



# The Importance of Relative Value in Credit

Stockholm (HedgeNordic) - [Capital Four Credit Opportunities](#) of Danish sub-investment grade credit manager Capital Four has reached its ten-year anniversary at the beginning of the new decade, with the fund achieving an annualized return above 10 percent over the past decade. While happy with the performance, Sandro Näf (*pictured*), the CEO and co-founding partner at Capital Four, reckons that the way returns are achieved matters more than the level of returns delivered. “Instead of focusing on achieving a certain level of returns, the fund mostly focuses on the quality of returns,” explains Näf. “The strategy aims to achieve a good combination of attractive returns at optimized risk levels and with risk that is significantly lower than high yield.”

*“The fund has the flexibility to look for alpha opportunities across the entire spectrum of credit markets.”*

When explaining the investment strategy of the Credit Opportunities Fund, Portfolio Manager René Kallestrup highlights two main aspects of the strategy. First, “the fund has the flexibility to look for alpha opportunities across the entire spectrum of credit markets.” Second, “this is an all-cycle strategy that should do well both in up and down markets,” adds Kallestrup. “Over the last decade or so, we have shown that we are able to do just that.”



Portfolio Manager René Kallestrup.

Capital Four Credit Opportunities invests dynamically across the entire credit universe, specifically considering relative-value features across bonds, leveraged loans, structured credit, bank capital, derivatives and various types of other credit-related instruments. In addition to focused asset allocation, Capital Four conducts fundamental credit analysis to identify investment opportunities and build long/short positions to exploit those opportunities through detailed and disciplined bottom-up analysis.

Capital Four has an army of investment analysts to search for and examine opportunities others may not be able to access. “If you are a company that has a big invested asset base and is a recurring investor and partner with other parties that are relevant in the credit formation process, it is much easier to get access to opportunities over the entire economic cycle,” explains Näf.

Whereas some managers are more focused on specific corners of credit markets, Capital Four Credit Opportunities “has a quite diversified portfolio within sub-investment grade credit” that is enriched both by the flexibility of the fund allowed by its mandate and the size of Capital Four’s platform and network. With about €530 million in assets under management, the fund is relatively small compared to the firm’s asset base of over €13 billion. “This allows us to be super selective in building a focused portfolio,” emphasizes Näf. “This fund would have never generated the return it did over the last ten years if it was not for the network and presence we have in the market that allows us to access these

opportunities.”

Capital Four Credit Opportunities, which has been hard closed since March 2018, is re-opening its gates for fresh capital once again as the coronavirus-fuelled market volatility has created investment opportunities. The fund seeks to attract an additional €100 million in new capital on the month-end subscription dates in March and April. After that, Capital Four Credit Opportunities will be hard closed again and will not match demand from waitlisted investors with redemptions before assets under management fall below €500 million.

## **Expanding Universe and Opportunity Set**

The pool of investment opportunities in the sub-investment grade spectrum has expanded significantly over the previous years. Describing how the investment universe has evolved over the past decade, Kallestrup says that both the universe and the opportunity set have expanded significantly. “There have been a lot of new issuances since the financial crisis, creating a lot of opportunities in European and U.S. markets both on the long and short side.” The founding partner and CEO of Capital Four, meanwhile, points out two important secular trends that contributed and continue to contribute to the expansion of the opportunity set.

*“At Capital Four, we believe that we are in a secular bull market for credit formation outside the banking sector.”*

“At Capital Four, we believe that we are in a secular bull market for credit formation outside the banking sector,” outlines Näf. In Europe, banks have dominated the financial sector and had a primary role in financing the corporate sector. “For decades, Europe has been lagging the U.S. in connecting investors directly with end markets in credit,” highlights Näf, who adds that “we are starting to pick up in Europe and the banking crisis in Europe has accelerated that.” The second development, which relates to the sub-investment grade space in particular, has been the spread of “focused ownership companies over the broadly diversified ownership model.”

*“We have two strong secular forces that continue to supply us and our clients with investment opportunities.”*

The flood of private equity firms and the mounting dry powder in their hands has

facilitated new credit formation. “Many institutional investors have increased allocations to private equity or focused-ownership type of funds,” says Näf. “And increasing allocations to private equity need to be supported by more credit formation to facilitate this type of companies with concentrated ownership,” he emphasizes. “We have two strong secular forces that continue to supply us and our clients with investment opportunities.”

As the opportunity set has continuously expanded, the team at Capital Four has grown as well. “Ten years ago, when Capital Four Credit Opportunities was launched, we had six people,” says Näf. “Now we are 90 people with a large majority being investment professionals.” A team focused on sub-investment grade credit needs the depth and breadth of knowledge and capabilities to spot and analyze investment opportunities. As Näf explains, “in addition to having the opportunity set and being able to access it, you need the right team to capitalize on those opportunities.”

There is a lot of expertise required to understand when to invest, in which part of the capital structure (mezzanine, senior, etc.) to invest, and what level of leverage to employ. Around 40 people work on the investment side and this team has to understand all nuances related to investing in the sub-investment grade credit and beyond. “Having the opportunity set, being able to access them, and then finding the right opportunities at the right time are the three layers that translate into good risk-adjusted returns,” argues Näf.

## **Increasing Interest in Structured Credit**

Faced with low interest rates and large allocations to low-yielding assets, institutional investors on the quest for solutions and yield have turned to structured credit, one of the most underappreciated asset classes in credit, according to Näf. A structured credit product operates “like a very simple bank,” according to Näf, “serving as a mechanism to access the leveraged loan market.” Structured credit products are created through a securitization process that packs financial assets such as loans into interest-bearing securities backed by those assets. “Now the leveraged loan market is predominately funded by structured credit, and investors should think of structured credit as a vehicle used to fund the formation of loans,” explains the CEO of Capital Four.

Capital Four’s clients have been able to access the structured credit market for

more than a decade by investing into Capital Four Credit Opportunities. “But in the last couple of years, we have received more and more requests from clients to have dedicated vehicles to access this market,” says Näf. In response to increasing investor demand, Capital Four is soon launching a dedicated Structured Credit Opportunities Fund. “The strategy would mostly be investing in the mezzanine and equity tranches of collateralized loan obligations (CLOs), but we also think it makes sense for certain types of investors to access the least risky, senior or investment-grade tranches of CLOs.”

*“You don’t have to be a genius to figure out that something with lower risk and higher expected returns will attract investor interest.”*

Sandro Näf identifies two main reasons why investor interest has increased in recent years. The relative value between certain tranches of the CLOs and the underlying investments with equivalent ratings being one. “The historical default rates on BBB-rated tranches of CLOs have been lower the default rates of BBB-rated direct investments, but the spreads are higher on CLOs than on underlying instruments with similar ratings,” explains Näf. “You don’t have to be a genius to figure out that something with lower risk and higher expected returns will attract investor interest.”

The second reason for the increased attractiveness of structured credit “has to do with the floor mechanism of CLOs.” When investing in BBB-rated corporate bonds offering a spread of 20 basis points, investors receive 80 basis points over Euribor or other reference rates, explains Näf. “But if you invest in the AAA-rated tranche of a CLO, the 90 basis points investors get is over zero, not some reference rate.” If Euribor is negative in the range of 45 to 50 basis points, “CLOs offer an additional spread component that makes the asset very attractive.” According to Näf, “in this current environment, being able to buy AAA-rated at a spread of 130 to 140 basis points versus other AAA-rated assets is mindbogglingly attractive.”

Describing the essentials for being a successful investor in structured credit, René Kallestrup outlines three main areas. First, “you need to be good at manager selection.” Capital Four has a dedicated team focusing on interviewing all asset managers running CLOs. Second, granular analysis of individual credits is important, according to Kallestrup, who emphasizes that “we have to know the underlying names going into each structured credit product.” Third, the understanding of the CLO capital structure is paramount. “If you combine these

three areas, you have a very strong platform to add value in structured credit.”

Näf concludes by saying that “it is important for investors to realize that there are no hidden secrets or mysteries about structured credit. “The structured credit markets offer fantastic transparency and you have a very clear transfer mechanism of risk and a very robust type of solvency regime. We are able to fully utilize our credit platform’s synergies to analyse each underlying individual loan in the structures.”