HP Fonds: Broadening Out Offering

Stockholm (HedgeNordic) – Copenhagen-based HP Fonds celebrates its 15th year in 2019. The owner-managed boutique was started by two founders – Henrik Fournais *(pictured)* and Peter Nauntofte. Fournais is active in the business to this day, while Nauntofte retired, but is still on the board of directors.

The other two co-owners – Michael Nielsen, who joined in 2008 from Carnegie Bank, and Thomas Kjaer, who joined in 2015 from Alm. Brand Bank – make up most of the five-strong investment team. Staff "eat their own cooking" by investing in their own funds. The firm manages DKK 8 billion (just over EUR 1 billion) in three segments. DKK 7 billion is in unleveraged long-only, split between HP Invest and HP Wholesale, which offers fee discounts for institutional tickets. Here, HedgeNordic will focus on the DKK 1 billion managed by HP Hedge, which is composed of two leveraged strategies and three vehicles.

HP's Expanding Fund Range

HP's oldest hedge fund strategy, which has been nominated for two categories for the 2018 Nordic Hedge Award, and received a EuroHedge award for "best fixed income hedge fund" this year, has been hard closed since August 2018 and will only grow assets through performance. Capacity is constrained because the strategy seeks out older mortgage bonds that are an endangered species because a very small percentage of the original loan pools exist. They can be inefficiently priced, partly due to there being little coverage from brokers or the buy side. They can also offer higher yields because they are not eligible under the Basel LCR (Liquidity Coverage Ratio) hence are more costly for banks to hold. Danish mortgage bonds are viewed as an attractive asset class to leverage because there has never been a default on the bonds since the market was born in 1797. Yields are leveraged using repoes or loans, to generate carry of over 1% per turn of leverage, and a return forecast of CIBOR 12 +5% over three years, while hedging interest rate risk.

Henrik Fournais and thomas Kjaer at Eurohedge, receiving an award for "best fixed income hedge fund"

HP's new hedge fund strategy, HP Hedge Fixed Income, has the same return target, generally hedges rate duration risk, and uses the same investment process that complements quantitative models with qualitative analysis. "But it has only around a 15-20% position overlap with the closed fund," says Nielsen. While the DKK 3.4 trillion (EUR 450 billion) mortgage market still makes up 75-80% of the fund, it is invested in more liquid mortgage paper, including more recent bond issues. Leverage of 3-6 times, provided by custodian bank Nordea, magnifies the carry.

Most of the Danish mortgage bonds have a AAA credit rating from Standard and Poors, but a small part of the Danish mortgage market is not rated, probably due to the fees required to get a rating. The fund has some flexibility to invest in unrated Danish mortgage bonds, but is not currently exposed to them. In any case, the bonds are over-collateralised, and lenders have full recourse to other assets or income of the borrower (in contrast to non-recourse mortgages in the USA, where lenders can only foreclose on the mortgaged property).

Most of the holdings are non-callable bonds, with interest rate risk that is hedged, and spread risk that provides the carry: yields of 0.25% to 0.50% are around a whole percentage point above funding costs (which are slightly lower than for the older hedge fund).

"Around 20% of the mortgage bond allocation is in callable bonds, which offer a higher yield in return for their prepayment risk, which cannot be precisely hedged. Around 10-15% of the carry can be spent on options hedging the rate risk, but a sharp increase in prepayments could be costly: we estimate a 1% rise in prepayments could cost the fund about 0.25%. Conversely, a drop in prepayments could produce profits for the fund. Prepayment rates in Denmark vary a lot: they are at all-time lows for high coupon bonds, but can be much higher on low coupon bonds" explains Nielsen.

Carry is a key driver of returns, but roll-down is also important, particularly given steep yield curves. "With five- year senior non-preferred bonds from Nordic SIFI banks paying 160 and three-year bonds paying 100, as the five-year bond matures it should see some capital appreciation from the tighter spread," says Nielsen.

Beyond Mortgages

The new fund can also invest in a range of other areas in the Nordics and elsewhere in Europe: covered bonds issued by Danish central and local government agencies; Swedish Bostad bonds, and sometimes it may make opportunistic excursions into other European government and corporate bonds, including Finnish municipals issued in Denmark, and bank paper.

Some trades are carry trades but others are more based on relative value. For instance, the fund currently has a trade investing in senior, unsecured 'tier 3' bonds recently issued by European banks under the new 'bail in' rules. "These rank above contingent convertibles (CoCos) in the capital structure and pay around CIBOR+160 basis points. As usual, the interest rate risk is hedged, using one or more of: German Schatz/Bobl futures, Danish government bonds or swaps. We expect that the spread could compress as the paper, which as an investment grade BBB credit rating, should attract demand from pension funds and insurers" points out Nielsen.

Currently, the fund has no exposure to non-bank corporate debt, but could opportunistically invest in it in stressed conditions. Similarly, European government bonds, normally up to a maximum of five-year maturity for BBB rated countries. Countries rated below BBB can only be invested into a very limited amount, and only with two-and-a-half-year maturity.

Liquidity and Bid-Offer Spreads

Given that interest rate risk is hedged, and credit risk has historically been a spread risk rather than a default risk for Danish mortgage bonds, the returns on HP's strategies can be seen as partly an illiquidity premium.

"The number of banks making markets in Danish mortgage bonds has dropped from 20-25 down to a handful, and the new Basel rules forced the banks to roughly halve their holdings in 2015. As a consequence, bid/offer spreads have widened out to 0.25% or 0.50% in some cases. In a low-interest rate climate, this can add up to one or two years' coupon income" reveals Nielsen.

"We try to trade inside the spread and would only expect to pay more in stressed market conditions," he says. Therefore, the strategy is mainly about buying and holding bonds for many years – and usually to maturity.

It also makes sense for the strategy to have entry (1.5% for retail and 0.5% for institutional) and exit (0.375%) fees, so that inflows and outflows reflect the associated transaction costs of buying and selling bonds. These fees are sometimes described as an "anti-dilution levy". The subscription and redemption fees are paid to the funds, to protect investors from these frictional costs, though part of the subscription fee can also be paid to distributors under MiFID II.

Danish mortgages are not alone in having become less liquid over the past decade. Many parts of the corporate credit markets in the US and Europe have also reported liquidity issues, as regulations mean banks hold less inventory. Equally, if some investors cannot accept this liquidity risk, there could be better opportunities for those who can take a longer-term view.