

A Vintage Year for the Asgard Funds

London (HedgeNordic) - With the credit strategy up 26% and the fixed income strategy up close to 9%, 2019 has been another strong year for the Asgard funds. "The funds, which are fully hedged against outright movements in interest rates, have not benefitted directly from falling interest rates this year, but they have benefitted from the benign behavior of the targeted risk premia during the period", says Moma Advisors CEO, Birger Durhuus.

"The **Asgard Credit Fund**, which targets risk premia in the credit space, got a tailwind early in the year from the relaxation of the spread widening which happened in late 2018 and hit US investment grade disproportionately hard. For the remaining part of 2019, when credit spreads have been rangebound, the fund has benefitted from the high inherent alpha in its core strategy in the form of high credit spread carry in a year with low default rates. The spectacular 26% return is impressive and must in part be attributed to the successful active management of the fund, as the return of comparable passive strategies with similar risk profiles have only yielded around 18%", says Asgard Credit portfolio manager, Daniel Vesterbaek Pedersen.

"The **Asgard Fixed Income** strategy has had a solid if less spectacular year with a return around 9%. The fund, which targets risk premia in Nordic mortgage bonds, cross-currency and related fixed income markets, has not had a significant head or tail wind in the form widening or contracting spreads this year, but it has benefitted from the carry and roll which results from the risk premia in the carefully selected positions in the portfolios. The strategy is also one of the few direct beneficiaries from the current ultralow interest rate environment. This may seem contractionary, but since the fund operates a leveraged portfolio of the safest bonds, it benefits from the sub-LIBOR financing in secured lending rates", says Durhuus.

Although the fixed income strategy and credit strategies operate in different markets and geographical jurisdictions, the funds follow a common philosophy - i.e. to pursue and isolate the risk premia which offers the highest reward-to-risk ratio. "The active management of the funds seeks to maximize the ex-ante information ratio within the respective risk mandates. The continuous optimization - in effect buying cheap and selling expensive - will over time mean that mean-reversion of the various risk premia available to the funds contributes to the long run return. This is evidenced in the 2019 returns, which exceeded comparable passive and suboptimal strategies", says Durhuus.

"The continuous optimization - in effect buying cheap and selling expensive - will over time mean that mean-reversion of the various risk premia available to the funds contributes to the long run return."

"The credit fund returns in 2019 have been exceptional, and partly represent a recovery from a drawdown in late 2018. Over the credit cycle, the base case return target is around 7% annualized, and this is also the expectation for 2020", he adds.

The returns in Nordic fixed income markets have been mixed in 2019. In both Denmark and Sweden, investors are facing the challenges of negative yields leading some unleveraged long only bond funds to have a negative yield, and regulators questioning whether it is appropriate for clients to invest in them. A low and negative interest rate environment is clearly challenging for some strategies, but less so for Moma Advisors. "Our funds are a natural place to look, as our expected

returns are not dependent on absolute levels in interest rates, and in some cases, we even benefit from the low borrowing costs. This means healthy liquidity and overall support for credit and asset swap spreads in the fixed income markets”, says Durhuus.

“Our funds are a natural place to look, as our expected returns are not dependent on absolute levels in interest rates, and in some cases, we even benefit from the low borrowing costs.”

“For the fixed income strategy, we also see some bond segments cheapen up on a relative basis, as long only investors shy away from bonds that are delivering negative rates. But for us these bonds may still be attractive due to low financing and hedging costs”, he adds. A typical breakdown of returns could include carry of 0.25%, rolldown of 0.25%, and relative value of another 0.25%, before leverage, which then multiplies these up to a high single digit expected return. The credit fund is using leverage of around 4 times. The fixed income strategy moves leverage around partly based on the maturity of holdings, applying less leverage to longer dated papers.

The strong performance has not gone unnoticed among the global investor community, as there has been a marked increase in the interest in the funds managed by Moma Advisors. “Historically our investor base has been solely institutional investors, primarily large Scandinavian pension funds, but this year we have seen a surge in requests from family offices around the globe”, says Durhuus. Investors come from regions such as Southern Europe, Switzerland and the UK. Further afield, there have been requests from Singapore, Hong Kong and Japan. Moma has some exclusive agreements with a handful of third-party marketers. Typical ticket sizes from this investor segment are US\$1-5 million, and are invested in either EUR or USD share classes.

The Credit Cycle

Some managers have spent years arguing that credit markets are late in the cycle, and been proven wrong. Pedersen has been constructive on corporate credit for some years and he remains so: “the end of the credit cycle is still a few years away. Historically, default rates spike when nominal economic growth slows and the last three years have seen some pickup in nominal growth. US nominal growth slowed between 2010 and 2016, before speeding up between 2017 and 2019”. He is upbeat on US economic growth: “we expect the United States Mexico Canada Agreement (USMCA) to be completed in early 2020. Together with the regulatory reforms of 2017 we see these two important events as being catalysts for a continuation of the increase in employment rate among the prime age group (25-54Y) in US”.

“The end of the credit cycle is still a few years away.”

Growth rates do vary between regions. “Europe, and Germany especially, have been challenged by having a higher proportion of manufacturing in their economies: 20% in Germany against 11% in the US. But Europe has now bottomed out and we expect better nominal growth in 2020”, he adds.

While corporate debt to GDP is at quite elevated levels, Pedersen finds this is not a consistent measure over time because companies have grown their international revenues. He therefore prefers to look at net debt to EBITDA, which averages about 3 times. “This is about 0.5 times higher than it was in 2013 but there has been no increase in the median leverage since 2015. Debt servicing costs are manageable for most companies.

Focusing specifically on the US corporate BBB segment, leverage went from 2.3x to about 3.4x during the energy crisis in 2013-2015. As of Q2 2019, US Corporate BBB leverage is at approximately 2.5x using fundamentally the same accounting standards. Accounting standards were changed as of end of 2018 (related to operating leases). Using the new accounting standards, US Corporate BBB leverage is at approximately 3.0x as of Q2 2019. In reality therefore, US corporates have reduced leverage slightly since 2015. In Europe, BBB Corporates have also been deleveraging since 2015, for example from 2.3x in 2015 to about 2.0x as of Q2 2019", he says. There is some controversy around EBITDA adjustments but Pedersen uses the traditional EBITDA measure rather than corporates' adjusted figures.

Sectors and Companies

Crossover credits remain the sweet spot in terms of credit spread, with around 70% of the book investment grade and 30% high yield. The vast majority of the high yield book is in companies with a 'BB' rating, though some single 'B' names that are deleveraging are also held. The CCC and D rated names that have sold off this year are generally avoided. The priority is to find companies with stable cash flows.

"We see credit spreads overall fairly priced within High Yield issuers trading just below 400bp in spread (unchanged since the end of 2016) and investment grade just above 100bp. US corporate credit spreads are at fair levels overall. However, we urge caution on some autos, oil and gas services, and the lower end of retailers. Auto makers are trading tight but need to spend a lot on capex. Natural gas and oil producers are performing well with higher production levels and stable output prices, but in services there have been several filings for Chapter 11".

Whether it is worth actually shorting them depends on how wide spreads are. Pedersen judges that, "oil and gas service providers would not be worthwhile shorts because spreads are already pricing in probable defaults. But car rental companies are under pressure from multiple angles: ride sharing, Airbnb for cars, and other new business models, yet they trade around 300 basis points, which is tighter than the market average".

"In other sub-sectors of autos, such as parts and equipment, it is possible to earn as much as 500, 600 or 700 basis points from BB or B+ rated names. The higher quality names such as Faurecia, which might soon be upgraded to Investment Grade, is trading around +230bp. These firms can have a more stable top line than auto makers and can be very diversified in terms of customer base, without too much dependency on ICE cars", he adds.

Liquidity and Capacity

Liquidity in CDS markets is adequate for the typical position sizes of \$1-3 million per name, and the CDS markets can be more liquid than cash bond markets. Repo liquidity in the Nordic countries has also been fine, and Moma does not use the US repo markets that saw a spike in overnight rates in September. Repoes are used for the fixed income strategy, in the same currency as the holdings of covered bonds.

Capacity remains in both strategies. The credit fund has AuM of around EUR 140 million and has no specific capacity limits. The fixed income strategy runs EUR 700 million and could go up to EUR 1 billion. Moma keeps an open mind about launching a third strategy at some stage if the right managers can be found.

This article featured in HedgeNordic's Special Report on "Alternative Fixed Income."