Interview: Caba Capital in fixed income hedge fund launch

Caba Capital is the latest addition to the successful group of fixed income hedge fund managers that have been coming out of Denmark in recent years. Following a capital raising period which, according to the fund manager has brought in DKK 200 million in initial investments (well above the DKK 100 million that was set as target), the team started trading the fund last week.

The fund, which is managed through Caba Hedge, a department within Nykredit's "Kapitalforening" InvestIn, is looking to return 8 percent annualized to a low volatility through exploiting yield spreads between primarily Danish mortgage bonds and government bonds.

The fund is managed by Carsten Bach *(pictured)* a former investment manager at Danske Bank who earlier this year teamed up with Niels-Ulrik Mousten, who was previously head of Danske Capital, to set up the fund structure.

Following the recent launch of Caba, HedgeNordic took the opportunity to find out some more details about the new launch in an interview with Carsten Bach.

HedgeNordic: *Your strategy aims to take advantage of the yield spread between Danish, Swedish and British mortgage bonds and government bonds, what makes this spread hold over time and how do you profit from it?*

Carsten Bach: The Danish markets are the core markets in the fund, where the spreads have been positive here for now 25 years. They will remain so for a number of reasons. The Danish state is AAA-rated with a stable outlook. It has achieved an ever more solid rating during the past 25 years. The public finances looks good on headline level. In addition to that, the Danish government has a very strong future tax base, since very large pension savings from mandatory labor market pension schemes are tax deductible for the saver until retirement. The pension funds has holding of more than 500 billion euros now.

The perceptions of the Danish mortgages on the other hand are, that there is a level of default risk to these bonds. It is very small but it matters. There are also many issuances perceived as less liquid, and there are features to these bonds, which makes Denmark an expert market, for which investors demands interest rate compensation.

As for mortgages in Sweden and Great Britain, they are added opportunities within the investment mandate. I would be less willing to offer predictions in public about the future spreads; however much of the analysis of spreads in Denmark applies to Sweden and Great Britain as well. Generally, we enter positions with positive carry and can hold them as long as we want, so we are comfortable with these markets as well.

HedgeNordic: *What are the inherent risks with the strategy, what could make the spread less attractive from an investment standpoint (or disappear altogether).*

Carsten Bach: The mandate would become obsolete if the spread becomes negative for a long period. Then we would take action accordingly, we have our own money invested as well.

The main inherent risks relate to external shocks, which are in its very nature almost impossible to predict or quantify in advance. Shocks can generate sudden big shifts in spreads which will effect the positions in the fund.

I have managed money through many crises starting from the currency crises in the nineties – Mexico, Asia and Russia, the crisis related to the high profile hedge fund Long Term Capital Management, and of course the big Financial crisis in 2008-2009. This is the advantage of being an experienced senior portfolio manager. We do not become complacent; risks are always real.

HedgeNordic: *In what interest rate environment does the strategy work best?*

Carsten Bach: It works in different interest rate environments, especially when external shocks to the market are few and far away events.

HedgeNordic: *Why is Denmark, Sweden and Great Britain your markets of choice?*

Carsten Bach: Danish bonds are likely to become the largest part of the portfolio. This kind of fixed income arbitrage has generated returns for skilled investors for decades. By the way, this is already reflected in the annual HedgeNordic Awards for Fixed income Arbitrage Funds. The Danish mortgage fixed income market is very large, and long duration bonds comes with added opportunities for expert investors with local knowledge, since homeowners have a quarterly prepayment options.

Sweden and Great Britain offers diversification and other opportunities for the fund, which has an indefinite investment mandate.

HedgeNordic: *You come from a banking background where the strategy has been executed successfully for many years, what challenges do you see running the strategy in a fund with what presumably is a much smaller asset base?*

We see this smaller size as an added opportunity to generate returns. Due to our reputation, experience and strong contacts in the market, we have been able to secure competitive funding terms just like before. We are very grateful to our trading partners, who have put belief in our future success as a fund, even though we are still a start-up entity. In addition, we no longer have to manage very large flows, where liquidity becomes an issue, unlike when I was investing a very large pool of money in the large bank.

HedgeNordic: *You target an annualized return of 8 percent using a gearing of max 20 times, in what environment would you be less prone to use gearing thereby lowering the stated return target?*

Carsten Bach: You refer to a section of our pitch book, where we write about combinations of gearing and duration. In the very short end of the market, where we can hold a stable positions with positive carry to maturity, a high level of gearing is warranted and reasonable. We can also enter positions with Long-term bonds, where less gearing is prudent and sensible, but returns at +8 percent or more is still the objective. In times of turmoil in the market, we can stay out all together or establish positions with a lower level of gearing. There is a lot more to the management of the fund than buying mortgage, selling state, and going home.

HedgeNordic: *As you are now launching the fund, what is your view on the absolute levels of interest rates going forward and how do you see that having an impact on the spreads you trade?*

The investment strategy carries almost no interest rate or currency risk. We believe the current interest rates is the unbiased predictor of future rates, even though we would sometimes hold different views ourselves than the average market participant. Spreads can widen from here; then our opportunities will improve somewhat. In the current environment, we believe the 8% return target is achievable. This is attractive for institutional investors, since the fund is also uncorrelated to equities and fixed income, and has a low level of volatility.

HedgeNordic: *Give us three reasons why one should invest in your strategy.*

Carsten Bach: It is uncorrelated and has a low level of volatility. Given our 8 percent return target, it is attractive in a portfolio context, it will reduce the overall risk of the portfolio without lowering return expectations in the current environment. This is exactly what investors should look for in a hedge fund!