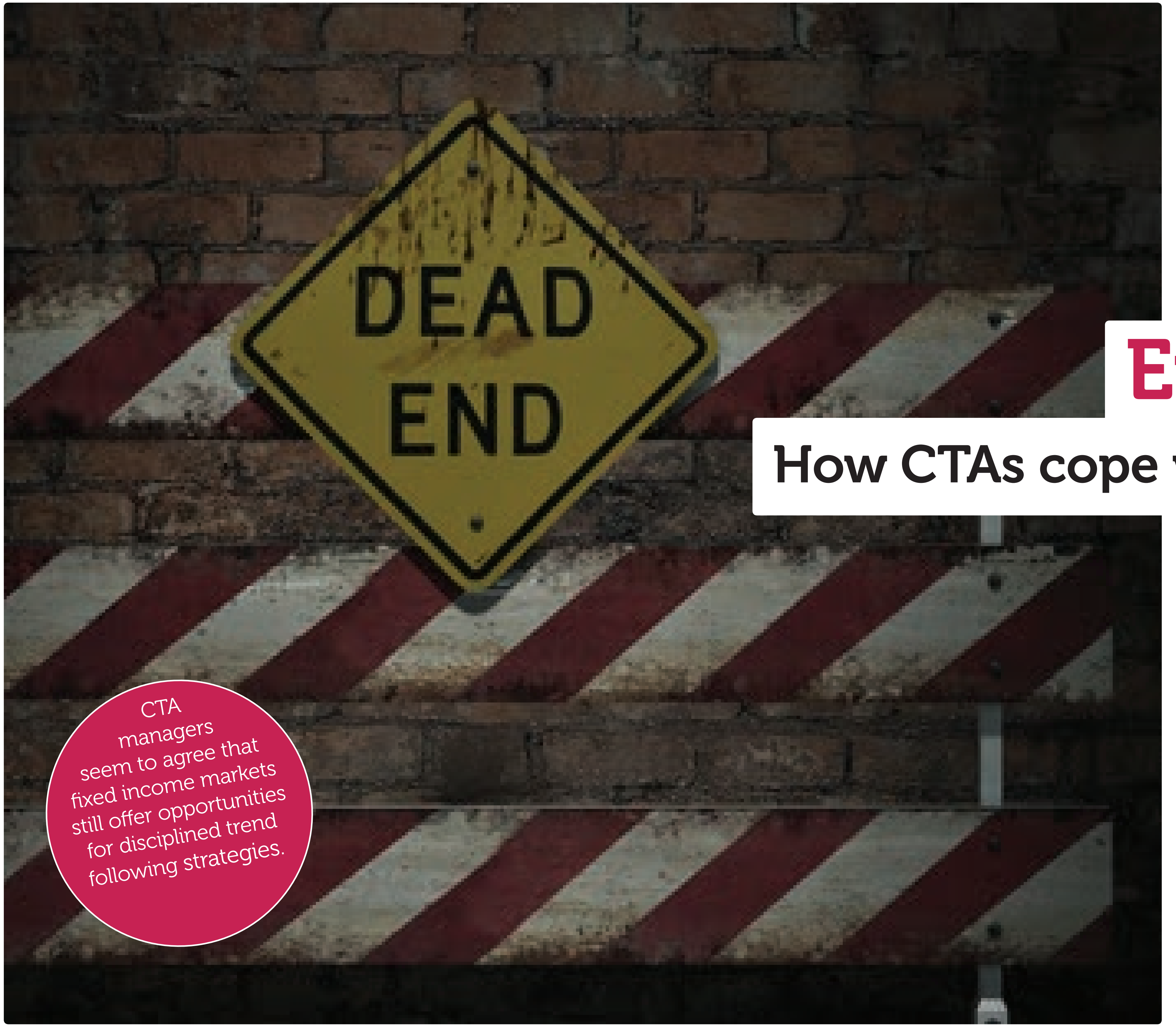
In evaluating managers Agesen and her team looks at experience, discipline and the operational set-up, among other criteria. All due diligence is conducted in-house whereas legal and tax issues for infrastructure investments are outsourced. Apart from a database of managers the team also uses industry conferences as well as word of mouth as a source for new ideas.

> **"ESG considerations are an important part of our investment beliefs and certain standards need to be met. However, we are not investing just for the good of the community, it does also have to make financial sense..."**

Currently Nykredit is also looking at direct debt and direct lending in order to diversify its fixed income portfolio, Agesen said. "We are looking at how this could add to the current product mix within Nykredit and how we ensure that it is relevant to our clients", she said, adding that it seems many other institutional investors are considering the same route.

As they say, there are first mover advantages but there are also many ways to skin a cat so in the coming.

*By **Pirkko Juntunen**, HedgeNordic.*



CTA managers seem to agree that fixed income markets still offer opportunities for disciplined trend following strategies.

"According to research by US-based CTA FORT the 7.5 per cent annual returns that were generated by CTAs between 1990-2008 was to a large extent driven by interest earned on excess cash."

by Jonathan Furelid – HedgeNordic

End of the road -
How CTAs cope with the nearing end of a bond super-cycle

Systematic trend following futures strategies, formerly known as Commodity Trading Advisors or CTAs, have for the most part benefited from the sustained decline in global interest rates over the past few decades. As bond markets are approaching extreme valuations, and with implied yields trading at rock-bottom levels or even entering negative territory, how are quantitative strategies adapted, if at all, to cope with an interest rate environment never experienced before? HedgeNordic asked CTA managers, both Nordic and international, how they view the current environment and how they look upon the prospects for the strategy going forward.

To trend follow or not to trend follow?

Given the current extreme bond market valuations, are there still opportunities to extract trends from the long side? CTA managers seem to agree that fixed income markets still offer opportunities for disciplined trend following strategies although some point to having taken on a more defensive approach.

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> "...we have actually seen a number of fixed income markets continue to function completely normally with implied yields below zero..."
>
> Christopher Reeve
> Director of Product Management
> Aspect Capital

Christopher Reeve, Director of Product Management at Aspect Capital, says that their original approach was a more conservative one but that they have seen markets functioning in an orderly manner even with negative implied yields.

"We originally took the more conservative approach of avoiding markets where rates were at or below zero because we had never really seen this happen before and there were concerns that zero would act as some kind of barrier or that market functioning and liquidity levels would change. However, we have actually seen a number of fixed income markets continue to function completely normally with implied yields below zero, with trends continuing.

Alexander Mende, senior researcher at Stockholm-based RPM, a provider of multi-manager CTA portfolios, says that the way their underlying managers approach fixed income markets in the current environment differ widely.

"Admittedly, the current zero-or-below-interest rate environment is unprecedented in financial history. Thus, our managers' approaches differ from each other. Some managers have introduced caps on fixed income exposures other have not made any adjustments. Obviously, managers without any caps have performance better year-to-date."

Niels Kaastrup-Larsen, Head of European Business of US-based CTA DUNN Capital Management, points to the fact that not only spot prices but also the so-called roll yield plays an important role in assesing the opportunities for trend following systems in global fixed income markets.

"There are two sources of returns on positions in futures contracts. The first and more obvious is the change in spot prices. The second is the so-called "roll yield," which is the change in futures prices due to the necessary convergence of futures and spot prices when time approaches the contract expiration date. In the particular case of interest rates, we have realized gains in the last two years due mainly to the second source of returns. The roll yield will be positive in a long position on interest-rate futures if the expectation of raising rates is not realized. This behavior has been displaying a persistent trend, which has favored disciplined trend-following systems."

Serge Houles, Head of Investment Strategy at Stockholm-based quant macro firm IPM, says that "making investment decisions based on the rationale that interest rates cannot go lower as they are already too low can lead to sub-optimal decisions."

According to Houles, the drivers that determine the position-taking in fixed income markets for IPM, including the mean reversion tendency of real interes rates, inflation expectations, the bond risk premium, and the shape of the yield curve are valid no matter the absolute level of interest rates.

> "In the particular case of interest rates, we have realized gains in the last two years due mainly to the second source of returns..."
>
> Niels Kaastrup-Larsen
> Head of European Business
> CTA DUNN Capital

Are quant models being changed to reflect new environment?

Rather than changing underlying models to adapt the zero or below zero interest rate environment, CTA managers are highlighting the importance of monitoring market dynamics, adding contracts or to adjust the risk exposure to the fixed income sector.

"The key thing is monitoring the market volatility and liquidity levels – which is something which is built in anyway in all markets. But particularly in fixed income we look out for any changes in volatility environment which might show that market functioning is changing and the market is becoming less suitable as a trend following opportunity", Reeve of Aspect Capital says.

According to Reeve, Aspect has also recently added cleared OTC interest rate swap markets to their Programme, which are a synthetic way of gaining exposure to a far broader range of yield curves and maturity points than would otherwise be available in the futures markets.

Alexander Mende of RPM notes that it is "impossible to adapt your models to something you don't know anything about. The key to face unknown scenarios is diversification, Mende argues.

"We apply diversification over trading strategies, time frames, and markets traded. Broad structural diversification is the key to face all unknown scenarios. In our experience, losses in fixed income are often balanced by profits in other sectors."

> "...it is "impossible to adapt your models to something you dont know anything about. The key to face unknown scenarios is diversification."
>
> Alexander Mende
> Senior researcher, RPM

Despina Xanthopoulou of Stockholm-based CTA Lynx says that they have implemented some risk management changes to adapt to the new environment but that she cannot reveal in what way.

"Lynx have taken certain measures in the program to respond to the changing market conditions within the fixed income sector, the way this is being done is however something we do not share publicly", Xanthopoulou says.

No interest on collateral – does it hurt performance?

Historically, interest earned on cash to cover margin for futures contracts has bolstered the return for CTAs. According to research by US-based CTA FORT the 7.5 per cent annual returns that were generated by CTAs between 1990-2008 was to a large extent driven by interest earned on excess cash. Adjusting for this component, the actual return was only 3,9 per cent annually as expressed by the Newedge CTA Index.

According to Aspect Capital's Reeve, the impact from no return on collateral is easy to quantify as it is "pretty much a direct relationship between the risk free interest rate on collateral and its contribution to performance", he also notes that "the programme has been in a position of not earning anything on our spare cash or collateral for a number of years now".

Lynx´s Xanthopoulou also refers to the direct relationship of interest rates and the return on "unencumbered cash" but highlights that the effect has been small given the volatility profile of their programme.

Kaastrup-Larsen of DUNN says that the zero- or negative-rate environment in recent years has worked well so far for their program, despite that return on collateral has been "a very small fraction of overall return". In fact, the return of the DUNN WMA Program has been significantly higher since

> "It is true that the low level of interest rates has an impact on the absolute level of returns delivered by some strategies."
>
> Serge Houles
> Head of Investment Strategy, IPM

2013, compared to the long term average return since inception of the program in 1984. "Reseach improvements are much more important than level of interest rates", notes Kaastrup-Larsen.

Alexander Mende of RPM refers to a research piece that RPM has done on how performance of CTAs is linked to inflation. It shows that the cash interest component has played an important role in times of inflationary pressures.

"Our research shows that CTAs have provided good trading returns in both high and low inflationary regimes over the last 15 years. Looking at industry total returns, however, the high inflationary environment has actually been better, due to the cash interest rate component. This means that even if trading profits has been slightly lower during high inflation, the cash interest rate component has more than compensated for this.

Serge Houles of IPM downplays the role of the cash component for their performance. "It is true that the low level of interest rates has an impact on the absolute level of returns delivered by some strategies. This could be the case for strategies with high unencumbered cash or strategies invested in securities where yields are tied to the level of interest rates. In our case, it has had a minor impact on the absolute level of performance although the alpha generated above the risk free rate has been relatively stable", Houles says.

CTA performance and rising interest rates

The CTAs that we have talked to do not see any major negative impact of a rising interest rate environment, which is often cited as having had a negative impact on the strategy´s performance historically. Instead they are pointing to the diversified approach of their trading programs capturing trends in other markets when interest rates are on the rise.

Lynx´s Xanthopoulou says that the ability of CTAs to generate performance in an environment of central bank interventions has been questioned and also there have been concerns regarding CTAs performance in rising interest rate environments. However, she emphasizes that the Lynx strategy has shown its ability to perform in recent years despite these concerns being ever present and that diversification has been key.

"In 2015, it was currencies contributing the most to our performance, in 2014 fixed income, FX and commodities all contributed strongly while in 2013 equities was the best performing sector. Over time we expect all asset classes to contribute to our performance and on a strategic level we are almost equally weighted to the different asset classes. We have also not revised the return target for the trading of our program which shows we are confident to continue to perform independent of changing dynamics in underlying markets."

> "...the ability of CTAs to generate performance in an environment of central bank interventions has been questioned and also there have been concerns regarding CTAs performance in rising interest rate environments."
>
> Despina Xanthopoulou, Lynx

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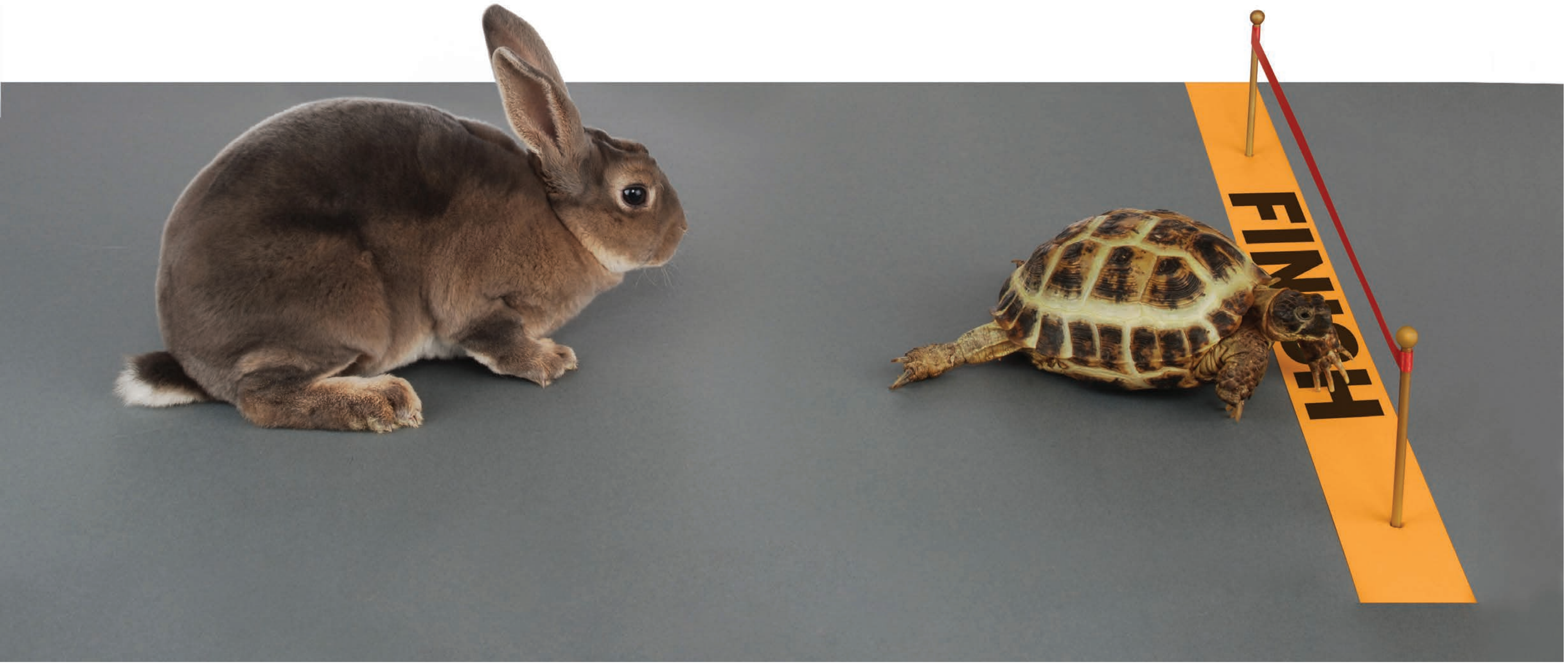

Fixed Income comprises a number of areas that lend themselves naturally to SRI/ESG principles. The Nordics – with Denmark here in focus – provide examples of the successful convergence of civil legislation with optimized opportunities for investor returns, particularly through corporate governance. While many still play the short-term game, SRI/ESG may be winning out longer-term.

The Socially Responsible Investment (SRI) question often raised in conjunction with Fixed Income is whether increasing normative pressure to adopt SRI/ESG (Economic, Social & Corporate Governance) mandates is driven by ethical and/or reputational concerns, or through the desire to reduce portfolio risk. One answer is likely dialectical, interweaving the two: the demand for a heightened focus on ethics and concern for a fund's reputation are reinforced by findings and increasing awareness that portfolio risk is thereby reduced. Simultaneously, reduction in portfolio risk is reinforced by the increasing adoption of ESG norms and resulting creditworthiness.

As the UNPRI (UN Principles on Responsible Investment) Fixed Income Investor Guide suggests, moreover, there are a number of characteristics inherent to Fixed Income that lend themselves seamlessly to Responsible Investing (RI).

Where investment-grade fixed income strategies are concerned, for example, bond investors focus on potential downside protection, thereby paying especial attention to risk, low volatility and the preservation of capital. Such strategies can have asymmetrical return profiles by comparison to e.g. equity risk-return profiles. Investors are thus compelled to evaluate the contribution of SRI/ESG factors to financial downside, such as event or systemic risks that can affect issuer creditworthiness. In addition, issues like corruption allegations or lack of transparency, which can sometimes be linked to local and regional customs, can have serious effects on global creditworthiness. Corporate governance, which can have a marked effect on a company's credit spread as well as its equity price, thereby becomes an increasingly significant factor.

> "The Nordics have a global reputation for excellent performance in SRI-related international rankings such as the Human Development Index and the Environmental Performance Index."

Corporate governance is also important for structural reasons inherent to corporate, sovereign and other forms of debt. Where lenders are not owners and have a contractual relationship with borrowers, and access to management is often infrequent, the UNPRI urges signatories to use any opportunity to engage issuers on factors of ESG concern in the run-up to issuance. This includes collaboration between bondholders and holding votes on governance concerns during debt restructurings. Debt, which can be issued as a public or private instrument and issued as investment grade or high yield, also requires an RI approach relative to access to management, investor influence and the availability of information. Debt instruments, for example, have fixed durations covering different periods relative to ESG and its materiality to creditworthiness. For example, would carbon regulation impact 3- or 10-yr bonds the same way? The first key to ESG implementation, therefore, is communication. Key Performance Indicators (KPI's) in terms of SRI/ESG implementation thereby become an inexorable consideration for bond managers, relevant to the assessment of both single and overall portfolio risks.

Small Denmark, such SRI!

The Nordics have a global reputation for excellent performance in SRI-related international rankings such as the Human Development Index and the Environmental Performance Index. Their business communities and government policies are often held up as an example to other countries. When it comes to SRI/ESG KPI's in Fixed Income funds, the smallest country among them, Denmark, provides some concrete and vivid examples:

According to the European Fund and Asset Management Association's Report on Responsible Investment. Denmark has a very high proportion of UNPRI signatories, there being a statutory requirement from the Danish government (dating from 2008) that large companies must take a position on CSR in their annual reports. This includes reporting on SR (Socially Responsible) policies, how companies translate SR into action, and evaluations of yearly progress on SRI initiatives. The same reporting requirement has been introduced for institutional investors and investment funds.

In addition, the Danish Council on Corporate and Social Responsibility was established in 2009, comprising members across all sectors of society, and provides guidelines for SR considerations in investment decisions according to the preambles of the UNPRI. The guidelines, written in cooperation with Danish investment and pension funds, give an overview of methods, strategies and approaches to RI to be used by investors. The underlying objective is to normatively optimize financial gain in tandem with societal gain.

Denmark's high number of UNPRI signatories is mostly gathered in DANSIF, an impartial forum for players with a substantive interest in SRI. The most recent DANSIF Responsible Investment Study (December 2015) reports that (among other factors):

> **"Denmark has a very high proportion of UNPRI signatories, there being a statutory requirement from the Danish government (dating from 2008) that large companies must take a position on CSR in their annual reports."**

- 44 of the 50 largest institutional investors in Denmark have an RI policy, representing 98% of combined AUM;
- 66% of investors, representing 93% of AUM, have a specific engagement policy, up 10% from the previous survey in 2014;
- 52% of respondents confirm the responsible investment policy covers all AUM (up 11% since 2014), with 41% saying it covers the majority of AUM;
- Use of proxy voting continues to grow, with 68% of respondents casting votes on some or all listed equities, and 88% using negative screening;
- 60% confirm that a process for responsible investment in government bonds is in place, up 12% from 2014.

Among Danish hedge funds, such developments are already reflected in the evidence of measures taken. To take three of the most prominent:

1. Nykredit Asset Management's Fixed Income Nykredit KOBRA Hedge Fund is subject to its sustainable investment policy that covers not only associations but also investment in its own funds, thereby covering a value of 198 billion (DKK). Nykredit's sustainable investment policy is built upon two KPI pillars:

a) Do companies live up to sustainability expectations? All companies in shares and bond portfolios are screened biannually for transgressions against UNPRI and Global Compact principles (with the most recent screening revealing 22 such transgressions, prompting Nykredit to belabour changes in conduct through Active Ownership), and

b) The use of sustainability criteria e.g. environmental, social relations and corporate governance issues in the investment process. This increasingly includes consideration of non-financial data such as CSR reporting in the evaluation of a company's future results.

Nykredit also offers specialized products such as Global SRI, where every company in conflict with UN conventions or which has in excess of 5% of its revenue from tobacco, alcohol or weapons is excluded from the portfolio.

2. The PFA Investment Fund, which was renamed in July 2016 from Midgard Fixed Income Fund, incepted in 2009 follows similarly stringent policies for RI, as Denmark's largest pension fund. PFA claims its experience has already been obtaining optimal results by investing in responsible companies that meet UNPRI and Global Compact standards, partly a result of its Responsible Investment Board consisting of investment and CSR executives overseeing implementation of SRI policy and also through seeking to be an Active Owner. This includes implementing measures such as voting rights, exclusion lists and norm-based screening based on the Global Compact, such as the systematic exclusion of companies involved in the production of controversial weapons.

3. Danske Invest, which has the Hedge Fixed Income Strategies and the Fixed Income Relative Value funds under management, announcedd in July 2016 the creation of a special Sustainable Investment fund, the Danske Invest European Corporate Sustainable Bonds fund. Corporate bonds are selected on the basis of two criteria: a financial assessment of the company, and an evaluation of the company's sustainability efforts. "The fund's philosophy is to have a sustainable profile that is clear about what you should not invest in and which simultaneously places high demands on what one actually invests in, which is forward-looking and actively scales to support sustainable development," says Thomas H. Kjærgaard, head of Sustainable Investments. For Danske Invest to consider investing in a company at all, it is similarly contingent that the company complies with the UNPRI and Global Compact. At least 90% of the fund's portfolio will consist of companies in the top half of the ESG rankings for each relevant sector, e.g., companies already well positioned in terms of ESG criteria. Fund holdings should consist of at least 75% corporate bonds with a high credit rating, thus "investment grade."

> **"The lack of fully transparent, 'hard evidence' may yet deter adoption of SRI/ESG principles in favour of short-term gains."**

The Long & Short of It All

The argument against SRI/ESG tends to be centred on the detriment of short-term performance in favour of the unpredictable long-term strategic effects of its standards. Is it possible, then, to isolate the effect of ESG factors from other factors affecting Fixed Income performance? ESG KPI's can be sorted by materiality and relevance for different sectors and/or regions, but isolating the precise impact of ESG factors remains difficult because of the number of extenuating factors that can usually be taken into account when evaluating a company's performance. In addition, a stock's price is unlikely to reflect all available ESG (or other) information incorporated into the fund's analytical framework, considering it can take weeks for this information to be assimilated and taken into consideration. Finally, Fixed Income has both multiple issuer types (e.g. corporate, government, financial sector, supranational, etc.) and uses multiple instruments, whereas ESG analysis varies for different issues and metrics, criteria weighting and engagement, there being no one-size-fits-all metric. The lack of fully transparent, 'hard evidence' may yet deter adoption of SRI/ESG principles in favour of short-term gains.

There is, nonetheless, hard performance data proving ESG integration enhances performance in the long term: Bauer & Hann's (2010) "Corporate Environmental Management and Credit Risk" and other empirical studies such as the Arabesque Asset Management/Oxford University (2015) study present clear evidence that environmental concerns are associated with a higher cost of debt financing and lower credit ratings, and that proactive environmental practices are associated with a lower cost of debt. There can still be shortcomings, however, in the quality of the indicators extracted, and PM's may not always be forthcoming with information. "A company can be proficient in employing alternative energy technology but fail to provide detailed reporting of its KPI's," as Christoph M. Klein, CFA, of Deutsche Asset & Wealth Management suggests, which can lead it to be portrayed negatively despite its efforts.

The predominant focus on short-term performance is one of the main reasons some institutional investors have been slow to adapt to SRI/ESG. Investing in it requires patience. But SRI/ESG issues are set to become much more significant in the future - though it may take decades to achieve normatively in some places. Some, such as Denmark and the Nordics more broadly, have decided not to wait that long, and are starting to find they've arrived at the mutually profitable and proficient implementation of SRI/ESG-norms over the longer run anyhow.

About the Author

Glenn W. Leaper, Associate Editor for HedgeNordic, completed his Ph.D. in Politics and Critical theory from Royal Holloway, University of London in 2015, and is currently involved with a number of initiatives, including advising businesses and writing his first post-doctoral book.

While pursuing his academic career, Glenn is also in the process of founding a Communications Consultancy. Glenn's services span a range of activities, from writing, editing and branding to speechwriting, delivery, and tactical and strategic advice.

He holds an MA in English from the University of London and a BA in International Relations from Webster University.

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