

Old, New Player on a Market that has not seen Defaults in 200 Years

Stockholm (HedgeNordic) – One of the notable characteristics in the Nordic hedge fund industry is the strong range of Danish-originating fixed income funds that often focus on the domestic mortgage market. One of the most prominent recent fund launches in this corner of the industry is HP Hedge Fixed Income, the second hedge fund by Copenhagen-based HP Fonds.

HP Hedge Fixed Income, launched in October 2018, seeks to identify and take advantage of market moves exacerbated by the reduced capacity of risk absorption of market-making banks. “New regulations have forced banks to scale down trading books and risk-taking considerably following the financial crisis in attempts to sanitize balance sheets of financial institutions,” explains CEO and Chief Portfolio Manager Henrik Fournais (*pictured*). “The number of banks making markets in Danish mortgage bonds has dropped from 20-25 down to only a handful.”

The Core

The primary strategy employed by HP Hedge Fixed Income involves the purchase of Danish callable mortgage bonds below par and non-callable mortgage bonds. According to Thomas Loldrup Kjaer, Partner and Senior Portfolio Manager, “the majority, a minimum of 70 percent, of the fund’s long positions will always be in Danish mortgage bonds.” The team at HP Fonds predominantly seeks to “make a profit on the spreads between Danish mortgage bond yields and the fund’s borrowing rate.” This carry trade approach involves borrowing at low rates – currently between a negative 0.35 percent and negative 0.1 percent – and investing in mortgage bonds yielding between 0.3 percent and 2.25 percent.

While HP Hedge Fixed Income can use as much as 12 times leverage through borrowed capital or repo transactions to multiply the spreads, the HP team takes a more defensive approach and uses lower leverage than many peers. The fund’s leveraged portfolio of selected Danish (and Swedish) mortgage bonds can provide investors net returns of at least five percent after costs over a longer term horizon. The Danish mortgage bond market has not seen a single default in its over 200-year history, which makes it an attractive asset class for the use of leverage.

“Danish mortgage bonds are of extremely high credit-quality, and there has not been even a single default during the 200-year history of the system, a period including the bankruptcy of Denmark in the early 19th century, the great depression in the wake of World War I, and more recently the subprime crisis in 2008,” highlights Fournais. Despite this “virtually non-existent default risk, Danish mortgage bonds still offer considerable pick-up relative to Danish government bonds.

” In terms of risk premia, “HP Hedge Fixed Income seeks to harvest carry and redemption risk premia from Danish callable mortgages, and roll down premium from adjustable-rate mortgages,” explains Loldrup Kjaer. Danish mortgage bonds with pre-payment options are particularly attractive in the current interest rate environment, offering attractive spreads due to the option feature. These spreads can be considered a combination of the carry and redemption risk premia – additional sources of return unrelated to the credit risk. To isolate these risk premia and prevent the fund’s performance being significantly affected by yield trends, HP “seeks to minimize the interest rate risk on the bond portfolio through sale of futures, interest rate swaps and other financial derivatives or by short selling Danish government and mortgage bonds.” According to Loldrup Kjaer, “while the

net interest rate risk is hedged away, the fund can still harvest yield curve premia from exposures to different moments of the curve.”

The Second Leg

At the end of February, HP Hedge Fixed Income had 85 percent of its long positions in Danish mortgage bonds. Depending on the set of opportunities, the fund can also invest in Swedish Böstader property-backed bullet bonds and floaters, senior non-preferred bonds issued by Danish and other Nordic systematically important financial institutions (SIFIs), as well as European government and corporate bonds. HP Hedge Fixed Income was solely exposed to the Danish securities at the end of February, as the remaining 15 percent of its portfolio was comprised of senior non-preferred corporate bonds issued by Danish SIFIs. In senior non-preferred bonds, the fund mainly seeks to harvest credit risk premium. However, “the allocation changes over time as opportunities arise,” explains Loldrup Kjaer. “We pursue an active investment strategy seeking to pick the market positions expected to yield the best return relative to the risk profile.”

Finding Opportunities

The strategy of HP Hedge Fixed Income was built on the resources and experience accumulated during the 12 years of managing HP’s award-winning fund, HP Hedge Danish Bonds. “We use custom-built software to monitor the entire Danish mortgage and government bond market to maintain an overview of the relative attractiveness of bonds across the chosen universe,” Fournais describes their approach to finding opportunities. Only the best risk-reward opportunities may enter the fund’s portfolio. “Each individual bond is modelled and priced using various assumptions regarding future interest levels and pre-payment rate levels, as well as tested for its impact on the return and risk characteristics of the entire portfolio,” says Fournais. Whereas the carry trade approach resembles a “buy-and-do-nothing” strategy, the team at HP Fonds always keep their eyes and ears on the market. “We receive daily research and data from all Danish and several foreign financial institutions, monitoring reported trades,” Fournais describes the research that goes into their decision-making process. “Views are discussed daily with market makers and bond dealers from all Danish banks, and publications of official figures are closely watched, and continuously analyzed and used to update pre-payment expectations,” he adds.

There is no Free Lunch

Just as any other investment approach, the strategy employed by HP Hedge Fixed Income does come with some risks to deal with. Some of the risks HP Hedge Fixed Income is confronted by may be unlikely to materialize (yet worth mentioning), but others are more material. One of these is that the Danish and Swedish covered bond markets lose their AAA rating, highlights Fournais. “As foreign investors are very important in both these markets, a change in their behavior could hurt these markets,” he points out another risk his team is keeping a close eye on, “besides, of course, that the use of leverage increases the impact of unforeseen events.”

The more realistic risks that keep hunting the team at HP Fonds and other fixed-income hedge funds in the space include “redemptions in high-coupon bonds and spreads going the wrong way, which implies that the mortgage spreads to government bonds widens.” However, the well-equipped team at HP Fonds believes it has accumulated enough experience to account for these risks and find the best risk-reward opportunities in their investment universe.

This article featured in the Nordic Hedge Fund Industry Report 2020.



Nordic Hedge Fund Industry Report 2020