Going Global With Fixed Income Arbitrage

Stockholm (HedgeNordic) – For the past five years, Michael Petry, Head of Hedge Funds at Danske Bank Asset Management, has started each year with a rather cautious outlook that it will not be easy to generate returns, and that market conditions have probably made it more difficult. Returns in 2018 were well below the long-term average, but have bounced back in 2019. Petry's teams keep an open mind about spontaneously adapting to new opportunities and market conditions.

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They run market neutral strategies, which are rarely expressing a view on the direction of a single interest rate, but are more likely to be trading the relative value between two or more fixed and floating interest rates, within or between government bond, mortgage bond, swap and repo markets. For instance, "we never expected to see negative 30 year swap rates, but the market volatility in August has contributed to some new trades", he says.

"This discretionary investment process has worked consistently: the flagship fixed income hedge fund strategy (Danske Invest PCC Ltd Hedge Fixed Income Strategies) that launched in 2005 has generated positive returns every calendar year (except in 2008, where we had a negative return), and is up c 6,75% in 2019 to November", he adds. It received the 2018 EuroHedge performance awards for long term performance over 10 years, in the macro, fixed income and relative value category for an annualized return of 17,8% in the period 2009-2018 (415% in total).

Michael Petry, Head of Hedge Funds and Gabrielle Hagman,
Head of Institutional Clients & Fund Distribution, Sweden for Danske Bank Asset Management

This fund is not exclusively Nordic in focus but has generated most of its 2019 returns close to home from positions in Danish, Swedish and Norwegian Government bonds, mortgage bonds and interest rate swaps (in those 3 currencies). "Interest rate and currency risks are hedged, and the return has come from for example interest rate spreads between government bonds and the swap curve.

The changes in Swedish interest rates from the Riksbank this year have not impacted the spreads. Very little exposure now remains as profits have been taken", says Petry. Though yields on Danish non-callable mortgage bonds are now negative – at around minus 25 to minus 70 basis points – borrowing costs via repoes are even lower, so it is still possible to extract some positive carry through leveraged trades.

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Callable bonds in Denmark can still produce a positive yield without using leverage, but this yield is partly a compensation for borrowers' prepayment optionality, which makes the duration of the bonds variable. "This duration extension and contraction risk has been very difficult to hedge this year, due to interest rate volatility. We have had very little exposure, but have made a small profit on callables", says Petry.

The Danske strategy has also profited from interest rate curve trades at various maturities, including some outside the Nordic region. "Short term curve trades have taken leveraged positions in the DKK and EUR interest rate swap markets. Longer term trades have included one which went short of 30-year swap rates in EUR with forward start vs 30-year swap rates with forward start in US at a spread of 160 basis points. The trade was closed at a spread 25 basis points better", says Petry.

Cross currency basis trades involving USD, GBP and EUR have also been a fruitful way to exploit an inefficiency that contradicts academic textbooks. In theory, the cost of hedging between currencies should be very close to the interest rate differential, in order to eliminate arbitrage opportunities. In practice, flow imbalances regularly cause dislocations which result in divergences from interest rate parity. "Markets eventually normalize, so there is a window of opportunity to take advantage of dislocations.

We monitor flows by keeping an eye on issuance and hedging activity from major players such as KfW in Germany and the European Investment Bank in Luxembourg", says Petry. The Danske Invest PCC Ltd Hedge Fixed Income Relative Value strategy is run by the same team and has some degree of overlap with the flagship strategy, but is not involved in the same degree in Scandinavian mortgage bond trades (which are less scalable), and tends to have more exposure to European government bonds, such as opportunistic trades in UK, French, Dutch and Italian government bonds.

Both of these strategies are soft closed, at assets of around DKK 8 billion and DKK 4 billion, respectively, and Petry takes some pride in maintaining conservative capacity targets. He is of the opinion that some hedge fund managers raise too much money, but has been able to identify more available capacity for a global strategy: Danske Invest SICAV – SIF Fixed Income Global Value, which launched last year. It has assets of almost c EUR 600 million and another EUR 400 million of spare capacity before it reaches EUR 1 billion capacity target.

This strategy is run by a different team, led by Anders Moller Lumholtz, who was previously Head of the Rates Strategy at Danske Markets. It it has a risk budget at the same level as Fixed Income Relative Value, but 50% higher than Fixed Income Strategies. On a risk-adjusted basis, returns of 11% in 2019 are pretty similar to the others. The new fund has already been shortlisted for the Eurohedge award 2019 and has already won the HFM award for 2019 for new fixed income hedge funds.

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"The fund was launched partly in response to strong demand from Swedish institutional investors who could not allocate enough capital to the other fixed income strategies. Currently it has institutional investors from primarily Sweden, Denmark and Finland, but is also sold to to retail investors in Denmark. The fund is still waiting for an approval from Swedish FSA for retail clients in Sweden. Some of Danske's other hedge fund strategies are invested in by private wealth firms", says Gabrielle Hagman, Head of Institutional Clients and Fund Distribution, who is based in Stockholm.

Most of Danske's hedge fund assets come from investors in Scandinavia, and the firm generally seeks marketing permissions from individual regulators under the national private placement regimes. "We would love to do a UCITS to make marketing easier, and have spent a lot of time looking into it, but it is just not possible for our investment strategy", says Petry. Two of the funds are Guernsey-domiciled AIFs and the global fund is a Luxembourg-domiciled AIF. All three strategies have a management fee below 1% and a performance fee of 20% (above risk free rate and with high watermark).

Going forward, Petry remains circumspect in his outlook, but his teams will continue to look for dislocations and inefficiencies in a wide variety of fixed income markets globally in their search for trade ideas to generate alpha.