To BBB, or Not to BBB

Stockholm (HedgeNordic) – March was a stormy month for most asset classes and the Swedish fixed-income market was no exception. In fact, during month of March alone, 35 corporate bond funds in Sweden closed doors for redemptions amid a liquidity crunch in the country's fixed-income market. Aware and wary of these short – but painful – patches of illiquidity, Nordic Cross Asset Management designed an investment strategy that shall not only limit the impact of liquidity squeezes but also relies on them as a source of extra returns.

"From time to time, the corporate bond market is dysfunctional with large liquidity challenges," Fredrik Tauson *(pictured centre)*, a founding partner and portfolio manager at Nordic Cross Asset Management, tells HedgeNordic. This structural dysfunctionality was obvious during March when investor worries about the Covid-19 pandemic triggered a broad sell-off in corporate bonds. "There was about SEK 30 to 40 billion in capital investors wanted to redeem from Swedish corporate bond funds. As the market was overwhelmed by funds that were forced to sell their holdings to meet redemptions, large price anomalies occurred with significant liquidity premiums," says Tauson.

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"The most obvious way to go around this liquidity problem is for traditional corporate bond funds to take on less liquidity risk by holding more cash and liquid assets, which, of course, may hamper their future returns," asserts Tauson. Instead of being fully invested all the time and being left at the mercy of investors and markets in times of turmoil, **Nordic Cross Total Return Bond Fund** rests on three main pillars to provide investors exposure to BB and BBB corporate credit while maintaining ample cash on hand for turbulent periods. "Instead of investing every last penny in holdings hampered by scarce liquidity, we invest only about 60 percent of the fund in direct corporate bond holdings during normal markets," says Tauson.

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"We combine this portfolio of long-term core holdings that generate the carry with an opportunistic strategy of investing during turbulent periods, when we see obvious liquidity premiums in the market," explains Tauson, who manages Nordic Cross Total Return Bond Fund alongside Emil Nordström *(pictured left)* and Magnus Nilsson *(pictured right)*. "On top of that, we have a strategy where we boost our credit exposure via derivatives during periods of low volatility, which compensates for the low yielding cash equivalents."

The Core

"In the bottom of the fund, we have the core portfolio with solid names, with satisfactory credit quality corresponding to BB to BBB credit ratings," Tauson tells HedgeNordic. "These are normally called cross-over bonds, since they are in between the high-yield and investment-grade bond segments," he continues. Cross-over bonds also tend to be more liquid than bonds with weaker credit quality, Tauson also points out. About half of the core holdings represent investment-grade bonds and the other half consists of high-yield bonds.

The portfolio of core holdings is designed to serve as the main contributor to the fund's return over time due to the carry of corporate bonds and the pull-to-par, the tendency of a bond's price to approach its par value as the maturity date approaches. This pillar of the fund's portfolio generates the "hold and earn" carry, which can be defined in its simplest form as the additional yield of corporate bonds on top of the risk-free treasury bond yield. "A portfolio of BB and BBB bonds approximately generates a carry of STIBOR plus 300 basis points," highlights Tauson.

The Derivatives and Opportunistic Leg

In addition to the core portfolio, Nordic Cross Total Bond Return Fund allocates a pre-determined risk budget to call options that provide exposure to the BB to BBB credit risk spectrum, aiming to add credit exposure during favourable periods. In this sub-strategy, the fund's credit exposure automatically accelerates or slows down depending on underlying volatility. "We get more boost during low volatility, with the exposure being automatically reduced as volatility rises," says Tauson. "This is totally, fully quantitative and automatically risk budgeted, so it is no decision of ours when to reduce or increase exposure."

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The automatically-adjusting credit exposure through derivatives has low capital utilization, which leaves the team with ample cash to deploy opportunistically in times of turmoil and liquidity crunches. "This toolbox enables us to hold more cash and liquid positions that we can use for opportunistic investment decisions," explains Tauson. Nordic fixed-income markets occasionally encounter periods of interruption with limited liquidity, similar to the environment experienced in March earlier this year. "We activate our opportunistic strategy in turbulent markets like the one we just had," says Tauson.

"We activate our opportunistic strategy in turbulent markets. We go for corporate bonds with large liquidity premiums. The perfect target are names with strong credit quality, but for liquidity reasons, trade well below par."

In times of distress, the team running Nordic Cross Total Bond Return Fund opportunistically buys high-quality corporate bonds trading significantly below par. "We go for corporate bonds with large liquidity premiums," says Tauson. "The perfect target are names with strong credit quality, but for liquidity reasons, trade well below par," he elaborates. During the market turmoil earlier this spring, the three-member team added between 15 to 20 names to the opportunistic portfolio. "Most of them have now been sold, as the rebound has been pretty sharp and many of them approached par again."

Three-Year Milestone and Competitive Edge

Nordic Cross Total Return Bond Fund has just reached its three-year anniversary along with two other Nordic Cross hedge funds. The three-year journey "has been a ride," says Tauson. "The investment process has been tested in all kinds of markets, with different scenarios, with both bull and bear markets," he continues.

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The fund is now up over 2.5 percent for the year, while many peer corporate bond funds are still in negative territory. The unique design of the strategy enabled Nordic Cross Total Return Bond Fund to outclass peers, reckons Tauson. "We have a clear strategy to manage the most obvious risks in the fixed-income market," he points out. "We also have the possibility to boost exposure during benign periods of the market when volatility comes down," Tauson lists a second distinguishing feature of the strategy. "The third is, of course, that we are opportunistic buyers in distressed markets."