

The hunt for yield

Stockholm (HedgeNordic) – 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 (*pictured*).

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.

"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 to 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 look 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.

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.

This article was written for the HedgeNordic Special Report on Fixed Income Strategies. You can view the entire report, here: <https://hedgenordic.com/wp-content/uploads/2016/09/FI.pdf>