Borea Fund Succeeds in World of Negative-Yielding Debt

Stockholm (HedgeNordic) – The swelling pool of negative-yielding debt has created a hostile environment for most fixed-income investors. Against this backdrop, **Borea Høyrente** has found a way to deliver returns for investors.

The Norwegian fixed-income hedge fund managed by Peer Hastrup Thorsheim and his team at Borea Asset Management delivered an annualized return of 10.5 percent in the past three years, the highest rate of return among all fixed-income funds in the Nordic Hedge Index. Borea Høyrente has achieved this feat by exploiting "what academics refer to as the credit spread puzzle," according to Thorsheim.

Exploiting the Credit Spread Puzzle


Peer Hastrup Thorsheim

As Thorsheim explains, the credit spread puzzle is "a phenomenon where relatively safe companies (BB-rated equivalents) have to pay a higher credit spread on their loans than can be explained by expected losses and other factors." Past research shows that investors can achieve higher risk-adjusted returns by building a leveraged portfolio of loans issued by these relatively safe companies instead of "moving further out on the risk curve" and building a portfolio with a similar risk profile comprised of single-B or CCC-rated loans.

Although the primary strategy involves exploiting the credit spread puzzle, the fund has a very flexible mandate which allows to go both long and short, apply leverage, vary exposure from zero to 150 percent, invest in derivatives, and do capital structure trades. The latter type of trades involves taking long and short positions in different instruments of a company's capital structure.

Thorsheim and his team are opportunistic and possess the required tool kit to act when "great risk-reward opportunities present themselves." Whereas the fund is country and currency agnostic, "we have a considerable home bias with most of our exposure currently being in the Nordics," Thorsheim tells HedgeNordic.

Security Selection and Analysis Processes

The main risk associated with Borea Høyrente's investment approach is credit risk, which makes the security selection process paramount. "Generally, we look for good businesses with a positive fundamental outlook, manageable business risks, adequate cash flow generation and preferably a clear path to improved credit metrics," Thorsheim explains the security selection used to populate the loan portfolio. To find attractive risk-reward opportunities, the team at Borea Asset Management usually looks for "special situations like forced selling, or situations where we find that the market has over-reacted or are otherwise misreading a situation."

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Borea Høyrente's security selection process relies on two main pillars: company analysis and an analysis of terms in the bond agreement. According to Thorsheim, "the company analysis has much in common with the way fundamental equity investors analyze companies, but with more emphasis on downside protection." This company analysis involves examining both business and financial risk, with the business risk being evaluated by examining factors such as company track record, competitive position, business and industry cyclicality, and management and ownership. The financial risk, meanwhile, is assessed by analyzing "common financial metrics like net interest-bearing debt to EBITDA, loan to value, interest coverage and cash conversion, amongst others."

When conducting company analysis, "the most important thing for us is that the company will be able to pay us interest on the money we lend them," says Thorsheim. In addition to this analysis, the Borea team conducts a review of terms in the bond agreement. "Where our analysis differs most from fundamental equity analysis is the bond term analysis," emphasizes Thorsheim. The analysis is much harder to quantify and involves the assessment of the terms of the specific bond deal. "This analysis includes an assessment of covenants, security package, permitted indebtedness, what happens in a change of control situation, what happens if the company disposes of assets, cash distribution allowance," explains the portfolio manager.

Whereas the bond term analysis may seem irrelevant for equity investors, this analysis can help bond investors avoid a permanent loss of capital. "We have seen many examples of loan agreements where the allowed cash distribution, for instance, is based on some adjusted net profit metric and the adjustments allow for most cash generated to be distributed," says Thorsheim. "In this part of the analysis, the devil is in the detail."

Perfect Environment for Borea's Fixed-Income Hedge Fund

The ideal environment for Borea Høyrente's strategy is "a benign macro environment with low default rates and generally periods with low volatility in financial markets." However, as is always the case, a volatile market creates investment opportunities. "Many of the seeds that grow into said returns are usually sown when the market is presenting itself from a different, more volatile side," argues Thorsheim.

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Whereas increased market volatility can create opportunities, it can also cause panic among a fund's own investors. Borea Høyrente, therefore, needs to maintain an appropriate investor base to be able to weather unpredictable markets and deliver attractive returns to investors longer-term. "The importance of this feature cannot be stressed enough," reckons Thorsheim. "Having clients and owners with a long-term industrial mindset give us the ability to weather through the storm without selling high-quality names to meet redemptions,” he concludes.