

# Nordic Hybrid Security Hedge Fund, a New Type of Diversifier

Stockholm (HedgeNordic) – Non-correlated returns have always been in high demand among institutional investors, more so in the current environment. Backed by Swedish real estate investor Erik Selin, the team at Carlsson Norén Asset Management launched a new hedge fund investing in hybrid securities with features of both debt and equity. The fund earned a positive return in each of the first five months of 2019, including May – a tough month for markets.

Launched on the first day of 2019, **Carlsson Norén Yield Opportunity** represents “an actively managed alternative fixed income fund which invests in the space between bonds and equities, or so-called hybrid securities,” CEO Fredrik Carlsson tells HedgeNordic. “This is a unique niche fund,” argues Carlsson, a fund that invests in hybrid securities such as preferred stock, corporate hybrid bonds, bank hybrids such as additional tier 1 or tier 2 bonds, and to some extent, convertibles. The fund also invests in collateralized loan obligations (CLOs).

“Many investors are not able to invest in hybrid bonds or CLOs, and many others don’t have the time to spend to analyze these complex instruments,” argues the co-founder of Gothenburg-based Carlsson Norén Asset Management. “We offer a simple way to enter this attractive and under-exploited market segment.” What can this segment offer investors? As Carlsson points out, “during the spring, we have seen several issues [hybrid bonds issued by banks and other institutions] with coupons in the range of 5-8% in Swedish krona or Euro.” These issues do not fall in the “junk” category, he argues, adding that these are issuers “with fairly strong balance sheets and cash flows.”

“Many investors are not able to invest in hybrid bonds or CLOs, and many others don’t have the time to spend to analyze these complex instruments. We offer a simple way to enter this attractive and under-exploited market segment.”

“We find excellent opportunities to invest in high-quality companies but still get high expected returns, as well as fairly low correlations with other asset classes,” explains Carlsson. He acknowledges that the prices of hybrid securities do fluctuate, “but as long as you can avoid credit events, the high coupons provide significantly lower volatility than equities over time.” Carlsson Norén Yield Opportunity aims to generate equity-like returns at a lower volatility level than equities over time, with the fund targets an annual return of 7-8%.

## Geographic and Industry Focus; Existing Pool of Opportunities

Explaining the rationale behind launching a fund investing in hybrid securities, Carlsson says “the market opportunity was initially identified by our partner and seed investor, Erik Selin.” This partly explains the geographical focus of the team running the fund. “We have a home market bias because we have better insight in the Swedish and Nordic markets, but we also have exposure to North America, Europe, and other markets,” he explains.

“We have a home market bias because we have better insight in the Swedish and Nordic markets, but we also have exposure to North America, Europe, and other markets.”

Carlsson Norén Yield Opportunity's sector exposure, meanwhile, depends on each industry's hybrid securities issuance activity. "The fund has a natural bias to financials and real estate because of the higher issuance in those sectors," says Carlsson, "but we try to have at least 30-40% in other sectors such as industrials, consumer products, technology, energy, materials, and medical equipment." The existing pool of opportunities has not dried up just yet. "We still find attractive returns in hybrid bonds and preferred stock in the real estate sector and smaller banks," Carlsson pinpoints the sectors offering opportunities at the moment.

He also views convertibles as an appealing asset class, with this group of securities offering a potential for upside and downside protection. At this point, however, "many convertibles are well in-the-money, which means that they behave like equities," argues Carlsson. CLOs represent another group of securities that seem attractive for the Carlsson Norén team. "CLOs may not be hybrid securities, but we find the risk-adjusted returns excellent in this segment if you choose the right manager."

## **Security Selection and Research Process**

According to portfolio manager Magnus Dahlgren, the team prefers to invest in hybrid securities in the primary market "because the pricing is usually rather attractive" as issuers seek to attract investors. Besides, "we monitor expected yields across countries and sectors in the secondary market, and we try to find the most attractive ones," says Dahlgren. The secondary market can present appealing opportunities at times. "Comparing instruments along the debt to equity spectrum sometimes renders interesting opportunities, such as finding hybrid bonds which are cheap compared to preferred stock or senior bonds."

Initially, the fund maintained a rather concentrated portfolio, but portfolio expands and becomes more diversified as new opportunities emerge. The current number of positions stands at 20, a figure expected to increase over time. Yet, the fund maintains a well-diversified portfolio that also contains "a few ETFs and other listed vehicles, which offer indirect exposure to hundreds of issuers."

Explaining the security selection process, Dahlgren says "we don't try to reinvent the wheel if it isn't necessary," adding that "we may look at external research or existing credit ratings, but we always have our own opinion." As a general rule, the Carlsson Norén team searches for companies with stable cash flows and strong balance sheets, which operate in fairly predictable environments. The team is very prudent with speculative-grade issuers. "The better the credit rating, the more junior positions we are willing to take."

"We don't try to reinvent the wheel if it isn't necessary. We spend a lot of time reading prospectuses to understand the different kinds of scenarios that may arise."

Hybrid securities are complex instruments, and the process of determining the value of these securities is complex too. "We spend a lot of time reading prospectuses to understand the different kinds of scenarios that may arise, including temporary or permanent write-downs or conversions, calls, resets or step-ups of coupons, among others," explains Carlsson. To determine the value of a security, the team uses "event trees with many possible outcomes, and the valuation depends on which branch of the tree is the most likely scenario." As probabilities constantly change, a "very dedicated and experienced team with a good understanding of the market" is needed to capitalize on existing opportunities in this space.