Good Foundations for a Comeback

Stockholm (HedgeNordic) – **Catella Hedgefond**, which aims to achieve stable returns at low risk by investing in Nordic equities, bonds, preference shares and derivatives, declined by about 13 percent in the first four months of 2020, as the coronavirus-induced turmoil impacted all assets. The portfolio managers of Catella Hedgefond, one of Sweden's largest hedge funds, reckon that there are good foundations for a comeback.

Fixed-Income and Equity Portfolios Share the Losses

Catella Hedgefond's fixed-income portfolio and long/short equity portfolio contributed a roughly equal amount to the year-to-date losses. A basket of high-yield bonds, part of the fixed-income portfolio, added a negative three percent to losses, according to portfolio manager Stefan Wigstrand, as credit spreads rose violently during the month of March. "It all happened with a velocity we have never seen in the past," Wigstrand says in a podcast. "Normally we have hedging positions on, but this time we came into this market positioned for rising interest rates," he adds. The high-yield portfolio was impacted "as risky assets sold off and interest rates sank."

Wigstrand and his team were most surprised by the speed of the change in the market rather than the magnitude itself. "The fact that crossover today is trading around 500 basis points is quite reasonable given the current situation," says Wigstrand, referring to an index that tracks the credit risk of junk-rated European companies. "It is reasonable that crossover compensates for this increased risk of higher default rates," adds Wigstrand, but "it was the speed from 200 basis points to 750 that surprised the most."

Investment-grade bonds from Catella Hedgefond's fixed-income portfolio and preference shares also sold off aggressively. Catella Hedgefond has been owning preference shares that behave like fixed-income instruments under normal market conditions. "When there is a real crisis and there is talk of cancellation of dividends, they quickly change from being fixed-income-like instruments to equity-like instruments," explains fixed-income portfolio manager Thomas Elofsson.

The Equity Portfolio was Hit Too

Before the coronavirus-fuelled turmoil, Catella Hedgefond had been positioned towards more defensive shares that had lower-than-average valuations and, under normal circumstances, exhibited a lower beta. The portfolio of short positions, meanwhile, comprised stocks with valuations deemed aggressive and that reflected high investor expectations. "In a normal cyclical slowdown, this type of positioning would perform quite well," says Mattias Nilsson. During the coronavirus-induced market turmoil, these defensive shares, which normally have a lower beta, moved in lockstep with the overall market.

Mobile operator Tigo, which operates a relatively non-cyclical business that is less vulnerable to the effects of COVID-19, saw its shares fall by over 50 percent from their peak. According to Nilsson, Catella Hedgefond's investments in less liquid stocks can also explain the performance of the equity portfolio. With fewer natural buyers in less liquid stocks, the selling pressure during the turmoil had a larger impact on Catella Hedgefond's less liquid equity holdings.

Is it Possible to Recoup the Losses?

"On the high-yield side, which has been the most dramatic, today we have an average price of 88 percent of nominal value," says Stefan Wigstrand. With the portfolio's credit duration sitting at around three years, "if we were to receive back the full nominal amount on the high yield bonds, we would get approximately four percent per year in recovery," according to Wigstrand. "To this, you need to add the direct yield in the portfolio, which is around 7.5 percent currently. You would, therefore, receive a total return of 11.5 percent per annum over three years given that you receive back all money invested," explains Wigstrand.

The outcome will not be so good, reckons Wigstrand. After all, bankruptcies are expected to rise as a result of the coronavirus crisis. "This time, the revenues have disappeared in a manner which makes it inevitable that many companies won't be able to survive," argues Wigstrand. To estimate a more realistic return from the high-yield portfolio, one would have to deduct the probable losses due to defaults from the gross return of 11.5 percent. "If defaults would amount to ten percent, you need to assume that six percent are losses," says Wigstrand. Losses, however, are expected to affect different sectors in different ways. "We hope to have a portfolio that can manage better, with fewer holdings exposed to energy, hotels, restaurants and travel and similar," says Stefan Wigstrand.

With the majority of Catella Hedgefond's preference shares within real estate, the development of this sub-portfolio depends on the real estate market. "To a larger extent than previously the real estate market is dependent on what happens in the credit market," argues Thomas Elofsson. "When you have developments at such a rapid speed, even policymakers are struggling to catch up."

The team managing Catella Hedgefond expects the equity portfolio to recover some lost ground as well. According to Nilsson, some holdings have good upside when concerns over the coronavirus abate. "Going into the crisis, we had some companies that had unexpected negative market reactions," says Nilsson, "companies that aren't cyclical, but still were affected by the coronavirus turmoil." According to Nilsson, some holdings have seen their share prices fall significantly without major changes in their business prospects, which can lead to a large upside when uncertainty over the coronavirus decreases.

Whereas some investors foresee the risk of a "double-dip" and a "second bottom" in the stock market, Nilsson and his team remain focused on what happens in the real economy. "The volatility remains high in the market and it can easily move 3-4 percent without anything underlying really changing," says Nilsson. "We try to evaluate the data points: is it getting better or worse? That is what drives our activity and positioning."

Image courtesy of Catella Fonder.