



# Moan and Groan or Fish Lucrative Waters?

Stockholm (HedgeNordic) - Banks are now required to possess more capital and liquidity to operate due to tightening banking regulations, which has affected the cost of holding securities on their books and the cost of acting as market makers. Reduced bank risk-taking, in turn, has led to increased volatility in fixed-income markets and an expanded pool of opportunities for funds such as [SEB Eureka Fixed Income Relative Value](#).

You can either moan and groan about that and do nothing, or you can set up a new fund to boost liquidity into the markets and offer uncorrelated returns to investors by exploiting opportunities at the same time. Bo Michael Andersen, who had his Eureka moment during his 15-year tenure at SEB Denmark, chose the latter and launched a relative-value fixed-income hedge fund in SEB Investment Management in early 2018 to capitalize on attractive risk-reward opportunities available in Scandinavian fixed-income markets.

“Banks are coming down on risk-taking in both Scandinavian and global fixed-income markets, where historically they have been absorbing risk, holding onto risk and then offloading it at some point,” explains CIO Andersen, who co-manages the fund with Portfolio Manager Tore Davidsen. Reduced bank risk appetite and the associated drying liquidity led to increased yield fluctuations in

fixed-income markets, thus, creating attractive opportunities for SEB Eureka and other players.

Andersen, who has been building up experience in fixed-income markets since 1996, had tested the strategy behind SEB Eureka before the launch. “We had been observing increasing relative-value opportunities for many years. Starting a broad relative-value fixed-income hedge fund made complete sense, as investors could get the opportunity to benefit from those opportunities.”

## **First Leg: Relative-Value Ops in Covered Bonds**

Denmark has the largest mortgage covered bond market in the world, with Sweden and Norway closely following suit. The size of the overall Scandinavian covered bond market is more than three times as large than the region’s government bond market. The sheer size of the market and the structure of the Danish mortgage market, in particular, create a fertile hunting ground for vehicles such as SEB Eureka.

Credit risk in covered bonds is considered low, yet, the average yield spread between covered bonds and risk-free rates is higher than what one would perhaps expect. Partly for that reason, “one-third of our expected return comes from taking advantage of yield pick-up in Scandinavian covered bonds” says Andersen.

More importantly, the so-called pass-through structure of the Danish mortgage market, where borrower activity directly affects bond issuances, creates periodical and exploitable market inefficiencies. The large flows or gross issuance activity driven by borrower activity represent a constant source of relative value opportunities for SEB Eureka and other players.

Some hedge funds operating in this area employ significant leverage using repos to magnify returns, while SEB Eureka considers themselves more conservative. “An important pillar of our strategy involves holding leveraged positions in mispriced covered bonds, so, in essence, one-third of our expected return comes from harvesting risk premia,” explains Andersen.

The conservatism reflected in the use of leverage does not necessarily translate into lower expected returns, as the team running SEB Eureka is tapping other sources of return as well. “Although we may hold a little bit less leverage compared to some of our peers, we rely on being more active,” argues Andersen.

## **Second Leg: Active Management of Covered Bond Portfolio**

The passive harvesting of risk premia is one of the three pillars of the strategy employed by SEB Eureka. “The second part of our expected return stems from the active management of the covered bond portfolio, maturity-wise and regional,” he continues. “The active management involves increasing or decreasing exposure depending on how appealing our existing trades are,” adds the CIO, “the geographical mix of existing positions comes into play as well.”

The active approach to managing the covered bond portfolio has proven quite successful since the launch, as the “estimated performance contribution from the average passive exposure accounted for less than one-fifth of the total contribution from the covered bond strategy bucket,” explains Andersen. “If we only had a passive exposure to covered bonds, our return for last year would have been around half a percent or one percent instead of the four percent we earned,” he analyzes.

## **Third Leg: Other Relative-Value Strategies Make Full House**

“Banks have cut down on warehousing covered bonds on their books quite significantly, but the reduced risk-taking by banks does not only apply to this area of fixed-income markets,” explains Andersen. In addition to capturing yield pick-up in covered bonds, SEB Eureka Relative Value Opportunities allots a significant part of the risk budget in other relative-value strategies, including relative-value trades in Interest Rate Derivatives and XCCY derivatives, carry and relative-value trades in Scandinavian government bonds and Danish callable mortgage bonds, among others.

“We are trying to run a more diversified approach by employing a wide range of strategies that are uncorrelated in nature,” says Andersen. The team running SEB Eureka, set to expand with the upcoming hiring of a third member, strives to avoid “having multiple strategies that are basically pointing in the same direction,” adding that “we want to have as many uncorrelated strategies as possible. We’d strive to maintain four to eight different strategies, but looking at the number of positions, each strategy can be associated with dozens of separate positions.”

## **Investment Process: What, Why and How?**

The process of identifying “What” is mispriced and offers value relies heavily on market screening using proprietary quant models. “We use quantitative tools to screen markets all the time to find price-wise dislocations as a result of commercial flows [borrower activity],” explains the CIO. “Sometimes we hear about a commercial flow creating dislocations in markets, but more often than not, we find opportunities by screening markets using our tools,” he adds.

When dislocations are found, however, the duo running SEB Eureka use their experience to understand “Why” certain securities are mispriced. The use of a quant approach to exploit seeming mispricing can be dangerous at times. “Especially these days, you notice price changes that can be perfectly natural, maybe these changes should have happened a year ago,” clarifies Andersen. “But trying to assess why certain dislocations occur, estimate when these will normalize, and how commercial flows will eventually change are a crucial part of the way we invest.”

The final part of the “What, Why and How” investment process involves “determining the risk-reward characteristics of each trade, finding out how to capitalize on mispriced opportunities, and taking a portfolio perspective by assessing how a new strategy correlates with other strategies or positions we might hold.”

## **Return Target and Main Risk**

SEB Eureka has an annual return ambition of four to eight percent with a volatility target in the same range. More importantly, however, the fund seeks to avoid exposure to market directionality in the pursuit of alpha. As Andersen explains, “if we can truly deliver uncorrelated returns, SEB Eureka does not have to yield six or eight percent to be an appealing investment. We focus extensively on being uncorrelated.”

Currently managing DKK 2.1 billion, SEB Eureka Fixed Income Relative Value returned 4.05 percent in 2018 and returned an additional 2.54 percent during the first three months of 2019. The fund’s Sharpe ratio since its inception in mid-January 2018 stands at 2.96.

Although the fund’s exposure to credit and interest-rate risks are limited, “the

main risk faced by our fund is a drawdown in a distressed scenario,” acknowledges the CIO. “If you enter a Lehman-type scenario, will you have a loss to the degree that you are forced to unwind positions? Much of the risk management, of course, is to evaluate the risk we hold in stress scenarios.

Yet, “a stable low-volatile market would not be good for our strategy,” reckons Andersen. Whereas smooth markets limit drawdown risk in the bucket of leveraged positions in covered bonds, “volatility tends to be lucrative for the other relative-value strategies,” continues the CIO. “Volatility creates opportunities we can exploit.”